ADDING VALUE

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SUMMARY:

Ben Graham's Intelligent Investor is the definitive book on value investing. Chapter 8, "The Investor and Market Fluctuations," states: "Since common stocks, even of investment grade, are subject to recurrent and wide fluctuations in prices, the intelligent investor should be interested in the possibilities of profiting from these pendulum swings. There are two possible ways by which he may try to do this: the way of **timing** and the way of **pricing** . . . we are convinced that the intelligent investor can derive satisfactory results from pricing of either type. We are equally sure that if he places his emphasis on timing, in the sense of forecasting, he will end up as a speculator and with a speculator's financial results. This distinction may seem tenuous to the layman, and it is not commonly accepted in Wall Street. As a matter of business practice, the stock brokers . . . seem wedded to the principle that both investors and speculators in common stocks should devote careful attention to market forecasts. . .It is absurd to think that the general public can ever make money out of market forecasts." The first edition of this book was published in 1950; some things never change!

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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INVESTMENT REVIEW AND OUTLOOK: The different faces of fear and greed

Volatility is a frequent visitor to the stock market. Each time volatility returns (this time precipitated by the subprime mortgage crisis), it is common to question whether one shouldn't simply retreat to cash until the dust settles and a more promising environment presents itself. This is simply a fool's proposition. In a recent paper entitled Black Monday and Black Swans, Jack Bogle illustrates the folly of trying to follow this strategy. He cites a recent study which indicated that the S&P 500 had risen from 17 in 1950 to roughly 1540 in October 2007 (it was 1300 on June 30, 2008). If you deducted the 40 days of highest returns out of the 14,528 trading days in this period, the Index would have increased to only 276, some 70% less; or if one eliminates the 40 worst days, then the S&P would be sitting at 11,235, more than seven times today's level. This is pretty humbling data. For this reason, as a firm we have never embraced market timing, nor will we ever include this concept in our asset management plans.

This does not mean that the past nine months haven't been a very difficult time for equity investors. Markets, both domestic and foreign, have fallen sharply, as have many industries, almost without exception. Indeed, as described by Lewis Sanders of Alliance Bernstein, difficult markets are the "domain of progressive discouragement." He went on to point out that value opportunities often present themselves in high anxiety environments and that "anxiety-producing assets" will be priced to offer returns justified by the actual risks taken. Importantly, the markets themselves are far more volatile than the underlying businesses that they represent. Put another way, investors are more volatile than investments. Economic reality governs the return in our businesses, but emotions and perceptions govern the returns in the markets. Finding these business opportunities with a minimization of mood swings is, in our opinion, what you hire us to do. We always need to put anxiety in perspective and to behave rationally, so that we can capture for you some of the rewards which we are confident will come in the future.

What follows are some of the (mostly enthusiastic) recent analysis of some of the mutual fund managers in your portfolios.

Tweedy, Browne Global Value Fund

The management at Tweedy, Browne Global Value specializes in non-U.S., mostly European stocks with a policy of 100% currency hedging. Their long-term performance history is stellar. In the short-term, they are being affected by the weakness of the dollar. Currently, management is finding new opportunities as follows:

1. There have been 4 times over the last 18 years when financial stocks have corrected by more than 30% as follows:

Period	Event	% Decline
6/90-10/90	S&L Banking Crisis	-39.4%
7/98-10/98	Russian Default	-35.1%
1/01-10/02	Post Tech 9/11	-38.3%
6/07-Present	Credit Bubble	-34.3%

   Tweedy, as are other managers, is searching for opportunities in this very shunned financial area. If you had been a buy-and-hold investor even during these difficult corrections, your return from financial stocks would have been 8.4%/year, or approx. 10%/year including dividends, as detailed in the latest quarterly report.
2. Another area of opportunity is Japan. The NIKKEI Index's meteoric rise during the 1980's was matched by its equally dramatic decline into 2003. Japan's market is once again approaching its historic lows. This time there is some evidence that Japanese management is more attuned to creating shareholder value, so many managers are beginning to search in Japan for opportunities.
3. Another area of current opportunity for Tweedy is high dividend stocks. Consider this interesting comparison: An investor can currently receive a 3% yield on a CD issued by Bank of America (BofA) that will be taxed at ordinary tax rates, alternatively, an investor in the common stock of BofA receives a dividend yield of 6.5% which is taxed at 15%. Investors are irrationally shunning all financial stocks. In 2007, Tweedy also opened a new fund just to concentrate on higher dividend paying stocks. The research for the new fund is also enhancing existing shareholders in this flagship fund.
4. Similar to Warren Buffet, Tweedy has taken positions in railroad stocks which have a growing competitive advantage over the trucking industry in the face of higher oil prices. Furthermore, railroad consolidation, which has led to a decline in track miles, should allow railroads to raise prices. Sitting on AirTran en route to Atlanta, it is interesting to observe all the trainees reporting to work at Norfolk Southern. Who would have thought that a revival of trains could happen in America?

Third Avenue Value Fund

Marty Whitman, the lead manager of the fund, has an investment specialty in distress investing. He usually excels during periods such as now, when he has the credit expertise and the capital to demand from corporate America outstanding financing terms. He demands high yields to maturity and/or significant discounts to NAV in his negotiations. To this end, he has been a purchaser at favorable terms of CIT Senior Unsecured debt, GMAC Senior Unsecured debt, MBIA Insurance Corp. Surplus Notes, and has acquired the common stock of MBIA, AMBAC, and St. Joe. Seizing these opportunities has become an important new business for the fund.

Marty, in his inimitable style, also had some pithy comments on the Bear Stearns debacle. In his mind, it's simple. If it was creditworthy, it was worth about $100/share. If not, it was valueless. Apparently, it was deemed worthless and was rescued through the intervention of JP Morgan through a common stock exchange for a common stock exchange at a value for Bear's stock of $10/share and the Federal Reserve's provision of a $29 billion special funding facility. There are several important

financial lessons from this unexpected collapse. First, it appears that it collapsed because of a concerted bear raid, an old-fashioned "run on the bank". This is more possible today, even more so than in 1929 because of four financial market changes:

1. There is no longer an uptick rule (with this rule a stock can only be shorted at a price higher than the last price).
2. There are well-developed options markets where one can short without a cash outlay.
3. It is possible to sell short specific indices.
4. Rumors or innuendos can be spread through the Internet instantaneously.

The major lesson to be learned from this debacle (for fund managers and individual investors) is the importance of avoiding ownership in common stocks where businesses need continuous access to capital markets in order to survive. (One of Third Avenue's key selection criteria is ensuring that a company is well-capitalized). Other companies to whom access to capital was a major stumbling block during this period include Thornburg Mortgage and Countrywide. It is still unclear if these companies will survive. Intuitively, we all knew how important it is the limit the short-term borrowing needed to fund long-term operations, but the degree to which this was happening was not totally understood. To those investors who learned the lesson the hard way, we suppose more diligence will occur in the future. Confidence is still essential for markets and leveraged institutions to function.

Longleaf Partners Fund

Longleaf ended 2007 with a large cash position and a letter to current shareholders to increase commitment to the Fund. We heeded the call, but in hindsight the investment was premature. For the first quarter, Longleaf posted negative results and underperformed its benchmark. Fortunately, Longleaf was able to continue to buy shares of companies at the continued decline in prices, so that in aggregate the portfolio now trades at a 50% discount to intrinsic value. We all know that capital migrates to underpriced businesses. In Longleaf's opinion, America is on the bargain counter for international business buyers. It will be interesting to observe how many of Longleaf's holdings will be taken out at higher prices when purchased by foreign owners. Stay tuned to these events.

Clipper Fund

Chris Davis was named Morningstar Domestic Equity Manager of the Year in 2005. He was subsequently chosen to assume responsibility for Clipper as of January, 2006. With his management, short-term performance results have been awful. But Chris Davis periodically provides intense review of holdings and delves deeply into their decision-making process – on both the good and bad decisions. The biggest advantage of the fund currently is:

A. Relatively larger positions in smaller companies, such as Oaktree, RHJ (Belgium), Redwood Trust (a real estate/mortgage operation)
B. Larger percentage of international companies (40% of the S&P earnings are from overseas, i.e., Millea – formerly Tokio Marine, Nippon KOA (Japan non-life)
C. Some financial stock concentration, such as AMBAC and Merrill Lynch. They added $5 million of their own money in March. They are not pleased with performance, but the quality of the portfolio is good. They remain opportunistic, concentrated, and true to their history of buying controversial companies in times of pessimism.

Summary

We are seeing something of a perfect storm – weak economy, high oil prices, inflation, and troubled financials. We do not know how long the slowdown in the U.S. economy will endure, nor do we know when the housing market in this country will turn around. We do not know the true extent that international economies still depend on the U.S., and we have no idea what the price of oil will be in two weeks, let alone

two years. We do know that investment returns in equities are a function of the quality of the economics of underlying businesses and the prices paid for those businesses. As long-term investors, we have found that the recent market environment has continued to present the managers in your portfolios with a steady flow of attractive opportunities to put capital to work. Most are reporting that buying opportunities have been abundant (except for financial stocks) and that cash levels have been greatly reduced.

Finally, this has been a very difficult market for us and it is somewhat discouraging that the portfolios have not held up as well as in 2002. This has been primarily because the markets have been momentum-oriented and therefore, anyone with a diversified portfolio has had both ups and downs. In addition, we use diversified portfolios with a value orientation. This value-orientation, by default, results in a portfolio construction with a relatively higher concentration of financial companies and real estate. For the most part, the managers have held higher quality financials, but even quality has not stemmed the pull back. For instance, Berkshire Hathaway, with a Fort Knox balance sheet, is down about 15% year-to-date. We would expect that reintermediation of bank balance sheets, triggered by the subprime crisis, will continue over a reasonable investment horizon. At the highs of the credit cycle, anyone can get money for any purpose. At the lows, even deserving borrowers are shut out. The former is highly expansionary (good times), and the latter depresses economic activity (bad times). This situation coupled with higher oil and food prices are the flash points for a perfect storm. During these trying times, we appreciate the confidence you have placed with us. Even in the face of this struggle, life goes on. And no matter how we played the last hand, we'd better get ready because cards will get reshuffled and new hands dealt. And the faster we're able to learn, recover, overcome, and evolve, the better we'll get at playing the hands that come next.

Sincerely,

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