

As we write, New York is ending its second week of steamy, hot summer weather, the kind that makes the city and its people unpleasant. Each morning begins with the hope that a change will bring relief, but instead the sweltering humidity continues unabated. We have an old fashioned barometer on the wall whose needle hasn't budged in two weeks, empirically indicating what we already know to be true: we are stuck in the doldrums. After a strong first quarter protecting capital in a down market, the action (if one can call it that) of our portfolios in the second quarter resembled the local weather. Halfway into the year the major indices are essentially unchanged. The current equity market seems to be seeking some resolution, but the weather has yet to break. Commodity prices, which were on fire as we entered the year, have eased, with the important exception of oil. Financial stocks, the whipping boys of the market as the year began, have stopped declining. Healthcare, Capital Goods and Technology all seem to be range-bound. Outdoors and in, there is dissatisfaction with the status quo and a longing for a change that produces a more pleasant environment.

At the end of the first quarter we wrote about the exuberance in the commodity markets. Much of that excitement abated in the second quarter, so quickly in fact that it hurt the remaining cyclical positions in our portfolios. Both 2003 and 2004 were strong years for us, in part because of our heavy investment in economically sensitive stocks. But recently, as much of the investment community has come to accept our view that commodity inflation has returned, we have been selling shares of chemical, refining, housing, drilling, coal, railroad and shipping stocks. At one point these made up over 40% of the portfolio. Even today, we have some exposure to these areas – stocks we retain because they remain deeply undervalued – and those investments hurt our portfolio in the second quarter.

One example of such an investment is **Cleveland Cliffs**, a 150-year old company that mines and sells iron ore, the raw ingredient for steel. The stock was down more than 20% for the quarter, but remains up 11% for the year. The pessimism that currently surrounds Cleveland Cliffs reminds us of similar sentiments concerning the homebuilders a couple of years ago as interest rates started to rise. Back then the macro-economic environment was no longer the *most* favorable, but with mortgages still below 7% it remained benign. Even with these low (but no longer lowest) mortgage rates, the housing stocks declined 20-30% when rates first rose, before ascending almost 100% over the following year as earnings continued to come through. The fact that steel prices are down from record highs (but still well above average) has caused the sharp decline in Cleveland Cliffs's share price. The company should still earn about \$11 this year, with the stock at \$58. At five times earnings, with little debt, we believe this remains a compelling investment. With a market capitalization of just over a billion dollars, we also think Cleveland Cliffs has a fair chance of being acquired by one of the three international iron ore conglomerates (none of which are American). Having said all that, our investment in Cleveland Cliffs is an example of a stock that hurt our portfolio this quarter. We remain committed to this investment, and in fact purchased additional shares late in the quarter. We believe over a three year period it will reward our (and your) patience.

One stock that did justify our (severely tested) loyalties was **MBNA Corp.**, the credit card company. Early in the quarter it announced disappointing earnings, and the

stock dropped more than 10% in a day. We believed there was still much value there in the long term, and that the current issues could be cured. Bank of America ultimately agreed with us, and on the last day of the quarter announced a takeover of MBNA at a 31% premium to the previous day's closing price. This transaction underscores one overlooked advantage of buying high quality, discredited assets. The stock market is sometimes slow to recognize a company's asset value, and value investments can languish for quite a while. But often, a company's savvy competitors are not so disinterested. At the right price, and in the right investment climate (for example, with available credit on good terms), lightning can strike to break the summer doldrums.

Several other investments reached fair value in the quarter and we have sold them. Among these are **Diamond Offshore** and **Transocean**, both oil drilling companies. Each returned over 100% since our initial investment about 18 months ago, when we first wrote about them in our quarterly letter. The large appreciation, coupled with the fact that the forecasted increase in profits has yet to be realized, has led us to take profits. While we have no reason to think the earnings won't materialize, we are already getting paid for them, and the excitement surrounding the names has grown to a fever pitch, typically a good time to exit.

We purchased only one new stock in the second quarter, **Citigroup**. Sometimes our investment ideas are complex, relying on, for example, the realization of hidden asset values (like **Temple Inland**) or the exploitation of new technologies (like **Comcast** and **Time Warner**). Other investments simply rest upon our view that the market has gone to extremes of pessimism and overly discounted the value of a strong collection of assets. Citigroup is in this latter category. Until recently the largest bank in the world (eclipsed last month by portfolio holding **Mitsubishi Tokyo Financial Group**), Citigroup generates revenues in a myriad of different financial business, not just lending. While banking remains the single largest source of income, investment banking, brokerage, insurance, asset management, proprietary trading, private equity and venture capital all contribute (or at least should contribute) to the bottom line. Because interest rates have been rising, and because Citigroup specializes in financial rather than hard assets (like oil, gas or coal), the market has lately spurned its shares. Now Citigroup is selling for the same price as it did five years ago. Then, it was trading at 22 times earnings, while now it sells at 10 times, its credit profile is more favorable, its international assets remain superior, and the dividend has more than tripled. The stock now yields 3.7%, about as much as the ten-year Treasury bond. Our time horizon for this investment is three years; we believe that by 2008 interest rates will moderate, investors will evolve away from their pessimistic view of financial assets, and Citigroup will return to a more normal valuation. If the stock sells for its average multiple of 12 times anticipated 2009 earnings of \$6.05, the stock would appreciate 67% from current levels (including dividends) over a three-year period. Coupled with last quarter's purchase of **J.P. Morgan**, we are pleased to be increasing the portfolio's financial exposure when such investments remains unpopular.

The turgid weather here is unchanged, but will eventually break. While frustration at the slow pace of change is understandable, it would be foolhardy to think that the climate will remain like this forever. Similarly, continued reliance on energy and other commodity stocks to provide the bulk of the returns in portfolios, even as their

valuations start to reflect wild-eyed optimism, is not prudent. While we began the year with about a quarter of the portfolio invested in energy related stocks, that has been reduced considerably. Energy stocks (including the now-sold Diamond Offshore and Transocean) were (again) our best performers for the quarter. The market continues to favor these names, but like the weather this will eventually change. Not to be alarmists, but we would also note that summer weather often changes quickly and violently. We would rather anticipate the changes – which we think will favor financial stocks and steadily growing communications companies (which many people call cable companies) – and transform your portfolios before the climate shifts.

As always, we welcome your questions and comments, and thank you for your continued support.