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2nd Quarter 2008

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

Stagflation is Real

The second quarter came to a close with a whimper. June of 2008 was the worst single month experienced by the S&P 500 since 2002. We are now officially in a bear market as defined by the "universal" definition of a 20% decline for the S&P 500. The index recently crossed this threshold with a 20+% drop from its 2007 peak. That, of course, yields no clue as to where we go from here. It does put a seal on the "correction" talk, and everyone can now turn their discussions to the question of when the bear market will end.

Suffice it to say, investors have experienced a lot of pain with nearly every major stock index around the world down more than 10% for the year. Almost all stocks have succumbed to the sell-off. Some stock indices around the world are down more than 20% for the year and nearly 50% from their peaks. The cause of this decline has been well documented in the press, but most of the discussion seems to be centered on the meltdown in the credit markets and rising oil prices. While these factors are certainly a large contributor to the pain, they are only part of the story. The unfortunate reality is that it appears stagflation is here and is not likely to leave us anytime soon. What is stagflation? Some would argue that stagflation is just a buzz word that attempts to describe an economic environment that does not fit a normal definition. The truth is that stagflation is real, and it is a very challenging environment for investment assets of nearly all types.

Stagflation is normally defined as an environment where the economy is slowing down, possibly even in a recession, while at the same time inflation is accelerating. Sound familiar? Indeed, the U.S. and much of the world are now experiencing a severe economic slowdown, and at the same time we see inflation nearly everywhere we turn. Obviously, oil is the most visible but one only needs to look at food, steel, raw materials, etc., to see the cost of goods rising at an alarming rate. This is stagflation and trying to define it differently is an exercise in futility.

The combination of a weak economy and rising inflation may seem to be benign at first, but by analyzing the impact on profitability of companies, one will understand why it is such a challenging environment. A company makes money by selling a product or service for more than the cost of producing that product or service. In a weak economic environment, consumers and companies are concerned about spending money and do not have a large amount of disposable income. Therefore, they cut back on their spending and this creates a reduction in overall demand for products and services. We all know that the economy is challenged by falling home prices and other factors. People simply do not spend as much when they are struggling to pay the bills on their homes, etc. That is not complicated and will continue until such time as home prices stabilize and people "feel wealthier." Next, you add a rising unemployment rate with more people simply being out of work, and we have a further reduction in demand. Include substantially rising energy costs that cause drivers to spend almost twice as much per month to fill up the gas tank in their car and provide energy for their home, and you get more contraction in spending.

That addresses the slowdown, which is straightforward and exactly what occurs in most recessions. Stagflation is different from a recession because of the inflationary pressure companies experience on their costs. In an inflationary environment, companies have to pay higher prices for what they use to make their products and this creates a dilemma for the companies. If they raise prices for what they sell, it will be harder for the already stressed purchaser of their products to afford it. Thereby, that purchaser may further reduce the amount of buying they do. The simplest example that we can think of would be restaurant owners. If the cost of beef doubles in price, the owners of the steak houses are faced with a decision. Do they drastically increase the price of the steak on the menu in order to keep their profit per steak the same? If so, then they risk running off their customers. Would you be willing to pay $70 for the filet mignon that you are used to paying $40 for? Would you accept that as "just the cost of going out to eat"? Probably not, and that is in a normal environment. Imagine the contraction in demand in a very weak economic environment. The resulting loss of revenue is obviously unacceptable for the restaurant owners, so most likely they keep their prices the same in order to keep their customers. They just make less money per steak while they "hope" that beef prices come down. The owners will then try to reduce their costs in another way. They stop providing "frills," or they reduce their staff by letting employees go, etc. While this is a simple example, it applies across all industries from consumer businesses to the largest industrial companies.

This is a vicious cycle. Consumers are strained, and businesses' profit margins are reduced. This leads to cutbacks on employees, which accelerates the slowdown, which strains the consumer, which… The question is how does the cycle stop? This is why stagflation is so problematic. If the Federal Reserve reduces interest rates dramatically to help the economy, that creates more inflation. If the Federal Reserve raises interest rates to fight inflation, it creates more weakness in the economy. Thus, the Fed is in a pickle and is limited in their ability to help. Fiscal stimulus is also typically ineffective in this type of environment. So what stops the cycle? Unfortunately, it is usually only time and gains in productivity that remedy the situation.

Let us all remember that stocks trade based on a price to current levels of cash flow and more importantly, the expectations for future cash flow. If investors are concerned about the future pressure that stagflation is going to put on company profit margins, and thereby cash flow, then valuations/multiples will contract. This is what we are seeing now. Stock price multiples are contracting at the same time that earnings are declining.

Outlook for Second Half of the Year

So where does that leave us? Unfortunately, it leaves us with as much uncertainty with which we started the second quarter. Companies are beginning to report earnings for the second quarter and what we have heard thus far is not encouraging. They are seeing the pressures we discussed above, and they are not sure what the impact will be on their businesses. Some companies naturally see it more than others, but as a rule, businesses across most sectors are being impacted negatively, and the companies are talking about the problems. These comments are not what investors like to hear, and that is one of the reasons why the sell-off accelerated and took us to new lows for the year. There are other reasons that are well known, including the possibility of hostilities with Iran which is looking more likely.

HOWEVER, there is a silver lining in there somewhere. Notice that we said that companies are now beginning to "fess up" to the negative news, and investors are responding to that news by selling. What should be obvious is that stocks have come down in price, and valuations have contracted substantially. As a result, we are getting closer and closer to valuations that become more compelling. We are not there yet, and we feel the market needs more time and value to become "cheap." Make no mistake, though, each month that passes that we stay at these levels we are getting closer to those compelling valuations. In several cases, we are seeing very attractive values, and we believe that they have reached a point where they must be owned aggressively by investors with a reasonable time horizon.

The second half of the year will continue to be choppy and filled with uncertainty. This will come from the same forces that we described above and be compounded by the significant unknown around the November elections. Many pundits are forecasting that this election will be every bit as close as the 2000 race. Markets don't like uncertainty, especially when you have two candidates at polar opposites on major issues regarding the economy. This uncertainty will add to an already difficult environment.

The forecast we put forth for 2008 was that we would likely see a slightly negative to flat year in 2008. We expected a decline of valuations coupled with marginal growth in cash flows. The caveat that we gave was:

> "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."

Unfortunately, this scenario is now looking more and more likely. While we feel that the market is probably oversold and likely to bounce at some point over the summer months, we believe the final tally for 2008 will be a negative number that approximates the rate of decline of cash flow for the year. We still do not believe that housing prices will bottom until at least 2009, and that will accentuate many of the issues that we detailed above.

So what should investors do? Be selective, but stay true to your asset allocation. If you should be buying stocks now to keep your allocation in line with your targets, do so. Don't try to guess if this is the bottom or if the bottom will occur in four months. Make the changes that are required by your plan, and do not waiver from that plan. Long-term investors who abide by their plan in an unemotional way will be rewarded for doing so.

Portfolio Changes

What are we doing in the stock portfolios to position for the future? We have made a number of changes in the portfolios in the last few months. These changes are in response to the clarity that we now have that the economy is likely to be in a stagflationary environment for the next several quarters. The tone we heard from companies in the fourth quarter of ’07 and early in the first quarter of ’08 was optimistic. They felt the economy could avoid stagflation and simply suffer a slowdown and “soft landing.” That tone has changed and it is clear that many companies are “hunkering” down for a much more difficult environment.

In this environment, there were several of our companies that simply would not accomplish what we thought they would, and they needed to be sold. At the same time, we are attempting to reposition the portfolio in those companies that should perform much better in this environment. The changes to the portfolio should allow us to own more companies with stronger prospects over the next several years, coupled with near-term business momentum. At the same time, for taxable clients, we are following the practice that we have always followed in periods of significant market declines. We harvest losses in the portfolio that we can then use to offset against gains that are earned in the future. This practice has allowed us to be extremely tax efficient, and we will continue to attempt to provide the highest after-tax return possible for our taxable clients.

New Additions at CAZ

We are very excited to announce two additions to the team at CAZ. Toby McMillin, CFA, has joined our team as Senior Analyst. Toby has a long tenure in the investment business and has tremendous skills. His presence will provide us with further depth of research of the companies that we own. In the short time he has been with us, we have already seen the impact of his work in the organization. Jennifer Counter has joined our team to assist in both the Operations and Client Service areas of the firm. Her pleasant demeanor will be enjoyed by the clients and employees of the firm, and we are pleased to have her.

In this challenging market environment you have probably noticed an increase in the correspondence that we have sent you. We want to make sure that all clients have enough information to help them understand the market dynamics. If there is anything we can do for you, or if you have any questions that we can answer, please don’t hesitate to let us know. We continue to work hard to provide the best possible risk-adjusted returns for your portfolios. Thank you for your continued confidence in our firm.

All our very best to you and your family.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer