

Market Commentary

April 2, 2007

Despite a plethora of unsettling headlines in the financial press over the past three months, our efforts in the first quarter of 2007 in both our Large Cap and All Cap strategies might be best described as “no harm, no foul” as we ended up essentially unchanged. The same might be said of our relative performance as we gave back a tiny bit of a very strong close to 2006. Given the volatility of the first quarter and the exceedingly small numbers involved, let’s call it a draw. In the Small Cap strategy, our internally generated efforts produced strong absolute return numbers which further stand out on a relative basis due to a rather weak showing by the small cap indices, something we expect to be a continuing theme in 2007. Amongst the numerous reasons which lead us to feel this way is that REITs have been a scorching performer in the past two years and now represent an 11.5% weighting in the Russell 2000 Value index. We cannot help but notice a few unsettling developments in the real estate world that may assist our relative performance in the future.

In our Large Cap and All Cap strategies, Mattel was our largest winner as the market appears increasingly comfortable with the distinct possibility that the erosion of Barbie’s market share has flattened. Growth in other product areas as well as the mathematics of Barbie’s decline – it’s a smaller piece of a bigger pie – means that the issue simply matters less in the long-term picture. Our premise on Mattel was that this was a high margin, high return, high free cash flow collection of franchises run by a management team that was terrific on cost control and capital allocation, and the stock price discounted a growth rate of nearly zero. Our downside was boredom and our upside was north of 50% in a two year period if management could move sales growth towards a mid-single digit percentage rate. Recent results indicate this process is well underway and the stock has responded accordingly by doubling in the past twelve months.

We would like to think this is an excellent example of how we approach investing and currently believe our portfolio is full of similar ideas as large capitalization companies with steady growth and rock solid balance sheets remain inexpensive today.

In our Small Cap strategy, we were again helped by two takeovers in the portfolio: Smart & Final Corp, in which we were the largest institutional shareholder, and USI Holdings. Smart & Final is a cash and carry mini-warehouse retailer operating in the western United States. Having owned the company at various times over the past fifteen years, we have made a material amount of money through our in-depth knowledge of the company’s operations and intrinsic value as well as pricing opportunities that have presented themselves during this period as several different management teams have torpedoed and rescued operations. This is an excellent example of the value of focused research and having a good memory. USI Holdings is one of two insurance brokers in the portfolio



and we are currently evaluating whether we are experiencing a takeover or take-under from a management led buyout. Nonetheless, it has been a solidly profitable investment for our clients. Other strong performers include Lodgenet, our largest position, which received Federal Trade Commission clearance to merge with its largest competitor and Ralcorp Holdings, which has done a good job of passing through price increases and integrating recent acquisitions.

Detractors from performance were Conesco and PLATO Learning, both of which continued to snatch defeat from the jaws of victory. We continue to believe that we are early rather than wrong and both stocks represent exceptional values.

The fixed income world remains painfully inert as the yield curve remains flat between 4.5%-5% and credit spreads remain, in our opinion, historically and inately tight. We do not see any alternative to a continuation of our strategy of staying short in maturity and high in quality as we await opportunities in the months ahead.

We think we are in excellent position to take advantage of increasing volatility in the financial markets in 2007 for all the reasons you are reading about in the financial press. While it produces some indigestion and consternation in the short-run, we welcome periods of volatility as it gives us the opportunity to make long-term investments that set-up our subsequent periods of out-performance.

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