

SGB's holdings of economically sensitive companies continued to lead the way with three investments, in the oil and gas, iron ore and construction industries, rising 47% or more during the period. Other holdings performed strongly as well, and with the exception of our frustrating investment in Fannie Mae (discussed below), we remain pleased with the portfolio positions as we move towards 2006.

Having said that, we have become sensitive to one factor that bears further discussion: the runaway train of energy investing. A brief story captures the point. In our business, we attend numerous conferences where companies make presentations in the hopes that investors will find them attractive. The format is an efficient way for us to sift quickly through potential investment choices before delving deeper. In early 1999, at the height of the technology bubble, we attended the Internet Conference sponsored by Morgan Stanley in Arizona. The conference was mobbed. You couldn't get a seat at many company presentations. When Meg Whitman, CEO of newly-public EBay spoke, there must have been 200 people standing in the rear of the auditorium. To us, this was but another sign of the technology-induced delirium, as these stocks were already at crazy valuations and appreciating more each day. We continued to sell the rest of our technology stocks not long thereafter, missing out on part of the tremendous run in 1999, but also averting the gigantic capital losses of the succeeding four years. Some of these companies still survive at a fraction of their 2000 prices, like Amazon (down 57% from its high in 2000), Juniper Networks (down 90.2%), Akamai (down 95.4%) and Palm (down 97.8%). Other presenters became "dot bombs" and went bankrupt: Webvan (the first internet grocer), Etoys, PlanetRX.com (on-line drugstore), Kozmo.com (delivery service). The point is not that all these companies had unsustainable business models -- after all, EBay has been a wonderful innovation. Rather, the point is that none of *the stocks* of these companies were good investments after hysteria had taken hold. Even Ebay, up 32% since then, has significantly underperformed stocks that were down and out in 1999, like oil and gas or homebuilders. Once the hysteria starts, superior returns are typically a thing of the past.

But what does all that have to do with our portfolio? Last month we attended the annual Lehman Brothers Global Energy Conference. We have been to this conference a number of times, and, to be truthful, it's a sleepy affair, attended only by resolute value investors sifting among mature companies in a competitive business. For the most part these are large established firms, like Union Oil of California (Unocal), Burlington Resources, Chevron, and Valero (the nation's largest independent oil refinery). We recall not so long ago (early 2003) when the mention of these companies would make most investors cringe. At best they were boring investments, mature, with little or no growth; at worst, as in the case of the refiners, they were perceived as toxic-laden dinosaurs. These companies have thousands of employees and billions in revenues. It is a tough, very un-sexy business. In short, these are not internet companies.

Or perhaps, in 2005, they are. The surge in the price of oil has created another investing mania. We were astonished to find no seats left in the Waldorf ballrooms for many presentations at the energy conference. Investment luminaries such as Peter Lynch from Fidelity were conspicuous in the crowd. Even the press was in attendance. (This

would be akin to the New York Times covering your daughter's kindergarten pageant: You *have to* be there, but you'd be shocked to find the Times theater critic in the seat next to you.)

As you may recall, we have been big believers in the asset appreciation themes over the past three years, including oil and gas as well as coal, tankers, chemicals, refiners and iron ore. In late 2002, when "deflation" was the bogeyman of the moment, these stocks were selling at record low valuations. No one wanted them. We were not smart enough to forecast \$60 oil, nor did we think we needed such an extreme price to realize strong gains on these investments. We just needed the world to return to normal. Thoughts of deflation would recede, we reasoned, oil would find a home around \$30 (up 50% from 2002 levels) and these shares would do just fine. Instead, of course, the pendulum has swung past center with a vengeance. And in mid-September, with one catastrophic hurricane just gone and another on the way, oil prices hit \$70 in what appeared to us to be the perfect storm of energy hysteria.

Our experience at the energy conference, the Katrina/Rita crescendo, and the extreme valuation of these mature companies add up to a flashing red warning signal. We believe that the energy sector in general will no longer outperform the market, and continued investment in the area will require some sort of exceptional, company-specific story. For that reason we have been taking profits in energy, even in (or perhaps *especially* in) strong performers like **Encana**, now the largest capitalization company in Canada. Our older accounts have enjoyed more than a tripling in price in Encana. It is a wonderful company, strongly positioned, but trees don't grow to the sky and this was a mature Canadian Maple to begin with. Its valuation, like its share price, is at an all-time high. We believe it is prudent to reduce our position.

Over the past year we have sold all of our holdings of oil drillers **Diamond Offshore** and **Transocean**, the refiner **Premcor** and coal companies **Peabody Energy** and **Consol Energy**. We have begun to reduce our position in Encana, and we have taken the energy position in most portfolios down sharply from 25% to under 10%. Instead, we have started looking at companies hurt by higher energy costs and by rising interest rates. In the latter category, we wrote to you last quarter about the financial sector, as we increase exposure there in the belief that 2006 will see interest rates decline and margins (and multiples) improve. In the former category, we are examining companies that seem oversold due to their reliance (real or perceived) on energy as a raw material.

We have purchased a large position in one such firm, **DuPont**. If you think DuPont is purely a chemical company, you might be surprised to learn that its two largest sources of profits are seeds and drugs, businesses in which petroleum costs do little to alter the profit margins. DuPont's other four businesses – safety, coatings, electronics and packaging -- are directly affected by oil prices, and the stock is down from a high of \$56 in March to less than \$40 today. It is selling at a 10-year low valuation on both price-to-earnings and price-to-cash-flow measures. We do not believe business will be good in the short term, but our job is to assess whether this security will sell for a

significantly higher price at some time over the next three years. We think it will, and meanwhile the 10-year high dividend of 3.8% provides extra return while simultaneously supporting the stock on the downside.

One investment that didn't measure up in the third quarter was **Fannie Mae**. We continue to believe at current prices the stock is overly discounting even the worst case scenario, which would include legislative restrictions on its business. Absent such limitations we think long term earnings power will approach \$10 a share. Even with such restrictions, which we estimate at only about a 30% probability, the company would earn about \$4-\$5 a share. With the stock in the mid-40s, and with new, credible management, we currently do not plan to sell, although facts can change at both the company and in Congress. We recall that Freddie Mac was a strong investment in 2004 as it turned the ship with new management and (glacially) slow financial restatements. We believe that pessimism surrounding Fannie Mae has reached a climax.

Finally, a word about Spears Grisanti & Brown. Our business has continued to grow, and in an effort to expand our availability while simultaneously controlling our burgeoning backoffice and trading responsibilities, we are starting a mutual fund, the SteepleView Fund (named for our office view of St. Patrick's cathedral). It will be managed in the same style as our other portfolios, with a minimum investment of \$250,000. We will pool our smaller accounts into this vehicle. Our separately managed account minimums will remain at \$5,000,000 for individuals and \$10,000,000 for institutions. Our Chief Operating Officer, David Salomon, has also been named our Chief Compliance Officer, and we have hired a new head of operations. The investment staff remains the same four professionals as when we founded the firm in 1999, namely Bill Spears, Chris Grisanti, Vance Brown and Jared Leon. There are no current plans to add to or change that lineup.

We wish you a happy and prosperous end to 2005.