June 15, 2007

To Our Friend and Clients:

In the nearly 30 years I have been in this business, I have written to **all** my clients very few times.

Once when the bond market collapsed in 1994, again after George Soros created the Asian mess in 1998, and again after technology stocks tanked at the turn of the century. All those prior letters discussed the problem and what we should do about it.

As I write this now, <u>the news is good</u> and I want it to stay that way.

I want to update you on where we are in this great country in what has to be the most exciting economic times for the world. This is all my opinion and conclusions and thoughts about what is likely to be happening in the future, however like hurricane forecasting, there is no guarantee any of this will come to pass.

It's a wonderful world out there. The "virus" of Capitalism has infected nearly the entire world. Almost the entire population of the world are increasing their consumption of energy, technology, and improving their standard of living. It's truly a magical time.

I want to cover what I see as a few big things that are going on and what I think is best to do about it.

The World is Awash in Money

As more and more countries are joining our western style banking systems- the various central banks are letting the "big dogs hunt". Interest rates are low and monetary policy all over the world is promoting rapid growth. The various developing economies are pushing to get into the big game and promote rapid growth within their own borders.

The world is acting much like this country did during our recent real estate boom. Cheap money is buying things, those things go up in value due to the demand, that causes more people to borrow more cheap money and the cycle repeats itself. Making money seems easy.

We have seen this before- the tech boom- our real estate boom- the bonds in 1993 and so forth. This time it's different in that it's not just a section of the stock market, like technology, it's nearly everything, art, antique cars, aircraft, high end homes, yachts and of course – stocks. It's cheap and fast money that gets the credit for this, and this is not a bad thing.

The Carry Trade

This liquidity that is out there is coming, in part, from international leverage. Institutions are borrowing money cheap (like in Japan at ½%) then investing it over here in private equity funds trying to earn as much as possible. We call this a carry trade as the money is made by the difference in the rates of return, if money costs ½% and you can invest it at 20%, you can make a lot of money, and you would continue to do this and expand on it as long as possible. This is how these hedge fund guys can make a billion a year in compensation. They are highly leveraged.

This is the type of things that the hedge funds and private equity people are benefiting from- by getting it directly or by being able to get their hands on some of that cheap money from investors who are leveraged up. How long can this last? It's been going on for quite a while now. To some degree, it will always be there, however the risk we face now is any kind of reduction in these levels will send ripples through the markets as trillions (not billions) of dollars are involved.

Private Equity and Good news

One unusual thing about this “bubble” caused by the cheap money is it isn’t Mom and Pop investors playing the games and acting greedy, these are professionals and they are running huge hedge and private equity firms where the investors are wealthy people or institutions (including pension funds) so it’s not the small guy that will get hurt (at least directly) when the business slows down.

This is good news as those people will have more staying power. Also, the problems when and if they comes will be concentrated in fewer hands. You might remember Long Term Capital Management which was a hedge fund run by some very smart people which toppled a few years ago. When it did, the Federal Reserve got involved not to save the investors money but to save the markets the stress.

The fed will not bail out a few million small investors (we know that after the tech bust) but if the problem is concentrated in a few hands it might be able to help. This is good news and makes this a slightly different and better problem. More good news- the deals they are doing are large enough to not only give them the full attention of the banking system, but also large enough to attract people to take them out when they start to hurt.

China moving large sum back to the US to Private equity

Another big thing that is going on is that China seems to be getting more aggressive with all the dollars we send them every month. It is believed that China (which has and is accumulating huge reserves of US Dollars, because of your’s and my Wal-Mart purchases) has been using dollars to buy our mortgage backed securities and treasury debt. This may be the reason why our yield curve has been so flat, all these dollar coming in from the China central bank have kept long term interest rates from going up, while short term rates have gone up because of the Federal Reserve.

A couple of weeks ago, it was announced that the Chinese are investing $3 billion in a large private equity firm. This might indicate a change in their strategy. If so, it might mean that a lot of things we are taking for granted are getting ready to change. Should they slow their purchases of that debt, the yield on it will increase, and the prices of the bonds will fall. If they plug that same money into stock or private equity firms here then what might happen is the bonds will fall and the stock will rise.

Remember back in the heyday when the Japanese starting buying Hawaii (all of it) and a lot of real estate in California- years later when things settled down they sold it back to us for a whole lot less than what they paid for it. That can happen again.

The Future and What do we do now

Enough of the technical talk. I don't think many people would disagree with my analysis there is a lot of cheap money out there, the next question is what do we do to profit from this AND how do we stay out of the way of the mess that will be created if it comes to screeching halt.

Before I answer that question lets look at the things that might stop this locomotive, I see three:

1) Higher interest rates and restrictive Central bank policy, like Mr. Greenspan raising our interest rates a few years back, this time it might be in China or elsewhere
2) A Terrorist attack, due to it effect on business and travel.
3) Protectionist Government policies (always bad, never good)

This situation is very susceptible to interest rates. If the money isn't cheap anymore the prices on the takeovers will come down, building will cost too much to build in China, the carry trade will unwind and so forth.

Remember the real estate market and what happened here when our Federal Reserve starting increasing rates. It sure slowed down that train. I think that is our biggest risk in this situation. This is not just our rates but the rates in Europe, Asia and all over the world.

A change in interest rates either by changing demand or central bank intervention is the big risk we see.

Where is the Decline on our interest rates we have been expecting?

We have been expecting, logically, that the real estate slowdown will give our economy a pause and actually cause interest rates to decline, yet a lot of time has gone by and that has not happened. Perhaps all this other activity is compensating for the real estate decline. If that be the case, when the real estate slump ends (I think sooner than later) then our economy will one again heat up probably causing the Federal Reserve to increase interest rates.

Our Answer

In prior situations we stayed away from playing the "bubble" because what was attractive to the speculators was poison to us. This was like Yahoo at 2400 times earnings in 1999, real estate that has doubled in price in 3 years, gold near 1000. We didn't want any of those as investments because they were all obviously over priced and too risky. It was pure greed and was doomed to dish out some severe pain to investors.

It's funny, if you live long enough you see this all happening time and again. The same type of person who thought that tech stocks where the one and only answer to success in 1999, now has four condos they bought pre-construction (that are nearing completion) and maybe right now they are looking to make an investment in a private equity firm. God Bless these people! We need them.

These days much of the stuff that is attractive to the private equity firms is not poison at all, but is very attractive to us. They seem to be hungry for stable businesses with large cash flows; these are companies with stock buyback programs and high dividends. These are the kinds of thing we like and already own. These are also (historically) the type of stocks that don't go down as much when the market falls.

Conclusion

We believe the biggest risk this market faces is higher interest rates. Hence we want to start selling our Mortgage backed securities due to this new perception and buy instead high dividend/stock buyback /stable companies.

While continuing to buy what we consider to be cheap companies of any size, we want to keep an eye out for the smaller cap situations that a private equity firm can afford to take over. That way we can try to get in the way of them and let them buy us out at a profit.

Of course this is not a call to make changes in a panic, but this is a definite shift in how we feel about things.

These are great times and certainly a time to be acting as a capitalist. Not a time to hide one's head in the sand. This trend could last for years. But like all capitalists we want our investment dollars in a safe place that is also in the way of growth. The most unusual (and fun) thing about these times, in our opinion, is that the very thing that is attractive to the speculators as we refer to private equity/hedge funds etc is also attractive to us. <u>We want to act on this</u>.

Thanks for all the confidence you have placed with us in the past. We look forward to continue to earn your trust and confidence for many more years.

Being always looking at your best interest, I remain,

Sincerely,

Charles Stoll

Please Note:

The above represents our opinion based upon our experience and interpretation of current news and events. While the facts presented are believed to be true there can be no assurance that the conclusions will come to pass, or if they do that they will persist. Stocks, bonds, mutual funds are not guaranteed and may go down in value. Past performance is no guarantee of future success.