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3rd Quarter 2006

CAZ CORNERSTONE PORTFOLIO
Performance Update

The Revenge of the Large Caps

For the first time in quite awhile, large capitalization U.S. stocks outperformed small and mid caps in the 3rd quarter. This was rewarding to see, and when coupled with good security selection, we had an excellent quarter.

We have talked about how large cap stocks have been trading at very inexpensive relative valuations for several quarters. This discrepancy in valuation finally got the attention of many investors, and money began to flow into this area. Naturally, large caps are the universe in which we invest, and we are glad to see investors finally paying attention to these stocks, which are very reasonably priced compared to their cash flow growth.

Specific Valuations

As stated above, one of the reasons we have seen this renewed interest in large cap U.S. stocks is simply valuation. The stocks in our universe have really not received the credit they deserve for the cash flow they are generating. We sense that investors are now starting to recognize this, and the stocks are beginning to play “catch up” with the rest of the market. A visual aid should help illustrate this point, so we have brought back a chart that clients indicated was very helpful to them.

In the 1st quarter of 2003 we printed a chart that showed how the net income and market capitalization of our top 10 holdings compared to five years earlier. We have updated that chart to illustrate how much cash flows have improved for our companies, yet the market is not giving them as much credit as in the past. Again, we focus on the entire company and what it should be worth.

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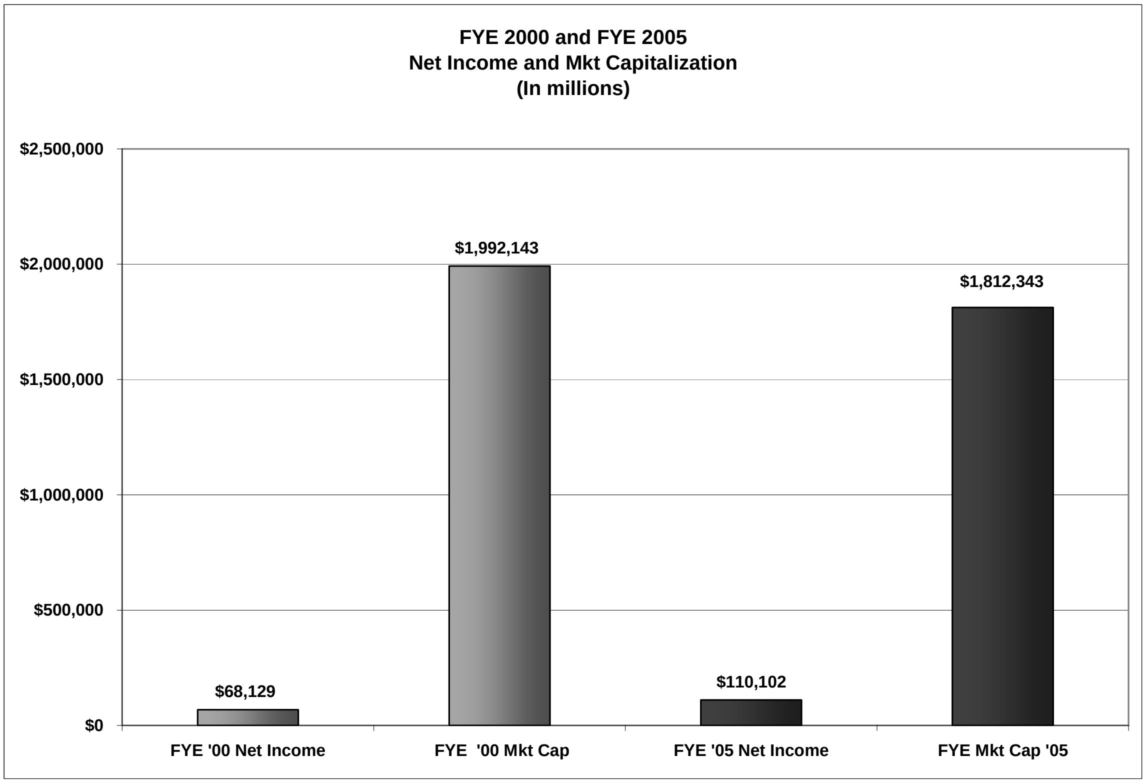

What does this chart tell us? First, the companies that make up our 10 largest holdings have increased their profits from $68 billion to $110 billion in five years. Second, the market has dramatically reduced the multiple to net income that the companies trade for. Even though our companies are earning **61% more** than they did in 2000, the total value the market is paying for these companies has gone **down**! These are some of the very best companies in the world, and they are trading at substantial discounts to what they should be worth over the next three to five years. Our optimism is partially based on growth and partially based on valuations. The companies we own will be able to continue to grow at moderate levels, while their valuations have little downside risk. Therefore, if we simply receive the company's expected growth and valuations stay the same, our return is going to be the cash flow growth of the companies. An illustration may be helpful to understand this point:

If you own company XYZ that is growing cash flow by 12% and is trading at 10X cash flow, then you can project what you think your investment return is going to be based on your expectations for cash flow growth and valuation levels at the end of a specific time period. We tend to look for a three- to six-year holding period. Therefore, if we expect that XYZ is going to grow by 12% for the next six years, we know that the cash flow for the business would double in that six-year period of time. Next, we determine what we feel the market will pay for the rate of growth at the end of the sixth year. We call this our target valuation. Specific to this case, if XYZ is trading at 10X cash flow, and we feel the market will pay 10X cash flow at the end of six years, then we feel confident that we can double our money in six years.

Obviously, this requires us to be approximately right on the growth rate of the business for a long period and on a target valuation. There is no way to be exact with these numbers, but based on conservative expectations, we can reach a level that provides a high level of confidence. We also build in a margin of safety to our estimates. We always want to be sure that if our estimates are high, we will still earn an acceptable rate of return. The key for us is to focus on the business as a whole and think like an owner. That way we can participate in the long-term growth of the enterprise.

Year to Date

The amazing thing about the market is how it can quickly change the perspective of people. In May most investors were frustrated with the market and tired of its choppiness. With the rally in the 3rd quarter, it is remarkable how the mood of investors has improved. The interesting thing is that, so far, the market has really done exactly what we expected.

In our January letter, we indicated that the cash flows from our businesses could grow by 10-11% and that valuations might contract by 2-4% as a result of higher interest rates. This gave us a target for the year of approximately 6-9%. It now appears that cash flow growth may actually come in at 11-12%, and valuations thus far are close to the same levels that they started the year. As a result of the strong cash flow and consistent valuations, the markets have rallied (as of the date of this letter) by 6-10% (depending on the index surveyed).

We must critically evaluate the quarterly reports from companies as we begin to wrap up 2006 and look to 2007. We will pay very close attention to the outlooks of the companies and begin to come up with our cash flow growth assumptions. Obviously, we cannot set 2007 valuation targets until we see where they end up in 2006. So, like in years past, we will detail our yearly expectations in the January letter.

For those of you who were not able to join us for our Annual Client Conference, we missed you. The evening was spectacular with a great turnout. It will be hard to replicate the energy and enjoyment that we all experienced with Dr. Barry Asmus. We will do our best to find an equally-captivating speaker for our 2007 conference. When we set the date, we will forward it to you so you can hold that slot on your calendar. We appreciate your business and ask you to please let us know if there is anything we can do for you.

Regards,

Christopher A. Zook
Chairman and Chief Investment Officer