

U.S. Stock Markets: 3Q07

The third quarter was marked by volatility. In August the indexes were down about 10% from their earlier highs when credit markets froze, and fears of a United States recession were high. However, by quarter-end the S&P 500 Index and Dow Jones Industrial Average had inched out gains of 2.0% and 3.6%, respectively. These gains were all produced in the final 10 trading days of the quarter (Sep 17 – Sep 28), when the U.S. Federal Reserve surprised investors with a greater-than-expected 0.50% cut in the Federal Funds rate from 5.25% to 4.75%.

We're in a unique time for investing. The recent market appreciation in response to the Fed's rate cut has pushed valuations to levels that I don't view as particularly attractive. Simultaneously, the U.S. bond market is experiencing a mini-bull run, dropping yields to unattractive levels as investors rush to higher quality bonds to gain protection from both a faltering U.S. economy and riskier fixed income securities. Outside the United States, global markets are near all-time highs. If you have an employer-sponsored retirement plan, check it out - odds are your best returns have come from your international investments. A couple of quarters ago I read an article that warned me to be careful of some of the over-heating international stock markets. The article stated droves of Chinese citizens are showing up at the local stock brokerage and taking out loans to buy Chinese stocks. This reminds me of listening to my co-workers in the late 1990's debating over which tech or telecom stock to buy, JDS Uniphase, Lucent, Cisco, or Broadcom? Conversely, very few seem to want to touch businesses that generate the majority of profits in the U.S., despite the depressed valuations associated with some of our nation's best businesses. In my humble view, investors seem to be suffering from a bout of cognitive dissonance – seeking increasing returns in fairly to over-valued businesses or asset classes, while shying away from investment opportunities that have under-performed. Instead of buy low, sell high, the mantra today appears to be buy higher and don't buy anything lower. This is dangerous mental behavior that we are avoiding via buying strong but unloved businesses at what I believe to be selling for bargain prices, and holding more cash than normal. We also continue to be invested in businesses with exceptionally strong balance sheets such as Berkshire Hathaway. I detail my outlook in the Market Outlook – Opportunities & Risks sections below, which I hope you find informative.

Comments on Our Performance

The Q3 was practically a repeat of the Q2 – energy, industrial, and materials stocks out-performed the market with fundamentals supported by growing economies outside the United States, while consumer discretionary and financials under-performed. But unlike our Q2 performance, in Q3 most accounts under-performed the market with values down 2%, vs. a market up 2%. Our energy-related investments such as **National Oilwell Varco (+30%)**, **Canadian Natural Resources (+14%)** and **Diamond Offshore (+12%)** significantly out-performed the average stock. These gains were on top significant Q2 gains of 34% for National Oilwell Varco, and 20% for Canadian Natural Resources. I'm still constructive on global oil supply vs. demand fundamentals, but energy valuations after big runs are materially less attractive, especially considering the inherit risks investing in cyclical, commodity-based businesses. What also disturbs me is the recent oil price run from the \$70's to \$90 appears not to be governed by fundamental supply vs. demand

characteristics, but by other factors such as speculation and geo-political fears. This tells me it's time to begin taking a conservative stance on energy businesses. Rounding out the winners, our top holding, **Berkshire Hathaway**, appreciated 10%.

The majority of our Q3 under-performance was related to our investments in US consumer businesses. **Home Depot** and **Lowe's** were down 17% & 8%, respectively. These two businesses offer some of the best long-term risk / reward in market, which I update on the following pages. Our other businesses with under-performing stock prices were also retailers - **Advance Auto Parts**, down 17%, and **Wal-Mart**, down 9%. At the beginning of Q4 we've exited Advance Auto Parts. This is a business I think we may be able to re-enter at a cheaper price. As for now, I prefer to remain in the dominant consumer businesses selling at discount prices. In my opinion U.S. consumer discretionary businesses are pricing in a recession, while energy, industrial, consumer staples, and materials businesses are priced as if global growth will continue unabated for the foreseeable future. To put this into context, if the U.S. goes into or is already in recession, my valuation work suggests our consumer businesses are priced for this. Conversely, when earnings growth materializes out of our consumer-related investments, the stock prices should appreciate markedly. Likewise, if global growth slows, or the faster growing emerging economies hint at slowing growth, many fully valued industrial businesses are likely to materially fall in value. I discuss my valuation thinking in greater detail in the Market Outlook – Opportunities & Risks sections, below.

In summary, Berkshire Hathaway and our energy-related investments significantly out-performed the S&P 500, while our consumer discretionary businesses under-performed.

Comments on Our Performance - Winners

For the second quarter in a row, **National Oilwell Varco's (NOV - \$135.00)** 30% appreciation marked our best performing stock. After almost doubling in value from our initial cost basis, I made the decision to sell all our shares in NOV on the premise the company is fairly valued in light of robust fundamentals. It's certainly possible I've under-estimated the appreciation potential of the shares, but also view our risk vs. reward equation as neutral at this point – and we don't want to invest our money in a 50 / 50 game...we want the odds 75 / 25 in our favor. As an anecdote to our sell decision, when the majority of investment managers interviewed on CNBC (cable news station covering the stock markets) unabashedly tout "the energy, materials & industrial sectors are my favorite places to invest" it's generally wise to begin taking a cautious eye toward your investments in those sectors.

Sticking with the energy theme, **Canadian Natural Resources (CNQ - \$75.75)** and **Diamond Offshore (DO - \$113.29)** continued to be big winners for us, and we currently continue to hold our positions. As one of the few oil service businesses leasing deepwater drilling rigs, Diamond's earnings prospects vs. its 10x PE multiple are appealing. Critically, Diamond's management team understands how to use cash flow to create shareholder value. I expect Diamond Offshore to pay about a \$5 per share special dividend in the Q1, with the potential for a \$10-plus special dividend in Q109.

I think the near-term upside for Canadian Natural Resources is limited at its current \$70-plus price, as it has appreciated over 45% this year, and is facing the potential for higher taxes in Alberta, Canada. Recently, a panel hired by the Alberta government (where Canadian Natural's primary assets are based) issued a recommendation the government significantly increase taxes on oil and natural gas producers. There's a lot of economically uneducated Albertans pushing the government to increase taxes, which could put political

pressure on the Premier. If implemented, this tax increase would impair CNQ's value. Likewise, if a compromise is reached, CNQ's stock could increase. The stock fell about 6% on the day of the announcement, and could fall a similar amount if the proposal is implemented in full. A decision on the proposal is due in late October. My best guess is the Albertan government will increase taxes, but not as dramatically as the recommendation suggests. I believe this outcome is probable for a couple of reasons. One, if the new taxes are implemented in full, energy producers will dramatically cut spending in Alberta, which will severely shock the local economy (although the contingent pushing for massive tax increases could be too ignorant to understand this until it's too late). And two, the ultimate decision is in the hands of a fairly intelligent government in terms of tax policy, and at a recent speech the Albertan Premier hinted a compromise solution makes sense for the long-term viability of Albertans. Maybe it's a fool's hope to wish the government is not as economically bankrupt as some of the pro-tax contingent is, nor bend to political pressure. Stay tuned.

Finally, **Berkshire Hathaway** returned 10% in Q3. In my opinion, Berkshire continues to be the premier investment for the current market – I view it as materially under-valued, plus, should we face a U.S. recession or some sort of stock market panic like we did in August, its strong balance sheet consisting of about \$40 billion in cash offers a distinct competitive advantage and numerous opportunities. With global stock markets hovering near all-time highs and, in my view, sentiment in the markets being a little too optimistic, I envision Berkshire remaining a core strategic investment for us.

Comments on Our Performance – Losers

Dominant, large-capitalization retailing businesses were the market dogs in Q3, with fears of a United States consumer recession spurring intense and indiscriminant selling. Within our portfolios, **Home Depot (HD - \$32.44)**, **Advance Auto Parts (AAP - \$33.56)**, **Wal-Mart (WMT - \$43.65)** and **Lowe's (LOW - \$27.94)** were down 17%, 17%, 9% and 8%, respectively. Our positions in this sector were the primary reason most accounts were down 2% for the quarter, vs. the market up 2%. It's important to distinguish short-term business fundamentals from stock prices and longer-term value, especially when the market is down on a sector (like U.S. retailers today) or excited about a sector (like large industrial businesses with exposure to growing international economies today). As your investment manager, part of my strategy is to simply try to identify certain sectors of the market where fear and negativity are offering good businesses at discount prices, and take advantage of the situation. Conversely, I try to identify the sectors where the market is most giddy, and take a cautious eye toward the sometimes overly-optimistic valuations placed on those businesses. My valuation work suggests we have favorable investment opportunities in the unloved sector today. Specifically, U.S. retailers appear to be priced for a recession, leaving us a large margin of safety. To illustrate this point, I've highlighted Lowe's in the paragraphs below, and included an insert page with your letter describing what I think the business is worth vs. where it's trading given multiple economic and earnings scenarios.

I was clearly too early investing in both **Lowe's** and **Home Depot**, under-estimating just how negative sentiment could get surrounding housing-related businesses. Fundamentally, the stocks deserve to trade down from their 52-week highs because earnings expectations have come down. However, I want to communicate that in my valuation models I've been using earnings estimates for 2007 and 2008 that are 10% to 15% below current analyst's consensus expectations. This tells me the stock prices are currently not being driven by fundamental long-term value, but rather on the uncertainty surrounding the current U.S. housing market, which provides long-term investors good opportunity.

Lowe's offers a prime example of the just how negative the market is toward U.S. retailing businesses (especially true for businesses related to U.S. housing). In my investment analysis – aside from studying qualitative factors such as the durability of competitive advantages, and management's motivations and attitude towards building shareholder value – I analyze and build valuation models based on estimating future cash flows and earnings power. Because Lowe's is a significant investment for us, I've mapped out a detailed valuation analysis based on four different economic scenarios occurring in 2008, which I've included in the chart enclosed with your letter. You'll notice I've estimated Lowe's earnings per share (EPS) and valuation per share under the following economic scenarios from worst to best: "Massive Recession," "Recession," "No Recession – Weakness Persists," and "Stability."

The top-line conclusion I draw is there's a significant margin of safety investing in **Lowe's** at today's price (\$28 per share / \$41.5 billion market capitalization). The cash flow Lowe's is capable of producing under recession-like circumstances is equal to or greater than the cash flow being produced by other outstanding businesses currently experiencing robust business conditions. The inherent margin of safety investing in Lowe's in conjunction with a three to five year investment approach are reasons why I'm not too concerned whether Lowe's earns \$2 per share in 2008, or \$1.70 per share. When Lowe's earnings and cash flow bottom and begin growing again, Lowe's stock price has room to appreciate considerably. In contrast, other businesses I research for investment consideration – especially those in the industrial sector of the global economy – are pricing in continued good times. For example, recently I researched **Textron (TXT - \$62.21)** as a potential investment for us. Textron is a global designer and seller of business jets under the Cessna brand name, helicopters under its Bell division (both commercial & military), and also operates a smaller industrial business which makes golf carts and other products. I thoroughly researched its latest annual and quarterly earnings reports, and I read the last ten years worth of the CEO's letter to shareholders – I can tell you its business is booming today, and will likely stay that way through 2008 and 2009. Year to date Textron's stock price is up 40% vs. Lowe's down 7%. I'd love to invest in Textron, but at the right price. When you consider the cash-flow Textron's business should produce in 2007 – 2009 in a bull market, and compare those expectations vs. the cash flow Lowe's will likely produce in the bear years of 2007 & 2008 (I expect earnings growth in 2009), it becomes difficult to not to appreciate the investment value in the latter. There are quite a few businesses out there like Textron today – solid competitive advantages – bullish near-term outlooks that help you sleep well at night – fully valued stock prices. Conversely, in my opinion, there are not many truly under-valued businesses along the lines of Lowe's quality currently trading in this market.

Market Outlook – Opportunities & Risks

I think the majority of businesses are fully valued in today's market. Early in my career I spent time valuing each of the 30 businesses in the Dow Jones Index. Every quarter since 2002 I've updated my valuations for these 30 businesses, analyzing where I see the best absolute and relative values in the market (the Dow includes businesses from each major sector, providing a broad look at how sectors are being valued vs. the other). You may recall 2002 as the year the market declined about 20%, making the asking prices for businesses attractive. To start Q3, I had never before in my career seen valuations this unattractive, and am less optimistic on the market as a whole because of it. For example, there are businesses in the Dow Jones Index that I'd love to own for us – **United Technologies, McDonalds, Proctor & Gamble** – to name a few. These businesses in particular have all the attributes you'd want in today's economic climate – strong franchises with equally solid operating performance, less exposure to the currently weak U.S. consumer but big exposure to international growth opportunities, and beneficiaries of a weak U.S. Dollar. The problem is the asking prices for these businesses reflect a decent amount of optimism. For example, United

Technologies is being priced at about 21x my estimate of its 2007 *free cash flow, while Lowe's is being valued at about 16x next year's free cash flow.

*Free cash flow explanation: This is a metric I use to value businesses. It's equal to the cash your business produces each year, less the cash needed to be re-invested back into the business to maintain normal operations. For example, imagine you own 100% of United Technologies (you're net worth is around \$75 billion right now). If you took all your free cash flow in 2007 and paid it to yourself as one big dividend, your dividend yield would equal 4.6% at "21x free cash flow." In contrast, if you own Lowe's in 2007 at 16x free cash flow, you're dividend yield would be 6.25%.

In general, it appears to me investors have become too enthusiastic about businesses with solid near-term prospects, and too pessimistic on businesses undergoing cyclical downturns. The dilemma this produces is most of the business I find to be attractively valued, such as Lowe's and Home Depot, are in industries that will likely take all of 2008 to finish correcting (as a reminder, Home Depot and Lowe's began their cyclical downturns in the 3Q06 when same store sales turned negative – so by the end of 2007 it will have been one and a half years of declining same store sales...one more year of same store sales declines would be rather extreme but not entirely surprising, but would also lead to strong stock performance once a clear bottom for earnings is identified). In the process, earnings estimates for each business will likely come down, and the stock prices at least through the first half of 2008 will likely under-perform the broader market. The stock prices will begin turning north about six months before any strong fundamental sign of growth appears. I expect by 3Q08 we'll begin seeing some early signs of same store sales stabilization, and the stock prices will begin reflecting a more optimistic view for the businesses.

Our Portfolio Strategy

I'm being defensive with your money in light of my views of a fair to slightly over-valued market for business prices; and investment opportunities residing in sectors that require patience. This means our top position, Berkshire Hathaway, will continue to be the cornerstone of our portfolios. I've also been adding some cash reserves via selling businesses that I like, but feel we may be able to get at cheaper prices. In the short-term we may regret holding cash if the market rises, but I'm reluctant to pay the asking prices for a majority of businesses in this market. What's more, our big energy stock winners year-to-date continue to do well, but with energy businesses and direct investments in oil becoming more popular, these stocks feel like they could be particularly vulnerable to a global economic slowdown. For example, when Canadian Natural reached the high \$70's, we reduced our exposure in some accounts as it appears near-term upside is limited.

With a fully valued and fairly optimistic stock market, during Q3 I found select values in, of all places, the high-yield bond market. Some higher yielding bond prices took a hit in August when sub-prime mortgages began defaulting in droves; some of these are paying decent yields because they're associated with the U.S. housing industry. Below I've listed these bonds with some top-line comments.

- Echostar Communications, due October 2014, yielding 7.2%: Echostar is the satellite TV company that owns the "Dish Network." In the past I researched Echostar as a potential equity investment and decided to pass (I should have bought – one of the mistakes you don't see). We purchased the

bonds when they were yielding 7.2%. The bond's price has increased since we purchased, and if we were to buy now they'd yield about 6.0%. Echostar's liquidity seems manageable at current levels, but the bonds tend to trade at a discount due partially to the fact the company is on it's own in the battle for our living rooms, vs. tough triple-play (TV, internet, phone) competition from cable companies and the regional bell operating companies.

- KB Home, due December 2008, yielding 7.5%: I'm still not brave enough to invest in the common stocks of home builders, but the bonds of KB offer a decent alternative. We invested at a price that yields us about 7.5% until December 2008 – not a bad one year rate vs. a traditional money market fund or one-year U.S. government security yielding 4%...assuming KB doesn't declare bankruptcy. The business is in the thick of a housing depression, but KB's liquidity appears sound for one year. KB has very little debt due before December 2008, about \$600 million in cash on its balance sheet and an untapped, \$1.5 billion line of credit available if needed.
- HCA, due May 2012, yielding 10%. HCA is the largest for-profit operator of hospitals in the United States. It recently was taken private in a leveraged buyout transaction, burdening the business with a large debt load. Because of its massive debt load, HCA is the riskiest bond investment we've made, which its 10% yield reflects. The buyout owners are intelligent investors and have a lot more to lose than our minor bond investments in a bankruptcy event; plus the business has favorable demand characteristics via the aging population to fuel profitability.
- Mohawk Industries, due January 2016, yielding 6.2%. Mohawk is an exceptionally well-run flooring maker, operating in U.S. and Europe. The bond's 6.2% yield is 40% greater vs. a comparable 10 year U.S. Treasury bond yielding 4.4%. We purchased Mohawk's longer-dated bonds for conservative, income-seeking clients as an alternative to the paltry mid-four percent returns found in today's government and higher rated corporate bond market. Unlike the KB Home and HCA businesses listed above, Mohawk, in my opinion, is *far* from being a bankruptcy candidate. In fact, if Mohawk were to go bankrupt, most of us would probably be experiencing bright lights and some form of harp music.

Comment on Citigroup's SIV's & the Larger Financial Risk

Early this Q4 we invested a small amount in Citigroup, maybe on a Tuesday. That Friday evening Citigroup issued a press release detailing, in not very clear terms, its involvement with and exposure to tens of billions of dollars in off-balance sheet securities held in Structured Investment Vehicles, or "SIV's." We were out of Citigroup the next Monday morning (I set my alarm for this one). Thinking back to the "Risks" section of my 2Q07 letter, SIV's are another by-product of the securities Wall Street created in the credit bubble. What's especially nasty about them is you can't analyze a financial institution's exposure, because the financial institutions not only don't list them on the Balance Sheet, they don't even detail them in their 100+ page annual filings! Without going into too much detail, SIV's represent another accident waiting to happen in the credit markets, and the sizeable exposure – both financial and reputation – to Citigroup and some peers shows how a management's short-term, irresponsible thinking can lead to longer-term problems. The SIV example really illustrates why I try to invest our money alongside management teams that, if not large owners of the business, act like long-term owners in everything they do. Right now Citigroup and our federal government are trying to build a consortium to create a "super fund" that would attempt to head-off potential financial losses and restore trust in the credit markets. What's important is this displays more evidence of why longer-term interest rates are destined to move higher. As SIV and related credit instruments blow-up in

the coming years, the supply of credit could diminish, and / or the existing suppliers of credit will become more risk-averse – both actions that should raise rates long-dated loans.

In a rising rate environment, we want to be wary of over-exposing ourselves to utilities and real estate investments trusts (REITS), which have been some of the best performing investments since the Federal Reserve dropped interest rates to 1% this decade. We also want to take our wallets and run the other way from longer-dated US Treasury bonds. Ten year US Treasury notes yielding 4.4% could best be used for wallpaper if rates rise in response to the credit bubble imploding. Hopefully I'm more of an alarmist than a predictor of future rates. If longer-term rates rise, pushing mortgage rates to the 7.5% to 9% range, many investments could suffer, including Lowe's and Home Depot. I'm watching this carefully, and am currently researching ideas to hedge us against this potential scenario.

Comment on our new Investment – Smart Balance

Smart Balance (SMBL - \$12.34) is a tiny company (\$350 million market capitalization) which I view along the same lines as Buffalo Wild Wings – a relatively undiscovered “cult” growth company on the verge of taking its growth national. The company's primary asset is the Smart Balance brand of food products, including its flagship margarine, popcorn, cooking spray and peanut butter. The products are manufactured using a patented technology that avoids the use of hydrogenated oils, and are marketed as raising good and lowering bad cholesterol vs. the entrenched market share leaders (hydrogenated oils create trans fat...trans fats clog our arteries). The company achieved initial success among what I describe as a “cult following.” For two years in a row, Smart Balance margarine has been named the best-tasting margarine in national food judging competitions. In response, Smart Balance's U.S. share of the \$1.2 billion margarine market has climbed from 3.4% in 2002 to 11.4% in 2006. Also, similar to Buffalo Wild Wings, Smart Balance is on the cusp of introducing its first national advertising campaign. In fact, if you watch evening sitcoms, you might see one of the original Smart Balance commercials using the theme song “Put a Little Love in Your Heart.” The company went public in May 2007 at \$8 per share, so the share price is going to be volatile in response to quarterly earnings numbers as the market both “discovers” it, as well as figures out how much Smart Balance can earn over the next couple years. As an aside, I'm a microwave popcorn fan favoring movie theater-like butter taste (I've tried every major brand in search of my favorite). I recommend trying the Smart Balance movie butter microwave popcorn, it's my favorite.

Per my view of a fully valued market and fairly optimistic investor sentiment, I'm trying to find more ideas like our Buffalo Wild Wings and Smart Balance investments – relatively undiscovered, small growth companies, capable of flourishing in multiple economic environments.

Thank You!

I very much appreciate your trust, and the relationship we're building. Best wishes for the upcoming holiday season.

Thank you!

Sincerely,

Bryce Peterson

President - Washington Street Investments, LLC

Quote of the Quarter: "Certainly we like large shareholders who have Berkshire's investment philosophy around long-term assets."

– This under-statement of the quarter was brought to you by Burlington Northern Santa Fe CEO Matthew Rose, commenting on Warren Buffett's recent accumulation of a 17% ownership stake in the railroad.

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