Washington Street Investments

U.S. Stock Markets: 1Q07

The U.S stock indices were volatile in Q1, but you wouldn't know it looking at the final numbers. For the quarter the S&P 500 Index rose 0.2%, while the Dow Jones Industrial Average lost 0.9%. Despite the appearance of low volatility, the indexes were far from stable. Both indexes reached their highs on February 20th, with the S&P 500 up 2.9% and the Dow Jones up 2.6%. The mood was marked by an aura of optimism as the market appeared on its way to a fifth straight year of gains led by a stabilizing housing market, solid economic growth and an acceptable amount of inflation. The bulls called it the "goldilocks economy" – not too hot…not too cold…just right. Then, in a matter of a couple weeks sentiment turned sour. Reports of major troubles in the sub-prime mortgage market (home loans to people who aren't as likely as others to pay you back), former Federal Reserve Chairman Alan Greenspan's remarks addressing a crowd in Asia that the U.S. could face a recession, talk that the Chinese government desires to slow down the rapid growth of its economy, and an assignation attempt on Vice President Cheney while traveling in the Mid East all occurred on the same day and got investors nervous. Fears of a housing / consumer spending-led recession drove the markets to their lows on March 5th, with the S&P 500 down 3.1% and the Dow Jones down 3.3%. Overall, the markets ended on a calm note, barely budging from their levels at the beginning of the year.

Comments on Our Performance

A mutual fund manager once said, "sometimes our clients would be better off if we just took the day off and played golf." That line would basically describe our Q1 when it comes to the securities we sold. Unfortunately when I play golf I take about 100 shots vs. par of 72…so I prefer to work. Within our portfolios we had multiple winners that produced above-market returns. ***Buffalo Wild Wings (+19%), Dow Chemical (+15%), Coventry Healthcare (+12%), Advance Auto Parts (+8%) and Sears Holdings (+7%)*** were our most common winners across all portfolios. But overall, our two losers (discussed two sections down), ***CompuCredit (-21%) and Barnes & Noble (flat for the quarter, but I sold at about a 10% loss)***, hurt our performance as we generally performed in-line with the market averages. Both stocks hurt us because I timed their sells poorly. In other words, if I'd just left them in our portfolios (played golf) and let our winners work for us, our quarter would have been good. Instead, we did fine, but my sell errors masked what would have been a good start to 2007.

As a reminder to new clients, each letter I discuss two or three companies in the quarterly winners and losers sections that I think garner the most attention. For example, Coventry Healthcare (winner) and CompuCredit (loser) constituted fairly small positions in most accounts (1% to 5% of total assets) depending on account size. Keep in mind that your portfolios are sufficiently diversified so that movement in any one holding will normally have minimal impact on overall performance.

Comments on Our Performance - Winners

Buffalo Wild Wings (BWLD - $63.20) was our most exciting stock during the quarter, appreciating 19% from $53.70. I describe the stock as "our most exciting" because a couple weeks before it released 4Q06 earnings, the share price fell from $58 to $48 on numerous analyst downgrades (concerns about the cost of chicken wing prices hitting profit margins). In fact, one day before it released earnings, an analyst from brokerage firm Piper Jaffray downgraded it from "BUY" to "HOLD." The next day the stock was up 10% in reaction to its terrific 4Q06 earnings report and a robust 2007 outlook. The following day it was up another 6%. I feel bad for the analyst and the clients that sold based on his / her report! Here's the story on the company:

Buffalo Wild Wings is a 435-chain sports-themed restaurant founded near the campus of Ohio State in 1982. By 1992 only nine restaurants existed. However, in 1999 management decided to take the concept to the next level. Using proceeds from private investors, the restaurant grew from nine locations to 245 locations prior to its November, 2003 initial public offering (IPO). Today, Buffalo Wild Wings has restaurants in 37 states, with 81 of its 435 restaurants in Ohio. What I find really interesting about the restaurants is they appeal to sports fans, but they also generate consistent traffic from families with small children (I fit both camps). From what I've heard from employees and patrons in numerous states, Buffalo Wild Wings is taking business from its only real comparable, nationwide competitor – Hooters. Specifically, the popularity of its wings (17 different sauces to choose from, I recommend the Asian Zing, Honey BBQ & Parmesan Garlic) and its classy atmosphere generate loyal, repeat business. Just to share a personal story regarding the restaurants cult-like following, two of my bothers-in-law play hockey and they'll regularly go on-line to find the nearest Buffalo Wild Wings when traveling for away games.

My vision for Buffalo Wild Wings sees it doubling the number of restaurants. For example, it has only two restaurants on the West Coast, and is highly concentrated in the Mid-West with 81 of its 435 restaurants in Ohio. In the east, New York has seven, Pennsylvania has four and Massachusetts has zero. If Buffalo Wild Wings can run 81 establishments in Ohio, I don't think it's a stretch to assume it can have a good deal of success in the states mentioned above. Given its steady growth prospects and strong balance sheet ($64 million cash & no debt), I view Buffalo Wild Wings as a classic growth company capable of doubling in value assuming it grows intelligently.

Advance Auto Parts (AAP - $38.55) carried over its strong performance from the back half of 2006, appreciating 8.5% during Q1. With 3,100 stores in North America, Advance Auto is the second largest retailer of auto parts in the U.S. behind ***AutoZone (AZO - $128.14)*** supplying both the do-it-yourself customer as well as the commercial auto garages. Its stock fell from $42 to $29 in early 2006 after forecasting 2006 earnings below expectations. The main issue with the company is its management's apparent weakness at controlling costs, boosting profit margins, and using its shareholders' capital. For instance, Advance Auto's net profit margin runs about 5%, vs. AutoZone's 10%. The good news is early in Q1 Advance Auto reported 4Q06 numbers displaying signs of cost control and revenue stabilization. Importantly, on the earnings conference call management outlined plans to slow spending and implement a company-wide cost reduction plan with the goal of producing greater profit margins and shareholder returns. When a previously pagan management team "gets religion," it can have a profound affect on its stock price. In Advance Auto's case, I think the stock can reach the mid-$40's by year end if management shows signs of improvement. Finally, if management fails to increase margins, I believe it's likely a large financial investor will buyout the company and do it on their own. Advance Auto has the infrastructure and brand name solidified to perform well. To work as an investment it needs the behind-the-scenes fiscal discipline that AutoZone has. After all, paraphrasing AutoZone's CEO Bill Rhodes on its 4Q06 earnings conference call, "what we do is not rocket science."

Dow Chemical (DOW - $45.86) appreciated 15% during the quarter on persistent rumors that it would be acquired. We began buying shares in the high $30's to low $40's range in early 2007. After such a rapid price appreciation, I made the decision to sell even though we only held the stock for a couple months. Dow Chemical is a tough company to handicap. Its profits are about evenly split – 50% of its earnings come from selling performance chemicals and 50% from basic chemicals. Performance chemicals earn greater profit margins and are less susceptible to economic conditions, thus providing steady profits through economic cycles. On the other hand, Dow's basic chemicals business is very cyclical. When the economy is good – like it's been for the last four-plus years, it's very profitable. But when the U.S. economy is bad…the basic chemicals business is marginally profitable, and Dow's total earnings decline dramatically. The worry today is our economy has been so solid for so long, that new investors are getting in at peak profitability. For example, the company earned $4.25 per share (EPS) in 2006. When you look at analyst's EPS estimates for 2007 and 2008, the consensus calls for Dow to earn $3.96 and $3.45, respectively (so profits are expected to decline as the economy shifts from good growth to slow growth). When we initially bought Dow Chemical there was some pessimism priced into the stock that I thought offered us a favorable risk / reward. However, when the shares appreciated so fast, I thought it best not to play Russian roulette with our gain. We own plenty of businesses that will do well if the U.S. economy does well over the next year or two.

Comments on Our Performance - Losers

Barnes & Noble (BKS - $39.45) was my biggest disappointment in Q1. On March 5th Barnes & Noble issued a press release stating it expected to earn in the range of $1.65 to $1.80 per-share (EPS) in 2007, vs. the consensus analyst forecast of about $2.40. Specifically, the company stated its new Costco-like membership rewards program was estimated to shrink gross profits between $90 million to $100 million in 2007, vs. the company's previous guidance of $30 million. This is a significant deviation calling into question management's ability to control profitability, especially considering its initial $30 million estimate was only established a couple months earlier. Also, I was also somewhat disturbed by the announcement because I had talked to management (more than once) without sensing any softness in its initial projections. In consequence, my estimate of Barnes & Nobles' value declined to the point where I saw better near-term investment opportunities, therefore making the decision to sell our shares for a loss of about 10%. The irony of this is that I previously viewed Barnes & Noble as a prime candidate to be bought-out by management (please revisit our Winter 2006 letter for a refresher), attaching a $50 price tag. Barnes & Noble today is a more-likely buy-out candidate vs. three months ago, now that management has effectively lowered earnings expectations for 2007…but at a cheaper price. In the end our BKS investment ended in a loss of about 10%, which is something I'm not pleased about.

Sub-prime credit card issuer ***CompuCredit (CCRT - $31.22)*** dropped 21% during the quarter on worries the sub-prime mortgage market meltdown will spillover to sub-prime credit card lenders. In fact, most financial institutions, regardless of business mix, dropped in early March (please see the "Market Outlook – Risks" section for more information). Overall, our loss on CompuCredit was squarely my fault. Here's what happened:

At the height of the housing market mania, mortgage originators and brokers were offering loans to sub-prime borrowers – some for primary residences, others for "investment" purposes. Often these loans required no money down, or carried "loan-to-value" ratios of 90% or more. Obviously, when you have little to zero assets (as is the case with most sub-prime borrowers) the "risk" you're taking by putting zero of your money down in order to flip a property a couple months later for a potential $10,000-plus gain is enticing. During Q1 the vintage of loans made to sub-prime borrowers at the peak of housing prices came back to haunt the lenders, and caused the stock prices of all financial institutions to fall on worries that the sub-prime mortgage contagion would spread to "prime" mortgages, and to sub-prime and prime credit cards. CompuCredit, as a sub-prime credit card and auto loan originator, saw its stock price decline in sympathy with the pure sub-prime mortgage lenders. Despite performing extensive research on the company prior to our investment, I did precisely what I try to avoid – excessively worry and panic – and sold our business interests during the height of the market fears. Instead of acting like a rational business owner, I acted like a short-term stock trader. The next time around I'll strive to remember the stock market exists to serve us, not guide us on business valuation. The silver lining is during the market fall, we used our CompuCredit proceeds to invest in fallen bank stocks, some with dividend yields of 4.5%. When managing a portfolio of businesses you'll inevitably have individual stocks that go down during a given quarter. My goal in future events is to practice what I preach – i.e. find value in what others are selling in difficult times, and selectively sell businesses in our portfolios if they become fully valued.

Market Outlook – Opportunities

<u>Value in Housing & Construction-related Businesses</u>

"We simply try to be fearful when others are greedy, and greedy only when others are fearful."
- Warren Buffett on his investing success

Often times you'll hear people talk about the economy and use the word "recession," to describe a bad economic period. As a reminder, an economy is officially in recession when it experiences two consecutive quarters of negative growth. For example, the last recession in the U.S. started in March 2001, and ended roughly in December 2001. If we could time our investments perfectly we'd have our money in cash today…wait for the next recession and the impending stock market sell-off, invest 100% of our assets in businesses at bargain prices, and meet each other on a sandy beach with margaritas in-hand. That sounds easy, but the problem with market timing a recession is it's literally impossible to do. In fact, every year the media parades out a host of "experts" predicting the U.S. is about to go into recession (one of these years they'll be right!).

Today it's probably safe to say the U.S. housing market is in recession. For example, if ***Home Depot (HD - $36.74)*** and ***Lowe's (LOW - $31.49)*** were considered economies, they'd have been in recession since the beginning of the 3Q06. Here's a look at both Home Depot's and Lowe's same-store-sales numbers for the past decade ("Same-store-sales" is a statistic used to assess the business performance of a retailer. It measures revenue at stores open at least one year on a year-over-year basis...so, a same-store-sales percentage for the 4Q06 of -6.6% means if a store sold $100 worth of goods in the 4Q05, it sold $93.40 of goods in the 4Q06):

Dates	HD	LOW
FY97	**7.0%**	**3.8%**
FY98	**7.0%**	**5.9%**
FY99	**10.0%**	**6.2%**
FY00	**4.0%**	**1.2%**
FY01	**0.0%**	**2.4%**
FY02	**0.0%**	**5.6%**
FY03	**3.8%**	**6.7%**
FY04	**5.4%**	**6.6%**
1Q05	**2.1%**	**3.8%**
2Q05	**3.4%**	**6.5%**
3Q05	**2.7%**	**6.2%**
4Q05	**4.5%**	**7.8%**
FY05	**3.8%**	**6.1%**
1Q06	**3.5%**	**5.7%**
2Q06	**-0.2%**	**3.3%**
3Q06	**-5.1%**	**-4.0%**
4Q06	**-6.6%**	**-5.3%**
FY06	**-2.8%**	0.0%

The reason I think this is important is investing is best done in times when people aren't optimistic, because negative sentiment leads to depressed stock prices. The stock market is like a daily auction where business owners offer to sell their business interests at prices reflecting both their rationale and irrational outlooks. When times are good and the future is exciting, the price for a particular business is high – sometimes appropriately high. Conversely, when times are bad and the future is depressing or uncertain (Home Depot and Lowe's today) business owners show-up at the auction to sell their businesses at not always rational prices. When investing during bad times, the key is to correctly distinguish between a business that's temporarily going through a downturn vs. a business that's in secular decline. My thought on both Home Depot and Lowe's is they're excellent businesses with favorable long-term earnings growth outlooks that have been in cyclical downturns since the 3Q06, and will remain so during the first three quarters of 2007. However, I think both will return to positive same-store-sales and earnings growth, hopefully by early 2008, and when the first sign of this occurs their stock prices will sharply appreciate. Conversely, an example of a business that I believe to be in secular decline is the newspaper business. Newspaper circulations are diminishing nationwide, and newspaper owners have failed to replace lost earnings with on-line advertising revenue and subscriptions. Trying to pick an absolute bottom for a business that's in secular decline can lose you a lot of money, because, if you don't pick the bottom correctly the downside can be limitless. Whereas when investing in a business experiencing a cyclical decline, timing your investment at the precise bottom is a bonus, but unnecessary, because the bad days will inevitably end and growth will return. Lowe's and Home Depot are going to have difficult 2007's – everyone knows this – and the stock prices will likely under-perform the market averages this next quarter. However, there's a tremendous amount of value in their stocks at these levels, and I expect over the long-term we'll be talking about happier days.

The Energy Sector

As you may recall from my prior letters, investing in the "hot" sector is not an idea I'm entirely comfortable with. However, despite energy stocks' impressive price escalations from 2003 through 2005, there are select energy businesses I find appealing. For example, during the quarter we increased our position in ***Canadian Natural Resources (CNQ - $55.19)***. Canadian Natural Resources is an oil and natural gas exploration & production (E&P) company with significant oil production growth slated to come on-line between 2008 and 2012, as its $6 billion initial investment in the Canadian oil sands begins to pay off. With global oil demand increasing at a quicker rate than global oil supply, the oil price equation suggests the days of cheap oil are over (oil averaged about $15 per barrel in 2001 vs. today's $50 to $70 price range). As tensions in the Middle East escalate, ownership of massive oil reserves in politically stable countries will be a prime asset. Also, it doesn't hurt that CNQ's oil properties are located next to the world's #1 consumer of oil – the United States. In fact, as I write this letter CNQ's stock price has climbed from a low of $45 in Q1 to a high of $58 in reaction to the Iran / British solider incident, and the price of oil from has climbed from $59 to $66 per barrel. Regardless of the current political situation, the fundamentals behind CNQ's future oil production growth are compelling. Currently CNQ produces about 500,000 barrels of oil per day, with a goal of producing one million barrels per day within eight years. Importantly, its production growth is 100% organic growth and not reliant on expensive acquisitions. At some point in the oil cycle, CNQ's common shares will either appreciate as its oil production and cash flow increase, or a major global oil company seeking to secure long-term oil production growth in a stable region will attempt to buy the company. Finally, please recognize that Canadian Natural Resources' stock price will trade with the price of oil in the short-term. Your guess is as good as mine on where the price of oil will be during the next three months. Middle East tensions could worsen and oil could shoot to $75 per barrel, or the U.S. economy could go into recession and the price of oil could fall to $45 per barrel. What's important is the fundamental long-term supply / demand picture of oil is intact, and Canadian Natural Resources is in my opinion one of the premier energy growth companies in the world, operating in a politically safe region.

Market Outlook – Risks

Housing & the Sub-prime Mortgage Risk

There are two primary risks that I'm focused on today. The first is a repeat from, what it seems has been just about every letter I've written: I view a potential slowdown in U.S. consumer spending driven by the impact of a declining housing market as a primary risk to our portfolio values. I don't want to repeat what I've written in my last two letters. What I'll add is a summary on the troubles that appeared in the sub-prime mortgage market during the Q1 and a few top-line conclusions.

The rapid price appreciation in U.S. residential real estate drew its share of speculators, as well as loose lenders eager to earn lending-related fees today, without worry about what would happen if the loans they wrote went bad tomorrow. At the height of the mania, we had people looking to make a quick buck by buying a home property and selling it a few months later to pocket a return. This strategy worked for a number of months, and because it worked, the easy money-making scheme attracted people who had no idea what they were doing, or worse, people with no money to even put down to buy a home (sub-prime borrowers) to get into the game. For example, in 2003 sub-prime borrowers accounted for about 9% of the homes sold in the U.S. In 2006 it's estimated that 24% of homes sold in the U.S. were to sub-prime borrowers (speculators late to the party). In fact, the U.S. housing bubble / speculative buying situation reminds me of my high school days – the better the party, the worse the hangover. In consequence, most lending-related financial institutions saw their stock prices decline in Q1 regardless of exposure to sub-prime lending. The pure sub-prime mortgage lenders got hit the hardest, culminating with New Century Financial declaring bankruptcy. Notable financial institutions hit were ***Countrywide Financial (CFC, -21%), Washington Mutual (WM, -10%), Citigroup (C, -7%), Wells Fargo (WFC, -6%), Fifth Third Bancorp (FITB, -6%)*** and ***Capital One (COF, -2%).*** Given this big-picture summary, here are a few opinions and actions we've executed, or are contemplating taking in regards to your investments:

- We bought small positions in a few regional banks, ***U.S. Bancorp (USB - $34.97)*** and ***Fifth Third Bancorp (FITB - $38.69)***. Both businesses pay dividends yielding over 4.25%, and have core operations in the Midwestern states.
- The big money-center and regional banks are too diversified to be significantly affected by what appears to be a problem isolated to a select group of loose lenders and borrowers. We continue to own small positions in ***J.P. Morgan (JPM - $48.04)*** and ***Citigroup (C - $51.34).***
- Housing-related businesses such as Home Depot and Lowe's could be affected via a lack of sales in select regions where sub-prime borrowers and speculative buying was the most prevalent, such as Southern California and parts of Florida. Regardless, the short-term affect shouldn't dissuade us from the inherent value and favorable long-term picture of both businesses.

<u>Geopolitical Risk</u>

Global political risk is another concern that we should not under-estimate. There continues to be terrorist groups and militant countries that target the U.S. as an enemy to be destroyed. In addition, there is growing divisiveness among Western countries caused by differences on how to respond to security threats and complicated by competing economic interests (for example, Russia sells military equipment and nuclear technology to Iran). Clearly, events and developments stemming from these situations could have a significant impact on our investments in common stocks – mostly negative, although some of our investments would potentially benefit.

The question for investors is: What should we be doing, if anything, to appropriately factor in the above political and economic risks? Do we allocate a portion of our portfolios to cash-equivalent investments such as short-term U.S. Treasury bills or money market funds? If we were living in the 1980's and grew concerned over the Russian nuclear threat, such a portfolio strategy would have produced dismal returns. I think the answer is to not stray from our basic investment principles – manage a portfolio of good businesses; buy them at prices offering a significant margin of safety; and selectively sell our businesses when they appreciate to fair value. For example, our #1 investment, ***Berkshire Hathaway (BRK-B, $3,640),*** is an ideal holding for such an environment. Berkshire provides all the attributes a conservative, long-term investor desires at this moment. On the offensive side, it's priced at an attractive discount to my estimate of value ($4,600 to $5,000), providing stock price appreciation potential in a rising market. Defensively, its businesses are diverse (GEICO, reinsurance, building materials, utilities, etc), and its balance sheet is arguably one of the strongest in corporate America with $63.5 billion in net cash & investments (it actually has more than $63.5 billion – the "net" $63.5 billion is after subtracting both its debt and its estimate of what it owes its insurance customers in the future). Should the U.S. stock market tumble, Berkshire's financial strength will allow it to buy businesses (in whole or in-part via common stocks) at rewarding prices.

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 I appreciate that. Please email me at bryce.peterson@washingtonstreetinvestments.com with questions or comments on your portfolio holdings, suggestions, or improvements you'd like to see.

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: "I don't want to be too sophisticated, but 2007 is going to suck. All twelve months."
– Donald Tomnitz, CEO of homebuilder D.R. Horton

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