

Manager Commentary

January 4, 2006

We would like to start off by wishing you and your family a fabulous, healthy and prosperous 2006.

As you can see from the performance page of your statement, 2005 was not a wonderful year for either absolute or relative performance, as our predictions for a flattish year annoyingly rang true.

Cutting through all the usual capital market digressions that financial firms are fond of spouting, our mediocre showing in 2005 was the result of three issues. The first was our lack of exposure to the energy sector, a choice upon which we have spent much air and written time during the year. We are actively reviewing this position in light of the fourth quarter downturn in the sector, but our gut sense, supported by fundamental analysis, is that if the world economy remains strong, the energy sector will be a solid investment going forward. If the economy is weaker in 2006 than in 2005, energy stocks will be flat to poor performers. In other words, it boils down once more to much more of a macro-economic bet than the product of enlightened securities analysis, and we continue to cling to a long-held notion that our efforts tend to be much more successful in the latter pursuit than the former.

The second issue was, and continues to be, our large concentration in media-related stocks, which went nowhere to down in 2005. The “consensus” is telling us that traditional media - cable, radio and television broadcasting, newspapers and a number of related advertising related businesses - is “history.” The digitization of content, legally or illegally, the proximity to ubiquitous broadband distribution and the availability of cheap electronic devices mean that old business models are in secular decline and investors will be surprised at the slope of that decline. While we respect the probabilities of our being wrong, we think the prices of Disney, Comcast, Dow Jones, Clear Channel Communications, Time Warner and DirecTV already more than reflect this possibility. On the other hand, they may represent huge cash flow businesses with more stability than suggested by the “consensus” and may not price in the possibility that creative management with the enormous advantages of scale, incumbency and financial wherewithal, might actually read the same newspapers (and to be fair..blogs) that investors do and are hell-bent on adapting their content and distribution platforms to a digital world. We expect this sector to move from a source of boredom to a source of material out performance for our clients in 2006 and beyond as valuation reflects more of a balance between reality and hype.

The third issue was frankly, and in retrospect, an overly conservative position by the RCB investment team. We researched a number of stocks in 2005 that, like the overall market, were “reasonably” valued and we made a number of “no decision” decisions in

2005 in which cases, had we pulled the trigger we would have been better off. Obviously, this is what makes investing the fiendish process that it is. One of our expectations for 2006 is more volatility than the flat-line of 2005, which should create more opportunities for us to see deeper value. One of the core fundamentals behind our long-term success is our ability to act with conviction when we see it, no matter what the headlines say or the number of phone calls we receive.

In balanced accounts, we remain locked into a fairly static asset allocation as we see neither greater values in equities (but improving!) nor fixed income. The bond market remains a huge enigma and source of confusion for investors, as longer maturities appear to be locked in place no matter what the intentions of the Federal Reserve or the fact the "real" return after inflation of a 4.5% ten-year bond is near zero using the trailing 12-month gauge of likely understated inflation.

The decision path for the fixed income investor could not be more disparate. If the longer end of the bond market is indeed being held down by uneconomic foreign buyers or pension plans actuarially desperate for longer duration, then short-term interest rates may have to go higher than anticipated in the short run to have the desired effect of slowing the economy. The question then becomes at what point does one extend maturity to lock in the "pre-slow down" yield? Contrary to basic instinct, when the yield curve inverts, the correct trade is to buy the longer term, lower yielding bond, not the ephemeral attraction of the short-term note, which will soon reset itself at lower rates.

The contrary option is the thought that only a complete masochist would buy into a structurally weak currency, with questionable fiscal policy and a central bank about to be run by a chairman who is on record saying that deflation is the big evil to be avoided at all costs, and be compensated with a 4.45% yield. In other words, longer term yields have nowhere to go but up.

We stand firmly in the middle. The one absolute certainty we have is that corporate bonds remain in general a distinctly unappealing investment. They are priced to reflect best scenario probabilities which is not impossible of course, but there remains little margin of safety.

Going forward, we expect a "reasonable" year of absolute performance and a much better year of relative performance. In regard to absolute performance, barring a shattering of the housing market (we expect a dull slide), the economy should continue to trudge along, generating decent corporate cash flow growth. Interest rates may move somewhat higher on the short-end, but barring another huge energy spike, an argument can be made to peer around the corner and factor in the case for a more normalized (flat to lower front-end) yield curve. This creates a stable and positive floor for "reasonable" mid-single digit equity returns.

In regard to our own performance, we feel more positive than we did a year ago because much of what we own has become more valuable, and yet the stock price has either not moved or declined in a number of cases. In other words, the RCB portfolio has become a better value in and of itself. As we have noted on a number of occasions (and annoyingly we were right in 2005), returns tend to be muted after a period of great performance. Conversely, our mediocre year in 2005 sets us up for better results in 2006.

RCB has just finished its 46th year as an investment advisor, and we are particularly pleased with the team we have built in both investing and operations. We recognize that some of our newer clients have yet to see the fruits of our laboring due to the mysterious vagaries of the mathematics of random start dates, but we continue to feel that we have the people in place as well as the correct ownership structure to deliver results which in the future will be similar to those in the past. In a recent article in the [Financial Analysts Journal](#), noted investment thinker Martin Leibowitz reflected on superior investors and investment firms: "The great ones share a number of positive characteristics - focus, patience, clear-cut philosophy, a willingness to go beyond the diversification mantra, an innovation-prone attitude, the organizational sponsorship and personal fortitude to endure significant periods of underperformance and a disciplined process for pursuing goals." We will leave accolades to someone else, but we come to work every day trying to build on this philosophy and it is this process that has delivered our long-term results.

Again, please accept our best wishes for the New Year!