INVESTMENT OUTLOOK

December 31, 2005

Our outlook for 2006 investment prospects is shaped by developments in the recently completed year. The US economy experienced its third consecutive year of strong growth in 2005. This surge is evident by any measure, including Gross Domestic Product (GDP), employment, industrial production, and productivity. Since the beginning of 2002, the US total economic output has grown at a real annual rate that exceeds the 3.1% 25-year average. The 2005 economic expansion was particularly remarkable in the face of extreme adversity (high energy prices, Hurricane Katrina, and eight Fed fund rate hikes). "Expert" opinions diverge for 2006, with many calling for the delayed effects of higher energy and rates, in addition to the much-anticipated housing decline, to cause an economic slowdown. However, some deceleration could benefit financial markets, which have been frightened by the prospect of inflationary growth.

Coming off what will likely be the 15th consecutive quarter of double-digit growth, corporate earnings have continued to expand at a rate exceeding nominal GDP. This phenomenon is driven by high productivity and increasingly strong international business, especially in emerging markets. Over the four-year period from 2001 to 2005, annual operating earnings for the S&P 500 index have doubled from $38 to $76, with very little market appreciation, effectively cutting valuations (price/earnings ratios) in half. During the same period, companies have accumulated billions of dollars in cash on their balance sheets. Other than increasing dividend payouts, conservative managements have been hesitant to deploy these funds in an era of "uncertainty".

The halving of valuations in a four-year period is partly explainable as an unwinding of the "1990s excesses". However, we believe markets are undervalued considering the following beneficial characteristics:

- Low long-term interest rates
- Mild core inflation

- Little evidence of increasing unit labor costs (which often leads to core inflation)
- A tax environment friendly to capital and investment
- High profit margins

A flat market in the face of such a strong economic backdrop is a result of today's higher risk premiums, caused by a formidable group of issues:

- Energy prices
- Hurricane Katrina
- 1½ years of Fed fund rate hikes
- Iraq war and Middle East tensions
- Housing/Real Estate concerns
- Inflation fears

In 2006, market appreciation could result from continued earnings growth, the diminishment of the aforementioned risk premiums (which would result in rising multiples), or a combination of the two. We believe that S&P 500 profits are likely to grow in 2006, albeit at a moderate rate – the consensus expects +7-10%. The equity market will always have a "wall of worry" to climb, but greater clarity on some of the listed concerns is likely in 2006. For example, the FOMC minutes of January 3, 2006 lend some visibility to an end to the series of short-term rate hikes, and each subsequent inflation report (CPI, PPI, Fed Consumption Deflator, Employment Cost Index, etc) is helping to alleviate recent market fears of core inflation spiraling out of control. In 2006 we expect stocks to generate returns at least commensurate with their earnings growth. An easing of the risk premiums could allow the market to reverse its valuation slide and achieve higher performance.

A contrarian Wall Street strategist recently said there is "...plenty to fear, but the greatest risk (exuberance) seems muted." Past experiences have taught us that a period of extreme euphoria has the riskiest downside for equity investors. Whether looking at today's economic

and geopolitical threats, current moderate stock valuations, or conservatism with corporate cash, it is hard to find perilous levels of enthusiasm built into stock prices.

Saybrook Capital's strategy continues to be committed to the search for undervalued growth. Rather than invest only in a certain market capitalization or sector, we seek secular, long-term growth at reasonable valuations. We do not ignore short-term price movements; instead we exploit negative sentiment to buy an attractive company at a good value.

In 2000 we found growth opportunities in areas overlooked by the "New Economy". We invested in many mid-sized businesses in areas like drug distribution, bricks/mortar retailers, newspapers, and manufacturing. These stocks far outperformed the high-tech sectors in the collapse that followed.

In 2006, many large-growth companies are undervalued, having performed poorly since 2000. Although we always analyze and select businesses from the bottom-up, many of these companies have the following important attributes in common:

- Strong leadership
- Economies of scale
- Industry-leading products and services
- High exposure to international growth
- Sound balance sheet (in the face of rate hikes)
- Proven record of intelligent utilization of cash (including dividend increases, stock buy-backs, and business expansion)

Our time-tested valuation model has currently led us to a higher than usual exposure to large growth stocks. Although this area under-performed in 2005, these types of businesses look more attractive than they have for a long time. Goldman Sachs, UPS, Medtronic, PepsiCo, Home Depot, and General Electric are all large, dominant companies within their industries;

however, they also embrace innovation, technology, and international expansion. These types of companies are inexpensive versus their historic relative multiples, and we expect them to post strong results in 2006 and beyond.