INVESTMENT OUTLOOK

June 30, 2006

At Saybrook Capital, we make a concerted effort to concentrate on what is directly relevant to your portfolio when we compose our quarterly communication. In most cases, this amounts to a focus on the type of companies we buy and hold for the long-term. As there has been an unmistakable return to market volatility in recent months, we feel it is important in this report to take a 'macro' view of capital markets as a whole and the economic and geopolitical backdrop that is impacting them. We will follow this with a discussion of the type of high-quality companies in which we have invested, and how they are positioned for various uncertainties that lie ahead.

Readers of our quarterly investment letters will know that we have been concerned for some time about some of the excesses building up in certain financial markets. In addition to the much-heralded 'real estate bubble', the middle part of this decade has also witnessed a disproportionate level of speculation in areas such as commodities, emerging markets, and small-capitalization stocks. Investment in these asset classes has surged even beyond what would rationally be warranted by the recent loose central bank policies and the resulting global economic boom.

In the period of May to July there was a significant decline in the value of these risky financial assets, as investors begin to flee toward the stability of cash, bonds, and defensive stocks. On one hand, the inability of 17 rate hikes, record energy prices, a handful of natural disasters, and bloody geopolitical strife to meaningfully slow the world economy has many market participants concerned about building inflation. Other investors worry that this threat will encourage central bankers to overcompensate, driving the world into recession.

Inflation or Recession?

Much of the debate over the last two months and looking forward is whether inflation or recession fears are causing this market upheaval. In our opinion, this 'binary' analysis is misguided, as the two risks are implicitly linked. The Federal Reserve, under an unproven

leader, is not only struggling in its traditional role to achieve monetary stability, but it is also fighting for its own credibility. With much fanfare, the Federal Reserve left rates unchanged at its August meeting, but investors will be intensely watching upcoming inflation reports. An acceleration in these figures would force the Fed to resume their two-year campaign of interest rate increases. Every piece of inflationary data is, counter-intuitively, a risk to economic growth, as Bernanke will most likely do all in his power to avoid an inflation spiral, even if it means driving our economy into a recession.

We have closely followed market reactions in recent months to the Fed's statements and other economic releases. Movements in interest rates, commodities, and different stock sectors indicate to us that the real fear in the market is a severe slowdown or recession, and that inflation reports could stimulate a possible Fed overreaction. While this is the worst case scenario, we think the market has forecasted an event that may not happen.

The Fed studies several different inflation indicators – not just the backwards looking Consumer Price Index. At its August meeting, the Fed highlighted its continued focus on economic growth, and many figures show the expansion beginning to moderate. There is no question that consumers are suffering from 'pass-through inflation' derived from high commodity costs. However, it is the vicious-cycle of a 1970s-style 'price-wage' spiral that the market fears. While headline inflation numbers have been a cause for concern, "unit labor cost" figures have remained modest until this quarter. Since labor makes up a far greater proportion of consumer prices than do raw materials, the labor cost per unit of production is the most important inflation measure. In recent years, productivity, technology, and globalization have enabled companies to produce more units without the accompanying rise in wage inflation. When and if the Fed is confident that economic growth will remain moderate and productivity healthy, it can cease its series of rate hikes. If this occurs in the next few months, as we believe, the current economic slowdown is less likely to develop into a full-blown recession.

A recession is damaging for all sectors of the economy (except perhaps alcohol and cigarettes), while a more modest slowdown from the recent strong growth could prove beneficial. Either way, investors should be prepared for a continued realignment in equity

leadership away from the more speculative asset classes. We have been calling for a resurgence of large capitalization stocks for a couple years now, due to their relatively low valuations. Admittedly, we have been early, but we are starting to see signs of life in this category, as the economy decelerates. The improving performance of large-growth companies is evident when one compares the results of broad indices, as the Dow Jones Industrial Average has outperformed the more speculative NASDAQ.

Attractive Stocks

In our opinion the best source of undervalued growth today is found in large stable growth businesses. Stocks of these companies have underperformed smaller and more economically-sensitive businesses for the last few years and are now very reasonably priced. In addition to their aforementioned defensiveness and low valuations, these companies have significant economies of scale and are being run leanly after several years of cost-cutting. They have record levels of cash on their balance sheets, which are leading to stock buy-backs and meaningful dividend increases. Furthermore, most of these large companies have multinational operations, which take advantage of low costs, diversify away from dollar assets, and provide investors access to significant, albeit erratic, growth in developing markets around the world.

PepsiCo and General Electric are two companies held in most of our portfolios that possess the above attributes. During the exodus from risk that has occurred in recent months, PepsiCo has reached a new all-time high, benefiting from its impressive product portfolio including Gatorade, Quaker Oats, and Frito-Lay snacks. We expect a smooth transition as Steve Reinemund retires as CEO, and Indra Nooyi, who has impressed us as the CFO, takes over. GE, conversely, has been stagnant in 2006, as investors fear a possible global recession will hurt industrial stocks. Our analysis shows that the General Electric's broad spectrum of industrial, energy, medical, and financial products and services in the U.S. and abroad should provide steady and impressive growth of earnings and dividends through the latter part of this decade. Investors should be drawn to this type of predictable corporate performer as the economy cools off.