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4th Quarter 2006

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

What a Pleasant Surprise!

The market was very kind to us in 2006, and investors were rewarded for their patience with strong double-digit returns. The rally from the lows in July was not unprecedented, but was very impressive. Even more striking was how the market increase was almost completely unabated. The largest pullback the S&P 500 experienced during that 6½ month rally was only a bit more than 2%! This is very uncommon, but we are certainly not going to complain. Well, maybe we will take issue with it, but more about that later…

What caused the surprise upside in the markets in 2006? As we stated in our letters this year, we were looking for 10-11% cash flow growth and an approximately 2-4% pullback in valuations. Both of these metrics proved to be conservative. The companies we own delivered cash flow growth that was higher than we expected, and the market slightly expanded valuations during the year. These two factors allowed our portfolios to increase by approximately 15% for the year which was well above expectations.

How did it happen?

What caused this pleasant surprise? There were several factors that allowed the market to perform so well:

- Higher-than-expected cash flows. Never forget, long-term stock prices are mainly impacted by the cash flow of the businesses. This year companies delivered cash flow from their operations that was superb and well above market expectations.
- Valuations did not contract like they typically will at this point in the economic and interest rate cycle.
- Long-term interest rates did rise sharply, but they quickly fell back to nearly where they started the year.
- What everyone said could not go down went down. Believe it or not, commodity prices actually declined in price… “gasp!” In particular, after increasing sharply in the first six months of 2006, energy prices dropped dramatically in the last half of the year. Crude Oil dropped from $80 per barrel to $60 at year end, and to $52 as we write this. On a side note: Remember when Crude was at $80 and everyone on TV was saying the next stop was $100? Hmm…think back to the Crowded Room discussion in our previous letter.

The above factors were somewhat surprising, but we also saw some positives occur that were expected by most investors. The Federal Reserve stopped increasing interest rates. Company balance sheets continued to get stronger. More companies chose to be acquired and go private. All of these factors also helped lift equity values.

Enough celebrating. Where do we go from here?

Let's talk about what we know at this point. These are things that are obvious as we enter 2007:

- The Federal Reserve is on hold.
- The economy is slowing.
- The housing market is beginning to show serious signs of stress.
- Company profit margins are at extremely high levels.
- Investors are VERY complacent.
- The market has now rallied nearly 17% since July without a meaningful correction.
- Stock valuations can, at best, be defined as reasonable with some areas approaching expensive.

None of the factors above are definitive reasons for concern, but they cannot be ignored. There are the typical uncertainties we have documented before (geo-political, etc.) but none of those are quantifiable or predictable. Therefore, let's focus on what we do know and what we project for the year.

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.
- 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.
- Private Equity buyers will continue to take companies private at a significant rate, providing a floor for potential buyout candidates.
- Volatility will DEFINITELY go higher.
- 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.
- Company cash flows will grow slightly faster than general expectations at approximately 9-10% for the companies we own.
- Energy prices will rise, potentially sharply, from current levels.
- 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.

That's all well and good, but what does it mean for me?

The net result of all of these projections is we are more cautious as we enter 2007 than we have been in several years. Let us be TOTALLY clear -- we are NOT bearish. We are NOT forecasting a dramatic decline in stock prices for 2007. We are advising people to not be complacent. We are emphatically encouraging people to assess their risk tolerance and take a fresh look at their asset allocation. Make certain you are comfortable with the potential volatility in your portfolio. This is not a time to be greedy. This is a time to be prudent.

We showed a chart last year of the Volatility Index (VIX) and commented on how it was at historic lows. Well, if you recall, volatility did indeed spike in the 2nd quarter of 2006 (actually, it more than doubled), and it caught a LOT of investors off guard. The interesting thing to note is how quickly volatility dissipated, and now we have a situation where today's level is actually LOWER than it was a year ago. Mark it down, volatility will be higher this year than it is today, and every investor must factor that into their allocation decisions for 2007.

As stated above, we are looking for 9-10% cash flow growth and potentially a 3-5% decrease in valuations. This generates an expectation of approximately 4% to 7% upside for the year. While this is not an exciting number, it is still positive, and we believe 2006 simply borrowed some of the return from 2007.

Now, what could cause our estimates to be too conservative?

- Energy prices continue to decline dramatically.
- The economy begins to grow at a MUCH faster rate without inflationary pressures.
- Market valuations expand dramatically based on supply/demand imbalances.

This is a time of sensible opportunity, and we believe when the volatility increases it will create attractive entry points into selective stocks. We have been quoted in the media that we would be more comfortable with the market if it were 5-8% cheaper. This is definitely the case as we feel the risk/reward picture would be more favorable. We may not see that pullback, but every investor should be prepared and should feel comfortable with the impact it would have on their portfolio value.

On the housekeeping front, with this letter you will find your 4th quarter Portfolio Review. As always, this report 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.

We appreciate your confidence in us and while we are celebrating an extremely profitable 2006, know that we are continually focused on creating solid results for you in 2007. We hope that this year brings many blessings to you and your family.

Regards,
Christopher Alan Zook
Chairman and Chief Investment Officer