



## U.S. Stock Markets: 3Q06 Results

In our 1Q and 2Q letters, I commented on finding better risk/reward investments in the universe of the largest capitalization stocks. Specifically, last quarter I wrote, "2005 marked the sixth straight year that stock prices of large capitalization businesses under-performed their smaller peers. I believe this trend is on the cusp of changing. To profit from today's market environment I'm placing the majority of our assets in large, dominant businesses exhibiting attractive risk/reward valuations and strong balance sheets." During the just completed 3Q06 the Russell 2000 Index, which measures the stock price performance of small capitalization businesses, increased 0.4%. Larger capitalization stocks fared better, with the S&P 500 Index appreciating 5.7% and the Dow Jones Index gaining 5.4%. From my perspective, the valuations of large businesses continue to be appealing. If the large capitalization out-performance in the 3Q06 signifies a reversal of the six year trend, our portfolios should benefit.

## Comments on Our Performance

We had a solid quarter, with many of our holdings besting the indexes by appreciating over 10%. Sticking with the large capitalization theme, our positions in Dow Jones Index components **J.P. Morgan Chase** (JPM - \$46.96), **McDonald's** (MCD - \$39.12) and **American International Group** (AIG - \$66.26) each appreciated over 12.5%. The Dow Jones Index contains 30 large capitalization stocks, and our ownership of these three out-performing Dow companies helped our relative performance vs. the benchmark's 5.4% gain. Outside of the large capitalization space, our positions in auto parts retailers **Advance Auto Parts** (AAP - \$32.94) and **AutoZone** (AZO - \$103.30) increased in value 14.2% and 17.1%, respectively. We had very few losers, with the only glaringly poor performer being energy company **ConocoPhillips** (COP - \$59.53), which declined 7.2% due to falling oil and natural gas prices. Other relative under-performers during the 3Q06 were **Home Depot** (HD - \$36.27) and one of my personal favorites, **Sears Holdings** (SHLD - \$158.09), each appreciating 1.8% vs. the S&P 500's 5.7% gain. Because I believe it's important for investment partners of Washington Street Investments to understand our investment philosophy and my evaluation of our business' prospects, I've included my thinking below. Finally, please note in the section "Market Outlook – Opportunities" I discuss some of our new investments.

## Comments on Our Performance - Winners

**J.P. Morgan** provided a total return of 13.6% during the quarter fueled by a strong earnings report along with the market's expectation the U.S. Federal Reserve is done raising interest rates. The primary reason we own J.P. Morgan is that I highly regard the talent and competitive drive of its new CEO, Jamie Dimon. Mr. Dimon was CEO of Bank One before it merged with J.P. Morgan in 2004, officially taking the top job at JPM to start 2006. In short, I believe prior to the merger JPM was managed with a laissez faire attitude – not terrible, but not with the same level of attention to detail and determination its new management is instilling. In my analysis the combined company has the potential to dramatically increase earnings predicated on new management successfully executing its game plan. If my future vision of the company proves correct, in future years J.P. Morgan will be mentioned in the same sentence as Wells Fargo as being one of the truly well-run financial institutions in the United States; with the success reflected in the share price. If you want to read one of 2005's better CEO letters to shareholders, go to <http://investor.shareholder.com/JPMorganChase/annual.cfm> and click on the "Letter to Shareholders" link. After reading it you'll appreciate the fact Mr. Dimon is running one of your companies.

**McDonald's** recent strategy has been to slow the pace of new restaurant openings, opting to focus on increasing productivity at existing stores. The company's emphasis on improving the menu and patron experience has been successful. For example, in its latest earnings report, profit margins improved in all geographic segments for the second consecutive quarter. Particularly impressive was Europe's performance, where its 6.3% "comparable sales" increase was the strongest quarterly result in more than 10

years (“comparable sales” measures the performance of restaurants open for one year or longer). With a goal of returning at least \$5 - 6 billion to shareholders through 2007, in late September McDonald’s increased its dividend 50%, to \$1.00 per share for a 2.5% yield. The positive response translated into a 17.5% shareholder return during the 3Q06, significantly outperforming the Dow Jones’ 5.4% return. From my experience, when a company shifts its strategy from growth, to making a conscious (and successful) effort to improve its core business *and* commits to returning a substantial amount of cash to shareholders, its stock tends to do much better than expected. I’ve seen this strategy work well for shareholders in many different types of businesses – from utilities and oil companies, to retailers and now restaurants. We continue to hold the shares and may add to our position.

Finally, **American International Group’s** shares returned 12.8% during the quarter. For those desiring a refresher on why we own AIG, please reference the 2Q06 letter. In 2Q06, the shares fell from \$66 to about \$58 on little fundamental news. Most of that decline was based on general growth concerns in its Foreign Life Insurance segment. In 3Q06 the shares rebounded sharply after a decent earnings report relieved investors’ fears. AIG will announce earnings in a few weeks, and the lack of major hurricane damage in the United States through September 30<sup>th</sup> should bode very well for the company’s earnings and growth in book value.

### Comments on Our Performance - Losers

Energy stocks in general declined during the 3Q as prices for oil and natural gas fell. This is a good news / bad news scenario. The bad news is our investment in **ConocoPhillips** declined 7.2%, and the shares continue to decline to start the 4Q. The good news is two-pronged and, in my opinion, outweighs the bad. First, energy companies including ConocoPhillips represent a relatively small 3.0% to 6.0% of our total portfolios. In contrast, energy companies in the S&P 500 Index compromise about 9% of the index’s weighting. With the price of oil up over 400% since the year 2000 and many energy stocks having doubled or tripled over that time, finding good risk / reward values in energy is challenging. Given the choice between investing in an energy company whose shares are generally in-favor, vs. investing in a company such as Home Depot, whose shares haven’t appreciated at all in seven years and enjoys a more enduring business model, the choice from my perspective is fairly easy. Second, falling energy prices generally favor the businesses representing the remaining 95% of our portfolios. For example, I believe a major catalyst for Advance Auto Parts’ and AutoZone’s 14%-plus quarterly gains were directly related to declining energy prices. With that said, we continue to own ConocoPhillips as our primary energy holding for three reasons. One, it has a diversified mix of earnings sources – 50% oil, 25% North American natural gas, 25% refining – allowing us to participate in each area without taking an over-sized risk. Two, the stock is cheap. ConocoPhillips trades at a Price-to-Earnings (PE) multiple of 6.0x its 2007 earnings estimate. Comparable companies Chevron, British Petroleum and Exxon Mobil, trade at PE’s of 8.5x, 9.7x and 10.5x, respectively, or roughly 40% to 80% premiums to COP on this basis. I believe ConocoPhillips deserves to trade at a discount due to its weaker balance sheet and what I view as a second-rate executive management team. However, I believe my third catalyst, COP’s early 2006 merger with Burlington Resources provides the greatest potential for stock price appreciation. With a market capitalization of about \$35 billion, Burlington was one of North America’s largest independent natural gas companies before agreeing to merge with ConocoPhillips. I’ve followed Burlington Resources for several years and found its executive management team to be one of the few teams in the entire energy sector that I trusted to create shareholder value. Burlington’s executive leaders have stayed on with ConocoPhillips, and *if* their winning philosophies can permeate the COP culture, the stock will be a winner vs. its peers. Put more bluntly, if tomorrow Burlington’s former CEO were put in-charge of ConocoPhillips, I believe the smart money would bid the shares up 5% to 10% on the announcement.

**Sears Holdings** and **Home Depot** were two of our other investments which did not keep pace with the market, each appreciating 1.8% vs. the S&P 500’s 5.7% gain. Sears has been an excellent performer for us this year, up 37%. As one of our top five holdings, it has helped performance tremendously. However, recall from last quarter’s letter I stated, “I have a hard time believing the current valuation can expand much more in the short-term due to the recent stock price run-up combined with slowing U.S. consumer spending...we continue to own the shares with full confidence that we are partnered with some of the best owner-managers in the business world, who will generate outstanding returns over the long-term.” To update my thinking, I

continue to believe the shares need to rest another quarter or two. Long-term, I believe CEO Eddie Lampert's acumen is going to lead the shares higher as he invests Sears' excess cash flow in unrelated businesses. To the contrary, shares of Home Depot, down over 8% year-to-date, continue to draw little investor interest due to legitimate concerns over slowing sales and profit growth mostly due to the slowdown of the U.S. housing boom. Nothing in my thinking has changed from last quarter's letter. I continue to believe the shares are priced for a "worst case" scenario, offering a favorable risk / reward investment for patient investors.

### Market Outlook – Opportunities

There are three general areas I'm finding favorable investment ideas. The main area is among the large capitalization, dominant businesses with excellent balance sheets. Despite one quarter of solid out-performance vs. their smaller capitalization peers, large caps as measured by the S&P 500 Index are still trailing the small caps through September 30<sup>th</sup> of this year. I think there's more to go after six years of under-performance by the large caps.

Second, I'm finding new investment opportunities in companies that have been hit hard by rising energy and raw materials costs. One such business is residential and commercial flooring maker, **Mohawk Industries** (MHK - \$74.45). Mohawk's profit margins have been squeezed by the escalating costs of oil – the primary raw material used to manufacture the majority of its flooring products. As a result, the shares are down over 15% from a 52-week high of \$90. Today, the price of oil per barrel is down from the high \$70's to the low \$60's, and natural gas is fluctuating in the \$5 to \$7 per thousand cubic feet (mcf) range from a post-Hurricane Katrina high of \$15/mcf. When the company begins anniversaring its cost increases in 2007, margins and earnings growth could improve. Raw material costs aside, the long-term fundamentals of Mohawk's business are favorable, and include:

- It's one of the top two flooring producers and distributors in the United States, affording the company economies-of-scale advantages over much smaller competitors.
- Demand for flooring products from both the replacement and new construction markets in North America is relatively predictable in the long-term, and is not disrupted by "new technology" that dramatically changes the industry.
- Flooring is a distinctly local business. Due to the high freight costs of transporting flooring products, U.S. flooring businesses are relatively immune from cut-throat low-price imports.
- Finally, Mohawk's management team has a passion for the company, running it as fellow shareholders.

The third area of investment opportunity I'm seeing is in insurance businesses with direct ties to major catastrophe coverage. North American insurable losses for hurricane damages for 2004 and 2005 combined are estimated to be over \$100 billion. With seven of the top 10 costliest hurricanes on record in U.S. history occurring in 2004 and 2005, people are asking if we're living in a new paradigm of increased hurricane frequency and/or severity. With very few answers, investors are understandably hesitant to commit new capital to insurance businesses. In the investment world, major uncertainty and fear provides opportunity. The obvious result of the storms has been a substantial increase in insurance rates, benefiting insurers in the near-term. Possibly more important, insurers are likely to benefit from the more favorable policy terms and conditions being written on new business. To profit on my expectation of improving insurance profitability, we've taken positions in **Berkshire Hathaway** (BRK-B - \$3,174.00) and **Montpelier Re** (MRH - \$19.39). Berkshire, the holding company managed by legendary investor Warren Buffett, derives over a third of its profits from insurance businesses. With unmatched financial strength and diverse ownership of non-insurance businesses, Berkshire provides us a lower-risk investment vehicle to profit from the favorable insurance environment. "Reinsurance" business, Montpelier, is a higher risk / reward investment on improving insurance profitability. Reinsurance companies are not well-known, but are simple to understand. In a nutshell, reinsurance companies insure insurance companies...got that? For example, if State Farm wants to limit its exposure to hurricane damage along the Florida coast, it will transfer a portion of its risk to a reinsurance company like Montpelier. Very similar to how we pay our auto premiums to State Farm for a promise to pay our damages if / when we're in an accident, Montpelier is paid premiums from primary

insurance companies in exchange for severe storm liability. In summary, with 100% of its profits from insurance, Montpelier is our one pure-play investment on improved insurance policy pricing and terms. If North America escapes October with little storm activity the company's 3Q06 and 4Q06 earnings will likely beat expectations.

### **Market Outlook – Risks**

Not much has changed on my view that a slowdown in U.S. consumer spending is the primary risk to our portfolios and the U.S. economy in general. The impact of falling housing prices on consumer spending is a major wildcard that is very difficult to predict. Nevertheless, declining home prices could damage national consumer sentiment enough to lower spending. On the positive side, the national average gasoline price has declined to around \$2.30 after topping \$3.00 in the summer. This should help lower-income consumers living paycheck-to-paycheck, as well as the general psyche of the country. To combat these big-picture challenges I place an emphasis on valuing individual businesses. Only when the exercise of valuing businesses has been done can investors attempt to make rational buy and sell decisions based on market price vs. business value.

### **Business Announcement**

I'm excited to announce starting January 1<sup>st</sup>, 2007, Washington Street Investments will begin managing a hedge fund, the "Washington Street Investments Fund." The fund's objective will be to earn returns in excess of the S&P 500 Index over a three to five year time period while avoiding capital loss. The same value-based investment philosophy and research-intensive process applied to our separate account management will guide the fund. Please note that as a private fund, it will not be publicly traded. If you or someone you know are interested in learning more, please contact me.

### **Thank You**

Thank you very much for your trust and support. The best compliments you give are the referrals of your friends and family, and we appreciate that. We are grateful for the opportunity to continue to serve you. I wish everyone a wonderful holiday season!

Sincerely,

Bryce Peterson  
President

Washington Street Investments, LLC

**Quote of the Quarter:** "If you want to make God laugh, tell him your plans." - Woody Allen

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