

First Quarter 2008 Investment Update

After years of “pushing the envelope”, much of America’s financial system has pulled back, hoping to shore up their balance sheets and protect themselves against additional material write-downs. We are at the beginning of a long process of deleveraging. Banks, so eager to lend as recently as last summer, aren’t so eager now. Private equity funds are rediscovering the risks of deals built largely on financial engineering. Insurers are raising rates to compensate for potential claims once thought impossible. Everyone involved, it seems, is putting a premium on the possession of cash and its equivalents. The effect is reduced financial and strategic flexibility.

Our financial system is going through an adjustment period which is tough, but necessary. After all, do we really need investment banks and hedge funds buying residential mortgages at thirty to one leverage ratios?

The problem, of course, is confidence, as the process of deleveraging feeds upon itself. The selling of assets to raise cash leads to declines in asset values, creating more selling. Unable to sell certain positions at any price, some have tried to hedge their holdings by shorting other, hopefully correlated, assets. All of this is exacerbated by the sometimes illogical application of mark-to-market accounting. Nowhere has this been more apparent than in the case of mortgages and mortgage-backed securities.

Spreads are Getting Wider

Reflecting this setting, data published by Empirical Research Partners show a dramatic widening of valuation spreads, from below average a year ago, to average at the beginning of this year to one standard deviation above normal in mid March. The data also show that the two areas at the heart of the current controversy – financials and consumer durables – have widened out the furthest, with spreads at or near record levels. For value investors like us, widening spreads are not conducive to strong performance, as reflected in the numbers at the end of this letter. By any measure – price-to-book, price-to-earnings, price-to-cash flow – our portfolios are cheap. But cheap tends to get cheaper when emotions escalate.

Our Philosophy

As deep value investors, our view is that opportunities arise from emotional investors who are more concerned with market risk than business risk. We believe that near-term price movements are typically driven by hope or hype – reactions to recent news or events that are often irrelevant to a company’s long-term prospects. This price volatility is largely unrelated to volatility in the cash flows of the underlying investments. And so, over time, as investors react – and often overreact – to news, a company’s stock price often becomes disconnected from its underlying fundamentals. This creates opportunities for value investors. Our strict focus on the fundamentals – the operating environment, earnings and free cash flow – identifies companies whose stock prices have become cheap relative to their long-term normalized earnings power. Our portfolios consist only of companies that we believe have an outsized opportunity to appreciate in value.

On the other hand, without wide spreads, value investors would lose their reason for being: value stocks typically outperform when spreads revert to average as relative calm is restored. Thus, despite value's sub-par performance over the past 12-18 months, we believe now is the time for investors to start asking themselves when they want to make the contrarian play.

Not surprisingly, as a true value manager, our portfolios are heavily weighted toward those sectors of the market most out of favor. Among the financials, our largest bets remain with the monolines. Clearly, we made an early entry into these stocks. Our analysis then, as now, showed little liquidity risk, manageable loss exposures and adequate claims paying resources. With hindsight, however, we underestimated the pressure these companies would face to raise additional, and dilutive, capital. As that pressure mounted, we became concerned that the ratings agencies would chip away, demanding that the companies raise more capital again and again as a requirement for maintaining their AAA ratings. We expressed our concerns to the management of both Ambac and MBIA, privately and publicly. In the end, both succumbed to the pressure and undertook significant capital raising efforts in which we participated. While we believe that each company has always had more than sufficient resources to meet its obligations, for better or for worse, that process is now complete. For the foreseeable future, we find it very unlikely that the ratings agencies will again determine that either Ambac's or MBIA's capital resources are insufficient.

With that debate now (hopefully) complete, investors will turn their attention to the question of losses. We believe that picture will become clearer later this year as adjustable rate mortgage resets reach their peak, and as the "cumulative loss curves" for mortgages originated in 2005 through early 2007 begin to mature. Neither of these companies will get away scot-free. The move into insuring structured finance products tied to mortgages has clearly been a mistake. That said, we expect losses at each company to top out at a manageable \$3-5 billion per company, a far cry from the dire estimates of \$10 billion-plus being thrown around by many. This would leave adjusted book values in the neighborhood of \$33 per share for Ambac and \$48 for MBIA. Against a current stock price of approximately \$6 and \$12 respectively, we remain quite optimistic about the chance for significant capital appreciation in our investments.

As for our other holdings tied to the credit turmoil, there is little to report. While, in many cases, the market has priced these stocks lower on fears of their exposure to an economic slowdown, almost without exception the businesses themselves continue to perform well, perhaps in part because our focus has been on companies with excess cash or little debt. Jakks Pacific, Jarden, K-Swiss, Lear and MarineMax, are all examples of companies whose stock prices have been affected by credit concerns, either directly or indirectly, yet have balance sheets generally strong enough to withstand a prolonged downturn. To the extent this means we are able to buy additional shares in these companies at lower prices, that's okay with us.

Is Change Afoot?

We do not know what will happen with the economy. With years of liberalized lending standards turning into risk-aversion, attempts to significantly reduce leverage could have broad negative consequences for the entire economy. Moreover, neither consumers nor the financial sector can deleverage as quickly as they would like. Mortgage rates are not coming down as expected – the spread between the 10-year Treasury yield and the 30-year fixed-rate mortgage is stubbornly wide by historical standards. Confidence in the economy is quite weak, economic growth will likely remain slow.

That said, there are many countervailing forces beginning to come into play and our sense is that we are closer to the end than to the beginning. Fed easing, liquidity injections, capital raising, voluntary mortgage restructurings and a loosening of the lending standards at Fannie Mae and Freddie Mac should all play a positive roll. Government efforts toward more direct involvement in helping to minimize foreclosures suggests ever more help may be on the way.

In any event, we do believe that we've been able to find some real value opportunities. As long-term investors in attractively-priced assets, we see current conditions that remain challenging on the one hand but that are potentially extremely rewarding on the other. Current valuations in our portfolios reflect genuine bargains – akin to those available in 1990 and again in 2000. Given the buildup of negative news – first related to housing, then to credit and oil and now the broad economy – it's not surprising that value spreads have widened out so quickly. The stocks ranking at the top of our universe define the outer bounds of cheapness, having been hit earliest and hardest; and today they are trading at levels suggesting there's no resolution to the economic challenges we face. This is a value opportunity of major proportions and our portfolios are well positioned to benefit as sanity – and a focus on business fundamentals – returns to the market.

Portfolio Overview

Performance	1Q2008	2007
Small Cap Value	-10.2%	-18.1%
SMID-Cap Value	-9.4	-12.2
Partnership Value	-14.3	-24.9
S&P 500	-9.4	5.5
Russell 2000® Value	-6.5	-9.8

Net of management fees; Preliminary

Portfolio Characteristics	Small-Cap Value	SMID-Cap Value	Partnership Value
P/E (ex. negative earnings)	14.4x	12.0x	9.4x
P/B	1.0x	1.1x	0.9x
Dividend Yield	1.5%	2.2%	1.4%
Wtd. Avg. Market Cap.	\$1.0 b	\$2.1 b	\$2.2 b
Number of Holdings	44	37	11

Disclosures:

1. *The Small-Cap Value, SMID-Cap Value and Partnership Value composites comprise discretionary accounts with no material investment restrictions. Net of fee performance results reflect the deduction of advisory fees and brokerage commissions. The results also include the reinvestment of all interest, dividends and capital gains and were computed on a trade date (as opposed to settlement date) basis. Accounts that are open and fully invested for one full month are added to the composite at the beginning of the following month. Weighted performance measures the average performance of all portfolios in the composite weighted by size. The performance returns reflect the deduction of fees according to the applicable investment advisory fee schedule. Performance results for individual accounts vary due to the timing of investments, additions/withdrawals, length of relationship, fee schedule and size of positions, among other reasons. Past performance is no guarantee of future results. All investments involve risk including the loss of principal. The performance and volatility of an index may be materially different from that of a client's account. In addition, a client's holdings may differ significantly from the securities that comprise an index. The indexes have not been selected to represent an appropriate benchmark to compare the advisor's performance, but rather are disclosed to allow for comparison of the advisor's performance to that of a well-known and widely recognized index.*
2. *The securities discussed above were holdings during the quarter ended March 31, 2008. The stocks we elect to highlight each quarter will not always be the highest performing stocks in the portfolio, but rather will have had some reported news or event (e.g. new contract, acquisition/divestiture, financing/refinancing, revenue or earnings, changes to management, plant strike, product recall, court ruling, etc.) of significance. They do not represent all of the securities purchased, sold or recommended by the advisor, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. All information is provided for informational purposes only and should not be deemed a recommendation to buy the securities mentioned.*