INVESTMENT REVIEW

December 31, 2006

Following the successful completion of another calendar year, in our case the thirtieth, there is a tendency to reminisce about the past or, in some cases, wish for better times ahead. Fortunately, we have a 30-year compounded performance record in excess of +13% per annum, including equities, bonds, cash, and management fees. Moreover, we are pleased that in 2006 our clients' results approximately matched this long-term record, and our equity holdings easily surpassed it. Cognizant of the power of compounding, our ultimate goal remains to protect principal during difficult markets while continuing to deliver these superior results well into the future.

In most years the investment landscape has been dominated by particular industry themes (e.g. technology in the late 1990s or energy in recent years). Looking back at 2006, we cannot attribute our investment results to any specific sector; rather performance came from a range of companies representing industries such as finance, retail, and capital goods. If there was one definite area that lagged in 2006 it was healthcare, which has faced a variety of industry-specific pressures recently. A fourth quarter rebound in healthcare stocks, along with a positive secular growth outlook as the population ages and demands more medical care, gives us confidence that our diverse healthcare holdings will excel going forward.

Saybrook's best performance in 2006 came from two multi-year core holdings: Goldman Sachs (+56%) and CarMax (+94%). What do the world's premier investment bank and a chain of used car dealers have in common besides being exceptionally well managed companies in growing markets? They are both participants in what is called the "Platform Economy". Economist Charles Gave of Gavekal Research Ltd. coined this phrase to describe the "services" and "intellectual property" economy and the companies that benefit from it. This is a concept that you can expect to hear more about in future

Saybrook investment outlooks, as well as in the media. In simple terms a "Platform Company" depicts an organization that does not manufacture or sell basic commodity goods and services, but rather adds value through technology, marketing, outsourcing, and intellectual contributions. The best companies can use these skills to achieve higher profit margins and better insulate themselves from economic downturns. So while the US auto industry struggles, CarMax used technology, a unique marketing approach, and innovative financing to achieve significant profit growth in 2006. Meanwhile, Goldman Sachs increased their earnings by 75%, far surpassing all expectations, by creating and selling a wide variety of innovative financial instruments. In addition to playing "the house" in the worldwide market for risk, they also are the leading advisor to corporations and a multi-billion player in the private equity business. We are not naïve enough to think that these businesses are "recession-proof" or can forever maintain their rates of margin growth, but we believe that the way to profit in a slowing economy is to seek exceptional businesses with innovative offerings in expanding industries.

INVESTMENT OUTLOOK

For many working in the financial markets, the beginning of the year is a time for forecasts. We choose not to officially prognosticate at this time for two reasons: there are too many forecasts out there already, and we do not have a really strong conviction about how this year will evolve beyond our general anticipation of continued economic growth and some increase in stock prices. We do know that 2006 worked out quite well. It was a good year for many elements of the domestic economy, for most businesses, and for almost all of the financial markets. However, as is often the case, a fair share of the results differed significantly from the expectations of a year ago.

Economic activity proved to be stronger than forecasted for most of 2006, although growth trailed off some in the last few months. Full-year gross domestic product increased by about 3.2%, despite weakness in auto sales and a sharp decline in housing activity. Profits for the S&P 500 companies increased by approximately 15% in 2006, and many people are surprised that earnings probably continued to rise at a double-digit rate in the fourth quarter. In fact, there have now been eighteen quarters in a row where S&P 500 year-over-year profit growth has exceeded 10%. What was most unexpected was the +15.7% total return in 2006 for the S&P 500. Particularly surprised were those who have argued for some time that equities were already overvalued and that long-term U.S. stock returns should probably be no better than 5-7%.

Given the current uncertainty on the outlook for many elements of the economy, we think a useful exercise is to review a range of popular expectations:

ECONOMY

Forecasts for U.S. economic activity in 2007 are spread widely. Some expect the housing market to weaken further, resulting in a collapse in consumer spending and a subsequent recession. Others foresee moderate growth in GDP of about 2-3%, supported by both corporate capital investments and exports.

PROFITS

The consensus here is in a narrow range calling for modest 4-6% profit growth.

MARKETS

There is greater disparity in expectations for the U.S. stock market in 2007, varying from forecasts for an 8-10% gain in stock prices, resulting from a moderate increase in profits and price/earnings ratios, to the belief that stocks are distinctly overvalued (some compare current market levels to the excesses of the 2000 bull market). It is worth noting here that from 2002 to 2005 the average price/earnings ratio of US stocks declined sharply. In the last 18 months it has leveled off in the mid-teens, which is about the long-term average for the S&P 500. In 2006 the market valuation of earnings remained at this level, as last year's stock returns matched the companies' mid-teen earnings growth rate.

While it is far from universal, we think that there is a fairly broad consensus on 2007 expectations agreeing on a forecast of a 2% gain in real GDP, 5% growth in corporate profits, and a small increase in price/earnings ratios from 15.5 to 16.5. These inputs imply a year-end S&P 500 value of 1500, a 6% appreciation (8% total return) from the 2006 year-end value of 1418.

As we said above, we are not making a forecast. We believe that better investment results can come from our concentration on analyzing and valuing individual equity investments. While we appreciate that expectations were exceeded in the past year, we understand that if 2007 economic and business outcomes fall below the consensus, the results could be quite disappointing with a recession, earnings decline, and/or lower stock market valuations. We believe that this is unlikely. We would guess that if the consensus is challenged in 2007, it will probably be to the upside. Thus, we foresee a possibility of economic growth exceeding 3%, profit gains of 7-9%, and equity valuations rising as high as 17x, which would not be excessive in the current low-inflation/low-interest rate environment. In terms of the S&P 500, such an outcome could lead to a valuation as high as 1580 (17x $93), which would produce 11.5% appreciation during the year and, including dividends, a 13%+ total return.

But, please remember, this is not a prediction.