

Fourth Quarter 2007 Investment Update

A major value opportunity has developed in housing, financial and consumer-related companies. As we've positioned ourselves to take advantage of this theme, the pressures that brought on the downturn have intensified. With the market sorting through the mess, the price to play, it turns out, has been near-term poor performance.

From a value investor's perspective, however, things are finally starting to get interesting. So interesting, in fact, that we would argue we haven't seen an investment opportunity of this magnitude since the tech bubble. The time before that was the 1990 real estate cycle. It really is one of those "every 8-10 years" kind of events.

Like all value cycles, this one has its origins in a true "change for the worse." What we've witnessed recently is a textbook case of how value distortions are created. They begin with something very real which creates concern and builds to fear and panic. Consider the headlines. On any given day they are dominated by news about falling home sales, rising mortgage defaults, balance sheet writedowns, rating agency reviews and capital injections.

Make no mistake. The U.S. economy does face a potential crisis from housing and credit market conditions. But real value opportunities stem from real problems and many otherwise strong companies are now priced as if their earnings potential has been permanently impaired. These are precisely the kind of conditions that produce big opportunities for us as value managers. Our portfolios are increasingly invested in companies where some type of link to housing and related concerns has pushed their stock prices down to levels that we think significantly underestimate their true intrinsic value.

Presently, the problem and its collateral damage have affected banks and government sponsored enterprises; homebuilders and housing supply manufacturers; those that insure mortgages and those that guarantee financial securities. Further, the spillover has made its way to the broader consumer-related sectors. Before it's over, we expect those directly in the path of this problem will represent perhaps a third of the overall market.

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.

In one sense, the problem is quite complicated. Our financial system has changed dramatically in ways that are now arousing widespread anxieties. Many loans once made directly by banks are securitized. There's been an explosion of ever-more complicated financial instruments. Option ARMs, CDOs, HELOCs, ABX Indices and attachment points were terms unheard of, even on most of Wall Street, a few short years ago.

In another sense, however, the problem is rather simple; people can't pay their mortgages and because home ownership is so deeply rooted in American culture the headlines have spread from Wall Street and the financial press to Main Street and the popular press. It has become as tangible and widespread a controversy as any we've seen as investors. For many Americans this correction will end very badly. By some estimates, upwards of four million homeowners may default on their mortgages in the months ahead.

There is a difference, however, between factoring in an unfortunate reality on the one hand, and letting fear and panic dictate stock prices on the other. When that line is crossed, investment opportunities are created. Based on our research, we believe there are a growing number of areas where we've crossed that line. We expect this "value theme" to ultimately manifest itself across a wide range of stocks. As it does, our research will take us to the companies where the controversy has most impacted prices. Today, one of our largest areas of focus has been on the financial guarantee companies: Ambac (ABK), MBIA (MBI) and Security Capital Assurance (SCA). They represent perhaps the greatest controversy to date surrounding the housing mess.

Financial Guarantee Companies

Historically, these companies did business by providing a financial guarantee to the purchasers of municipal debt. In return for a fee from the issuing municipality, they guaranteed the timely payment of all interest and principal. The guarantee permitted the otherwise lower rated issuer to offer its debt as AAA rated which, in turn, permitted the issuer to pay less interest. In a sense, the issuer was "borrowing" the balance sheet of the financial guarantor. For years, this has proven to be a profitable, if somewhat mundane, endeavor. Premiums were steady and claims were next to non-existent.

Several years ago, as Wall Street began to create bonds from pools of mortgages, the companies branched out into the business of guaranteeing the timely payment of interest and principal on these structured finance securities, much like they did with the municipal bonds.

In light of increasing foreclosures, it's easy to see how investors have become fearful about the extent to which any of these companies may ultimately have to pay claims associated with these guarantees. To use Ambac as an example, it has insured mortgage related bonds and CDOs with a par value of approximately \$80 billion against which it currently carries approximately \$5.5 billion of book equity (and roughly \$9 billion in economic book value). So pervasive is the fear, that as of year end, ABK's market value had shrunk to less than \$2.5 billion. Some 30% of the shares outstanding have been sold short.

After a great deal of research, however, we have concluded that the outcome is actually likely to be much better than the conventional wisdom suggests. In a somewhat oversimplified fashion, we would highlight three main points.

First, these companies have insured only a small fraction of the total number of Residential Mortgage Backed securities outstanding and, we believe, were able to cherry pick across such variables as vintage, geography, mortgage originator, mortgage servicer and FICO score, etc. As a result, we expect the securities guaranteed by these companies to perform much better than average.

Second, much of the CDO insurance written by the guarantors was on the AAA tranches of these deals (and in most cases on the Super AAA level). Much like a game of chess, the entire CDO is structured to protect the AAA tranche (the "King") through a variety of provisions which in effect redirect cash flow away from the lower tranches toward the top. All of this is summarized in something referred to as the "Attachment Point" which is the level of loss in the entire CDO at which the guarantor starts to pay claims. On average, the attachment point is approximately 2-3 times the level at which the AAA tranche begins to take losses.

Finally, in the event a claim is made, the guarantors are responsible for paying interest and principal as they become due, in some cases over the next 30 years. In other words, the present value of the claims they would pay is much smaller than the headline figures some investors have begun to throw around. In the meantime they are generating free cash flow from their ongoing business.

Added together, we see the likelihood of claims which justify the current stock price as something approaching zero. In fact, we think there's a significant chance that the claims will actually turn out to be immaterial.

A potentially greater risk to our investments is the fact that the rating agencies themselves (S&P, Moody's and Fitch) have begun to panic (perhaps the best sign of a real value cycle), requiring each of ABK, MBI and SCA to raise additional capital in order to maintain their AAA ratings.

We think, should it come to that, that the companies should forego the raising of additional equity capital and, if need be, operate with a AA rating for the time being. The additional capital does little to provide greater protection for policyholders; by Fitch's estimates the difference between being rated AAA and being rated AA is the difference between a 99.8% probability of being able to pay all claims and a 99.2% probability. We have been in communication with both ABK and MBI regarding our opinions.

SCA's situation is a little different. Forty-six percent owned by XL Capital, the company is facing a request by Fitch that it raise an additional \$2 billion against a current equity market capitalization of less than \$200 million. We view this as almost impossible. Instead, we have communicated our belief that XL should simply spin SCA off to its shareholders and that the company should then consider going into run-off. This has the potential to produce very large returns to current shareholders, potentially equal to several times the current stock price.

If we're right, all three of these stocks (ABK, MBI and SCA) will produce very significant returns over the next several years.

The Broader Economy

Further, what of the connection between the financial economy and the real economy? In housing, there are some direct links. Subprime losses reduce mortgage lending, which has contributed to

lower housing construction, sales and prices. It hasn't, however, led us to invest in the homebuilders in a significant way. In some other areas, a similar retrenchment has occurred. We've found opportunity where concerns of a slowdown in consumption among the overstretched consumer have impacted valuations most significantly.

To be sure, we see a severe and prolonged downturn in big ticket consumer spending. The market does too, and the list of negative expectations seems to grow everyday, creating more opportunities. The valuation adjustments applied to companies like American Woodmark, Lear, MarineMax and Rent-A-Center are far too low. These are companies that hold significant market share, that have undertaken restructuring efforts to contain costs and streamline operations. They are companies affected by a tough industry environment but that are working hard to maintain profitability. Take Lear, for example. With benefits from its restructuring plan and strong operating performance, Lear is way ahead of schedule on a recovery path back to \$4 per share of normal earnings. Yet its share price is 30% lower than where it was in mid July and roughly 50% below our estimate of fair value.

These are challenging conditions. It takes courage to invest in out-of-favor, beaten-down stocks as everyone else is running in the other direction. Skeptical investors perceive anything tied to housing as risky and are still waiting to see who's left holding the bag. Committing, in times like these, though, is critical to delivering above-average returns. We are long term investors and recognize the recent period for what it is – a stage in the cycle. Panic will subside, deterioration in credit market conditions will abate and strong balance sheets and earnings potential will again get the attention they deserve. The fundamentals of our holdings are solid and we stand poised to capture meaningful upside.

Portfolio Overview

Performance*	4Q2007	2007
Small Cap Value	-12.1%	-18.1%
SMID-Cap Value	-15.7	-12.2
Partnership Value	-17.9	-24.9
S&P 500	-3.3	5.5
Russell 2000® Value	-7.3	-9.8

*Periods ending December 31, 2007; Net of management fees; Preliminary

Portfolio Characteristics	Small-Cap Value	SMID-Cap Value	Partnership Value
P/E (ex. negative earnings)	15.2x	13.1x	15.1x
P/B	1.2x	1.4x	0.9x
Dividend Yield	2.0%	2.8%	1.8%
Wtd. Avg. Market Cap.	\$1.1 b	\$2.6 b	\$2.9 b
Number of Holdings	44	37	12

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 December 31, 2007. 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.