WEDGEWOOD VIEW. 2ND QUARTER 2006

RENAISSANCE OF GROWTH

Many shall be restored that are fallen and many shall fall that now are in honor.

Benjamin Graham quoting Horace from *Ars Poetica* in the opening of 1934 first edition of Security Analysis.

The title and theme of this Letter are borrowed from a lecture entitled *The Renaissance of Value* presented by Benjamin Graham to the Institute of Chartered Financial Analysts in the fall of 1974. After reaching iconic status on Wall Street, and though 80 at the time, Graham was still at the top of his considerable faculties after 57 years on Wall Street (he would pass away in 1976). Before we get into Graham's lecture, a word or two is quite in order on this amazing individual. We, in the investment business, sit on the intellectual shoulders of the giants who came before us - few such giants - larger and more influential than Benjamin Graham. Graham was a prodigy in numerous fields.

Born Benjamin Grossbaum in London in 1894, his family immigrated to the United States in 1895. Financial hardship ensued upon the death of Graham's father when he was nine years old. Eventually graduating Phi Beta Kappa, second in his class at Columbia in 1914, he honored in English, French, Greek, Latin, mathematics, philosophy and music. After Columbia, Graham (he would change his name in 1917), went to work for the Wall Street firm of Newberger, Henderson and Loeb for $12 per week. By 1920, Graham worked his way up to partner at the age of 26. By 1928, he began teaching investment classes at Columbia. He would teach legions of future investors over the course of the next 28 years (notable students include Warren Buffet and Sir John Templeton).

Tragically, if not surprisingly, Graham and his family would be wiped out in the 1929 stock market crash – primarily due to excessive margin. Yet, out of utter financial ruin, and seared by this financial trauma, Graham, through force of his rare intellect would restore himself by developing a new security analysis and investment management framework. This formation would be a precursor to the launch of the professional investment management industry as we know it today. Over the course of the next 45 years, Graham would; co-author (and rewrite) the seminal investment text book, Security Analysis (1934, 1942, 1956 and 1972); author what is arguably the best book on investing for both the lay and professional investor, The Intelligent Investor (1949); run an uniquely successful investment partnership (Graham-Newman 1929-1956); and was an original founder of the first professional and accreditation organization for investment professionals (Institute of Chartered Financial Analysts – recently renamed the CFA Society).

Fast forward to the fall of 1974: Graham's lecture was, in large part, a postmortem on the state of the professional investment management industry after the worst bear market (1972-1974) since the stock market crash of 1929 (and ensuing bear market to 1932), but it was also a call-to-arms to recognize the substantial investment opportunities that the bear market was still creating. At the time of Graham's lecture, one must recall not only the turmoil the state of the world had fallen into, but also try to remember the chaos and abyss into which the world's financial markets had descended.

In mid-October of the previous year, the Arab oil embargo began. By May of 1974, the Prime Rate would be a record 11.5%. On August 8th, President Nixon resigned. In the first week of October, Franklin National Bank collapsed. Inflation (CPI) rose from 3% in mid-1972 to an unheard of level of nearly 12% by the end of 1974. The Dow Jones Industrial Average would finally bottom at 577 on December 6, 1974. From its previous peak of 1051, set on January 11, 1973, the Dow crumbled 45%.

The past is never prologue, but when it comes to the financial markets, it sure seems to rhyme. Our comparison to the end of 1974 is assuredly imperfect for two key reasons. The first is that the U.S. stock market, in the summer of 2006, has not suffered a Category 5 bear market and our economy is not in the throes of a severe recession. However, we believe there is compelling evidence of similarities to compare and contrast the periods. In Graham's, *The Renaissance of Value*, he lamented about the lack of investment versus the excess of speculation. So much so, that a "cult of short-term performance" had become much too prevalent. Furthermore, he was highly critical of the industry norm of equating risk with price variability. Graham's critique is succinct:

What bothers me is that authorities now equate the Beta idea with the concept of "risk." Price variability yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management… The idea of measuring investment risks by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says what actually happens to the owners' stake in the business…

Lastly, with regard to specific stocks, Graham noted the "reappearance of… investment opportunity."

The Perfect Storm for Growth

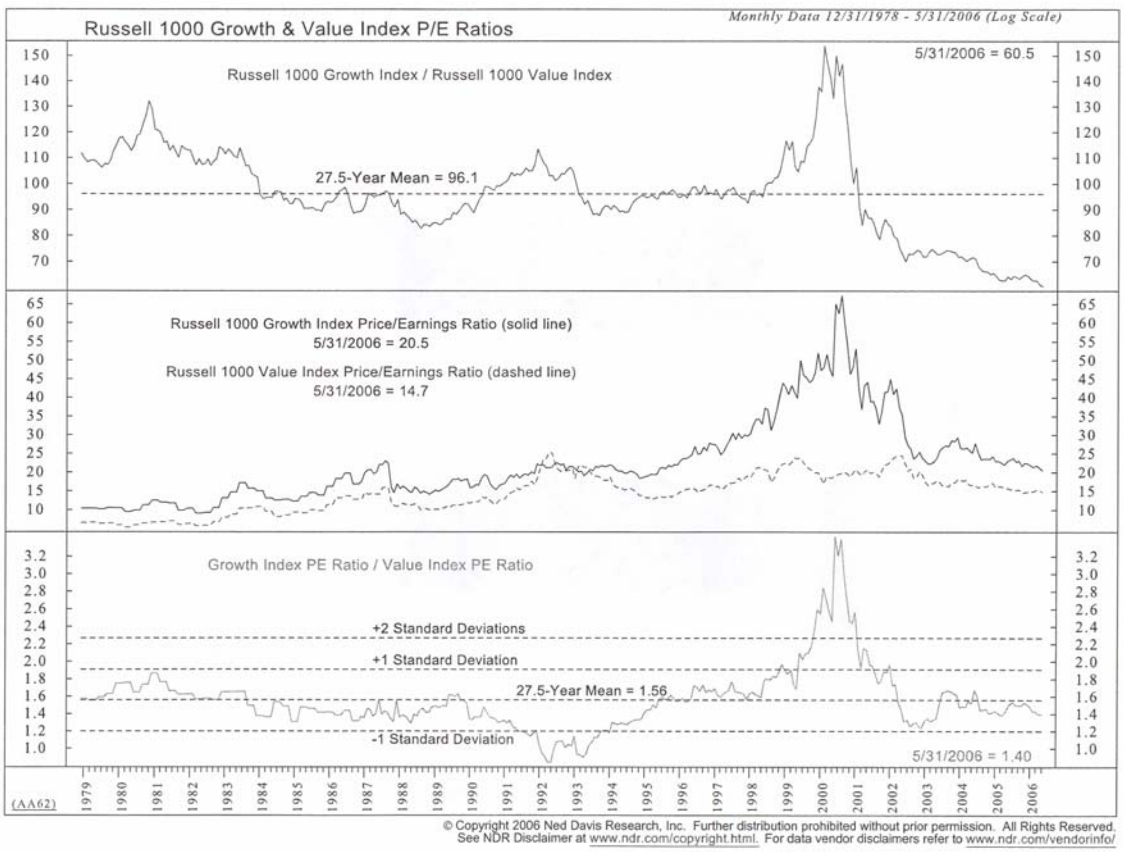
Our investment philosophy here at Wedgewood Partners is decidedly simplistic: We invest as "owners" (for the true long-term), in relatively few, uniquely profitable businesses, at reasonable valuations. That's it. What could be more basic? With such a seemingly powerful combination of superior corporate growth, plus a valuation kicker, how could we not possibly outperform the "market" and the majority of our peers' year-in and year-out? Well. For nearly 20 years now, such a philosophy has served our clients quite well. However, our results over the past year or so, particularly over the past six months, could be charitably described as… dismal! In fact, our relative performance against the Standard & Poor's 500 Index and the Russell 1000 Growth Index, for the first two quarters of 2006, has been the worst stretch of six months that we, as a firm, have ever had. Nascent clients are asking if we have become suddenly stupid. Seasoned clients are asking whatever happened to those late 1990-type returns we all enjoyed so much. Our answer to the first question is: We certainly don't believe that our investment philosophy and process has, somehow, suddenly become unintelligent. Our answer to the second question is: We were never so talented to compound annual returns in excess of 40%. So, what happened?

In our view, this so-called Perfect Storm for Growth over the past five-plus years was comprised of three key elements: excessive valuation of Growth stocks in early 2000; the most robust and protracted profit expansion (since the recession of 2001) on record; and excessive speculation in Value stocks over the past two years. Consider the matter of valuation; take a look at the graphic below from Bernstein Research: It shows the performance of Growth stocks versus Value stocks for five distinct periods going back to 1980.

Growth and Value Stocks Have Alternated Leadership

Individuals with a statistical bent are familiar with the nomenclature of "standard deviation events." This simply refers to observed phenomenon in extremes over average or likely normal occurrences. The one field that "2 and 3 standard deviation events" seem to manifest themselves in more than any other field is in the financial markets. In terms of "investment style," we as Growth investors have been the beneficiary and have suffered through such rare standard deviation events over nearly the past ten years.

The chart below compares the performance ratio of the Russell 1000 Growth Index versus the Russell 1000 Value Index since 1979. As depicted below (and on the previous graphic), up until about 1998, both Index's outperformance could last a few years, but extremes in outperformance were rare.

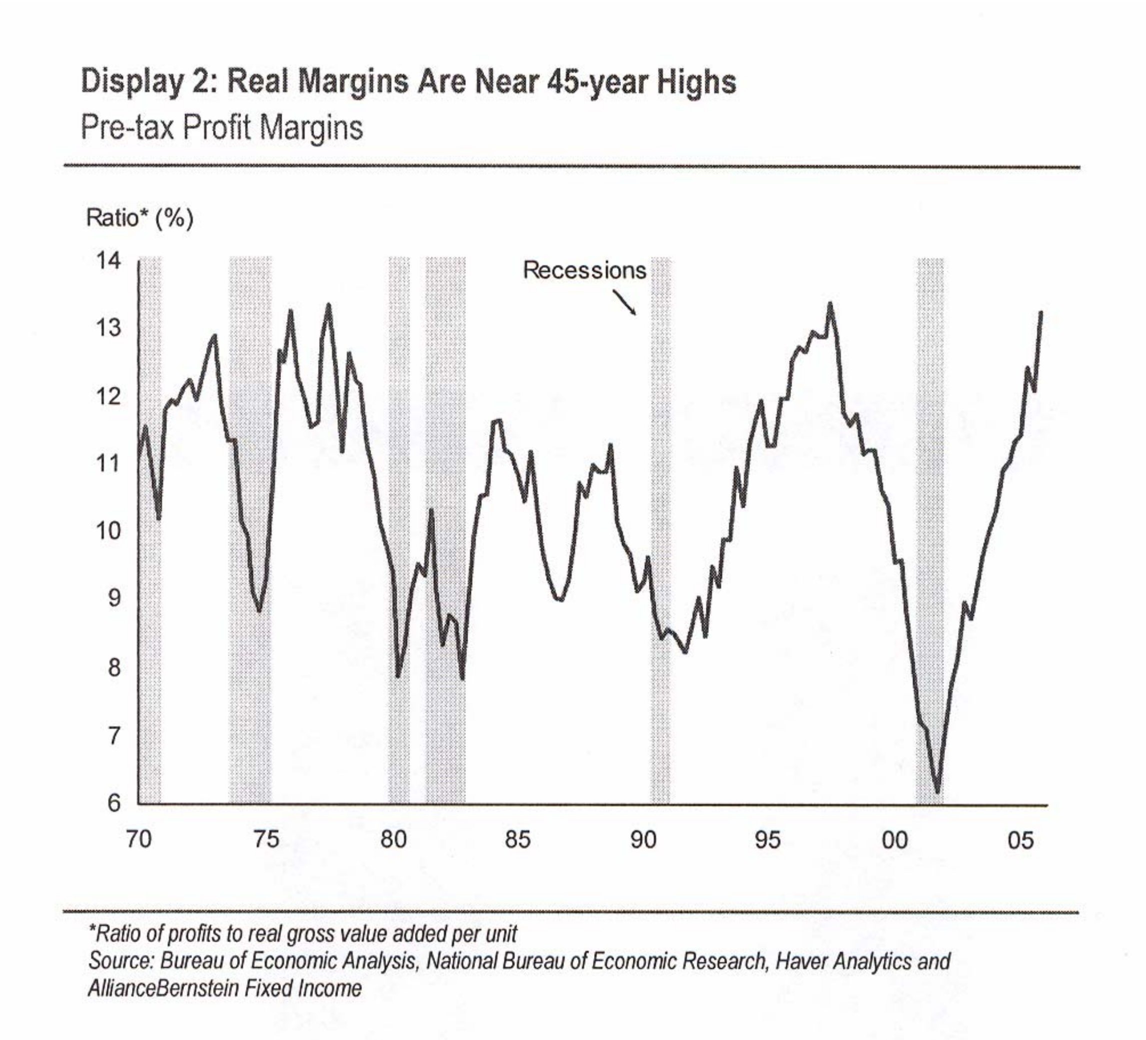


However, the Tech/Telecom/DotCom boom changed all that. The table below shows the compounded annual returns of each respective Russell Index from the beginning of 1997 through the March 2000. As you can see, the outperformance of "Growth" over "Value" was stunning – over *16* percentage points per year.

Index	**1/01/1997 thru 3/31/2000**
Russell 1000 Growth Index	33.93%
Russell 1000 Value Index	17.46%

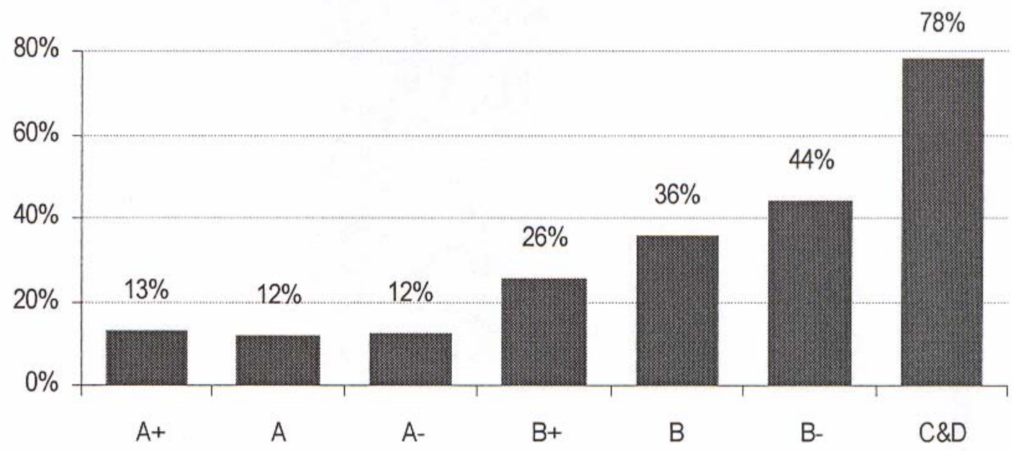
Calendar 1999 would prove to be the dénouement for Growth stocks. Return disparities between Growth and Value investment styles were outrageous. The Russell 1000 Growth Index gained 33.5% while the Russell 1000 Value Index gained just 7.4%. In a year when the Standard & Poor's 500 Index gained 21%, more than a few notable Value managers (Clipper Fund, Dreman and Sequoia Fund) actually posted negative returns in 1999 and one of the all-time best Value-oriented hedge fund managers (Julian Robertson) actually liquidated his enormously successful multi-billion dollar hedge fund family due to performance-related liquidations. We at Wedgewood Partners can more than relate to such underperformance woes these days.

The second element concerns the matter of corporate earnings. The chart below is quite instructive.



Historically, the profitability cycle has been the most significant determinant of differences in investment style returns. As you can see, corporate margins rebounded from multi-decade lows to multi-decade highs since the last recession in 2001. (Astute readers will recall that the 2001 recession was unusually mild, yet profitability and earnings were crushed – more on this in a bit). Coupled with strikingly high productivity and a considerable increase in foreign repatriated earnings, corporate earnings growth since 2002 has been the best since World War II. In fact, this most recent period of quarterly earnings (consistently in excess of 10%), has been the longest in duration since 1926. Without question, the amazing profit recovery since 2002 was a major driver of outperformance for Value stocks of all capitalization sizes.

Average Performance by Quality when the Profits Cycle Accelerated (Last Three Cycles)



source: Merrill Lynch Investment Strategy, Standard & Poor's

The third key element, in our view, revolves around the issue of sheer speculation. The marginal investment dollar follows performance. Always has; always will. The funds flowing into Value stocks – and conversely out of Growth stocks - has reached, in our view, unsustainable extremes.

Renaissance of Growth

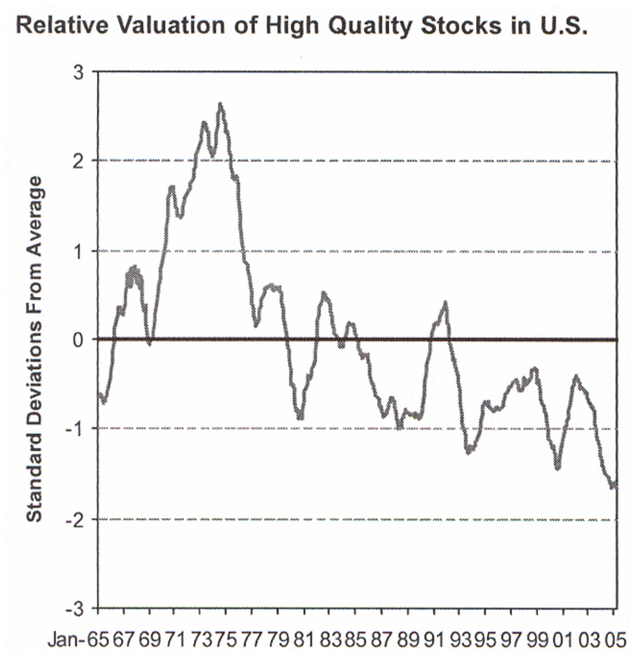
I'd love to run a large-cap portfolio, because these growth stocks are cheaper relative to the overall market than at any time in my experience on Wall Street.

Joe Rosenberg, 45-year veteran and Chief Investment Strategist for Tisch family controlled Loews Corp. Barron's 6/2006

High quality growth stocks have not been this cheap in decades.

Jeremy Grantham, Chairman of the Board, GMO

We believe the stage has been set for a true Renaissance of Growth stock investing. We could also call it "The Perfect Storm for Value." Simply put, the three key drivers of outperformance of Value over Growth, in our view, over the past five years have all reached reversal inflection extremes. The style pendulum swung too far in 2000, its reversal has swung too far in 2006. So, the three drivers for a Renaissance of Growth stock investing are; excessively cheap valuations, a current environment for corporate profitability that can hardly get better and a current environment of investor sentiment for Growth stocks that could hardly get worse.



Source: GMO

The chart above speaks volumes – high-quality Growth stocks are cheap. Period. The outperformance of Large-Cap Value stocks over Large-Cap Growth stocks has been nearly as great as the heyday of Growth stocks in the late 1990's. In fact, since the speculative mania for Growth stocks in the spring of 2000, Large Value has trumped large Growth by *14* percentage points per annum (see below).

Index	**3/31/2000 thru 6/30/2006**
Russell 1000 Growth Index	-7.70%
Russell 1000 Value Index	6.49%

The Value Opportunity Is at an All-Time Low

Through March 1, 2006
These data represent the amount by which the most attractively priced large-cap stocks within each market sell below overall market valuations. The proportion of Bernstein investments in stocks from this group will vary over time but will typically be high. Bernstein's estimates of the fair value of these stocks may not be realized for a variety of reasons.
Source: Compustat, Datastream, DRI, FactSet, MSCI, and Bernstein

On a price-to-sales basis, the Russell 1000 Value Index is sporting all-time high valuations of 1.4X. On the other hand, the price-to-sales ratio of the Russell 1000 Growth Index of 1.9X is at ten-year lows. Furthermore, the Russell 2000 Small-Cap index now sports a valuation at a 20% premium the Russell 1000 Growth Index. The last time such a valuation disparity existed was in 1983. The subsequent valuation reversal propelled Large Growth stocks on a multiyear period of outperformance.

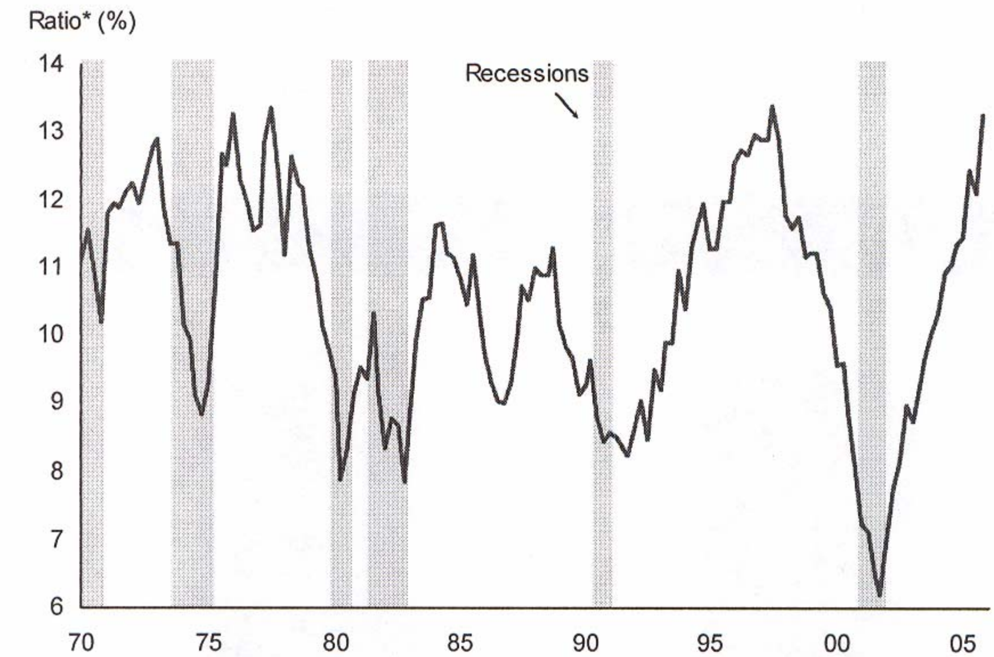
We now need to go back, once again, to the matter of corporate profitability. As "bottom-up" stock pickers – and stressing the all-important philosophical matter of investing as long-term "owners" of businesses - we at the firm don't spend too much analytical time thinking or worrying about the myriad of economic data that is reported and pontificated on a non-stop basis by investors of all stripes. Our reasoning is two-fold; much of the economic data is lagging in nature, possessing little predictive value and even if we could accurately predict such stuff we find it difficult to apply such broad-based information into the analysis of comparatively narrow business models.

That said; the one set of economic data that we believe to be quite relevant is the corporate profitability cycle. The information inherent in this series of data is particularly useful. Furthermore, we have yet to find an economic series of data that is more mean-reverting than corporate profitability. This mean-reversion reality is paramount at inflection points.

Please refer to the graphic on pre-tax margins below – the same as on page six. Would any reasonable investor, looking at the 45-year chart, try to make the case that corporate profitability is not *significantly* cyclical?

Display 2: Real Margins Are Near 45-year Highs

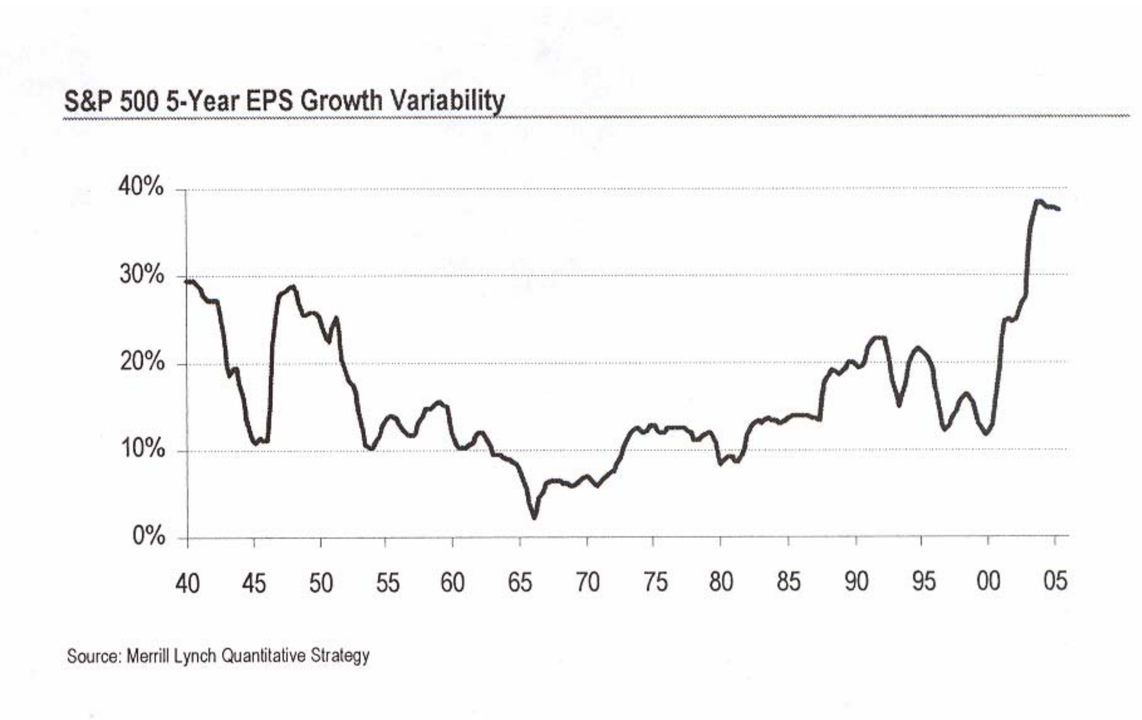
Pre-tax Profit Margins



**Ratio of profits to real gross value added per unit*

Source: Bureau of Economic Analysis, National Bureau of Economic Research, Haver Analytics and AllianceBernstein Fixed Income

We have already discussed what a remarkable profits recovery Corporate America has enjoyed since 2002 – truly one for the record books. But take a close look at the plunge in margins during the last recession. Despite the fact that the 2001 recession was quite mild, margins still posted the largest cyclical drop in 45 years. Why? Corporate America is a different animal than previous generations. Corporate America has never been "leaner and meaner." Operating leverage is abundant. However, "lean and mean" cuts both ways as was witnessed in 2001-2002. To repeat, Value stocks thrive in a rising profit environment. Is it reasonable to assume that the cyclicality of corporate profitability has been repealed? We don't think so either. Is it reasonable to assume that if corporate profitability has reached a zenith, seen in just a few previous instances during the past 45 years, could it get worse? We think so too. The headwinds now facing corporate profitability are becoming numerous. Herewith are a few to ponder: Profits, as measured by both operating margins and pre-tax margins, are at multi-decade highs. Profits as a percentage of GDP (12%) are at record highs. Similar to legions of homeowners, Corporate America has capitalized on generational low interest rates to refinance their respective balance sheets. However, never at a loss to over-indulge, corporate balance sheets have taken on debt to levels not seen since 1990, (i.e., Corporate America has financially levered up). Corporations have retired $2 trillion in equity since 1984. That's the good news. The bad news is that corporations have accomplished this by adding $4.2 trillion in debt. Business debt rose sharply by 10.4% in the first quarter of 2006 alone. Corporate earnings have also benefited handsomely with the sharp rise in commodity prices over the past few years. Commodity prices are a measure of "pricing power" – which distorts true earnings power. Lastly, would you be surprised to learn that the cyclicality of earnings is at *65-year* highs? So were we.



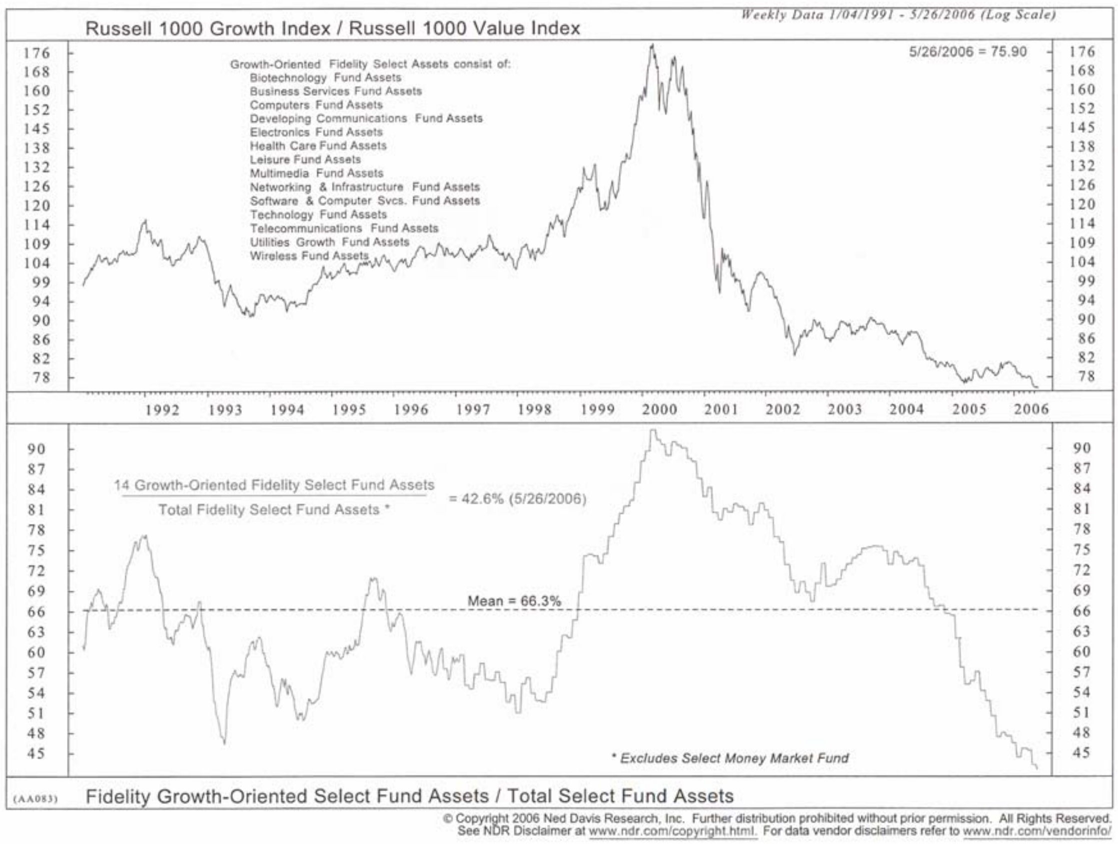
Consider a few more developing economic headwinds: The 17 Fed interest rate increases, in terms of both absolute and relative size, are the most since the Volker Fed-era of the early 1980's. The former housing boom – a tremendous driver of economic growth and employment - is over. Housing supplies are at multi-year highs. Fixed-rate housing affordability is at 1989 levels. Adjustable-rate affordability is at 1986 levels. Yearly mortgage equity extraction in excess of $1 billion is on the wane. Adjustable-rate mortgages have begun to reset higher - $2.5 *trillion* in ARMs are poised to reset higher, at a minimum, through 2007.

And last, but certainly not least, is the pesky matter of the current yield curve. Economists like to debate the predictive signals and significance of yield curve changes. Most agree that a flattening yield curve is a precursor to a slowing economy. Many still agree that an inverted yield curve is a precursor to an economic recession. Most of the debate, however, revolves around the time lag (typically about twelve months) of yield curve changes and subsequent changes in economic activity. We will let the facts, herewith, speak for themselves:

- ***Over the last 40 years the yield curve (as measured by the difference between the 3-month T-Bill and the 10-year T-Note) has flattened as much as it has recently on eight occasions. All but one of those was a prelude to a recession. (The exception was 1998 when the Federal Reserve ostensibly bailed out Long Term Capital Management by cutting rates twice during the fourth quarter of 1998).***

- ***Over the past 40 years when the yield curve just flattened (not fully inverted), in every instance, corporate profits fell into a profits recession.***

So far, we have examined the matter of valuation and profitability. The last issue to consider is that of investor sentiment. Investor sentiment is easy to recognize. Pinpointing reversals of investment sentiment is an altogether different – and difficult exercise. We invest in a world that is increasingly short-term oriented. Our average holding period here at Wedgewood Partners is typically five years or more. But the reality is that we have many clients who monitor our performance on a quarterly basis (and even monthly). Peer and career pressure, plus business risk of underperforming, certainly affects investment decisions. Investing contrary to the crowd is psychologically difficult. In an investing world (re: speculative), in which three-quarters of the current roster of 7,000 hedge funds have performance "lock-up" periods (in which to "perform") of one quarter or less - with 50% of these funds having "lock-up" periods as short as *one month*-is it any wonder that true long-term investment value does not turn on a dime? The chart below so smacks of performance chasing, that a skeptic might think it fabricated.



Analysis of fund flows within the Fidelity Select Funds offers a unique, and often times poignant, insight into investor sentiment and the never-ending pursuit for instantaneous performance. Since 1991, as the chart above shows, the mean percent of growth-oriented assets – as a percent of the total asset base within Fidelity Select Funds - is 66%. The average at the mania peak of the Growth/Tech/Telecom/DotCom in the spring of 2000 reached 94%. Today, Scarlet Letter growth funds garner a 16-year low of 42%.

Another example of such a self-fulfilling trend is the asset flows into today's red-hottest sector – Emerging Markets/Energy/Natural Resources. In our evolving connected/correlated world, international central banks, independent from our Federal Reserve, often times, can impact economies and financial markets in out-sized ways. Over the past ten years, no other central bank has had the relative out-sized impacts than Japan's central bank – the Bank of Japan. Since the deflationary implosion of Japan's economy in 1989 (remember "Japan, Inc.?"), the BOJ has, in large part, attempted to financially engineer economic growth via an excessively accommodating monetary policy. The last five years has seen a three-fold monetary policy of essentially zero short-term interest rates, "Quantitative Easing" and steadfast currency stability (Quantitative Easing is simply running the currency printing presses 24/7). The net result of such policies has inordinately flooded the world with massive amounts of seemingly risk-free capital far in excess of the needs of Japan's domestic economy. This lay-up financing of borrowing super cheap Yen and investing (speculating?) in anything, anywhere is called the "Yen Carry Trade." Your nephew, the hedge-fund manager, knows all about this stuff. Anyway, without question, such excessive liquidity has found its way into financial and commodity markets.

It is terrifically difficult to determine the fine-lines of where and when "fundamental investment value" turns into "speculative excess." So, we decided to look at the best performing mutual funds over the past few years to see if out-sized returns may suggest the existence of speculative fervor. We searched for the top-10 and top-40 performing mutual funds in the Morningstar database as of 7/6/2006. We considered both 1-year and 3-year returns. We included all share classes as well. Below are the results (note: 3-year returns are annualized):

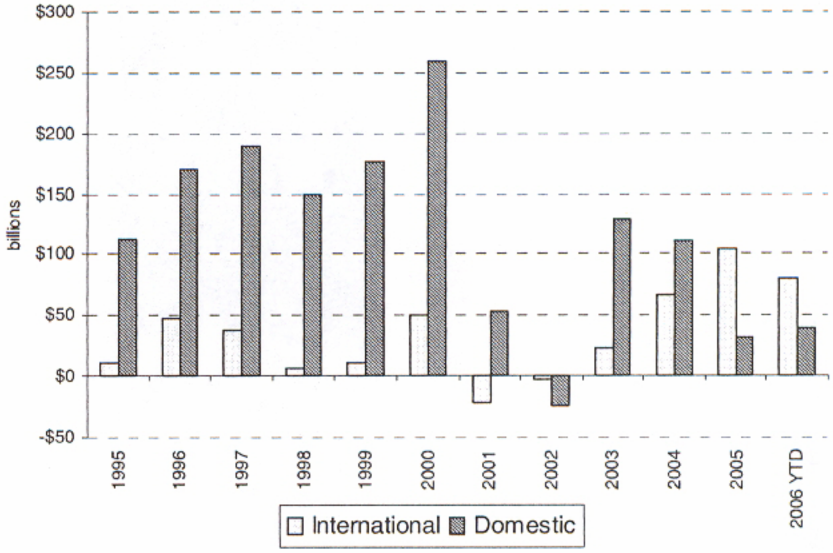
Morningstar: 1-Year and 3-Year Top-Performing Mutual Funds

Time	# of Funds	Ave. Fund	Ave. Top 40 Fund	Ave. Top 10 Fund	Russell 1000Growth Index
1-Year	19,314	9.7%	68.0%	92.3%	6.1%
3-Year	15,920	10.8%	43.5%	51.1%	8.9%

No doubt the performance figures above are remarkable. More remarkable to us that every fund – in the one and three, as well as top-40 and top-10, was either an Emerging Market/Energy/Natural Resource fund. These types of performance numbers remind us of prior excessive return periods: Japan 1989, Emerging Markets 1984 and Tech/Telecom 2000. Most ended poorly. ***An aside admission: We at Wedgewood Partners have not owned a single Emerging Market/Energy/Natural resource stock over the past three years.***

Figure 1. Annual Equity Mutual Funds Flows: Domestic vs. International

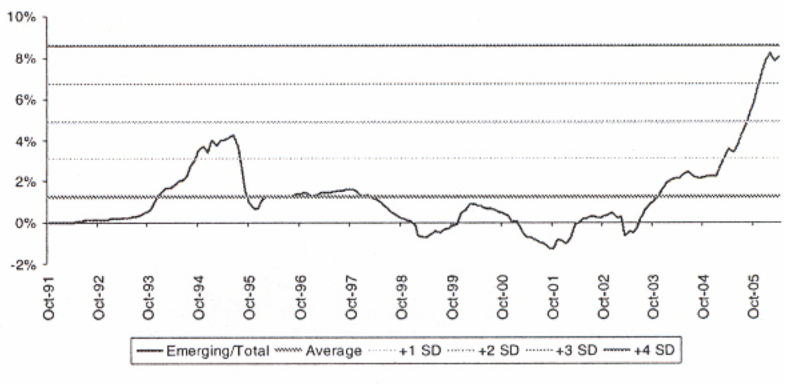
This year, almost 67% of money flows have been toward international markets. (The 2005 ratio was greater than three-to-one.)



Source: Investment Company Institute and Citigroup Investment Research U.S. Equity Strategy

Figure 2. Emerging Market Flows as a % of Total Mutual Fund Flows (12-Month Cumulative Flows)

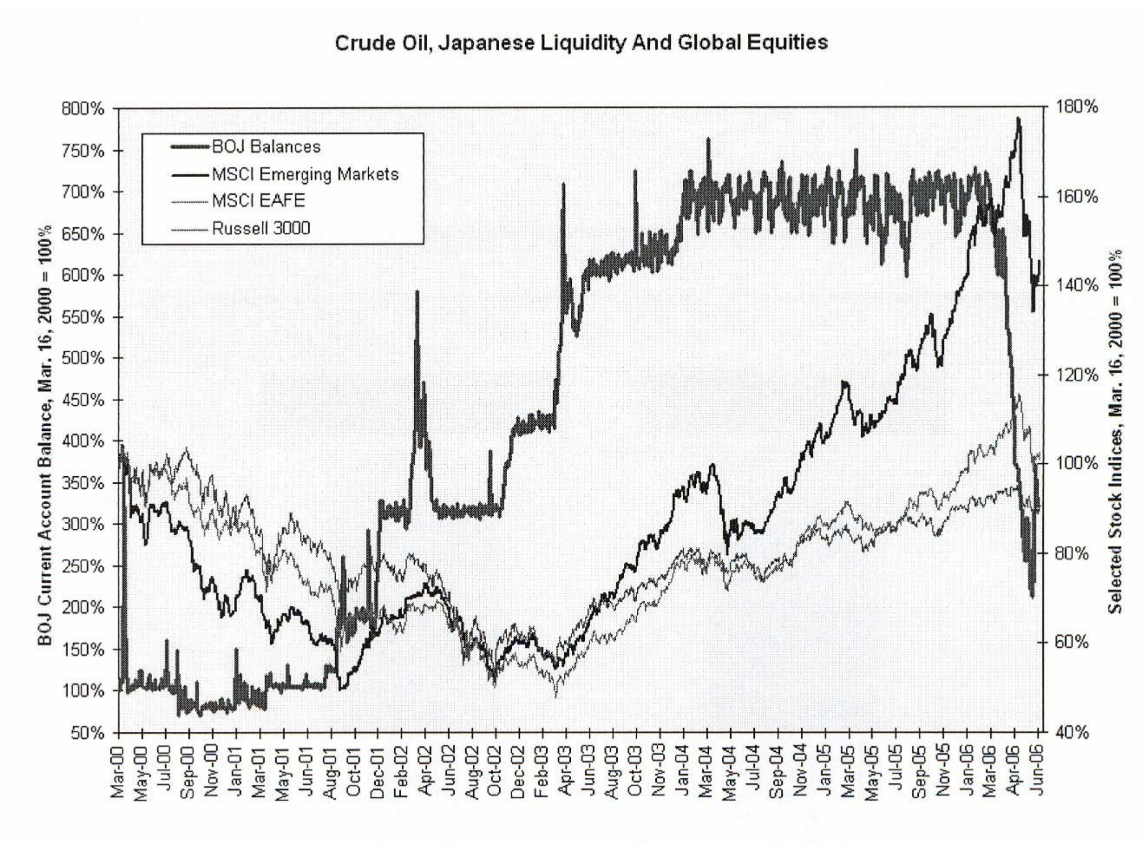
The proportion of emerging markets fund flows has jumped to near a four-standard deviation event.



Source: Investment Company Institute and Citigroup Investment Research U.S. Equity Strategy

Coincidental to the purported "Perfect Storm" elements, the BOJ's monetary policy has reached an inflection point too. The following is a graphic and direct quote from Howard Simons, President of Simon's Research. It is telling:

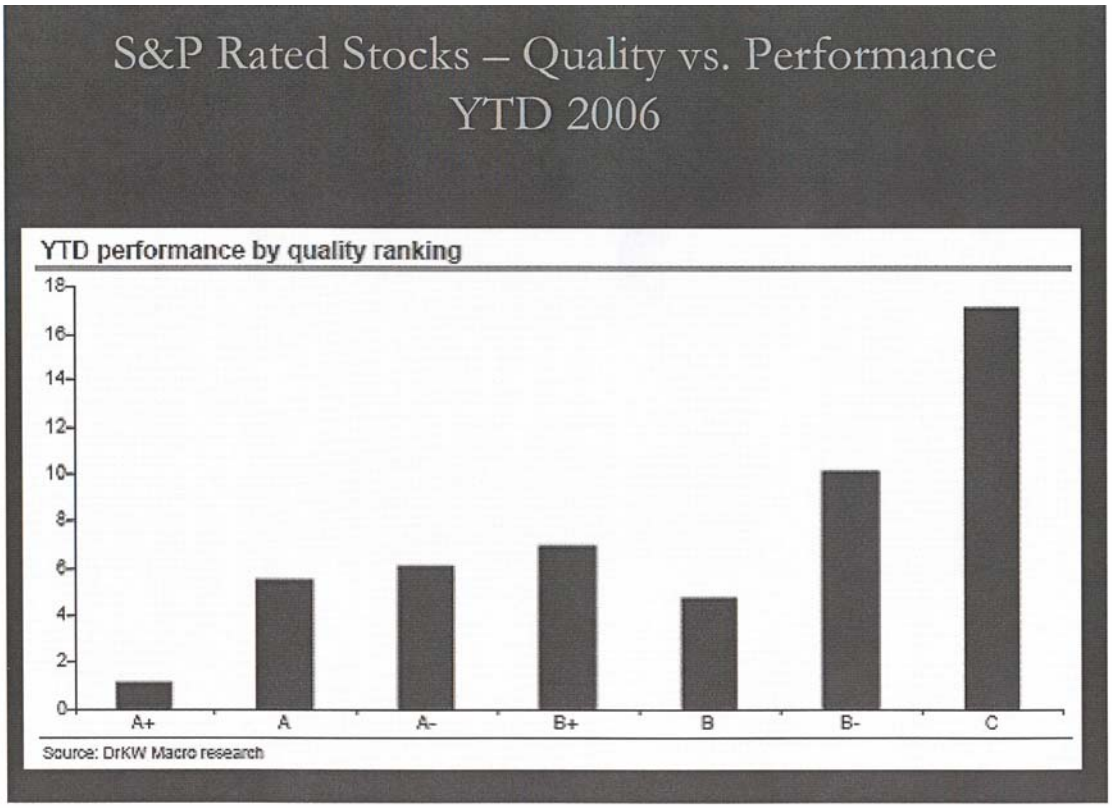
We can chart the course of quantitative easing by measuring the current-account balances held at the Bank of Japan. They increased dramatically between 2001 and 2004, and then hovered there until the start of the year. Then the fun began. Even though the BOJ hinted as early as Nov. 16 and again on Feb. 3 of this year that quantitative easing was going to end, Wall Street tends to be populated by people who believe they can exit a burning building faster than the next guy.



Between Feb. 10 and June 12, the BOJ's current-account balance shrank by 21.56 trillion yen. At an average yen/dollar rate of 115.432 yen over this period, the BOJ withdrew \$187.776 billion. As the U.S. GDP is 12.1688 times as large as the Japanese GDP, this would be the equivalent of the Federal Reserve withdrawing \$2.2285 trillion out of the U.S. banking system over a four-month period. By way of comparison, the St. Louis Federal Reserve's zero-maturity money measure, MZM, is \$6.9363 trillion.

Wedgewood Partners Portfolio

The current market environment for us at Wedgewood Partners is a striking dichotomy. On the one hand, our recent performance results have been poor - at best. On the other hand, we believe that we have done some of the best investing in our careers of late. It is oxymoronic (some clients may just say moronic) to state such a thing, and even though such reasoning may seem counterintuitive, the past record is clear; our very best investments over the course of our career have come in periods of underperformance. The current period has been so dismal for growth stocks that the pickings have been unusually fertile for us.



When we square our current portfolio in terms of any of the following attributes; business quality, balance sheet strength, cash on balance sheet, entrenched market share, new market opportunities, potential earnings growth, profitability, cash flow generation and overall state of each business's "economic moat" against the current valuation of the portfolio, we are hard pressed to recall building a portfolio with the sustainability of double-digit growth rates at such attractive valuations. More to this point, if we are even close in our view that the growth rates of corporate earnings are set to slow, our portfolio could post growth rates as much as three times that of the broad stock market (S&P 500 Index) at *zero* valuation premium.

In an investment world where hedge funds lock-in their performance on a monthly basis and the typical equity mutual fund manager turns over their respective portfolios 100% every twelve months, our portfolio activity at our firm seems rather sloth-like: It is, to be sure. But our reticence not to speculate and trade is by philosophical design.

When we postulate that "we believe that we have done some of the best investing in our careers of late," such a pronouncement requires proof. Often times our best "investing" is recognizing the all-too-common disconnect (which can be significant in scope and quite long in duration) between company fundamentals and the underlying stock. At other times, we try to act when others are too reluctant. Investing is a marathon, not a sprint. The following are two examples of "underperforming stocks," but not necessarily "underperforming companies."

Legg Mason

We have been owners of Legg Mason since September 2002. Through year-end 2005 the stock has been one of our best performers increasing from our initial split-adjusted cost basis of $30 to $130 by the end of 2005. In early December of 2005, the company closed on two transforming acquisitions which doubled the company's assets under management to $850 billion and significantly expanded their business internationally. The company acquired the fee-based money management arm of Citigroup (Citigroup Asset Management - CAM) and swapped their commission-based Private Client and Capital Markets Group. At the same time, the company acquired The Permal Group. The acquisition of CAM alone nearly doubled the company's assets under management and tripled their proprietary mutual fund assets. The Permal Group is a fund-of-hedge-funds manager with a 30-year history.

At the announcement of these acquisitions, the company's CEO, Chip Mason, could not have been clearer to shareholders that the integration of these two acquisitions would take nearly a year. We have long admired Mason, not only for creating extraordinary wealth for Legg Mason shareholders, but also for his candor. He has not minced words since these announcements. He has stated clearly to shareholders and to Wall Street analysts that the company's financial results, post-acquisition, for the next 3-4 quarters would be "messy" and essentially "useless" for comparative purposes and valuing the company. Well, since Mason's lack of "perfectly clear-cut guidance" the shares have dropped nearly 30% since March.

The "obvious" question is why do we hold on to these shares when the action of the stock certainly "signals" troubles? But in this case, the "obvious" question is a *non sequitur*. The stock price decline largely signals the selling of shareholders who demand instant gratification. These are "renters," not "investors." We hold the stock because the intrinsic value of the company continues to grow at rapid, and industry leading rates. 2006 is messy. We say: "So what!"

As we enter 2007, we are of the strong opinion that Wall Street, in their inimitable "wisdom," will recognize Legg Mason for what the company is today – a global powerhouse money manager possessing an unrivaled "Murderer's Row" line-up of money managers, with a global distribution encompassing 180 countries. As a money management firm ourselves, we could not have more professional respect for the roster of Legg Mason's in-house and owned, but independently managed managers (We will list them, but we ask our clients not to pay too close attention to their investment track records!).

Performance rules and performance sells. Legg Mason has outstanding managers in both equity and fixed income. Legg Mason Capital Management ($65 billion in assets under management) is anchored by the esteemed Bill Miller. Private Capital Management ($30 billion), headed by Bruce Sherman, garners one of the best 25-year Value performance records in the country. The Royce Funds ($28 billion), founded by Chuck Royce, is peerless in the management of Small-Cap stocks. CAM's U.S equity management ($115 billion) rechristened ClearBridge Advisors and added industry leading talent in Brian Posner, Hersh Cohen and Richie Freeman. Batterymarch Financial Management ($24 billion) has compiled an outstanding record of managing international assets. Brandywine Global ($30 billion) has a terrific record in both international equity and fixed income. Western Asset ($500 billion) is a fixed-income superstar. Acquired by Legg mason in 1986, Western Asset manages over 65 product mandates in fixed income. And last, but not least, The Permal Group ($23 billion) is one of the largest fund-of-hedge-fund managers.

Legg Mason earned $3.59 per share in fiscal 2006 (March). Earnings in fiscal 2007 are such a mismatch of non-recurring expenses and other non-comparables that the results will be relatively unattached to long-term performance. However, fiscal 2008 earnings start to matter. We believe that fiscal 2008 earnings could reach $7.00. As a pure fee-based money manger, and valued at a reasonable 20X earnings, the stock could easily march right back to $140 in short order.

Yahoo!

Undoubtedly and unquestioned, the Internet is still in its infancy with plenty of capacity for growth. Dominated by the big players; Yahoo!, Google, Microsoft, AOL, eBay and Amazon (including the occasional shakeups and startups) will undoubtedly alter the current status-quo due to technological advances and the ever changing demands and whims of internet users - both consumers and businesses. We believe the industry offers enough opportunity for 2-3 major players.

Large-Cap Internet companies have been hit hard this year with the average Internet company down over 17%. This is a space we felt we needed to participate in given the expected growth rates of many of these exceptional growth companies and the resultant risk-return tradeoff served up from recent declines. In other words, the market delivered Yahoo! to our front door and we welcomed it like a long lost puppy. (Yahoo! was down 25% for the year when we first initiated positions in our portfolios.) Much to the dismay of Yahoo stockholders, August 19th, 2004 was truly a day that will live in Internet infamy - Google's first day of trading on the NASDAQ (Yahoo! closed that day at $28.11). At the current price of $32.80 per share, Yahoo! stockholders have a 17% return on their investment since August 19th, 2004. Not bad. On the other hand, Google has returned 319%. Not bad. Yahoo! has not performed well (relatively speaking) since Google went public. Currently trading at 54X 2006 GAAP EPS estimates of .58 cents, the stock does not appear to be cheap. But if the company's cash holdings of $1.70 per share and the $8.50 per share not reflected in the balance sheet for Yahoo!'s stakes in Yahoo! Japan and Alibaba are stripped out - the P/E falls to a much more appealing 37X. On a price-to 2006 sales basis, Yahoo! is trading at a 9.0X P/S multiple, below the industry mean of 19X and Google's 16.7X - although Yahoo's estimated 5-yr. EPS growth is higher than the industry mean. On an EBITDA basis, Yahoo! trades at 15X estimated 2006 EBITDA – two-third's of Google's multiple. Although Yahoo! has grown sales 63% per year over the last five years and EPS have grown 77% over the same period, we believe Yahoo! still has plenty of growth ahead and will take a large percentage of future online ad spend. Yahoo!'s near term future revenues are expected to rise by 30% to 40% per year and cash flow is expected to jump 60% to $2.5 billion in 2007. The company is also increasing their capital expenditures to compete more effectively with Google and Microsoft. Also, Yahoo! has purchased over $1 billion of its own stock so far in 2006.

We are in the early innings as the Internet giant's battle for advertising dollars. Online advertising is expected to grow at rates much higher than the overall advertising industry, due to under-spending in relation to other media forms and the rapidly increasing exposure that individuals have on the Internet versus other media sources. Global advertising is half-a trillion dollars, of which, *only* 3.6% is spent online. By 2010, that total is expected to triple.

Other than pure valuation and industry growth opportunity, why Yahoo!? - reacceleration of growth in 2007.

Yahoo!'s strong brand recognition, services and content has resulted in Yahoo having the biggest audience on the web, reaching *500 million* unique users at least once a month. Their fee-paying base of users grew to 12.6 million at the end of 2005 - up 50% from 2004. Marketing services provides 87% of Yahoo's revenues and fee-based services 13%. A total of *3.8 billion* pages per day are viewed by a diverse audience through Yahoo!'s 30 different websites encompassing the following four areas: Search, Marketplace, Information and Entertainment and Communication and Connected Life.

Page views have increased 24% in the first quarter and revenue per page view grew by 10%.

Yahoo! offers the most options for advertisers and is currently the largest site offering search and brand based advertising. Brand based advertising is expected to grow 27% this year. A catalyst for the second quarter, most analyst projections don't include the 20% to 30% boost in paid-search revenues from Yahoo!'s improved search technology, Project Panama, will be available in August. Yahoo!'s improved search technology will make their search product more competitive with Google's and more profitable for advertisers with a wider range of key search words, better placement of more popular ads and a higher “click-through” rate.

With nearly 80 million Americas having access to fast Internet service, one of the biggest opportunities for Yahoo! to increase advertising revenue over the next couple of years may lie in Internet video with advertising supported downloads. Yahoo! is also striking a partnership with Motorola to install Yahoo! ready applications on Motorola’s mobile devices - allowing users to access e-mail and other favorite sites. Their recent announcement of a search advertising alliance with eBay offers significant possibilities for revenue growth. Yahoo! is also building a significant presence in Asia with Yahoo! Japan, Alibaba and the recently announced agreement to acquire a 10% stake in Gmarket - a leading e-commerce provider in Korea that has been gaining share in e-commerce from eBay/Korea.

In light of Yahoo’s new search initiative, video possibilities, increased online ad spend, strategic partnerships and alliances, increased R&D and an attractive relative valuation, we expect Yahoo’s stock price to respond quite positively in the second half of 2006.

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