



Spring 2006 Business Update

U.S. Stock Markets: 1Q06 Results

The S&P 500 Index and the Dow Jones Index each rose 3.7% during the first quarter of 2006, bringing both indexes to five-year highs. This marked the S&P 500's best January to March performance since the first quarter of 1999. In addition to the solid performances of the large capitalization indexes, the Russell 2000 Index, which measures the stock price performance of small capitalization businesses, rose an impressive 13.7%. Large capitalization stocks have under-performed their smaller peers for six consecutive years. Needless to say, we are finding better risk/reward opportunities in the large capitalization category today.

Comments on Our Performance

Washington Street Investments, LLC, had a good start to the New Year. Two of WSI's top positions, Sears Holdings (SHLD - \$131.83) and Michaels Stores (MIK - \$37.58), appreciated significantly during the quarter. This being the first time I've talked about either company, I have included a one-paragraph description of each below. I believe it's important for investment partners of WSI to understand what you own, and why you own it. I also believe it's imperative for money managers to talk openly about each quarter's positive and negative developments.

Sears Holdings increased 12.8% after reporting its fiscal fourth quarter results in March. Sears Holdings encompasses ownership of both the traditional Sears brand stores as well as K-Mart (yes, the BIG K). Most of you probably think of Sears and K-Mart as once formidable retailers currently in decline due to increased competition from Wal-Mart and Target, and you'd be correct. If our analysis stopped there, I'd be happy never to set foot in a Sears or K-Mart store again, let alone invest our hard-earned money in them (as current owners of Sears and K-Mart, I highly encourage you to shop there). However, what I believe most investors don't appreciate, or possibly don't realize, is Sears Holdings is 41% owned by one of our nation's most accomplished investors and someone who has been dubbed "the next Warren Buffett" - Eddie Lampert. I find this investment intriguing because of the strong analogy to how Warren Buffett created value out of Berkshire Hathaway. Students of investment history will recall Mr. Buffett's rise to national acclaim began when he invested in a textile company, Berkshire Hathaway, using the cash the company was producing to make investments in other businesses. While it may be unfair to directly compare the exact circumstances of Berkshire Hathaway at the point in time of Mr. Buffett's purchase to that of Sears Holdings today, they share three relevant characteristics I view as central to our investment thesis - each produced a tremendous amount of cash - each business was generally in decline or facing serious competitive threats - and, most important, each is run by a majority owner/manager given full discretion to use the business' cash to invest as he sees fit. As the Sears Holdings story unfolds, patience will be required as Mr. Lampert and his management team evaluate the competitive prospects of the combined company and allocate its cash accordingly. Our Sears Holdings investment no doubt entails risk, and I fully expect the stock price to be volatile as the market struggles to comprehend how to value it. Regardless, over time, I believe the true value of Sears Holdings will emerge as Mr. Lampert allocates the cash generated by Sears Holdings to attractive risk/reward investments.

Michaels Stores was our second big gainer during the quarter, increasing 12.9% upon announcing its "decision to explore strategic alternatives for enhancing shareholder value," which is fancy Wall Street code for saying "we think our shares are undervalued and we might sell the company." As the leading crafts and decoration retailer in the U.S. with solid growth prospects, I've been following Michaels for a few years.

With the shares drifting from the low \$40's to the low \$30's over the last nine months, I became increasingly interested in the company. We initially invested in Michael's at an average cost of about \$33 per share on the premise the market was not appreciating the incredible cash flow and cash-rich balance sheet of this leading niche retailer. Despite the stock's recent appreciation, we continue to hold the shares as of this writing. With initial rumblings of a potential sales price in the \$39 to \$42 range, I'm indifferent on whether a sale materializes given our estimate of the company's intrinsic value. Should a sale occur, we will use the proceeds to search for another attractive risk/reward opportunity. However, should a sale not occur, I believe Michael's management would elect to use its cash and balance sheet to buyback a significant amount of its stock. While a decision not to sell the company would likely result in a short-term drop in the shares, this latter alternative could prove beneficial to us in the long-term. Finally, for the male readers of the letter who are currently sleeping on the couch, I strongly encourage you to pick up a Michaels gift certificate for your significant other. It's a great way to support your investment portfolio, and maybe a ticket to a better nights sleep.

Just to assure you that I'm not sidestepping the issue, during the quarter we didn't have any significant losers across our equity portfolios. As any savvy investor knows, in the short-term the stock market will inevitably show its irrational behavior by dragging down the prices of otherwise solid businesses on the basis of fear, misunderstanding or emotion. Also, portfolio managers rarely time their buys at the exact bottom, and rarely time their sells at the precise top. If you desire a concrete example, look no further than Warren Buffett's 2005 Annual Report to shareholders. Upon taking a roughly \$2.0 billion stake in Anheuser-Busch (BUD), his position in the company has declined in value by about 10%. We probably won't know for at least a couple years whether his investment in BUD was a good one. In addition to short-term price fluctuations, in the long-term not all investment decisions by portfolio managers turn out well (we make mistakes). In the future WSI will undoubtedly have stocks that decline due to short-term, market-driven reasons, or longer-term, fundamental reasons. When we do, I'll write as candidly about those situations as I have about Sears Holdings and Michaels Stores.

Market Outlook – Opportunities

As we search for undervalued businesses, we're finding an increasing number of compelling risk/reward investment opportunities among the universe of large capitalization stocks. Contrary to historical times when large, dominant companies have been fully valued, I believe they tend to be under-valued as a group today. To appreciate what I believe is offering us these attractive opportunities, we need to step back six years to the stock market bubble of 1999/2000. For example, in August of 2000, Citigroup (C) traded at about \$47.50 per share for a Price-to-Earnings (PE) multiple of 20x earnings, and paid a dividend yielding 1.2% annually. Since then Citigroup's earnings and dividend have increased roughly 70% and 350%, respectively, yet today the shares trade on-par with levels five and a half years ago. Hindsight suggests in August of 2000 Citigroup shares were over-valued due to unrealistic earnings growth expectations. Conversely, I believe the opposite is true today. Citigroup's shares appear under-valued at 11.5x earnings and yielding 4.1%, offering us the opportunity to own one of the best global financial services businesses at a reasonable price. The result of six-plus years of large cap under-performance vs. their smaller cap peers is offering value-conscious investors opportunities to own some of best global businesses at compelling prices.

Market Outlook – Risks

What concerns me the most is potential ramifications of the high prices of commodities and raw materials including oil, natural gas, and steel. Profit margins of businesses are being squeezed by increased costs of such inputs. For example, in 2005 Budweiser's gross margins declined over 3.0% due to rising energy and aluminum costs. Capital-intensive businesses such as utilities and capital goods companies often feel the most pain during times of rising materials costs. Tyco (TYC), a diversified capital goods and medical supplies company recently reported lower profit margins in all four of its primary businesses due in-part to rising commodity costs. If companies cannot offset rising costs by simultaneously raising prices, profit margins, earnings and stock prices could suffer. Other companies such as Nike (NKE) and Kellogg (K) are doing exceptional jobs at maintaining profitability by controlling costs in other areas of their businesses, often referred to as "Selling, General, & Administrative expenses." Unfortunately, there's only so much cost cutting

businesses can realistically do without impairing future prospects. As an investor of your hard-earned money, I'm looking for non-capital intensive businesses with sustainable competitive advantages, and the ability to combat higher costs by raising prices, or capturing greater market share.

How We Invest – Brief Overview

We are patient, long-term, value investors. Our goal is to build portfolios capable of outperforming the S&P 500 Index in a three to five year time horizon. Because we view investing not as buying a piece of paper, or a "stock," but as owning a business, central to our investment philosophy is a belief we must know the businesses we're invested in better than the market. This requires a substantial amount of research. The body of knowledge it produces pays off during the inevitable swings of market pessimism or excitement. During such times, this intensive investment in research prepares us to make buy and sell decisions based on facts and value, rather than emotion.

As your investment manager, I think it is important to make clear Washington Street Investments' definition of "long-term." Something that bothers me in today's investment community is the vague reference to "long-term" when describing an investment time horizon. Often times, I believe investment institutions use this phrase to sound intelligent, rational, or even-tempered in nature. Unfortunately for their clients, I think "long-term" at times is code for "complacent," and is used to deflect attention from a multi-year streak of poor performance. As purely measured by time, Washington Street Investments analyzes businesses and projects expectations using a three to five year time horizon. Ideally, we desire to hold an ownership position in a business forever. However, we recognize businesses and industry fundamentals change, sometimes to the point an initial investment thesis is no longer applicable. We also recognize we will make mistakes in judgment. Whichever be the case, we strive to deliver outstanding investment performance by knowing businesses better than the market, which sometimes means exiting an investment earlier than initially expected. On the contrary, WSI holds positions in excess of five years when fundamentals prove better than expected, or we estimate the shares to be under-valued.

The foundation of our investment discipline is valuing a business. This provides us a frame of reference for making buy and sell decisions. As a rule, we only invest in a business when the market is pricing it at a 30% or greater discount to our estimate of intrinsic value. We think of our 30% rule as supplying a "margin of safety." We are not drawn in by the hot new sector, by price momentum, or other sorts of marketing-driven ideas. Our decision making approach may sound impractical or too rigid. However, our discipline is designed to protect us from over-paying for a business, helps focus attention on new investment ideas, and guides us on when to sell. Warren Buffett is famous for saying, "the #1 rule in investing is not to lose your principle. Rule #2 is never violate the first rule." WSI strives to accomplish this for you by practicing our value-based investment discipline, and through knowing the businesses we're invested in better than the market.

A Comment On Modern Portfolio Management

Data suggests the majority of professional money managers do not out-perform their benchmarks over long-term time horizons. I believe in order to consistently out-perform the indexes an investor must independently analyze businesses and have the courage to draw independent conclusions not influenced by the conventional thinking. Furthermore, going against the conventional wisdom for the sake of seeking publicity or attempting to "look smart" can lead to poor decisions (sometimes the conventional thinking is right). The best weapon an investor has when out-performing the markets is his or her own independent thinking. For instance, the market is fairly negative on Sears Holdings due to its declining same-store-sales and competitive position. I analyze the company and see not so much a pure retailer, but a cash-generating asset that also happens to own a fair amount of real estate, run by one the best money managers in our country. We also own Citigroup. The market is pessimistic on Citigroup's prospects – it's either too big to grow, too unfocused to grow, or too large an organization to be effectively managed. I agree in part, but I'm not as negative on its growth prospects as is currently being priced into its shares. I see a company with a fairly mature presence in the U.S. market, but with a substantial opportunity to grow earnings overseas.

Did you know Citigroup produces over 40% of its profits outside the U.S., and has almost as many retail banking branches overseas as in the U.S.? If I'm wrong and Citigroup really is a slow-to-no growth company, its 4% dividend yield provides us some cushion. Put another way, if you're a conservative investor with a goal of generating moderate growth and income, would you rather have an ownership stake in Citigroup, a superior financial services business yielding 4% taxed at a 15% rate, or a bank CD yielding 5% taxed at ordinary rates?

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.

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: "Getting fired at Morgan Stanley was good work during 2005, if you could get it." CNBC commenting on the million dollar severance packages given to "fired" Morgan Stanley executives.

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