



U.S. Stock Markets: 4Q07 & Year-end Results

The U.S. stock markets ended the year on a down note, as the global credit crunch intensified, and poor earnings at financial institutions and consumer discretionary businesses provided evidence of a potential U.S. recession. For the quarter, the S&P 500 and Dow Jones Industrial indices posted losses of 3.4% and 3.75%, respectively.

To close 2007, the S&P 500 and Dow Jones Industrial indices posted total annual returns of 5.4% and 9.4%, respectively. During the year the S&P 500 reached two mid-year highs about equaling one another – one on July 19th at 1,553, the other on October 9th at 1,562. From these highs, the market ended the year down about 5.5%. Three weeks into January 2008 the market is down about 15% from the October high and is in what I describe as a “bear market.”

Comments on Our Performance

After a below-market Q3 for us, we held our own in the Q4, primarily because we doubled our investment in **Berkshire Hathaway** in mid-to-late August. From that point our Berkshire investment appreciated 30% (+20% for the Q4). We had our share of down stocks, including most any business garnering a majority of earnings from the United States including **Home Depot**, **Lowe's** and **Fedex**. Fortunately, our well-timed Berkshire investment along with a few other tactical moves (like increasing our cash position in anticipation of a down market) helped our overall performance.

Comments on Our Performance - Winners

Berkshire Hathaway's (BRK-B - \$4,736) 20% appreciation helped us combat a down market. We originally bought our shares in the high \$2,000's, and added a large amount more in August 2007 at about \$3,600 per share. We initially bought on the premise the shares were significantly under-valued vs. the market, and also provided a hedge vs. a poor economy. In August, we added to our position when it became apparent the credit markets were going to be in worse shape than I had imagined in our 2Q07 Letter (thus offering Berkshire more opportunities to make money than I had projected). I think a fair amount of Berkshire's 30% appreciation from August to year-end was based on that second premise – investors were looking for “safety” in an otherwise disturbing credit market and economic outlook. As Berkshire closed in on \$5,000 per share in Q4, I made the decision to sell some of our shares in accounts where Berkshire constituted 20% to 30% of assets. I made this decision for a couple reasons. One, with the shares in the \$4,600+ range, I thought Berkshire was approaching fair value – and value always dictates when we buy or sell. Two, Berkshire's out-sized appreciation meant it had grown to become 20% to 30% of account assets, and I thought it better to diversify our portfolios to some degree. Today our Berkshire position across accounts represents about 10% of assets – a level I feel comfortable with given I think we have some tough near-term economic issues. I just want to close by saying the U.S. and potentially European economic outlooks are not pretty, and, despite Berkshire's recent appreciation it still constitutes an effective hedge against a down stock market.

iamond Offshore's (DO - \$142.00) stock price went up so much this quarter that it literally looks like my cholesterol chart. Its 27% appreciation was primarily in response to the company signing longer-than-expected contracts to lease its deep-water oil drilling rigs at favorable rates. The risk with having a business model predicated on owning and leasing out oil-drilling equipment is the business is historically cyclical, meaning you might earn large amounts of money during a “boom” period, and then move into a “bust” period that sees earnings fall. Typically, Diamond's contracts last six months to three years, priced at fixed/negotiated rates. The “risk” rises when that contract period is up, and a new contract at potentially lower rates for Diamond must be solicited. The big news in Q4 was a few of Diamond's customers signed lease agreements out four to six years, and at favorable rates. This is a big hint that Diamond's customers

think the demand for deep-water drilling rigs will last longer than the typical cycle, and potentially accelerate, prompting customers to lock-in today's rates at extended periods before other Diamond customers bid up rates. These contract extensions also give investors increased earnings visibility into 2009 and 2010. Given the extent of negative earnings in our economy across multiple sectors, Diamond's news was a bright spot in Q4.

Comments on Our Performance - Losers

Evidence of a consumer-led economic recession in the United States intensified in the Q4, causing stock prices of businesses predominately operating in the United States to fall. In our portfolios, this included **Home Depot**, **Lowe's**, **Buffalo Wild Wings** and **Waste Management**.

When I examine the risk / reward of **Home Depot (HD - \$26.94)** and **Lowe's (LOW - \$22.53)**, I think both businesses are selling at extremely cheap prices. With both stocks, I think we have about 10% to 15% downside potential vs. 75% to 100% upside. I still think they're likely to under-perform the broader stock market in the first half of 2008 as earnings expectations come down for each company, and, in a broader sense, investors come to realize the U.S. is in a consumer-led recession (which will further hurt stock market sentiment). However, these are dominate, high-quality businesses that have been unduly punished. More than anything else, negative sentiment is driving down their PE multiples, causing a double-whammy oof PE multiple contraction and earnings declines. When sentiment improves, I think PE multiples will rise first, followed by a steadying of earnings in early 2009. This will result in quick share price appreciation...hopefully by late 2008 or early 2009. I think the #1 risk is the extent of the U.S. recession. If it lasts through 2008 and carries over into 2009...ala a 1930's style depression, all businesses regardless of "value" or "how cheap" they currently appear will suffer. I've written in more detail about Home Depot in the "Market Outlook – Opportunities & Risks" section below.

We sold our remaining shares of **Buffalo Wild Wings (BWLD - \$23.22)** in Q4 at around \$27 per share (shares got as high as \$40 in the quarter). Buffalo Wild Wings probably has some of the best fundamentals in the entire U.S. restaurant sector, but with the U.S. consumer weakening and recession fears escalating, I saw a high probability of the market taking down the entire sector. I guess in the short-run my prediction has already come true, with the shares down another 25% to \$20. In the longer-term picture, this company is a screaming buy at \$23 and below...it's taking all my will power not to buy a little now. However, I prefer to review its 4Q07 earnings information and go on its conference call before re-committing new assets. I know this company very well, and I bet I'll be able to decipher earnings reports and consumer data as they relate to BWLD quicker than the market – in this vain we are well-researched and prepared to make our move when the timing presents itself. Big picture, the entire U.S. restaurant sector is getting pummeled by a consumer-led slowdown alongside higher food and labor costs. For example, **Darden Restaurants (DRI)** dropped about 20% in a single day n these issues (Darden's primary brands are Red Lobster and Olive Garden). Furthermore, **McCormick & Schmick's (MSSR)**, a Portland, Oregon-based operator of higher-priced seafood restaurants has seen its shares fall from the low \$30's to \$11.50. MSSR is operating its restaurants well and has an experienced, trust-worthy management team. However, like other U.S. restaurants and retailers, it can't escape the deteriorating macro-environment. FYI, MSSR is very cheap, and is another stock that we might be investing in when I feel the timing is right. It would not be surprising to see MSSR go from \$11.50 in early 2008 to \$15 to \$20 by late 2009 or early 2010 when earnings growth resumes.

Market Outlook – Opportunities & Risks

During the first three weeks of 2008 the stock market is down precipitously, roughly 15% off its October 2007 high. The bad news is I think we're in or headed for a consumer-led recession, and it's anybody's guess as to how bad things can get. The good news is stocks, especially U.S. stocks, are now cheap. Many of you will note we had an unusually large amount of cash in our portfolios to start 2008...this ranged between 15% to 50% of assets in cash or fixed-income securities, varying per account. I had shifted us to a large cash

position because the earnings and outlooks coming from a diverse swath of businesses were decidedly pointing to a 2008 recession. However, late last week (Jan 10th) we started putting some cash to work. I can't promise that I've timed things to where the market will start going up in two to three months, or even two to three quarters. But what I can tell you is stocks are cheap – with many stocks fully discounting a 2008 recession - & we're beginning to buy. I know seeing account values drop isn't pleasant. Unfortunately for the nervous-system, stock investments never go up in a straight line; but fortunately, cheaper prices mean greater long-term returns.

aking the above paragraph one step further...the "risk" embedded in our portfolios is the length of a recession. If a recession lasts only two or three quarters, and the economy rebounds in 2009, our portfolios are going to appreciate, perhaps rapidly, in the not-too-distant future. Playing Devil's Advocate, if the recession lasts well into 2009 or we're on the cusp of a 1930's-like depression, stocks will continue to go down. My fundamental belief is the U.S. is a growing nation, compromised of the most competitive, innovative people (and therefore businesses) in the world. The nation will grow again, stock prices will appreciate from current levels...and even the housing market will stabilize and grow (put me in jail & throw away the key for even whispering that thought). Not to get too detail-orientated, but there are a lot of other things that can go right that no one is talking about – be it short-term fiscal economic stimulus ala the 2001 tax rebates; making the tax cuts set to expire in 2010 permanent; the Federal Reserve cuts short-term rates; food and / or energy prices could come down...there are plenty of positives. Because I have a bullish long-term view of the United States, I think we should be willing to take "macro-economic" risk by investing during a recession. The risk I'm not willing to take is "valuation" risk – and I think this is the "good news" in today's stock market - valuations are not demanding following the December/January market fall. For example, if you look at the market crash in 1987 when the market dropped over 20% in a single day, the average PE multiple was around 20x earnings (PE = (P)rice of the stock, divided by the annual (E)arnings per Share). So if you have a stock price of \$60, and your business earned \$3 per share in 2007, the 2007 "PE ratio" is 20x (\$60 / \$3). Today, stocks are trading at an average PE of 15x – cheap vs. historical standards, and cheap vs. all other investments including fixed income and many foreign stocks. Just one side note – I'm talking a lot about a "U.S. recession" as if the U.S. is the only country we're invested in. If you take a quick look at where our profits are derived – you'll note 50% of GE's and eBay's profits are non-U.S.; 100% of Philippine Telecom's profits are...you guessed it...in the Philippines. Oil companies, while certainly affected by U.S. energy demand, are basically tied to long-term global growth...Berkshire Hathaway is certainly a global conglomerate. Even though we're primarily invested in U.S. dociled businesses, it doesn't mean we're not exposed to other geographies.

If you study great investors, they'll tell you the best buys they've made were during recessions. Warren Buffett, when asked the "what if" question about the U.S. heading into a 2008 recession, recently reflected on his career by stating his single best buy was the Washington Post newspaper company in 1973. His point - recessions for long-term investors are to be embraced as excellent buying opportunities. Of course Warren Buffett is genetically wired to invest. When stock prices go down, he feels happier because it allows him to invest at lower prices. I think 99.9% of us mere mortals are wired to get nervous, worry and potentially panic. When stock prices appreciate, Buffett does very little investing in common stocks. Where again, the majority of us want to invest when we see stocks going higher, because it "feels good" and we expect stocks, like housing values, to continue going up. For example, in 2007 Mr. Buffett purchased roughly \$3.5 billion dollars of **Burlington Northern Sante Fe (BNI - \$83.23)** for about \$80 per share. At the time of this writing, Burlington Northern's stock has fallen in sympathy with the stock market to about \$77. Instead of backing away or waiting until the economic outlook improves, Buffett bought more Burlington Northern almost every day the week of January 7th, and more on both the 14th and 15th of this week at about \$77 per share. Thinking about a recession and lower stock prices in this context, what businesses are priced for a recession and therefore present the best opportunities?

Home Depot and **Lowe's** are two examples of businesses priced for a significant recession. I'm going to walk you through the valuation of Home Depot as an example. In 2007, I expect HD earned \$2.30 per share, which, without giving you the calculation's details, equates to a 20% decline in net income from 2006. For 2008 I expect Home Depot to earn \$2.00 per share, equal to another 20% decline in net income (this would mean HD's net income declined 10% in 2006, 20% in 2007, & another 20% in 2008). This also means 2008 net income would equal about 2001's level of earnings – this represents a significant deterioration in consumer spending – the point being when valuing Home Depot we're using a conservative stance to gauge

value & risk. When I invest our money, I value the business under consideration and look to invest at a significant discount to my underlying estimate of the business' value. This is what I refer to as our "margin of safety." In Home Depot's situation, *if* it earns \$2.00 per share in 2008 and *never* grows earnings again (i.e. it earns \$2.00 EPS in 2008, \$2.00 in 2009, \$2.00 in 2010...\$2.00 in 2025), I estimate the business is worth \$23 per share. Furthermore, if you assume 2009 is *another* bad year and net income falls a further 10%, I estimate HD would earn about \$1.85 per share. *If* Home Depot earns \$1.85 forever, I estimate the business' value to be about \$21 per share. Now...another "if"...*if* you let your mind wander a little and let the radical thought emerge that the U.S. economy and housing market eventually gets out of recession by 2010 and grows again...our next question is "what is Home Depot worth assuming a modest growth rate off of a depressed \$1.85 EPS base in 2009?" Applying a 4% to 5% growth rate you'll calculate a valuation range between about \$45 and \$55 per share (vs. today's \$26 price), which means there's significant upside in Home Depot if we don't enter a massive recession or prolonged era in the United States of low-to-no GDP growth.

In Home Depot's case, it's rare to find this wide a discrepancy between estimated business value and stock market price for a dominate, well-known business. Only during recessions and bear market falls do you really see these opportunities emerge. In 2002 the market declined over 20%, and I remember thinking then how "under-valued" so many businesses were. For an investor, reflecting on 2002 was literally like "being a kid in the candy store." Of course, we were just emerging out of a business-led recession & 9/11. When I invested in 2002 it certainly felt nerve-racking because much like today, the market felt like it declined everyday without an end in-sight...there were a lot of uncertainties then just like there are today. In conclusion, the above exercise is what I do for all our investments in order to measure the risk vs. reward embedded in stock prices. Whether you're examining Home Depot, Burlington Northern or U.S. Bank, in today's bear market it's vital to distinguish between "stock prices" and "business value." I believe the market is punishing stocks to attractive prices for long-term investors. The underlying risk is whether or not we're headed for a very tough 1930's-style economic era. But as an investor, you make your money investing when and where others won't. Hopefully we'll look back two years from now and be happy we bought stocks in 2008!

Thank You

Thank you very much for your trust and support. I take this job very seriously, and I can't express to you how much I appreciate your trust and relationship. I hope you're doing well.

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: "I don't know why bankers come up with new ways to lose money when the old ways were working so well." – Wells Fargo CEO John Stumpf – Having a sense of humor in bear market is a great antidote © Wells Fargo's management team did a pretty good job resisting the irresponsible behavior other financial institutions engaged in (Citigroup, Merrill Lynch, Washington Mutual, Countrywide Financial, UBS, Barclays, et al).

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