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3rd Quarter 2007

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

What a difference a quarter makes!

When an investor sees their quarterly statement for the 3rd quarter, they probably could not be faulted if they let out a big yawn. Most major U.S. stock indices rallied slightly with the S & P increasing by 2%. This does not sound exciting, but in actuality the 3rd quarter was one of the most volatile we have seen in many years.

From the July highs, the S&P 500 dropped nearly 12% in 30 days, only to reverse course and rally back almost all the way to new highs over the next 45 days. Other market indices had even larger swings, with small cap stocks tumbling by more than 14% over the same period. Several international markets declined by more than 15% in a 30 day period of time.

What is really amazing is how the same pattern that has been prevalent for the last 5 years held true again. The market promptly bounced back and seems to be giving the “all clear” signal. As we write this letter, the market rally has continued and, we are now trading at all time highs in several markets.

To recap, the sell off in July was triggered by news that the sub-prime crises was indeed a crises and that it was spilling over into all forms of credit. In essence we saw a complete freeze of liquidity in the market place. In the U.S., England and many other developed markets there was a virtual dearth of liquidity for banks and short term borrowers. The Federal Reserve System in the U.S provided banks with emergency short term financing. The amount of short term liquidity pumped into the system was at a level that had not been seen since September of 2001, in wake of the World Trade Center attacks.

Additionally, we heard that two hedge funds that are run by a very large, well respected investment bank were closing down. They had lost the majority of their clients’ capital by investing in sub-prime mortgage securities using high levels of leverage. This news was followed by the revelation that several even larger hedge funds that specialize in statistical arbitrage needed multi-billion dollar bailouts, because they had lost more than 15% of their capital in a few days.

Corporate borrowing was virtually impossible to find, and the many high profile acquisition transactions that involved private equity firms were rumored to be in danger because the financing could not be secured. We heard that the major commercial and investment banks were going to have multi-billion dollar losses from their financing commitments that they had made.

The news flow was one directional, bad to worse. Fear was rampant. It was estimated that thousands upon thousands of homeowners were going to suffer foreclosure of their homes. It was stated that the private equity bubble was finished and the underlying "private equity bid" that had helped prop up stock prices was gone for good. The U.S. dollar was viewed as being in serious jeopardy, and people projected that the U.S. economy was headed for a recession.

Hearing all of that, it is not hard to understand why the market sold off by 12% in 30 days. Remember our last letter when we said, "Suffice it to say, we are not even close to seeing the final chapter in this sub-prime saga." Well, the market realized over the next few weeks that the saga was not over, and pain was felt by market participants in a way that has not existed in more than 5 years. Never forget how quickly perception can change and fear can enter the market. That, of course, leads us to… "the rest of the story."

The Fed to the rescue

Hold on a minute, didn't we say that the markets quickly reversed course and finished the quarter with a marginal gain? With all that negative news, how in the world did that happen? Enter from stage right, The Federal Reserve.

We all know the Fed is powerful, and they set the short term borrowing rates in the U.S. What many people do not realize is how important the DIRECTION of their rate bias is on the assumptions people make about the future. Always remember that markets move based on future expectations for economic strength and, as a result, future profits of companies.

In a very rare surprise move the Federal Reserve lowered the discount rate, by ½ of 1% in mid August. This is a HUGE move by the Fed, and they gave no warning that they were going to take this action. The Fed did this in response to the massive dislocation that was occurring in the banking and borrowing system. There was an immediate sigh of relief in the market, and they began to stabilize. Furthermore, later in the quarter the Fed slashed the Fed Funds rate and the discount rate by ½ of 1%. On this action, market participants felt that much of the risk in the economy was now less of a concern because the "Fed is on our side" and markets took off to the upside.

If you were wondering if the market can really be this psychotic, the answer is yes!

So where do we go from here?

That, of course, is the trillion dollar question. We are now in the early stages of earnings season, and as usual the market will be volatile and get its direction from these announcements. More importantly, the outlook given by management about the future will create substantial swings in earnings estimates.

We expect earnings to be decent this quarter, but we are concerned about the outlook we are going to hear from companies. The economy is obviously weakening, and the impact on corporate America is not totally clear. We have heard horror stories from the homebuilders and investment banks concerning their losses. Those are the front line players in the sub-prime story. The question is how much damage has the consumer suffered in relation to their spending habits.

Make no mistake, the direction of this market will be driven from this point by corporate profits which will be dictated by the severity of the economic slowdown. The question that everyone is trying to determine is whether the U.S. economy will dip all the way into a recession or if the Fed is once again able to manufacture a “soft landing”. The interest rate question has now totally shifted from, “when will the Fed stop raising interest rates” to “when will the Fed lower interest rates again and how low will they go”. Therefore, all eyes will be on the economic metrics.

We still believe the sub-prime saga has at least another year to play out, and we do believe it will have an impact in most areas of borrowing. This includes consumer, corporate and private equity. We also believe that the U.S. economy is going to continue to weaken materially. We are not convinced that we are going to have a recession, but we do believe that the slowdown will be enough to have a major impact on corporate profits.

It is for this reason that we continue to focus our portfolio on those companies that we believe are going to create cash flow growth in a tough environment. It is also for this reason that we are being very disciplined about the valuations that we are willing to pay for securities.

The hidden hole in the earnings story

One other major trend that we are watching with a cautious eye relates to corporate stock buy backs. These buy backs, which are always a good thing, are clouding the earnings picture more than many people realize. We have recently written a paper that discusses this issue at length. Instead of us giving a brief synopsis in this letter, we have chosen to send you the full paper for your review. This stock buyback issue is one that we don’t hear many people talking about, but we feel it has the potential to have a dramatic effect on P/E multiples, and therefore stock prices, in the near future.

Please let us know if you have any questions about the paper, or anything else in this letter. As always, we appreciate your confidence in us, and please contact us if there is anything we can do for you.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer

Corporate Stock Buyback Programs

An Effective (though potentially misleading) Practice

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CORPORATE STOCK BUYBACK PROGRAMS
An Effective (though potentially misleading) Practice

Alcoa is once again on the clock. What were their "whisper numbers" this quarter? Did you hear ABC, Inc. missed by a penny? Were there any non-recurring charges that impacted profits? How was management's forecast for the full-fiscal year? Comments like those can only mean one thing…it must be earnings season again.

Yes, four times a year in January, April, July and October, most corporations announce their quarterly results and offer some insight into past performance and future expectations. Once upon a time, these detailed facts, figures, and management insights were reviewed only by those experienced analysts who tracked the individual companies; the data served to confirm how well (or not) they had predicted the quarterly results. While the average investor may have been aware of earnings season, they rarely dissected every last report or made buy/sell decisions based on one quarter's numbers.

That Was Then; This Is Now

In the new world of financial information overload, the average investor is now privy to the same data being analyzed (and overanalyzed) through the daily business press, financial cable channels, and related web sites and blogs (complete with opinions from resident experts). With so many investors now following the daily announcements, markets potentially move more rapidly and volatility often increases during these quarterly reporting periods. For 14 straight quarters, from Q3 2003 through Q4 2006, investors were busy slapping high fives as S&P 500 companies experienced double-digit earnings growth. Since that time, the numbers have slid a bit, though the anticipation and excitement returns each season, even among those investors who cannot differentiate between a balance sheet and an income statement.

While some may argue that "more is better" and access to this financial information is a very positive way to keep the investor informed, certain issues arise when that data is misinterpreted (and that can even include the analysts). History has seen many examples of corporate management engaging in gimmicks or accounting "irregularities" to boast their numbers to this wider audience. Situations have included improper revenue recognition or off-balance sheet transactions (think Enron) or the inappropriate handling of company stock options. Investors often reacted one way when the earnings news was initially announced, only to learn that restatements will be necessary to correct prior releases.

The regulatory environment has changed over the past few years to hopefully limit such situations, yet, earnings numbers still can be confusing and open to incorrect interpretations. While new regulations were created to hold management and directors responsible for any misstatements, other factors may be involved that lead to some potentially misleading results. For example, in recent times, numerous corporations have initiated large stock buyback programs and, while often deemed positive for shareholders, such plans can leave earnings reports open to some misinterpretations.

The Lowdown on Share Buybacks

Management often shows confidence in the future operations of their companies by buying back outstanding shares of their stocks. In some cases, they choose to use excess cash flow to repurchase these shares, revealing that they do not have other investment options that look quite as favorable. At other times, they borrow money and assume new debt to repurchase outstanding shares. In these situations, management has determined that the stock will deliver a higher rate of return than the company's cost of capital (borrowing costs).

In the first quarter of 2007, Standards and Poor's estimated that companies bought back $118 billion worth of stock, an increase of over 17% from the same period in 2006. Over 100 companies reduced their outstanding shares by 4% or more during that quarter with technology and consumer goods companies among the top industries engaging in this practice. Investors generally react positively to such announcements and are often rewarded with higher share prices. After all, if management is confident in the future of the company, its investors should be as well.

There can be no question that stock buybacks are a positive for shareholders. That said, they often lead to some misleading analysis of the underlying companies' earnings growth that quarter. Since many analysts and investors look at earnings per share (EPS) statistics in evaluating profitability, those numbers may be elevated because fewer shares will be outstanding following the buybacks. Those companies that reduced shares by 4% in the first quarter reported stronger earnings growth (by approximately 4%) than were earned as the results of operations. Therefore, investors who glanced at the results to learn only the actual growth number (without analyzing the whole picture), may believe that the quarter was more successful than it really was.

And since Wall Street assigns a multiple to trailing earnings in determining the appropriate price at which the stock should be trading, investors may be using results that are unsustainable for future quarters (when the buyback program eventually slows down). After all, the whole point of paying a multiple to earnings is that investors believe that future growth is sustainable. How long will they pay for this balance sheet driven earnings growth, once they realize that the repurchases cannot last indefinitely?

Excess Cash Flow

So why the sudden popularity in share buybacks? Management has three primary options to consider when spending a company's excess cash flow. It can buy back shares; it can reward shareholders with a one-time (or multiple period) dividend; it can allocate those funds into other potential operational growth opportunities. Historically, corporate execs have been very poor allocators of funds as acquisitions and investments in infrastructure and capital improvement projects (or people) have not always generated the cash flow anticipated. Dividends represent an effective alternative, though, in the past, the tax consequences were not as favorable to the shareholders who were taxed at ordinary income rates. While the tax laws have changed for the benefit of the investors, management often shies away from increasing dividends as the market views such transactions as one-time events and the underlying share prices are less prone to appreciate in the aftermath.

Buybacks, on the other hand, are not perceived as one-time events and, therefore, management is able to reap some personal benefits from these programs. Bear in mind, many execs are compensated based on earnings growth and stock price appreciation and, therefore, may have incentives to engage in such repurchase programs. As earnings results look better with fewer shares outstanding, they may be rewarded with higher bonuses. As stock prices rise after the strong (perceived) earnings numbers, they see the value of their stock options and personal share holdings increase as well.

While investors may recognize these benefits in the short-term, one primary question still remains…just how sustainable is this earnings growth once the share buyback program slows down? How much excess balance sheet liquidity exists to provide for recurring periods of share repurchases? Maybe the company can continue on such a program for a quarter or two (or even over a few years), but, at some point, the buybacks will not be likely to continue at the same rate.

A Potential (scary) Scenario

As an extreme example, assume a company announces a massive self-tender and will be retiring as much as 15% of its common stock over the next few years. If the market doesn't look at buybacks in the same one-time manner as it does dividends, the share price trades up based on a multiple of the company's higher EPS. That earnings growth number will be elevated by about 15% over the periods that the buyback take place.

So what happens when excess liquidity has been depleted and the company has completed this repurchase program? How will its earnings look several quarters into the future, once analysts and investors have become accustomed to the financial ratios that reflect fewer shares outstanding during the past quarter? Logic states that unless the company produces a stellar operational period at that time, earnings growth rate will decline and the valuation and stock price could fall.

Couple that scenario with a weakening economy. Bulls assume that everything will be rosy for the foreseeable future. Global growth from China, India etc. is compensating for the negative effects of a sluggish housing sector. Inflation numbers remain manageable at the moment, but what happens should oil prices continue to skyrocket and the subprime debacle creeps into other sectors of the economy, namely consumer-driven industries? Remember, the consumer accounts for 2/3 of the activity in the economy. Recently, Countrywide Financial Corp's CEO, Angelo Mozilo, proclaimed, "We are experiencing home-price depreciation almost like never before, with the exception of the Great Depression." And delinquencies and defaults on subprime (and even prime) mortgages are expected to get worse before they get better.

For years, homeowners have used their houses as a piggy bank, finding ways to take out money by reducing their equity to sustain their lifestyles and spending patterns. When cash-strapped borrowers cannot sell their homes or refinance their home mortgages, those piggy banks get turned off and a snowball effect causes the overall economy to slow. No more plasma TVs; no more updated home furnishings; fewer evenings out on the town; less elaborate vacations; less frequent purchases of new cars. While the luxury buyer may not be dramatically affected, middle America certainly could be. A sluggish economy will have a major impact on the credit markets and the way investors evaluate risk. Operating earnings begin to decline as a result of the weaker economy just in time for buyback programs to slow. Under these scenarios, investors are greeted with a quarter or more of lower than anticipated earnings growth and stock prices could decline accordingly.

While no one is predicting the slowdown to happen today, tomorrow, next week or next month, at some point, a definitive event will transpire that prompts some weakness in the economy. (Maybe it already has.) Likewise, companies like Home Depot, Cisco, IBM, Oracle and many others have been engaged in significant repurchase programs that will surely slow at some point as well. And when these two phenomena coincide, the markets could experience some "challenges" (to put it mildly).

Cash (flow) Is King

While most equity market investors focus on earnings (and eagerly await the next earnings season), cash flow growth is actually a far more appropriate measurement of future profitability. And buybacks have no impact on operational cash flow growth. Think about this reasoning from a business owners' perspective. When people consider buying into a private business, they realize they are acquiring a future stream of cash flow and do not invest based on a reduction of share count. In other words, how much cash is being generated from operations today, and what are the projections for tomorrow? How long will it take to recoup the initial investment? Prospective buyers assign a multiple they are willing to pay for that cash flow based on its stability and the nature of the industry in which it operates. While earnings may be nice, cash flow is often the most important consideration.

Why should investing in public stocks be any different than buying a private business? And yet, many investors look at stocks as just a piece of paper and assign a different metric to the analysis. Unfortunately, even analysts often seem to overlook the crucial cash flow measures. One analyst pointed out that his firm projects EPS from a top down perspective and doesn't even consider how cash flow or buybacks impact earnings. Unfortunately there are still many investors who are less concerned with long-term investing and instead seek out that instant gratification of picking the hot stock-of-the-day. They typically look more closely at earnings growth without much concern about the longevity of any share repurchase program or sustainability of those EPS statistics. And why should they care since they may have moved on to the next stock before the buybacks have ended?

What's an Investor to Do?

What good is a detailed analysis of a potential problem without suggesting a few solutions? The current buyback phenomenon should be considered a positive development for shareholders as it reveals management confidence in the underlying company. Such announcements typically result in stock appreciation, and earnings growth increases in the quarters of the repurchases. However, with all the positives, investors should be fully aware of the whole financial picture.

- Continue to monitor earnings growth, but only as one financial measurement;
- Be aware that buybacks serve to inflate those earnings growth numbers in the short-term and the long-term sustainability should be questioned;
- Think like a true business owner and focus more on cash flow growth as the most appropriate measurement of the future viability and profitability of the underlying company;
- Company boards should consider revising compensation packages to execs to focus more on total shareholder return and other more pertinent financial numbers and less on price appreciation and earnings growth (easier said than done).

The market has become very complacent when it comes to earnings growth and that remains a very dangerous situation. These days, many investors merely lease their holdings for a short time (days, weeks, months) and then seek out that next stock-du-jour. Instead, they should be looking at their portfolios from an ownership position and focusing on the long-term. With that said, cash flow growth is a far more meaningful, long-term measurement.

Then again, investors don't want to miss out on all the fun of earnings season, anticipating "whisper numbers," and evaluating non-recurring charges. Alcoa, you're once again on the clock.