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Market Commentary
October 2, 2006

We enter the fourth quarter of 2006 with surprisingly solid year-to-date performance on an absolute basis and some reasonable make-up on a relative basis in each of our products.

Ironically, the timing of this letter has allowed us to get most of the hurricane season behind us so as to crow a little about our deeper move into property & casualty and reinsurance stocks earlier this year. What we own has ticked up nicely and we have also received some relative help thanks to the inevitable rollover in energy and commodity stocks. As our esteemed partner and colleague, Victor Hawley noted during the summer, “there's nothing wrong with this firm that $55 oil won't fix” and voilà, he was directionally correct.

The third quarter witnessed a number of successes in all our products. Broadly speaking, the recurring theme here that long time clients understand – buy steady businesses that have high returns on capital and solid franchise positions when they are out of favor with the typical short-term focus of Wall Street, and be rewarded with solid long-term performance.

On the fixed income front, the lengthy reign of low single digit rates has finally given way to promises of marginally more exciting mid-single digit returns. While the previous rate structure's lack of a reasonable risk/return led us to dwell at the short end of the maturity range, the strategy paid off as the Fed continued its steady ratcheting-up of rates.

More recently, as the Fed Funds rate approached a "neutral" level, rates have provided better prospective returns and we have extended the maturity of new purchases in the portfolio. Nevertheless, we continue our focus on the structure of the credit markets and find most offerings severely lacking. The corporate fixed income markets -- especially those dwelling in the junk territory -- seem to have bought into the notion that we've reached a point in the economic development of our world where business cycles, while not extinct, will be so moderate as to have little effect on the capacity of companies to meet their obligations. Hence, we find corporate bonds paying very small premiums compared to US Treasuries and government agency securities. As long as this tight pricing relationship holds, we will happily buy the later.

As regular readers of our musings know, for an extended period of time our portfolios have lacked exposure to energy stocks and have had a large concentration in media related securities and the aforementioned property & casualty and reinsurance stocks. With our media related holdings chugging along and our insurance holdings doing well, we would be remiss if we did not talk about “energy” stocks for what we think will be the last time in detail. Having missed the home run in oil and natural gas investing that was reasonably available three years ago, we did not see the need to participate just for the sake of participating in a sector that was at best fairly priced and was still subject to the same commodity and cyclical forces which had a more than fair likelihood of working in an opposite fashion. You don't have to compound a “miss” with a bad purchase. While oil is down 25% from its peak and gas more than 50%, much of the large cap oil and natural gas sector has only marginally retreated and we expect further lackluster performance as the world continues to wallow in accessible oil and gas. Our thought is that oil and gas stocks at these prices are “market performers” which is a neat way of saying they do not appear to us to be cheap enough to make us hugely enthusiastic.

Overall, we feel the tougher times are behind us. We continue to believe that a superior long-term record is accumulated by applying a conceptually sound, consistent investment methodology. And in maintaining this methodology, there is bound to be periods of underperformance on a relative basis. Most importantly, our portfolios reflect the steady application of our philosophy that has made us so successful in managing client assets for the last 46 years.

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