



U.S. Stock Markets: 4Q06 & Year-end Results

The U.S. equity markets made broad gains to end 2006. Large capitalization stocks as measured by the S&P 500 & Dow Jones Industrial Indices achieved Q4 returns of 6.7% and 7.4%, respectively. Likewise, the Russell 2000 Index, which measures the stock price performance of small capitalization businesses, increased 8.6%.

To close 2006, the S&P 500, Dow Jones Industrial and Russell 2000 indices posted total annual returns of 15.8%, 19.1% and 17.0%, respectively.

Comments on Our Performance

Washington Street Investments had another solid quarter, helped by a 15.4% return from one of our most recent portfolio additions and largest equity holding, **Berkshire Hathaway** (BRK-B - \$3,664.00). Other positions common across WSI accounts that out-performed during the quarter were **ConocoPhillips** (COP - \$71.95), **McDonald's** (MCD - \$44.33) and **Home Depot** (HD - \$40.16) appreciating about 22%, 16% and 10%, respectively. Our under-performing positions during the quarter included **Montpelier Re** (MRH - \$18.61) and **Pepsi** (PEP - \$62.55), each down about 3.5%. The key to our good numbers is we had both the winners and losers in the right places within our portfolios. Berkshire Hathaway's 15.4% appreciation helped because it is generally our #1 position in all accounts, at 10%-plus of assets. Conversely, Montpelier Re and Pepsi typically compromise only 1% to 3% of portfolio assets. Finally, please note in the section "Market Outlook – Opportunities" I discuss a new position we initiated in Q4, Barnes & Noble (BKS - \$39.71).

Comments on Our Performance - Winners

Berkshire Hathaway appreciated 15.4% during the quarter driven by an excellent Q3 earnings report that included its reinsurance operations posting a profit of \$735 million vs. a year ago loss of \$1.6 billion. The key to the quarter was a lack of major storm damage following last year's devastating hurricane season. Profits were also helped by a dramatic rise in insurance rates in the wake of hurricane Katrina's destruction. However, the key to Berkshire's success can not be simplified or dismissed by "lucky weather." Instead, Berkshire's pristine balance sheet consisting of about \$37 billion in cash and another \$55 billion-plus in stock investments makes it the insurer of choice for insurance shoppers. At a time when demand for reinsurance against further major catastrophes is at a high, the supply of reinsurance has decreased with companies folding or pulling back post-Katrina (please revisit the "Market Opportunities" section of the Fall 2006 letter for an explanation of reinsurance). In response to higher prices (favorable to Berkshire) management was savvy enough to step in and absorb the increased demand. We started buying Berkshire in the \$2,900 to \$3,200 per share range, and the shares closed the year at \$3,664. I currently estimate the company's value between \$4,800 and \$5,000 per share, suggesting a 33% under-valuation vs. the market price. I think Berkshire's valuation provides enough upside to at least perform in-line with an appreciating stock market. Importantly, as many WSI account's #1 position, I view Berkshire as significantly out-performing the stock market during bad years on the strength of its balance sheet, businesses and management savvy.

The other Q4 winner I want to comment on is **Home Depot**, because its 2006 story provides us a tangible example why I believe investing requires patience and a humble demeanor. We began buying shares of Home Depot in the \$39 to \$42 range in early 2006 when I valued the business in the \$55 to \$60 per share range. Key to our initial investment was my acceptance of the fact that we were long-term investors, and that the share price would be subject to near-term volatility on worries about how the housing market downturn impacts its 2006, 2007 and 2008 earnings (for a refresher on my detailed thinking please revisit our Summer 2006 letter). During the just completed Q4 its shares appreciated 10%, moving from \$36 to \$40 per share, which was nice to see. However, when the shares hit \$33 in the summer I was extremely humble, wishing I had been blessed with the foresight to withhold investment until then! I think the key for us in 2007

will be patience. The first half of 2007 is going to be difficult for Home Depot, and I won't be surprised if the shares continue to under-perform the market. With that said, I continue to value the business in the \$55 to \$60 range and see a very favorable risk/reward trade-off. In other words, my assessment of the risk that we lose money on our Home Depot investment is low, and the probability we earn a 25% to 50% return I view much higher. When a bottom to the housing and remodeling market is visible, Home Depot's stock could be good for a \$5 to \$10 plus move as sentiment changes from very negative to neutral. If you're in need of an opinion other than my own to validate that there's value in Home Depot shares, recent rumors are that the company could be taken private in a transaction valued around \$50 per share. I think this is highly unlikely because the sheer size of the deal (\$100 billion) will deter most investors, but I do think these rumors highlight the value others see in the company.

Comments on Our Performance - Losers

Montpelier Re (MRH - \$18.61) was our most disappointing investment during the Q4, falling 3.5% vs. an increase of 7% for the S&P 500 Index. Recall from our Fall 2006 letter that we purchased Montpelier and Berkshire Hathaway with similar bullish outlooks for reinsurance businesses following 2005's devastating storms. Berkshire was the large (10% or more of assets) and conservative investment, while Montpelier was the small (1% to 3% of portfolios) and more aggressive of the two. Montpelier's Q3 earnings report, while good, was somewhat disappointing to me as it appears the company did not choose to aggressively write new property and casualty reinsurance, unlike Berkshire Hathaway. During a time when the company should have significantly beaten consensus earnings per share (EPS) estimates due to favorable reinsurance pricing and a benign hurricane season, its Q3 earnings were only in-line with expectations. To date I've kept the shares in our accounts due to my bullish view on reinsurance profitability extending into 2007, but not without hesitation. I expect Montpelier will be one of the stocks that we could possibly sell in order to purchase other investments.

Pepsi's (PEP - \$62.55) 3.5% decline during the quarter was mostly related to fears that commodity costs for its products will cut into 2007 earnings, as well as Coke's (KO - \$48.25) improved Q3 performance in North America. Taken together I think these fears are overdone, and continue to value Pepsi's business in the high \$70's to low \$80's per share. Pepsi has a stable of brands including Gatorade and Frito Lay that continue to generate impressive volume gains in key geographies. Likewise, Pepsi's international business should be a source of earnings growth for the next three to five years as emerging markets continue to increase per capita consumption of beverages and snacks. Financially, the company has a strong balance sheet, and is generating enough cash to invest in growth opportunities, pay a dividend yielding 2% and buyback stock. I view Pepsi as a great stock for conservative investors to buy and hold today.

Market Outlook – Opportunities

In a broad sense I'm having a more difficult time finding truly outstanding values in the stock market – which I define as businesses trading at a greater than 40% discount to my estimate of value. Reflecting on 2006, when we initiated investments in **Sears Holdings** in the \$130's, **Michaels Stores** at \$33 and **Berkshire Hathaway** at \$3,000 I remember having that (don't laugh!) “special feeling” that we truly found a bargain. Today, the only business that comes close to replicating that feeling is Barnes & Noble (read below). Instead, many of our current holdings and new investments are what I label as good or solid investments, trading at 30% to 40% discounts to my estimate of value. What's heartening about this is that our portfolios include high quality businesses with exceptionally strong balance sheets. I think the primary difference today vs. early 2006 is instead of making large investments (10%-plus of portfolios) in a select few businesses, today our portfolios are more broadly diversified, with a multitude of “good investments” each comprising 1% to 3% of assets.

During the quarter we initiated a position in bookseller **Barnes & Noble** (BKS - \$39.71) on the premise the tremendous “free cash flow” the company produces is not being appreciated by the stock market (free cash flow is an investment term describing the cash left over after paying all expenses that can be used to grow the business, pay dividends, buyback stock or make acquisitions). As many of you probably know, Barnes &

Noble is the nation's #1 bookseller capturing about 17% market share, followed by Borders Group's 13% and Amazon's 10%. In general, retail bookselling is a simple wholesaling business subject to price competition and low profit margins. Furthermore, the barriers to entry are not great. Traditional retailers such as Costco, Wal-Mart, and Target often carry the nation's bestsellers at discounts to attract shoppers. Amid tough competition both Barnes & Noble and Borders Group have initiated membership programs designed to develop customer loyalty. Barnes & Noble's program is similar to Costco's. For a \$25 annual membership fee, Barnes & Noble members receive 40% off bestsellers, 20% adult hard covers and 10% off virtually all other purchases. The discounts offered to members has the investment community concerned that gross profit margins will decline in 2007. I share this concern, but, when factoring in my worst-case scenario for margins in 2007 I am still convinced the shares are attractive.

Also, the retail bookselling business isn't as bad as I make it out to be. Unlike apparel retailers, bookselling entails little inventory risk. For example, when an apparel retailer has poor sales, it's forced to heavily discount inventory and accept poor profit margins. Booksellers, on the other hand, can return unsold books for refunds to the publishing companies. This characteristic results in fairly stable cash flows. Another positive for both **Barnes & Noble** and Borders is they each have created nationally-recognized bookselling destinations that people enjoy, and that I believe will endure for years to come. I hate to shop (fortunately come Christmas time my wife likes to shop...a lot) but when book shopping I actually enjoy going to Barnes & Noble. There's something about the atmosphere there, flipping through a book...browsing sections and possibly grabbing a coffee, that can't be replaced by going to Target or buying on-line. What's more, I don't care if the book I buy costs a few dollars more there than if I bought it at Amazon.com. The experience matters more to me. When I put all this touchy-feely stuff together and weigh it against Wall Street's incessant fears that Amazon.com will destroy the economics of the bookselling business, I think the stock may provide a decent opportunity for us to make money.

On first glance **Barnes & Noble** doesn't look like a hidden gem. Its shares trade at a price-to-earnings (PE) multiple of about 18x earnings, a premium to the market average of 16.0x, and the company estimates it can generate a modest 3% to 5% annual square footage growth (a term retailers use to measure new store opportunities...faster growing retailers such as PetSmart or Dick's Sporting Goods will generate at least 10% to 20% square footage growth per year). Unnoticed or ignored among the worries over profit margins and a high multiple vs. the market is Barnes & Noble's impressive cash flow. The company is on-track to produce \$200 million in free cash flow for the year ending January 31, 2007. With a \$2.5 billion market valuation, \$400 million in cash and a debt-free balance sheet, Barnes & Noble sports one of the lowest cash flow multiples in all of retailing. Incredibly, Barnes & Noble's cash generation implies it could buyback 5% to 7.5% of its outstanding shares each year without taking on any debt. After applying my worst-case estimates of cash flow for 2007, I view the company as a prime candidate to be bought out by management or private equity firms. The company's founders are still active managers of the company and own over 30% of the stock. If the market continues to give Barnes & Noble little respect the founders may decide to take the company private. I'm sure we'll be talking more about the company in the future.

Market Outlook – Risks

There are two primary risks that I'm focused on today. The first is a repeat from our Fall 2006 letter: I view a potential slowdown in U.S. consumer spending driven by the impact of a declining housing market as the #1 risk to our portfolio values. Falling home prices potentially can hurt the consumer psyche, resulting in an unwillingness to spend as freely as during the good years. Also, there's no question the U.S. economy benefited from housing-related job growth and spending the last three-plus years. As with any bubble-like scenario, the loss of construction, mortgage and building materials jobs can have a negative affect on U.S. economic growth. In past housing cycles, these affects have not been felt by the macro-U.S. economy until six to twelve months after the bubble-like conditions subsided. In summary, the impact of falling housing prices and job loss within the industry on consumer spending is a major wildcard that is easy to talk about but very difficult to predict. My overall sense is the U.S. economy is strong and resilient despite a contracting housing market.

The second risk I'm focused on is the general stock market's valuation. The facts are we've had four years of stock market appreciation following 9/11 and a dreadful 2002. The line below illustrates the S&P 500's total returns per year starting in 2000:

2006 +15.8%; 2005 +4.9%; 2004 +10.9%; 2003 +28.7%; 2002 -22.1%; 2001 -11.9%; 2000 -9.1%

I've learned over the years that scared investors tend to not do well vs. the major market averages. However, I think it's prudent to have a conservative, watchful eye on the valuations of our current holdings and new investments considering the four year bull market we've enjoyed. Holding cash earning 4.5%-plus isn't a bad thing given the rate of inflation in our economy appears well contained. However, the S&P 500 Index trades at about 16x projected 2007 earnings, which isn't expensive. Recall from the tech and telecom stock market bubble of the late 1990's and 2000 it wasn't uncommon for companies to trade between 50x to 100x projected earnings. Even a "boring" consumer stock such as Home Depot traded at 50x earnings in 1999. Those were clearly ridiculous valuations. Today, HD trades at 15x my 2007 estimate of its earnings, and a well known growth company like ebay trades at 25x earnings. I think long-term investors entering today's market will do well given my bullish view that the U.S. is the best country in the world to invest and the market is reasonably priced. In summary, investing in stocks after four years of a bull market deserves an extra bit of attention to valuations and risk, and I don't take the responsibility of investing your money lightly.

Comments on Miscellaneous Stocks

In my quarterly letters I make an effort to discuss portfolio holdings that are common across all WSI clients. But often times, a new portfolio will transfer to us with stocks not common among WSI clients. Sometimes I choose not to sell these transferred securities because I see value in them. It's important to me to let you know my thinking on these select stocks, as well. In an effort to do so, I've decided to periodically include this section in my letters to address my thinking on stocks not widely owned by WSI clients. Two businesses found in a handful of accounts are **Wal-Mart** (WMT - \$46.16) and **Intel** (INTC - \$20.25). I want to share my thinking with you on these two names because both under-performed the market during the Q4 (Wal-Mart down 6% & Intel down 1%), and likewise had fairly poor 2006's.

The short-term picture for **Wal-Mart** is not favorable. Management's early 2006 efforts to update and revitalize stores have not translated into incremental gains in revenue and earnings. Also, the company is one people love to hate, meaning the business must execute well before achieving stock price gains. However, I have not sold Wal-Mart from some accounts because I view the negative sentiment engulfing it as fully priced into the stock. Over the next 12 to 18 months I can see Wal-Mart's stock price increasing 10% to 15% given some modest positive news. Specifically, if Wal-Mart chooses to cut capital spending on store remodels and new store expansion, and takes a McDonald's-like approach to its business via using its cash to buyback a significant amount of stock, I believe the shares can appreciate to \$55 by year-end 2007.

Like Wal-Mart, today **Intel** is not the most popular stock to own after falling about 20% in 2006 (side note – what's not "popular" to own today is typically what makes you money tomorrow). In 2006 Intel's rival, AMD, leapfrogged it technologically, resulting in Intel losing computer chip market share and profitability. If it were a title fight, you might describe Intel as caught flatfooted and on the ropes for much of 2006. Regardless, like a true champion, Intel's positive qualities are too powerful to keep it down. Intel has a great balance sheet, produces a tremendous amount of cash even in its cyclically down years, and has introduced competing microprocessors that, when taken all-together, can be a successful recipe for out-performing the major stock market indexes in 2007.

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, or suggestions on improvements you'd like to see.

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: "We may have experienced the best credit quality some of us will ever see in our lifetimes." – Paraphrasing J.P. Morgan CEO Jamie Dimon on its 3Q06 earnings conference call regarding the exceptional credit quality in the U.S. (both consumer and commercial) experienced by lenders from approximately 2003 through September of 2006.

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