

Good Valuations Plus Extreme Pessimism

T.S. Eliot wrote that April is the cruelest month. If he had lived to be an investor in June 2008, we think he would have changed his mind. Last month was the worst June for the stock market since the Great Depression, with the Dow Jones Industrial Average down 10.2%. In fact, until the last two weeks of June, we had a robust quarter to report, with strong positive returns. But by the end of the month we ended down for the quarter. While the news headlines were terrible, the Fund still outperformed our benchmark Russell 1000 Value Index for the quarter. We think the Fund is positioned well, and our play on the scarcity of resources in a global economic expansion has been paying off nicely -- it was just overwhelmed by the general market downturn in the last two weeks. We would urge you not to give up hope of making money, even in this dismal year. Value investors are attracted to two particular characteristics: good valuations and extreme pessimism. As we discuss below, that combination has almost always led to strong returns in the following twelve months. We believe both are present in today's market, especially after the June decline, and we are starting to decrease our cash position.

First, numerous valuations are getting quite attractive. Not only is the U.S. stock market (as measured by the S&P 500 Index) back to where it was two years ago, it is back to where it was at the beginning of 2000, *eight and a half* years ago. That means the S&P 500 Index was up only 0.29% from January 1, 2000 through June 30, 2008, even after dividends reinvested.¹ Meanwhile, earnings have continued to grow over time, and thus the market on a price-to-earnings basis is now considerably cheaper. We own a number of very high quality companies in our concentrated portfolio that are trading at close to either 10-year or record low valuations: **Microsoft** (12.1 times next year's earnings estimates, a record low), **Cisco** (13.2 times next year's earnings estimates, a 13-year low), **Honeywell** (12.3 times next year's earnings estimates, within one-half point of a 12-year low), **Archer Daniels Midland** (10.3 times next year's earnings estimates, within a point of an 18-year low), **Boeing** (10.5 times next year's earnings estimates, two points away from a 20-year low). Each of these companies has a strong balance sheet, market leading products, and most important, prodigious and growing cash flows. We have used this difficult time to upgrade the portfolio to strong companies like these (Cisco, ADM and Boeing have been purchased in the last year). While they have yet to appreciate much (with the exception of Honeywell), they underscore the valuations that are now available. In fact, the valuations of these stocks are the most attractive we have seen since at least 2002, and in some cases since 1994.

Second, besides attractive valuation, as value investors we look for excessive pessimism as a good backdrop for future returns. As the saying goes, we want to make investments when blood is running in the streets. For decades, the monthly Consumer Confidence Report (issued by the Conference Board) has measured consumers' relative optimism/pessimism on a scale for which 100 represents neutral. Rarely will the sentiment be as high (optimistic) as 140 or as low (pessimistic) as 60. Our friends at the research firm ISI Group just issued in June 2008 a fascinating study that took 480 months (40 years worth) of these reports and examined how the stock market performed in the 12 months following each of the 480 months. There was a direct correlation between how *pessimistic* the consumer was and how *well* the market did in the year following the assessment. The more pessimistic the

¹ The S&P 500 Index is an unmanaged market value weighted index representing the performance of 500 widely held, publicly traded, large capitalization stocks.

reading, the better the market performed.² As contrarians, that's easy for us to believe, as the market incorporates extreme pessimism into stock prices, discounting overly grim scenarios. When the world doesn't come to an end, confidence rebounds and the market rises. The reading reported for May 2008, at 50.4, was *the lowest confidence reading in 16 years and the third lowest in 40 years*. The study found that, when the confidence level was below 60 (as it was for 27 out of 480 monthly readings), almost all the time (96%), the S&P 500 Index was historically up over the following 12 months. And the *average* historical return for the market 12 months after these pessimistic readings was a positive 19%. We believe this is another indicator that better returns are ahead.

Based on this combination of attractive valuation and strong negative sentiment, we have become more positive on the equity markets looking ahead. For that reason, we are using cash and becoming selectively more invested. We are convinced that three years from now, this difficult period will have turned out to be a rewarding time to invest. This may not be the low for the market, but we're long term investors. We want to buy good companies at attractive prices when no one else wants them.

The Virtuous Inflation

We are cautiously optimistic that the Fund is heading in the right direction. While we are bottom-up stock pickers, accustomed to tuning out the world and focusing on our limited number of investments, it would be foolish not to pick our heads up from the financial statements of Fund holdings and take a look around at the truly exceptional events taking place. Housing prices falling year-over-year to an extent not seen since the Great Depression. Oil prices hitting new records each week, now standing at \$143 a barrel. The dollar steadily declining; corn, wheat and soy beans selling at new highs. Financial stocks remaining in a free fall. We have so much to say on these matters, and this is such an exceptional time, that rather than burden this quarterly update with our examination of the world economic landscape, we have enclosed a separate piece recently written by Chris Grisanti called "*The Virtuous Inflation*". It is purposely controversial, arguing, first, that we believe the current commodity inflation is permanent and, second, that we should be pleased about it, for both altruistic and not-so-altruistic reasons.

For reasons laid out in detail in "*The Virtuous Inflation*", we continue to believe that investing in companies that take advantage of the current scarcity of resources will result in outperformance. This was certainly true in the second quarter. We've written before about our investments in oil and gas infrastructure, as oil companies the world over finally have the cashflow to upgrade or build new facilities. Our investments in **Foster Wheeler** (up 29% for the quarter) and **KBR** (up 24% for the quarter) again reaped the benefits of this trend. Electricity, in ever shorter supply, was also a strong performer. **Dynegy**, our best stock this year, is up 7% for the quarter. (Read about our newest electricity investment, **Calpine**, below.) The exception to the rule was our investment in food, **Archer Daniels Midland (ADM)**, which was down 18% for the quarter, hit hard due to the flooding in the Midwest, which has driven up the price of corn so fast that the company's margins were hurt badly this quarter. We believe the long term food inflation story remains intact, with ADM anticipated to be a huge

² The opposite is also true. Market performance is usually sub-standard in the year following extremely optimistic consumer confidence readings (above 140). This was especially true as consumer confidence reached its optimistic peak in early 2000, and then the following year the market declined sharply.

beneficiary once prices can be passed through to their customers. The stock is back to our original purchase price, and we continue to think it is a real bargain.

We are also investing in this scarcity theme by looking for companies that help *conserve* existing resources. **Ingersoll Rand**, with its market leading position in building ventilation, is poised to respond to a call from the developed world for more efficient heating and cooling systems. **Boeing's** new aircraft, the 787, is 30% more fuel efficient than the 767 it replaces. This stock was weak in the second quarter, as high oil prices made investors fear order cancellations. We think this is overdone, as over 90% of the orders come from foreign airlines, which are generally healthier than U.S. carriers. We believe that so long as the airline can afford the plane, it makes strong economic sense to trade up to the much more fuel efficient aircraft. The 787 will likely be a "game changer", and it should take its first flight before year end. That flight has the potential to be a catalyst for Boeing's share price.

Investing for the Future

As mentioned, we have started to put our cash reserves to work. We still refuse to go near the credit sensitive financials (except that we have decided to retain our long-time investment in **American International Group [AIG]**), though one suspects that the companies that are strong enough to survive will provide an attractive return over time from these low levels. (We certainly feel that way about AIG.) Rather than bottom fish in the credit-sensitive sector, we have purchased a paint company, a financial advisory firm, and an unregulated electricity company, each discussed below.

Sherwin Williams was founded in 1866 and makes and sells paint worldwide. It is the third-largest coatings manufacturer worldwide and the largest in the U.S. Throughout its 142-year history there have only been *eight* CEOs. It is the owner of numerous leading brands including Sherwin Williams, which is only sold in the company owned stores, Dutch Boy and Pratt & Lambert. Sherwin targets the professional painter more than the Do It Yourself-er. Over the past 20 years the professional painter has moved from 49% of the market to 61% and we believe that this trend will continue. This group buys more than 90% of its paint from paint stores rather than larger hardware dealers like Home Depot or Wal-Mart. Sherwin acts as partners with its professional customers. Over the years there has been a large amount of goodwill built between the two groups. Most of the professional's cost comes from labor and Sherwin has developed paints that cut down on painting time. Some of its products do not need to be applied twice and the company just introduced an exterior paint that dries in half the time of other paint, allowing the painters to work on "non-perfect" weather days. It comes as no surprise that the current environment is the most challenging the company has witnessed in decades: costs (particularly oil) are rising and demand from new construction is down. The stock is down sharply because of this, and we believe this is the opportunity to buy a company with strong cash flows that will grow over time at a good value. Currently the stock is trading at 10 times 2009's earnings estimates. Historically the shares have traded at 13 times forward earnings, but we strongly believe that Sherwin will garner a premium as it is able to demonstrate the strength of its brand through the cycle. The company is conservatively managed and has increased its dividend in each of the last 29 years. One of its largest competitors, Benjamin Moore, is entirely owned by Warren Buffett, a sign that this is indeed a good business.

During the quarter we initiated a position in **Charles Schwab**. We believe that all Americans are generally in need of more advice when it comes to their investments. The

proportion of companies offering old-fashioned pension plans has dropped by half in the past decade, replaced with 401k's that employees must not only fund but manage themselves. The prospect for social security is increasingly dim for our younger generations. And, by the middle of this century baby boomers will have passed on trillions in wealth to the next generation. All this, combined with increasingly global and complex capital markets, result in people desiring to receive investment advice without being sold a bill of goods. Charles Schwab has created a company that serves the average investor with a brand that stands for trust, convenience and transparency and as a result has brought in more client assets over the past several years than Merrill Lynch, Smith Barney and Morgan Stanley *combined*. Margins have expanded, which will likely continue, although we think a greater portion of the cash flow growth will be reinvested to further widen their competitive moat. We think current earnings power could be 50% higher by 2010, and that the multiple on those earnings may move up as well. While the stock sports a higher absolute price-to-earnings ratio (P/E) than most in the Fund, the multiple on earnings a few years out is not materially different than many of the holdings, and we believe there is greater visibility into that growth. Moreover, the shares are trading near their ten-year low P/E, as a result of the market downturn. Although this stock is a "financial", there is very little credit exposure as Charles Schwab is not an investment bank, and has only a small prime mortgage lending business to existing investment customers.

We also purchased shares of **Calpine** in the second quarter. The company is a deregulated merchant power company (IPP) with electric plants spread across four regions of the United States; primarily California, Texas, the Southeast and Northeast. Calpine's fleet of mostly natural-gas-fired power plants are relatively new (under 10 years old) and well positioned if, as we suspect, potential carbon emissions legislation becomes law in the future. For example, the company's plants are the lowest in carbon, nitrogen, sulfur and mercury emissions among all the major power producers we monitor. About 97% of the power fleet is natural gas fired while the remaining 3% is geothermal. Geothermal assets are very difficult to recreate and generate virtually zero carbon or other potential pollutants and therefore are extremely valuable. As with our investment in Dynegy, we believe Calpine represents an attractive way to invest in the ever increasing tightness of the United States electricity market. The shares trade at almost a 40% discount to our estimate of our replacement value estimate of \$35 per share.

Darkest Before Dawn

We know it's a tough time. We can't control the near term market sentiment or direction, but we can state that our assessment of the long term value of the Fund remains materially above current market prices. We remain consistent to our discipline and recheck our research and conclusions often. We can't recall a time when pessimism was higher. The gloom seems more pervasive than even at the market bottom in 2002. There are lots of reasons to think things will be difficult in the short term, but the market, down 20% since last July, already reflects much of that. When you couple such pessimism with reasonable valuations, history tells us that staying the course will be rewarded.

We thank you for your support, and would be happy to answer any questions you may have.

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The views presented in the letter were those of the Fund managers as of June 30, 2008 and may not reflect their views on the date this letter is first published or at anytime thereafter. These views are intended to assist the shareholders in understanding their investment in the Fund and do not constitute investment advice. None of the information presented should be construed as an offer to sell or recommendation of any security mentioned herein.

As a non-diversified fund, the Fund may focus a larger percentage of its assets in the securities of fewer issuers. Concentration of the Fund in a limited number of securities exposes the Fund to greater market risk than if its assets were diversified among a greater number of issuers. Investments in smaller companies generally carry greater risk than is customarily associated with larger companies for various reasons such as narrower markets, limited financial resources and less liquid stock.

The Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price-to-book (P/B) ratios and lower forecasted growth values. One cannot invest directly in an index. P/B ratio is used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. Book Value is the total assets of a company minus total liability. Price-to-earnings ratio is the value of a company's stock price relative to company earnings.

Top 10 Holdings*

as of June 30, 2008

Ticker	Security Description	Percentage of Market Value
WMB	WILLIAMS COS	9.0%
DYN	DYNEGY INC.	7.7%
ADM	ARCHER-DANIELS-MIDLAND	7.0%
HON	HONEYWELL INTERNATIONAL	6.8%
CSCO	CISCO SYSTEMS INC.	6.5%
KBR	KBR INC.	6.4%
BA	BOEING	5.8%
MSFT	MICROSOFT CORP.	5.4%
HPQ	HEWLETT-PACKARD	5.2%
SHW	SHERWIN WILLIAMS CO.	4.4%

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* Holdings are subject to change