



Reed Conner & Birdwell, LLC  
Investment Market Commentary  
April 1, 2008

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We are certainly thankful to end the first quarter of 2008 as it was one of the most challenging quarters in recent financial history and a particularly difficult one for our All Cap and Small Cap strategies.

It is difficult to start this quarterly recap without starting with the global credit crisis, which shows few signs of abating despite truly unprecedented and creative actions by the Federal Reserve and its global counterparts. One can simply measure this by noting that despite a 300 basis point decrease in the Federal Funds rate, mortgage rates are nearly unchanged (if you can get one!) and the spread of ANY non-Treasury bond to Treasuries is at or near record highs. Dare we mention Bear Stearns?

Large Cap holdings were helped in particular by consumer businesses that supply basic non-cyclical products and services, industrial companies with well diversified international offerings, and the energy holdings that we added during the lull in prices last year. These companies are well capitalized and generated large amounts of free cash flow – traits that have tremendous value in this market environment. Further, we continued to focus on quality, particularly in the financial sector. We own what arguably are four of the highest quality, best capitalized financial firms in the world: AIG, Berkshire Hathaway, JP Morgan Chase, and White Mountains Insurance. It seems clear to us that there has been extreme value created in this space and we have focused on the strongest participants that will take advantage of other's weakness. Our research suggests that our financial holdings are excessively capitalized, have long-term staying power and are ideally positioned to take advantage of the problems in the global financial system with the JP Morgan/Bear Stearns proposed deal being just the start.

In our Small Cap and All Cap portfolios, our biggest and most frustrating self-inflicted wounds came from our purchases of a group of smaller capitalization companies starting last August. Our large cap stocks outperformed the market in the first quarter, but we have simply been clobbered by our smaller names. We could stop the conversation right here and say we did the research, we calculated what we thought were attractive values and we bought these stocks after significant declines at compelling discounts to our estimate of their fair value. But we proved to have been horribly early, which is to say we made mistakes.

While in some cases we have underestimated the economic impact on a company's operations, what we have materially underestimated is the market's reaction to these short-term challenges. In addition, the selling of some of our small cap companies in the market has been exacerbated by a variety of non-economic factors that we mentioned last

quarter and continues to hammer on these stocks such as forced selling by a variety of quantitative and hedge fund strategies and the elimination of “uptick” rules in short-selling enabling downward pressure to be taken to new levels.

Our laundry list for new investment ideas is as long as it has been since the depths of the market decline of 2002, but what we see in our portfolios are several potential doubles and triples over the next three year time period. Admittedly, some of that performance will be from stocks coming off a lower base due to the significant drop in their price, but a successful investment strategy should not be distracted by initial purchase prices as it seeks to identify where fundamental values have not changed nearly as much as market prices suggest by employing a prudent assessment of risk and reward today.

In fixed income, we have long stressed safety rather than chasing slightly higher yields in the construction of our bond portfolios, and the strength of this approach helped us avoid the recently heard refrain "I thought it was triple-A." This market has once again recognized that risk does indeed exist in the world and it should to be priced into bonds. Treasury bonds have performed exceptionally well while high grade corporate and essential service municipal bonds have done just fine. Spreads -- the rate differential between Treasuries and other classes of bonds -- have widened to more normal historical levels. Nevertheless, the flight to safety in US Treasuries has created some interesting anomalies. As we write, not only are the pre-tax yields on municipal bonds higher than comparable term Treasuries, but the rates are often as good or better than corporate bonds. We are truly living in interesting times when sizable government entities with full taxing powers are paying rates similar to corporations facing competitive forces. Normalcy will eventually return and until then we will gladly take advantage of the opportunities that the market presents.

So for the value investor, the key issue is to find stocks that are being priced where the perception of fear exceeds the reality of the fear. The normalized difficulty of this task is compounded in a crisis environment, since the increased volatility of pricing can produce irrational overshooting on the downside in the short-run. To paraphrase Lord Keynes, the market can remain irrational longer than most investors can stomach. Fortunately, we run unlevered portfolios for mostly long-term investors and thus have the ability to patiently buy into values until the market stabilizes.

These are clearly difficult economic times and with significant implications on the valuations of common stocks. But if allowed to operate with little interference, the process of adjusting the price of assets is in and of itself nearly sufficient argument of why value investing works in the long run. Buying reasonable businesses or assets at unreasonably inexpensive prices is a maddeningly simple process, but it needs to be applied consistently and with the benefit of time to create wealth. Financial history is chock full of crisis moments, but there are none as grave as the one an investor is actually



in that creates pressure to bend long held disciplines to the current whims of the time. While we rarely have any conviction that we will experience immediate gratification when we initiate a new investment, we remain highly confident that our best long-term investments are made in the worst times, and our valuation work suggests that now is an excellent time for investors to be leaning toward more equity commitments, not less.

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