CAZ INVESTMENTS
A Wealth Management Firm

2nd Quarter 2006

CAZ CORNERSTONE PORTFOLIO
Performance Update

It's BAAAACK!

In our first quarter letter we discussed how volatility had returned to the markets. We commented how the volatility levels of the last few years have been at extremely low readings and were bound to increase. The 2nd quarter of 2006 was the most volatile period we have seen in years. As a matter of fact, volatility is now running roughly DOUBLE that of the last few years. It is hard to believe that in spite of all the volatility, the market is roughly flat for the year, depending on the index evaluated.

It is critical that clients be prepared for the larger changes in the portfolios. Volatility creates uncertainty, but it also creates opportunity. As the market gyrates, dislocations of value are more common. These disturbances allow us to identify buying opportunities that have attractive risk/reward scenarios.

Even though the market was down approximately 2% in the 2nd quarter, there were pockets of extreme volatility. Some areas, like emerging markets and commodities, saw radical changes of value. Some worldwide exchanges actually closed for periods of time as "circuit breakers" were tripped.

Too Many People in the Same Room

Some of you may have seen the interview I did with CNBC a few weeks ago. I briefly discussed "the crowded room" theory. This is not a big revelation; simply the law of human psychology and markets. In the last part of 2005 and early 2006 we saw phenomenal increases in emerging markets and commodity-related securities which were premised on the worldwide growth of product demand. More and more capital flooded into these areas as speculators and momentum investors chased ever higher prices, hoping that prices would continue in an upward direction. In "industry talk," we call this a "crowded trade." Simply stated, there are more and more investors crowding into the same securities/investment thesis. Well, as anyone who follows investor psychology knows, if "everyone" is doing the same thing, bad things typically happen. What happens when you have 200 people crowded into a room that is designed to hold 30? Sometimes nothing, other times……

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The Market Always Punishes the Largest Group of Investors!

Now, this may seem like a very pessimistic view of the world, but if you ask anyone who has been investing for more than a decade, they will confirm that this is true. I have heard it put this way: "When the barber and taxi driver start telling you that you should be investing in X, you should be selling X!" It goes back to the old adage that if everyone is investing in X, who is left to buy? The crowd is wrong, always, no questions. The crowd can be right for a period of time, and as we all remember in the late 90's, the crowd was right for a long time, but the crowd always gets punished. That type of investing is known as the "higher fool method." Simply stated, it is buying something at a ridiculous price, because hopefully some "bigger fool" will buy it from the investor at an even more ridiculous price.

The normal process of unwinding occurs when there is a gradual shift in psychology followed by a mass run for the exits. Remember the crowded room analogy above? Well, if you have 200 people in a room designed to hold 30 and someone yells "fire," there is a mass rush for the door. Some will get out relatively unscathed, but the majority of the people in that room are going to get trampled. In the 2nd quarter, the slightest hint of a slowdown in the worldwide economy caused a near panic around the globe as investors rushed for the exits in relatively illiquid markets. This is the risk of trading on momentum without a fundamental basis for the investment.

At CAZ, we do not invest that way. As a result, we did not suffer from the decline like many other investors. Our portfolio was not immune to the worldwide sell off in stock prices, but we certainly did not have the volatility and chaos that impacted other investors. This is a result of our discipline and consistent approach to investing. We will buy great companies that have consistent cash flow streams when they are trading at reasonable prices. We always have, and we always will. As Warren Buffet has been quoted saying, "The surest way to long-term underperformance is to buy what is popular." Our decision-making process has not changed in 14 years, and it will not change in the future. We will buy great companies when they are trading at reasonable prices, and we will attempt to hold them for long periods of time. We will not buy stocks because they are trendy, and we will never manage the portfolio based solely on quarter-to-quarter performance. Our process has resulted in out performance of our benchmarks over the long term, while achieving tax efficiency.

Where Do We Go From Here

Let's talk about what we know:

- Earnings in the 1st quarter came in slightly ahead of expectations and stocks rallied.
- The market sell off in the 2nd quarter resulted from concerns of a slowdown in worldwide economic growth.
- The Federal Reserve has indicated they are getting close to ending the increases in short-term interest rates.
- Second quarter earnings are now being relayed and the results so far have been mixed.

- Geo-political activity has reared its ugly head again with concerns coming from Iran, N. Korea, Lebanon and India.
- The housing market is now slowing down and there are concerns growing about consumer spending.
- Stock valuations have come down sharply since the first of the year and are now in a range that has been historically very attractive.

Obviously, there is no way to know what the impact of the geo-political unrest will be. It has created uncertainty, and this has pressured expectations for economic productivity. We also will pay very close attention to the guidance issued by companies as they report this week and next. This should give us a good idea regarding corporate profits for the second half of the year. The Federal Reserve should at least take a pause from raising short-term rates before the end of the year.

When you factor all of these pieces of the puzzle together, we are still comfortable with our January projections. If you recall, we expect to see 10-11% growth in cash flow from our companies this year, and we saw a risk of 2-4% to valuations. Thus far, cash flows appear to be right on track, and the cash flow multiples have come down. Therefore, if cash flows continue to come in as expected, then we think that the second half of the year could be very attractive.

The Optimal Valuation Level?

Is there such a thing as an optimal P/E multiple for the market? Maybe or maybe not, but we do know from history that certain levels are much more attractive than others. The great thing about history is that we can compare today's situation to other similar times in the markets. This does not mean that the same thing is going to happen in the future. We all know that "past performance does not guarantee future results," but we also know that history does tend to repeat itself. Therefore, we can look at the current P/E multiple and see what has happened in the past. Below is a table that lists various ranges of starting P/E multiples and what the subsequent returns have been for the S&P 500.

Current P/E = 15.33	P/E Ranges & Subsequent 12 Month Returns (since 1940)	
Trailing 4Q P/E	Average	Median
<8x:	16.5%	17.5%
8x to 10x:	10.9%	7.7%
10x to 12x:	9.1%	7.6%
12x to 14x:	7.5%	7.9%
14x to 16x:	***17.0%***	***20.9%***
16x to 18x:	6.3%	6.8%
18x to 20x:	8.0%	7.6%
>20x:	-2.4%	-8.7%

Source: Global Financial Data and Citigroup Investment Research

As you can see, we are right in the “sweet spot” of historical levels. Can different forces keep history from repeating itself? Of course, but we feel confident that if cash flows from our companies can grow at our expected rate, and interest rates stay close to today’s level, then the next 12 months can be very rewarding. Therefore, we are comfortable with the portfolio and expect returns to be higher than similar investment alternatives may offer.

We appreciate your confidence in CAZ Investments, and we look forward to seeing you at our client conference on October 10. More data will be forthcoming, but please mark your calendar. As always, please let us know if you have any questions.

All our very best,

Christopher Alan Zook
Chairman and Chief Investment Officer