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Market Commentary

July 2, 2007

We just concluded an interesting and rewarding quarter as the stock market continued to do what it has done since the beginning of time—confound people!

Despite a number of "scares" including the latest chapters in the ongoing housing, mortgage and derivative saga, a nearly 50 basis point rise followed by a 40 basis point decline in longer-term Treasury yields, the restoration of a tiny sense of upwardly sloping normalcy to the shape of the yield curve and oil prices returning to north of $70 levels, the equity markets turned in a fine showing and we participated fully and then some.

The positives trumping the usual litany of woes were twofold: first quarter corporate earnings driven by large multinational companies came in much stronger than many investors (including us) expected and "guidance" from those who still stubbornly provide quarterly earnings guidance indicates a reasonable second quarter and the parade of mergers and acquisitions continues to chug along at a record pace providing a practical and psychological back-stop for investors.

Besides the tailwinds, the Large Cap and All Cap portfolios were helped via the maturation of some astute stock-picking, led by the announced bid for Dow Jones & Co by News Corp at a 60% premium to then prevailing prices (and our cost basis.) There is nothing more satisfying for a value investor (and their clients!) than to do independent work in a universally hated industry (evil-doing, tree-killing, hopelessly outdated newspapers – we are looking for more), recognize non-obvious value with an uncertain time horizon, and then have it be realized within a perfectly respectable time horizon. Our thanks to Tom Kerr , partner and media analyst, and Mr. Murdoch, octogenarian billionaire with an open checkbook.

As we have noted many times, we tend to eschew macro-economic themes and focus on bottom-up investing and this has led us over the past year to larger, higher quality, steady growth companies which after eight years of underperforming from their prior heights of valuation insanity, started to look both relatively and absolutely cheap. After some initial hesitation, this move has begun to produce results as a legitimate whiff of political, economic and financial uncertainty has started to blow around the edges of the financial markets raising volatility and producing renewed appreciation of the merits of bullet-proof balance sheets and a long-term positive outlook. Not only does this move have a lot of runway to play out, but it has the added benefit of material downside protection if things don't go as planned.

The Small Cap portfolio also enjoyed some astute stock-picking in some "different" areas like coal mining, where our first foray is Alpha Natural Resources, up 33% in the second quarter. Regardless of the political posturing of either party, coal is plentiful, politically secure and cheap. It will be a critical component of our energy needs for decades in either its current or a more environmentally correct form. This basic premise was not reflected in Alpha's absurdly low valuation six months ago.

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Going forward, the challenge in small cap investing remains how to find truly undervalued stocks in an asset class that has wildly outperformed nearly every other asset class for nearly seven straight years. This has been compounded by the mergers and acquisitions boom, which has taken 20% of our portfolio in the last twelve months and the replacements have been harder to come by. So the answers are: yes, we continue to lug around more cash than anyone desires; yes, we expect to put it to work shortly; and no, we do not plan on doing anything silly to spend our client's cash unless we have the appropriate margin of safety in a company whose business we understand, whose valuation is deemed inexpensive and whose management is aligned with other shareholders.

In our balanced accounts, our fixed income strategy continues to add value as our focus on quality and term have protected us from the sloppiness in the credit markets. We have been a broken record for some time, stating that the tight credit spreads between high quality and junk - combined with the relatively flat yield curve - led us to stay short term and stick to Treasuries and a few high quality corporate issues. While the sub-prime debacle earlier this year has begun to hammer some sense into the fixed income investment universe, the incremental boost that we are beginning to see in yields is still paltry compared to the risk in the markets. Given the difficulty of issuing debt to close some of the recent highly publicized private equity deals, the credit markets are sending a clear message that more needs to happen before the risk/reward trade-off achieves balance.

Our long-term value oriented strategy remains in place as do the people who execute it everyday. Please do not hesitate to call us if you have any questions.

The start of 2007 marks RCB's foray into audio broadcasting with the introduction of podcasts featuring our quarterly investment commentary. For those craving the spoken word, go to our website, http://www.rcbinvest.com , under the heading of Resources to find our complete library or go to the iTunes Store and search under RCB or Reed, Conner & Birdwell to subscribe.

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