INVESTMENT OUTLOOK
September 30, 2007

A casual glance at the record stock market values at the ends of both the second and third quarters reveals little of the turmoil that has characterized the period. Indeed the investment environment and, possibly, the economic climate have changed materially over the past quarter. In recent letters we have emphasized powerful international growth and healthy deployments of corporate cash as two positive trends that have boosted investment prospects. While these trends remain intact, they are joined on the negative side by a deepening domestic housing recession that threatens the overall US and international economy.

We have been observing and analyzing the domestic sub-prime housing crisis as it has unfolded this year. During the third quarter this "credit crunch" expanded to impact not only mortgage debt, but also high-yield financing, large bank balance sheets, and even parts of higher quality equity markets (particularly financials and consumer discretionary sectors). August was dominated by widespread losses at high-profile hedge funds, a global panic in money market funds and commercial paper previously thought to be safe havens, and cancellations of private equity deals as financing dried up. The Federal Reserve's lowering of the Discount Rate and later the Fed Funds Rate recognized the severity of the crisis and demonstrated official concern for its real economic impact. While the Fed's action has eased some credit disruptions and buoyed stocks, many underlying problems remain.

What does all this mean for an investment manager who concentrates on high quality growth companies and does not use leverage or make bets on derivatives, currencies, low quality debt, or energy futures? Although these various exotic instruments make for exciting headlines in the financial press, our ultimate concern is more focused: **the higher probability of a US recession stemming from a weaker than expected housing market and increased corporate risk-aversion**. Below we list several risks along with some positives:

Threats to credit markets, economy, and stock market:

- Weak housing market and the negative wealth effect of declining home values
- Increasing sub-prime mortgage delinquencies and defaults

- Lower quality corporate debt and restricted credit in some areas of the economy
- Derivatives – unintended consequences of collateralizing risk
- Weaker US Dollar and stubbornly high oil prices

Positive Economic and Market Fundamentals:

- Continued low inflation and interest rates
- Dynamic world economy as detailed in our 1st Quarter Investment Outlook
- Mostly good corporate earnings boosted by high margins
- Strong corporate balance sheets as detailed in our 2nd Quarter Investment Outlook
- Reasonably valued equity market when compared to interest rates and inflation

Since the world's smartest economists cannot agree on the likely economic outcome, we will not engage in predictions. An economic contraction would certainly lower corporate earnings and possibly the value that investors assign to those companies. Companies in certain industries (e.g. retailers) already appear to be indicating weakness, and their valuations are reflecting such a dire scenario. On the other hand, many say that foreign economies have grown less dependent on the US, and can continue their impressive growth, helping US companies with meaningful sales abroad. Additionally, an economic "slowdown" that avoids recession would likely foster continued low inflation and interest rates, and investors would begin to look towards an economic recovery. September's strong equity markets seem to be optimistically discounting this latter scenario.

Rather than hope that the "positives" outweigh the "negatives," we always seek to invest in high-quality companies with secular growth potential well beyond any one economic cycle. The stocks in the portfolio demonstrate several common characteristics beyond our "undervalued growth" strategy. As we mentioned in our first quarter letter, we like businesses with significant participation in international markets. They benefit from geographic diversification, strong growth trends in emerging markets, and the higher profits that result from a declining dollar. We also own companies returning large amounts of cash to their shareholders. During the third quarter, despite the credit panic impacting weaker businesses, several companies in our portfolio (e.g. Nestle, Sealed Air, and ITW) announced significant stock-buybacks. These net repurchases, when combined with annual dividend income, produce a "Corporate Action Yield," which exceeds a 6% return to shareholders. Most importantly, we look for companies that have significant control over their own destinies through new initiatives, unique market niches, dominant products, superior marketing, and outstanding management.

Over the past four months we have made a few portfolio adjustments. This activity was not forced, but instead resulted from our analysis of company fundamentals and how their prospects are impacted by recent economic developments. In particular, due to company-specific concerns we sold our holdings in UPS, trimmed our retail investment down to a core group of exceptional businesses, and decreased our already small exposure to financial services. At the same time, we have purchased the food producer, Nestle, which is leading and benefiting from the international rise in nutrition standards, and added to some other undervalued positions. These moves resulted in a slightly lower percent invested in equities overall and shifted our exposure toward less economically-sensitive sectors. This shift is counter-balanced by our continued confidence in our holdings in the "industrial" sector. While "capital goods" companies, such as GE, ITW, 3M, and Emerson (all in our portfolio), are traditionally considered harbingers of the US economy, their large and growing international businesses have been great beneficiaries of the continued industrial expansion in China, India, the Middle East, and other emerging markets. Along with our energy holdings, these stocks (up year-to-date between 11 and 30%) have been the best performers in our portfolio in 2007. We expect these companies to continue to benefit from the healthy growth in infrastructure development in many international markets over the long-term.

In conclusion, we emphasize our confidence in the quality of our overall investment portfolio, recent turmoil notwithstanding. Furthermore, history has shown that owning reasonably valued, high-quality growth equities through economic cycles has led to significant real growth of capital. Currently, we are in an environment where, even more than usual, companies with these strong attributes should outperform, first, as they continue to execute well in an unpredictable environment, and second, as investors in riskier assets begin to seek quality and safety.