



Fourth Quarter 2007 Commentary and Outlook

Following a credit market-induced correction, U.S. equities began the fourth quarter by briefly marking record highs en route to weakening through the year's closing weeks. Concerns of a slowing economy, disappointing corporate profits and continued dislocation in credit and housing markets hastened the retreat. The Russell series of U.S. equity market indexes declined for the quarter in all style and capitalization ranges.

Results for the fourth quarter and the full year reflect positive contributions from energy investments and select holdings in industrials, consumer staples and healthcare. An underweighted position in the financial sector compared to the benchmarks also aided performance.

The Near-Term Outlook for U.S. Economic Growth is Challenging

The housing sector is depressing economic activity and appears unlikely to reverse course much before 2010 due to the inventory overhang. In addition, oil prices are now so high they are squeezing consumers' disposable incomes much as they did in the early 1980s. The slowing pace of economic activity is being felt broadly:

- Employment growth has cushioned the negative effect of housing until recently. Real wages and salaries continued to rise and served to bolster consumers throughout much of 2007. More recent data on employment suggest the labor market may not be strong enough to continue to provide net job creation. If the pace of layoffs begins to accelerate, consumer spending is likely to suffer.
- In the face of slowing corporate earnings and uncertain demand, capital spending is likely to remain subdued.
- Net exports will provide some stimulus, but perhaps not as much as in the recent past because of slowing economies in Europe and Japan. At the same time, the global economy may face the emerging headwind of slowing growth in the developing world.

Government Response May Be Key to Future Pace of Economic Activity

In the U.S., fiscal policy may become more restrictive in the near term as federal, state and local tax receipts decline on the backs of lower property values and economic slowing. In addition, credit availability has already been tightened due to stricter lending standards imposed by financial institutions. At the same time, the erosion in the value of assets held by financial institutions is undermining their collective equity and their lending capacity. Even with fresh capital from sovereign wealth funds and other sources of liquidity, the situation is unlikely to be reversed soon and may worsen before it improves. This will be particularly true if the economy contracts.

Meanwhile, the uncertainties surrounding important fiscal, monetary and political issues appear to be undermining investor confidence:

- Monetary policy directed by the Federal Reserve has looked to be reactive rather than proactive since the credit crisis began. A more proactive stance could elevate confidence that monetary policy may be effective in bolstering the economy.
- Fiscal policy may provide a boost to the economy. President Bush is likely to propose meaningful fiscal stimulus in his State of the Union message. It will be important that political issues not delay timely implementation of a stimulus plan.

On balance, the forces in place suggest the pace of economic activity will continue to slow in the months ahead with corporate profits following suit. While equity markets have begun to discount this likelihood, the process may have further to go. Nonetheless, financial markets would likely respond constructively to the following confluence of events: a more proactive posture from the Federal Reserve to effectively employ the tools of monetary policy along with a timely and effective fiscal policy enacted by Congress. It would be particularly helpful if these developments were accompanied by a meaningful decline in energy prices and fluidity in the market for interbank lending.

In the prevailing financial and economic setting, our strategy of investing in well-managed companies with high quality cash flows and financial postures that position them to capitalize on opportunities that may emerge from the financial distress of competitors should prove particularly rewarding.

A recent important development representative of what we hope to realize in our strategy was the decision announced between the exploration and production company Delta Petroleum and Tracinda Corporation, the private investment firm wholly owned by investor Kirk Kerkorian. Tracinda plans to purchase a 35% stake in Delta for \$684 million (\$19 per share), with the sale's proceeds earmarked for helping Delta accelerate drilling. If this agreement receives shareholder approval, we believe it will place Delta in a strong position to surface significant embedded asset values in the years immediately ahead.

Sincerely,



Michael A. Steinberg
Managing Partner