

U.S. Stock Markets: 2Q07

The S&P 500 Index and Dow Jones Industrial Average both produced solid Q2 returns at 6.3% and 8.5%, respectively. The quarterly gains were produced in April and May, while June saw the U.S. markets fall about 2%. After a volatile Q1 which saw the Dow Jones lose 1.0%, the Q2 was marked by strong performance from energy and industrial / construction companies. The laggards during the quarter were consumer discretionary businesses, notably retailers of purely discretionary products such as home décor and electronics. We're in an interesting time, with the U.S. consumer slowing spending or possibly in recession, offset by strong growth in energy, construction, and infrastructure businesses.

Comments on Our Performance

We had a good quarter, with most accounts beating the S&P 500 Index by at least 1.0% on a total return basis. What's interesting is we beat the index's 6.3% total return despite a little over 20% of our assets producing a negative return. I'm especially encouraged that we beat the index with two of our top four holdings, Berkshire Hathaway and Lowe's, in negative territory at -1% and -2.5%, respectively. I view both as significantly under-valued, and the time will come when their stock price performance outshines the market.

In summary, our energy-related investments significantly out-performed the S&P 500, while most of our large-cap consumer discretionary businesses under-performed. Our notable winners included **National Oilwell Varco (+34%)**, **Buffalo Wild Wings (+31%)**, and **Canadian Natural Resources (+20%)**. I feel fortunate to have spent two years as the energy analyst at my former brokerage firm, and my conviction in this area paid off in the Q2. I continue to have a bullish outlook on global energy fundamentals. This is reflected in your portfolio with about 20% of your assets invested in the energy sector, vs. the S&P 500 index's 11% weighting. As a reminder, please refer to our Q1 letter for a detailed description of my thinking on Buffalo Wild Wings and Canadian Natural Resources. On the downside, three of our long term holdings, **Sears Holdings (-6%)**, **Lowe's (-2.5%)** and **Berkshire Hathaway (-1%)**, declined this quarter giving back some of the appreciation we experienced in recent quarters. In general, large U.S. retailers were weak during the quarter, with Sears and Lowe's being no exception. My hunch is the U.S. consumer and retailers will continue to feel the pinch of high energy prices, rising debt costs, as well as the potential for higher food prices in response to our government's ethanol mandate. Regardless, I see good value in both retailers and energy stocks. As a second reminder, please revisit our Q1 letter for my detailed investment thesis on both Lowe's and Home Depot.

Comments on Our Performance - Winners

National Oilwell Varco's (NOV - \$104.24) 34% appreciation marked our best performing stock. In my opinion, NOV is in the sweet spot of what looks like a multi-year energy boom. The company engineers, constructs and sells complex drilling equipment used to explore for oil and natural gas. It typically sells its equipment to "oil service companies." The oil service companies then lease the equipment to the actual oil or natural gas company that owns the land to be drilled on (such as an Exxon Mobil or Chevron). As you can imagine, with oil in the \$50 to \$70 per barrel range vs. a price in the low teens early in the decade (not inflation adjusted), demand for NOV's state-of-the-art drilling rigs is increasing. A second driver of demand is the worldwide fleet of drilling rigs is old. In fact, 80% of the 600 worldwide offshore drilling rigs are 24 years of age, or older. Here's a quick timeline of what got us to this point. Please note the oil price per barrel numbers are in January 2007 dollars:

- Late 1940's to 1972: Oil price per barrel hovers in the \$20 per barrel range.
- December 1979: Global oil supply shock culminates in \$100 per barrel oil.
- Early 1980's: Supply shock begins to abate. Oil trades between \$50 to \$60 per barrel.

- Early 80's to 2003: Cheap oil dominates. World enjoys twenty years of downward oil prices, excluding an early 1990's up-tick when Iraq invades Kuwait. 2000 to 2003 oil is back in the \$20 to \$30 per barrel range.

In response to higher prices in the 1970's and early 1980's, oil service companies invested in new drilling rigs. When the oil supply shock ended, the price of oil dramatically retreated and flat-lined until 2003...it was an unpleasant two decades to be in the energy business. As a result, very little drilling rig production occurred, resulting in an aging fleet. Today, NOV is benefiting from both strong demand fueled by high oil prices and the need to upgrade an aging fleet. I believe this is an under-followed story, and investors have not caught-on or bought into the long-term fundamentals taking shape in the global energy market. NOV has the potential to run much farther than I anticipated. Please see the Market Outlook – Opportunities & Risks section for a more detailed analysis of why I like energy stocks.

I talked extensively about **Buffalo Wild Wings (BWLD - \$41.59)** in our Q1 letter, but it's worth mentioning again as its stock appreciated 31% in the Q2. There was a tremendous amount of positive, and surprising, news in the quarter. The 31% run started with an outstanding earnings report, which was good for an initial 10% to 15% move in the shares. More importantly, along the way there were a couple of pleasant surprises. One, it announced a chicken wing supply contract that locks in BWLD's cost of wings for 2007 at what are now below-market prices. As a young and growing business, BWLD previously bought chicken wings at market rates, making the company susceptible to rising wing prices (but also the beneficiary when wing prices declined). Given our government's energy policy requiring a certain amount of ethanol (corn based) in the fuel supply, food prices, including chicken and beef are rising. Second, Buffalo Wild Wings agreed to acquire the assets of its franchised Las Vegas chain. This deal should be immediately accretive to earnings when the deal closes at year-end 2007. Taken together, I think the important message is the BWLD management team is proactive and thinking strategically. This gives me an increased level of confidence that it will manage its growth wisely. Also, near the end of Q2 the company split its shares 2:1. When that occurred the stock price split from about \$84 to \$42. In the days after splitting, the stock ran up another 10%. We sold some near the top, as I thought the stock price increase was an irrational reaction to a non-fundamental event. Hopefully I didn't sacrifice long-term performance for a short-term gain, but from a valuation and risk-reduction perspective I thought it the right thing to do. In conclusion, with about 450 restaurants today, I think there's upside to the stock given its goal of 1,000 restaurants by 2012.

Canadian Natural Resources (CNQ - \$55.19) is another company I wrote in detail about in our Q1 letter. It's currently one of our top three positions, and its 20% quarterly gain was a big contributor to our good Q2. CNQ's appeal remains the same considering oil price fundamentals remain favorable; with global demand increasing at a quicker rate than global supply. CNQ is:

- ✓ A rare growth company in an industry where its peers are struggling to find new oil supplies
- ✓ Whose growth is 100% organic and does not require high risk / reward explorative drilling, or expensive acquisitions
- ✓ Located in a politically stable country
- ✓ With a competent and shareholder friendly management team
- ✓ Trading at a price that I estimate to represent a reasonable margin of safety

It wouldn't surprise me if the shares take a breather after a 20% increase, but longer term fundamentals are appealing.

Comments on Our Performance – Losers

During the Q2 large retailer stocks under-performed the S&P 500 index, with **Sears Holdings (-5.9%)** and **Lowe's (-2.5%)** being no exception. Each company has its own investment merits, but in general large retailers tied to the American consumer are facing headwinds, such as:

- ✓ Rising debt expenses as a large amount of adjustable rate mortgages (ARM's) reset to higher rates in 2007
- ✓ A shift in consumer spending from discretionary items, towards energy-related costs such as gasoline and utility expenses

- ✓ Flat-to-declining home prices. This creates two issues. One, consumers are less apt to take out home equity lines of credit and spend the cash on remodels, electronics, or other discretionary items. And two, it throws a little water on the wealth affect that U.S. homeowners felt in the 2003 to mid-2006 era when their home values appreciated at unsustainable rates.
- ✓ Rising food costs

Despite a solid job market and an economy that seems to continually defy the skeptics, it's understandable how consumer discretionary spending needs to take a breather. Below are my company-specific comments on the large U.S. retailers.

After being one of our star performers in 2006 with a +46% return, **Sears Holdings (SHLD - \$169.50)** became our Q2 dog, returning a negative 5.9%. Sears, as you may recall from my previous letters, is 40% owned and headed by Eddie Lampert. Mr. Lampert is considered by many investment professionals to be his generation's version of the most acclaimed investor of all-time, Warren Buffett. Thus, when Sears reported lackluster 1Q07 results (Feb 28 to May 31) the stock didn't react too badly...hence the "Lampert premium." Specifically, the expense savings that helped propel Sears' 46% return last year dried up. Likewise, revenues at both Sears and K-Mart appear to be headed lower, following a period in late 2006 of relative stabilization. To me this is a combination of competitive pressure, and a challenging environment for retailers. After contemplating Sears' latest quarterly report, I made the decision to sell one-half of our Sears stock in the low \$180's per share. This was a little difficult to do for me because Eddie Lampert is an investor I "look up to," but I thought the risk / reward merited a reduced position. At the time I felt the shares were being given too much of a Lampert premium, and were due for a modest correction. With the shares closing the quarter a few cents under \$170, the sale looked to at least be timely. However, my most regrettable mistake for the Q2 was not listening to my gut, which was telling me to sell it all. On July 10, 2007, Sears issued preliminary results for its most recent quarter ending August 31, 2007. The 2Q numbers appear to be a continuation of the lackluster Q1 results, which confirms to me that profit margin gains in 2006 may have reached a temporary peak, and earnings for all of 2007 could come in lower than for 2006. We sold the remaining shares at \$155 on the basis that profit growth is going to be difficult to come by for some time. Most of our Sears stock was bought in the \$120 to \$145 range, so overall we should be satisfied with the result. Because of my faith in Lampert, this is a stock that you shouldn't be surprised to see back in your portfolio at a later date.

If I were you, one question I'd have after reading my skeptical comments on the domestic retail environment is, "why do we still own Lowe's (or Home Depot) if you think retail is operating in a bad environment? Anything tied to residential construction or the home is in trouble...aren't Lowe's and Home Depot operating in the worst-case scenario?"

My rationale is the stock prices of **Lowe's (LOW - \$30.61)** and **Home Depot (HD - \$39.35)** already factor in a very difficult 2007, and a not too terribly good 2008. If you remember our letter last quarter where I detailed same-store-sales dating back a decade, both Home Depot and Lowe's have been in a recession since 3Q06, when same-store-sales began falling. The psychology behind HD and LOW stock is that nobody wants to touch them, because the U.S. housing market is terrible. Who knows how long it will take LOW & HD to produce a quarter of positive year-over-year earnings growth? If you want a more detailed recap of my positive risk / reward outlook for either company, please read our prior letters. But what I want to re-emphasize is HD & LOW stocks price in a ton of bad news and negative sentiment...thus the opportunity. Conversely, many retailers with better near-term prospects, such as **Kohl's (\$71.03)**, aren't priced for difficult times.

Finally, **Berkshire Hathaway (\$3,605.00)** was down 1% in the quarter, under-performing the S&P 500 Index by about 7%. There was no bad news. Berkshire stock tends to trade independently from the market. What's important is Berkshire has one of, if not the strongest balance sheet in corporate America, making it a great defensive business during tough times. On offense, I value it in the range of the high \$4,000's to low \$5,000's per share, providing us with significant upside. Finally, I believe Warren Buffett has instilled a management culture that should ensure the company's continued success after his departure. This combination is the reason Berkshire is our #1 holding.

Market Outlook – Opportunities & Risks

The Energy Sector vs. the Financial Sector: A twenty year trend in the early days of change?

For this letter I decided to combine the Opportunities and Risks sections in order to tell a coinciding story about the energy and financial sectors. My past experience has prepared me well for understanding the changes these sectors are now going through. During the period of 2002 – 2005 I helped manage a mutual fund that was heavily invested in financial stocks, and later worked at a brokerage firm searching for “BUY” recommendations in the both the financial and energy sectors.

My Initial Impressions of the Financial & Energy Sectors

I was optimistic about covering the financial services sector because I viewed most financial services companies as having favorable fundamental characteristics, requiring low amounts of capital expenditures and therefore paying high dividends and repurchasing large amounts of stock. Importantly, I felt I could find a number of good investments and recommend them for purchase with conviction and integrity. It was exciting!

On the other hand, I was not excited about covering the energy sector. Here are a few reasons why:

- ▶ The industry is defined as having low barriers to entry. The oil you find in your backyard is just as valuable as the oil ConocoPhillips finds off England’s North Sea.
- ▶ Most energy businesses are highly capital intensive, meaning a very high percentage of cash flow needs to be reinvested back into the business in order to just maintain current operations and to grow a little. This leaves very little room for shareholder-friendly activities such as increasing dividends and buying back stock.
- ▶ It’s an industry plagued by management teams that do not know how to grow shareholder value...but do know how to destroy it. I like to joke that energy company management teams tend to have “my ranch is bigger than yours” syndrome. No wonder Viagra is so popular in Texas!
- ▶ Up until 2003 energy businesses had been below-average investments since the Mideast oil supply shocks abated in the early 1980’s. Why would you ever want to invest in the twenty year loser energy sector when you can invest in the traditionally strong financial services or consumer discretionary sectors?
- ▶ Furthermore, the energy business has its own language that I wasn’t well versed in. Go online and take five minutes to read an annual report of an energy company – you’ll find such everyday terms as “upstream, downstream, mid-stream, dry hole, horizontal drilling, jack-up rig, pressure pumping;” plus plenty of acronyms “boe, btu, mcf,” et al. I’d almost rather read Russian, which I took for one day my freshmen year at Lewis & Clark College.

A simple math problem of {bad fundamental businesses + twenty years of bad stock performance} = I was not excited. Of course in the end my energy picks out-performed my financial picks by a wide margin. Attitude is everything!

You can see where this is going. Today, I’m optimistic about the investment opportunities in the energy sector, and less comfortable with the financials. This has been an evolving opinion, formed through both past experience and a good amount of continuing education. In consequence, you’ll note your portfolio is more concentrated in energy stocks (Canadian Natural Resources, Diamond Offshore Drilling, ConocoPhillips, National Oilwell Varco, Rowan Companies, Atwood Oceanics) and almost void of financials (American International Group and Portfolio Recovery Associates, US Bancorp and Citigroup are smaller). Let me say there’s going to be a day when we invest more heavily in financials. The business models are fundamentally good, but I believe there are under-the-radar risks waiting to be exposed within the financials sector, particularly among lending institutions. I’ll detail my thoughts on the financials first, then close with my positive opinion on the energy sector complementing my comments on National Oilwell Varco and Canadian Natural Resources (please see our 1Q07 letter for more on CNQ).

Current Risks in the Financial Sector

“It’s only when the tide goes out that you discover who’s been swimming naked.”
– Warren Buffett, CEO of Berkshire Hathaway

The economy of the late 70’s / early 80’s did not provide a good environment for the financial sector. For example, the 30 year fixed rate mortgage touched above of 17%, while in 1980 the Federal Funds rate was 20%. Can you imagine a 17% mortgage rate today? Since, the U.S. economy has enjoyed roughly 20 years of declining interest rates, and a solid economy despite the usual hiccups. At the lows, the 30 year fixed rate mortgage reached below 5.5%, and the Federal Funds rate hit 1%. Credit quality has been outstanding since at least 2003, driven by a very good economy (low unemployment, low personal taxes, rising real estate values, rising stock market values, low interest rates)...lending institutions in particular have been living in credit nirvana. In fact, one of my favorite quotes regarding the currently favorable credit quality environment came from J.P. Morgan CEO Jamie Dimon on its 3Q06 conference call with investors, “We’ve probably seen the best credit quality that any of us will ever see *in our lifetimes*.” Today, financial services companies make up the largest sector in the S&P 500 Index.

From my perspective, there are several under-the-radar risks that have developed in the financials. These risks started with: (A) *Record low borrowing costs* that when coupled with a strong economy led to, (B) a *four year period of pristine credit quality* resulting in record earnings for many financial companies (but could get ugly when it reverts to the mean), which encouraged (C) *an erosion of underwriting and investment standards* among lending institutions and fixed income investors; which fueled the (D) further *development and use of untested / innovative fixed income products*, that ultimately led to the (E) *distancing of the borrower-lender relationship*.

The Potential for Hidden Problems in the Credit Food Chain

- (A) Record low borrowing costs are in themselves favorable for us. But in this case I fear it has played a role in encouraging less than desirable lending and borrowing behavior. One example of poor lending behavior is 20% of home mortgage originations in 2006 were made to sub-prime borrowers. In contrast, in 2001 only 5% of mortgage loans were made to sub-prime borrowers. To put this into perspective, near the peak of home prices, lenders decided to loan a disproportionately high amount of money to the least credit worthy participants. Already, dozens of mortgage loan institutions have folded over bad loans. When the tide goes out (i.e. an economic recession or slowdown) what other bad loans will we discover, and what lending institutions are currently swimming naked? Finally, an example of poor borrowing behavior are people lured by the low initial interest payments required by adjustable rate or interest-only mortgages (often people trying to buy a house that they can’t afford with a traditional 30 year fixed), but have not reserved money to pay for ballooning future interest and principal payments. In essence, we’re talking about a human behavior problem. Readily available loans at rock-bottom rates are like that hard alcohol drink that tastes so good you wonder if there’s any of the hard stuff in it...until you wake up the next morning with a hangover.
- (B) Record low borrowing costs coupled with a very good economy has led to pristine credit quality and powerful earnings at lending institutions. The recent period of pristine credit quality has only encouraged lending institutions to make more loans, which I fear contributed to an erosion of underwriting standards at some institutions. What’s tangible to this point is bank earnings have benefited from extremely low loan losses. When this trend reverses, earnings at some financial institutions are not going to be good.
- (C) The erosion of lending standards is something that is pretty obvious from what’s occurring in the sub-prime mortgage market. My concern is whether lending standards related to the consumer (credit card, auto, small business) or on the larger fixed income side (leveraged buyout transactions / junk bond market) were stringent enough during the good times? Again, investment banking firms are recording record profits in the current LBO boom. During this buyout mania, debt covenants have become things of the past, prices paid for assets are high, and the prices are based on current earnings that no doubt are benefiting from the strong economy. Somewhere, an institution is holding a massive amount of junk bonds (lowest grade of bond) that could go bad when the U.S. economy turns south. We will find out which Wall Street firms are swimming naked in due time.

- (D) The development and escalating use of loan securitizations and related fixed income products among large financial institutions bothers me more than the average financial analyst. Here's a hypothetical example of what happens in the real world: When I bought my house, the lender took my loan and packaged it like a Christmas present with other mortgage loans it had originated (hence the term "mortgage-backed security," or "collateralized debt obligation"). It then sold this security to non-affiliated fixed income investors (this can occur with home, credit card, and auto loans). Sometimes the fixed income investor sells the security *again*. In the process the original company that assessed my credit worthiness and lent me money benefited by (1) receiving a fee from selling my loan, and (2) passing along the risk that I default. This process enables lenders to make more loans...earn more securitization fees...and, since the secondary market is eager to absorb the loans, encourages the original lender to loosen its lending standards. One of my concerns is some lending institutions, eager to earn a continuous and low-risk stream of fees from selling packages of loans, have become loan-production machines, as opposed to traditional credit analyzers. I see the potential for this credit food chain to cause all sorts of problems.
- (E) The fundamental problem is the credit food chain distances the borrower-lender relationship. This distance has increased during our current credit boom, helped by the proliferation of securitization products mentioned above. The real problem could come when our economy heads south and borrowers begin defaulting. Traditionally, the lender-borrower relationship has remained close, meaning troubled borrowers could work with lenders to help them through bad times. Today, I fear the distancing of the lender-borrower relationship is setting up some financial institutions and fixed income investors for a headache. One of the investors I admire recently wrote that he's unloaded any type of fixed-income security that includes questionable standards for loan recoveries. He reports that many loan securitization products carry burdensome prospectuses or legal barriers that could make it very difficult to rework loans in the case of bad times. During the last credit crunch during the early 1990's, this circumstance was not prevalent. During the next credit crunch it will be very interesting to see how these securities perform, and how it affects the U.S. economy.

Financial Sector Conclusion: If You Think it Might Rain, Build an Ark

In laymen's terms, there's a lot going on in the financial sector that I don't fully understand and makes me uncomfortable. I don't pretend to know what will happen, but as a risk-reduction measure we're avoiding most lending institutions for the time being. Our recent portfolio addition in the sector is **Portfolio Recovery Associates (PRAA - \$60.02)**. This company buys defaulted debt for pennies on the dollar and works with the borrowers on payments plans. If the current credit boom turns south, Portfolio Recovery Associates should find itself in the enviable position of cherry-picking defaulted debt at distressed prices. Also, for clients with fixed income securities in their account, this credit risk is the reason we're only investing in the highest quality of fixed income security.

Optimistic on the Long-term Prospects of the Energy Sector

"The world is not running out of oil, it's running out of cheap oil."

- This is from, I believe, a Business Week article written in 2005. I read this line and never forgot it.

The 1970's Supply Shock

In the 1970's and early 1980's, the rise in the price of oil was caused by a sudden lack of supply. The Middle East oil embargo of 1973, and the 1979 Iran / Iraq war were the catalysts. This caused oil prices and energy business valuations to increase dramatically. In fact, in 1979 energy businesses accounted for 30% of the S&P 500 stock market index. Nine of the 10 largest companies in the United States as measured by market value at that time were energy businesses (two today – Exxon & Chevron). When the world oil supply came back on-line post the embargo and war, oil prices dropped for about 20 years. Consequently, investment returns were terrible from the early 1980's peak. At its bottom, the energy sector accounted for 5% of the S&P 500 Index.

The 2000's Demand Shock

Today, world oil fundamentals are very different than they were in the 1970's. Instead of a supply shock, we have a worldwide demand shock. How did we get here? Consider first that oil demand has about doubled from 1970 to today, led by slow-but-steady demand growth from the developed nations. Second, consider demand from China and India is growing rapidly, and is in its infancy. 2005 estimates of annual per capital oil consumption are 1.8 barrels per person in China and 0.9 barrels per person in India, vs. 25.6 barrels in the United States. During this time no major oil fields were discovered (last = 1968 Prudhoe Bay, Alaska, and Shaybah offshore field in Saudi Arabia). Despite consistent demand growth...no new major supply growth has occurred...we're living off the production of gigantic fields discovered decades ago. Here's one tangible example:

The United States was the worldwide leader in oil production through the first half the 20th century. As early as 1940 evidence surfaced that U.S. oil production could be set to peak. Regardless, oil production in the U.S. remained constant for 30 more years due to technology advances. Then suddenly, U.S. oil production peaked. In 1973 the U.S. produced 9.2 million barrels of oil per day. In 2006 U.S. oil production was 5.1 million barrels per day.

Examples similar to the U.S. are beginning to surface around the world. Mexico produces a little over 3.0 million barrels of oil per day, which accounts for about 4% of worldwide production. Cantrell, the country's largest oil field producing 60% of Mexico's oil, is in steep decline. Unless Mexico makes a dramatic new oil field discovery, it's possible we're going to witness in our lifetimes what happens to an economy when its most significant asset is depleted. What differentiates our current situation with the 1970's? The 1970's problem was temporary. The Mideast supply that went off-line didn't go away. Today, we do not have meaningful idle oil production that can come on-line to satisfy growing demand and stabilize prices. Instead, we either need a severe U.S. or global economic recession to curb demand, or we need to endure consistently high oil prices, let the free market work, and hope the world doesn't face a severe supply shortage to allow time for alternative energy sources to develop. In summary, the world is experiencing steady demand growth at the same time it's experiencing a potential worldwide peak in supply. This means oil prices and therefore profit outlooks for select energy businesses should remain strong.

Given my long-term bullish perspective on the energy sector, I imagine it will constitute a central and strategic position in our portfolios for some time. Should our energy holdings rise in value at a quicker pace than my estimate of value, we will begin selling. Likewise, should the price of oil fall into the \$50's and our stock prices with it, I imagine we'll be buyers.

Thank You

Thank you very much for your trust and support. I encourage you to please call or email me your comments, questions, or suggestions. The greater the amount of communication a portfolio manager has with clients, the better. I look forward to talking to each of you soon!

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: “The nub of the crisis: Demand too Young vs. Supply too Old.”
– Matthew Simmons of Simmons & Company, an energy research and investment banking firm, during an April presentation on the fundamentals behind the world’s energy situation.

This quote really hits the heart of the matter – rising oil demand that’s supplied by aging oil fields. Despite 30 years of advanced technology we haven’t found a meaningful oil discovery.

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