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2nd Quarter 2004

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

"A whole lotta nothin' going on."

If a person went to sleep March 31st and did not wake until July 1st, they would not have missed much. Stock markets in the second quarter were able to squeak out a small gain but remained in a fairly tight range for most of the quarter. Company specific announcements were the only real drivers of activity. There continued to be head turning news on the geo-political front, but none of this news really drove prices one way or the other.

The good news we can report is that while stock prices did not go anywhere during the quarter, company profitability rose dramatically. As we detailed in prior letters, we have been very concerned by valuation levels for the last few quarters. In January, the P/E multiple of the S&P 500 on estimated 2003 earnings was 20.76x. The median return of the index over the next 12 months when the multiple is at this level is a -5.3%. The "sweet spot" of performance in the past has been when the forward multiple is approximately 14-16x forward earnings. We have begun to make progress towards the "sweet spot."

There are only two ways stock price multiples can go down significantly: 1) Earnings go up much more than stock prices and 2) Stock prices go down much faster than earnings. Obviously, we would much prefer the first scenario, and this is what happened in the second quarter. We estimate that for the second quarter, the profits of the companies that make up the S&P 500 rose by approximately 24% over the same period last year. Due to the fact the S&P 500 index rose by such a small amount, this means that the P/E multiple of the index **dropped** by approximately 20%. While this improvement in valuations is helpful, we would like to see continued reduction in overall market multiples. The second quarter was definitely a step in the right direction.

Our portfolio companies performed beautifully as a group in the quarter. Notice we said the "portfolio companies," not the stocks of our portfolio companies. The performance of our stocks, like the market, was mixed. The actual profitability measures were excellent, and we are very pleased with the way our companies are operating their businesses at this point in the economic recovery. There are many factors we look for in our companies at all times, but there are some factors that we are especially focusing on at this time. The three main things we are focusing on right now are as follows: balance sheet strength; revenue growth and sustainability; management teams that are good capital allocators. In a slow growth economic environment, which we believe we are in and likely to stay in for some time, it is very important to us that our companies have financial flexibility, ample sources of revenue growth and financial discipline. We believe that these traits will separate the companies that will be able to manufacture growth well above the rate of the general economy from those that will stagnate in a slow-growth economic environment.

Interest rates are now rising

Probably the biggest structural change we have seen this year actually occurred on the very last day of the quarter. On June 30th, the U.S. Federal Reserve chose to adapt a tightening stance and raised interest rates by 25 basis points. A great deal of attention has been focused on what this means to the financial markets. Much of the commentary has discussed perception and what people think will happen. We thought it would be helpful to provide some historical statistical data that shows how markets in the past have performed as the Federal Reserve has begun to raise interest rates. As you can see from the table below, the impact in the first three to six months is mixed, but as you look out over the next year, the performance is positive 70% of the time.

Tightening Cycle in Federal Reserve Policy
S&P 500 Gain/Loss after 1st Discount Rate Hike
(1950 – Current)

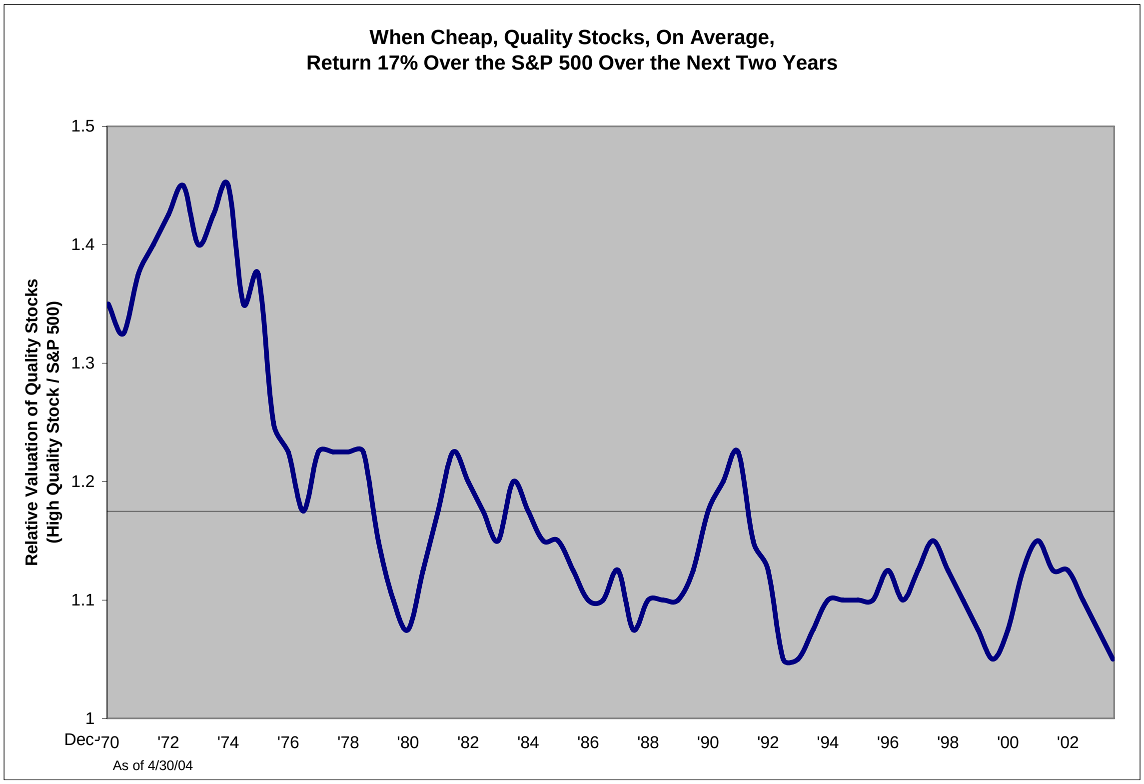
Disc Rate Hike	*3 Mo. Later (%)*	*6 Mo. Later (%)*	*12 Mo. Later*
4/15/1955	11.7	8.6	26.3
9/12/1958	9.7	16.8	18.3
7/17/1963	5.9	11.1	21.3
11/20/1967	-4.5	5.8	15.8
1/15/1973	-5.9	-10.7	-20.4
8/30/1977	-3.9	-11.4	5.2
9/26/1980	8.1	6.6	-10.7
9/4/1987	-29.3	-15.6	-16.5
5/17/1994	3.5	3.6	17.3
8/24/1999	3.0	-0.2	10.4

Source: InvesTech Research.

We do not know what the result will be this time, but we do know that the economy is recovering, albeit slowly, and corporate profitability is expanding. The battle now is whether or not rising corporate profits will allow stocks to grow faster than contracting P/E multiples hold them back. No one knows which will be the deciding factor that determines whether or not stocks rise or fall over the next year. This is why we are so focused on our companies' growth and their valuation levels. This is **not** the time to overpay for companies.

A valuation disparity

There have been very few large developments in the first half of this year. Therefore the opportunities to generate outperformance have been relatively few. The trends are developing slower and seem to be taking more time to change. One of the interesting developments we are focusing on is the gap that continues to develop between the valuations of high quality companies and the rest of the market. We have talked about this before, but it warrants mention again. As a result of the incredible run up in lower quality companies last year and the underperformance of the highest quality companies, we see the spread has widened to the largest level since the internet bubble of 1999. As the chart below shows, only three times since 1970 have "quality companies" been this inexpensive relative to the S&P 500. In each case the average out performance of these "quality companies", relative to the S&P 500, has been more than 17% over the next two years.



We believe this trend is likely to continue. Fortunately for us, this fits right into the sweet spot of our investment strategy. We have always focused on the best companies in the U.S., and we believe that this skill set will allow us to apply our selection process to an area that is already relatively inexpensive.

As always, we appreciate your business, and we ask you to let us know how we can service you better.

All my best,

Christopher Alan Zook
Chairman and Chief Investment Officer