CAZ INVESTMENTS
A Wealth Management Firm

4th Quarter 2007

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

What a Crazy Year!!

Don't say we didn't warn you! 2007 turned out to be every bit as bizarre as we cautioned that it might be. Volatility returned with a vengeance and stock market investors got a lesson again in probably the most under-appreciated stock market truism, "Stocks ALWAYS seem to go down faster than they go up!" This year was no different. We saw very sharp corrections in the broad market averages. They did not take long and were very painful. In February, the S&P 500 dropped by nearly 7% in less than two weeks. Then we had that wonderful 30-day period in July when the S&P declined by 12%. Next we saw a nearly 11% decline in October, and last but not least we have just finished experiencing a nearly 10% drop over the turn of the New Year!

In spite of all of those corrections, stock prices today are nearly at the same level they were one year ago. Many of the stock indices actually delivered positive returns for the year. The final tally for the S&P 500 was a positive 5.49% return for 2007.

What made 2007 a crazy year was not necessarily the volatility, but the way that the winners and losers were divided. It is well documented how the market became spooked by the unwinding of the housing bubble, the resulting credit crises and the possibility of severe economic weakness. Historically, in that kind of scenario, investors will typically flock to stocks that are considered "safe" and less sensitive to economic downturns. That is a logical thing to do, right? This year…..wrong!

This year when the market was declining rapidly, the safest place to be was where one would typically not expect safety: Technology, Energy, Cyclicals, etc. Yes, that seems bizarre, but that was precisely the pattern this year. Consumer Staples showed some of their traditional defensive characteristics, but the real winners in the market that led many of the major indices were stocks like National Oilwell (Energy), Amazon (Technology), Apple (Technology), Cummins (Heavy Truck Engines) and Monsanto (Chemicals). If one took a look at the valuations of those companies and saw how expensive they were, they might even be more surprised! Naturally, there were other winners, but the makeup of the largest gainers in the S&P 500 is quite a surprising list. To put it in perspective, the Materials, Industrial, Technology, Energy and Telecom sectors, as a group, increased by more than 12% for the year. On the other hand, the remaining sectors which include Consumers, Financials, Health Care, etc., declined by more than 8%. That is a sharp divergence from what one would expect in a weakening economic environment! In the first few weeks of 2008, the markets have sold off sharply, and the winners and losers are much more in line with historical trends. With that outline of the unusual action of 2007, let's see…

<u>How Accurate Were Our Predictions?</u>

We say it every year. We really don't like making predictions about the year from a top down perspective. We are bottom up stock pickers, and we focus on what is happening at our companies first. Naturally, though, we pay attention to what is happening at the macro economic level so we can make estimates of how those forces will impact our companies. So, it only makes sense to evaluate how accurate we were last January. Here is the exact reprint of our 2007 projections from last year's letter, in italics, with the follow up of how that prediction turned out:

This is what we believe will occur in 2007:

- *The Federal Reserve will begin to lower interest rates, easing monetary policy probably by mid-year.*
  - The Federal Reserve began lowering rates in August and did so again in September, October, and December.
- *Long-term interest rates will resume their climb as investors begin to factor in the impact of the Federal Reserve's rate cuts and the benefit to the economy of lower energy prices that have existed for the last few months.*
  - Long-term interest rates increased for the first five months of the year but began to decline in June, as evidence of the credit crises began to appear.
- *Private Equity buyers will continue to take companies private at a significant rate, providing a floor for potential buyout candidates.*
  - Private Equity buyers were VERY active in the first half of '07, with near record transaction volume. That activity came to a screeching halt as a result of the summer credit crunch.
- *Volatility will DEFINITELY go higher.*
  - That was an understatement; 2007 was one of the most volatile years we have seen in the last 25.
- *Growth will outperform Value for the first time in many years, and large cap stocks will outperform small cap stocks for the first time this century. While these projections are naturally self serving, since we manage large cap stocks with a growth bias, the valuation gaps are now at such extreme levels that it becomes very difficult to argue against this eventuality.*
  - Growth trounced Value at all levels. The Russell 1000 Growth index was up by 11.81%, compared to the Russell 1000 Value index which was actually DOWN 0.17%. Also, large cap stocks finally gained ground compared to small cap stocks.
- *Company cash flows will grow slightly faster than general expectations at approximately 9-10% for the companies we own.*
  - Cash flows were generally strong across the board, and we saw approximately 10% growth in cash flow.

- *Energy prices will rise, potentially sharply, from current levels.*
    - Crude oil prices rallied almost 100% from their year-end 2007 levels, and one time nearly touching the magical $100 a barrel level.
- *Valuations will contract as long-term interest rates begin to rise and energy prices begin to climb. We could easily see general valuations declining by 3-5% this year.*
    - Valuations contracted by approximately 4%.

The result of the projections above led us to forecast an *"expectation of approximately 4% to 7% upside for the year.*" The S&P 500 rallied by 5.49% for 2007.

In hindsight, our projections were more or less right on the money for the year. This will not always be the case, but we are pleased with our sense of the markets at the macro level. Let's now look to 2008 and see what the future might hold:

Now What?

We would love to say that after the tough sledding in 2007 the outlook for 2008 is rosy. That is simply not the case. This year is shaping up to be a very tough year. We have a confluence of factors that are going to make this year a particularly challenging one for stock prices. That said, we see some glimmer of hope for the year, but a lot of good things are going to have to happen in order for stock prices to continue their five-year streak of exceptional returns. People may not realize it, but the S&P 500 has now increased by more than 12% compounded annually for the last five years. That is above historical trends, and it is a long time to go without a negative year. Will this year break the streak?

Here is what we believe will occur in 2008:

- The Federal Reserve will continue to lower interest rates to combat the growing risk of a recession for at least the first few months of the year. Then the Fed will become increasingly concerned about the impact of those rate cuts on the long-term inflation rate, and they will stop lowering rates because of those fears.
- Company cash flow growth will begin to slow as consumers begin to reign in their expenses and corporations begin to reduce capital expenditures in the softening economy. Street consensus for earnings growth in 2008 is around 8% right now. We believe that the actual number will be approximately 2–5%.
- This disappointment in profit growth and the economic slowdown will cause valuations to decline slightly. The good news is that valuation levels are not expensive right now on a historical basis. The bad news is that if earnings growth slows materially, those valuations are still at risk. We feel that earnings multiples will likely stay in a range between current levels and a decline of 3%.
- Volatility is here to stay for awhile, and we expect this year to be in line with historical levels.
- Housing prices will accelerate their decline as "patient" sellers become "panic" sellers. We believe that in order for housing prices to return to the historical trend, they must decline by approximately 15% from their peak.
- Foreclosure rates will be substantially higher than most would imagine and could reach record levels.
- We believe that the political landscape in Washington will become significantly less favorable to the market, regardless of who wins the election.

- We will hear how many of the leverage buyouts from the last four years will run into trouble making their debt payments, and we will likely hear about several that have to significantly restructure.
- The economy will very likely slip into a recession.
- The year will be marked with debate as to whether or not the result of this economic slowdown will stop at a recession or if we will slide into a period of stagflation.

As a result of these projections, we believe that 2008 will be a very flat year. The result of the math above indicates that if we have 2–5% cash flow growth and a 0–3% decline in valuations, we will experience a range of -1% to 5% return in the market this year.

What could make it worse? One thing that could feasibly occur to cause a lot more downside would be if the earnings growth rate for the market did not just slow, but actually went negative. **If** earnings begin to decline, we would expect the market to decline by at least the amount of that negative growth rate.

Before we get everyone despondent and overly negative, we should point out that there ARE some positives that we should focus on. Company balance sheets are, by and large, in great shape. Company cost structures are fairly lean. Valuations really are not that expensive and global economic growth has shown surprising resilience. Therefore, could we build a case that stocks could do much better in ’08? Yes we can, but in order for that positive case to unfold, we feel like we are going to have to see a confluence of events all occur in short order to rescue this economy. As always, we will seek to find the very best companies that have predictable cash flow streams and are trading at compelling valuations. As a result, we will work to generate returns that are materially better than that of the broad market.

We will reiterate the same plea that we did last year at this time. If you have not reviewed your asset allocation and made adjustments in recent years, you need to do so. The time to adjust those allocations is “when you can, not when you have to.” Please let us know if you would like to discuss your allocation in more detail.

As a reminder, this letter accompanies your 4th quarter Portfolio Review. As always, this year end Portfolio Review includes **a summary of your realized gain and loss information for the quarter AND for the entire year.** The report is also broken down by short-term and long-term gains so, for a taxable account, your tax preparation should be simple. When paired with the 1099 you receive from your custodian, you should have everything you need for your tax preparers. Do not forget that you can access all of your personal information online at our website, www.cazinvestments.com. We are happy to help you get acclimated with this system, about which many clients have given us very positive feedback.

We appreciate your confidence in us, and we are striving to find ways to maximize your returns in a difficult economic environment. We hope that this year brings many blessings to you and your family.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer