U.S. Stock Markets: 2Q06 Results

Last quarter I commented on finding better risk/reward investments in the universe of the largest capitalization stocks, and in the 2Q06 the prognosis showed early signs of life. During the quarter the Russell 2000 Index, which measures the stock price performance of small capitalization businesses, fell 5.0%. Larger capitalization stocks fared better, with the S&P 500 Index declining 1.44% and the Dow Jones Index inching out a 0.9% gain. As a reminder, 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. A discussion of this is included in the "Market Outlook – Opportunities" section below.

Comments on Our Performance

All of our accounts out-performed the benchmark S&P 500 Index during the quarter after fees. That's the good news. Even though I place little emphasis on short-term stock market price movements, it's better to win the quarterly battles than lose them. The bad news is the markets in general were down during the quarter, so our relative out-performance doesn't translate into a new car or early retirement. This is where our goal of long-term investment performance comes in! The stock market in the short-term is often driven by emotions – greed on the upside and fear on the downside – but in the long-term the market tends to get valuations correct. The 2Q06 was volatile, with our portfolios exhibiting both winners and losers. Winners included two familiar names to WSI investors, ***Sears Holdings*** (SHLD - $155.30) and ***Michael's Stores*** (MIK - $41.24), as well as our positions in banking stocks such as ***Citigroup*** (C - $48.25). Losers included ***Home Depot*** (HD - $35.79) and ***American International Group*** (AIG - $59.05). Because I believe it's important for investment partners of Washington Street Investments to know what you own and my evaluation of our business' prospects, I've included my thinking on each below.

Comments on Our Performance - Winners

Sears Holdings continued its strong performance, appreciating 18%. The catalyst for the big gain was an exceptionally strong 1Q where earnings almost doubled the analyst consensus expectation. How many times have you heard of a mature retail business exceeding analysts' earnings-per-share (EPS) estimates by double? Not often! Under new management, improvements at Sears have come much quicker than I anticipated. In short, prior management was overusing loss leaders and measuring its success on the organization's "sales growth." The new majority owner, Eddie Lampert, places an emphasis on profitable sales and cost control, resulting in a reduction of total revenue but a dramatic increase in profits. 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. However, 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.

I'm happy to report that in late June ***Michaels Stores*** accepted an offer of $44 per share to be taken private. When we initially invested in Michaels at $33 per share I valued the business in the mid-$40's, so I think we're being paid a fair price for our ownership. The deal is estimated to be completed by the end of this year, upon which we'll receive and hopefully reinvest our proceeds in an equally rewarding opportunity.

Finally, another steady performer for us last quarter was ***Citigroup*** (C - $48.25), generating a total return of over 4% in an otherwise down market. While I generally don't comment on small gains or losses, Citigroup is a sizeable position for us, making its gains vs. a down market material to performance. There's a lot of apathy or indifference priced into Citigroup's stock. At its current price I estimate Citigroup is being priced to virtually never grow earnings again, which I view as a low-probability event. In my last letter I outlined some of the reasons I believe the company to be a good risk/reward investment opportunity.   In the coming quarters the U.S. Federal Reserve will likely end its interest rate hikes (positive for Citigroup) and consumer credit quality will likely weaken (negative). If Citigroup can withstand the inevitable decline in consumer credit quality, the stock should overcome the pessimism being priced into it and move higher. I continue to see upside north of $60 per share, with downside in the low $40's. Citigroup is not a stock that's going to double or triple in one year, but I like the risk/reward being priced into the shares along with the 4% dividend yield.

Comments on Our Performance - Losers

In the short-term the stock market inevitably shows its irrational behavior by dragging down the prices of otherwise solid businesses on the basis of either fear or uncertainty. During the 2Q06 WSI had the honorable distinction of owning the Dow Jones' worst performing stock, ***Home Depot***. Home Depot's stock price fell 15% over the course of the quarter on fears of a consumer spending slowdown and the uncertainty of how a housing market correction will impact the business. What's interesting to me is I agree with the primary concerns Home Depot "Bears" site when making the case against owning the stock. Specifically, I believe consumer spending in the U.S. will slow; and I believe the deceleration of new home construction and housing turnover will clip Home Depot's earnings growth in the short-term. However, what I do not agree with is the stock market value being applied to the business. When we started buying Home Depot shares in the low $40's, I saw upside in the high $50's per share and downside in the low-to-mid $30's. Today at $35.79 per share, the stock trades at very cheap price-to-earnings (PE) multiples of 13x last year's earnings and only 11.6x estimated earnings for the current year. To put the fear and uncertainty priced into Home Depot into perspective, the 29 other businesses compromising the Dow Jones Index trade at an average of 15x current year's earnings estimates, about a 30% premium to Home Depot. Furthermore, since its fiscal year end of 1999, Home Depot has roughly grown revenue 270% and earnings 400%. Yet today, Home Depot shares trade at the same level they did in May 1999 – *that's seven years of zero stock price appreciation.* Hindsight suggests in 1999 Home Depot's stock was overvalued trading at a PE of 50x. Likewise, I believe seven years from now we'll look back on today's stock price as having been under-valued. Despite a tough near-term outlook for the company, the current stock price is offering us a rare opportunity to buy an above-average business with favorable long-term earnings growth prospects at a reasonable price. It's possible I'm incorrect in my analysis, but I like the risk/reward tradeoff as a long-term owner of the company at today's prices.

Given the media attention paid to the dynamic growth of the emerging market economies such as China and India, a question I'm often asked is, "do you invest in foreign companies?" We do, but I prefer to invest overseas by finding solid domestic businesses with substantial international earnings growth. One such company is ***American International Group*** (AIG). For those of you not familiar with the company, AIG is the largest publicly traded insurance company in the United States, with primary operations in the commercial property and casualty market as well as in individual life insurance, annuities, and asset management. Shares of AIG declined about 10% during the quarter, primarily on growth concerns of its Foreign Life & Retirement Services operations and negative publicity from its ongoing legal battle with its former CEO, Hank Greenberg. Our attraction to AIG resides in the long-term growth prospects of its Foreign Life & Retirement Services business, which currently accounts for about 30% of its annual profits. AIG is the top foreign insurer in the Asian markets. I expect demand for basic insurance products to mushroom as middle class populations expand in emerging Asian economies. Consequently, AIG's multi-decade presence in countries such as China should be a catalyst for continued earnings growth. When AIG reports earnings in the coming weeks, I will be paying close attention to this segment's performance and outlook.

Market Outlook – Opportunities

Year-end 2005 marked the sixth straight year the stock prices of small capitalization business outperformed their large-cap peers. That trend continued through the first quarter of this year with the Russell 2000 Index posting a 13.4% return vs. the S&P 500's 3.7% appreciation. However, during the just ended 2Q06 that trend reversed, and I believe a new trend marking large cap out-performance is likely to take hold. Today, the valuations of large company, dominant businesses are at modest levels. Furthermore, the balance sheets of these businesses are the strongest I've studied in years. For example,

- Costco trades at $57 and has $6 per share in net cash on its balance sheet
- Dell trades at $24 and has $4.50 per share in net cash
- Exxon trades at $62 and has $4.50 per share in net cash
- Motorola trades at $20 and has $4.00 per share in net cash
- Nike trades at $80 and has $6 per share in net cash

Strong balance sheets combined with solid competitive positions affords businesses maximum flexibility to create value for shareholders, including increasing cash dividends, buying back stock, investing in organic growth opportunities, or making acquisitions. Importantly, a strong balance sheet helps stabilize a company during the inevitable economic slowdowns. For the Apple/I-Pod fans, there was once a time when Apple's shares traded at $20, and the company had net cash of $20 on its balance sheet, meaning the core business was being valued at nothing! It's amazing how quickly fortunes change in the technology world.

Currently, our portfolios are constructed with an emphasis on larger capitalization businesses I view trading at discount valuations. It isn't often the market prices dominant businesses with strong balance sheets in the same camp as higher risk, smaller or mid-sized companies. We are acting by taking advantage of the market's indifference toward high-quality businesses by "trading-up." Citigroup in banking, AIG in insurance, and Home Depot in retailing are three examples of where I'm seeing opportunities. In summary, 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. When large-cap businesses begin to materially outperform the stock market, we should be rewarded.

Market Outlook – Risks

A slowdown in U.S. consumer spending is taking place which has the ability to decelerate corporate earnings growth and U.S. economic expansion in coming quarters. The spending slowdown is particularly evident among consumers living paycheck-to-paycheck. Rising energy prices, increasing interest rates and a new law requiring higher minimum credit card payments are starting to take their toll on lower income consumers. For example, ***Wal-Mart's*** (WMT) same-store-sales growth (measures sales at stores open at least one year) in June came in at 1.2%, down from the typical 2% to 4% mark it posts. This slowdown could have wide implications on all sectors of the economy, including broader consumer discretionary spending and rising levels of bad loans on the books of lenders. Our positions in energy stocks could even be hurt if the spending slowdown results in decreased demand for natural resources such as oil and natural gas. Likewise, the spending slowdown could be just that – a slowdown in the rate of spending growth - not signs of a recession. With this in mind, I'm being careful of committing your money to businesses reliant on low-income consumers, and am placing a focus on business models capable of enduring an economic slowdown. In anticipation of a consumer spending slowdown, I trimmed our positions in some businesses I felt were in the line of fire during the latest quarter. What's interesting about the spending risk is that as it grows, the fear and uncertainty around it will provide some very compelling investment opportunities which I may be writing about in future letters.

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: "China has 250 cities with at least two million people." FedEx CEO Fred Smith on CNBC, commenting on China's growing influence in the world economy.

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