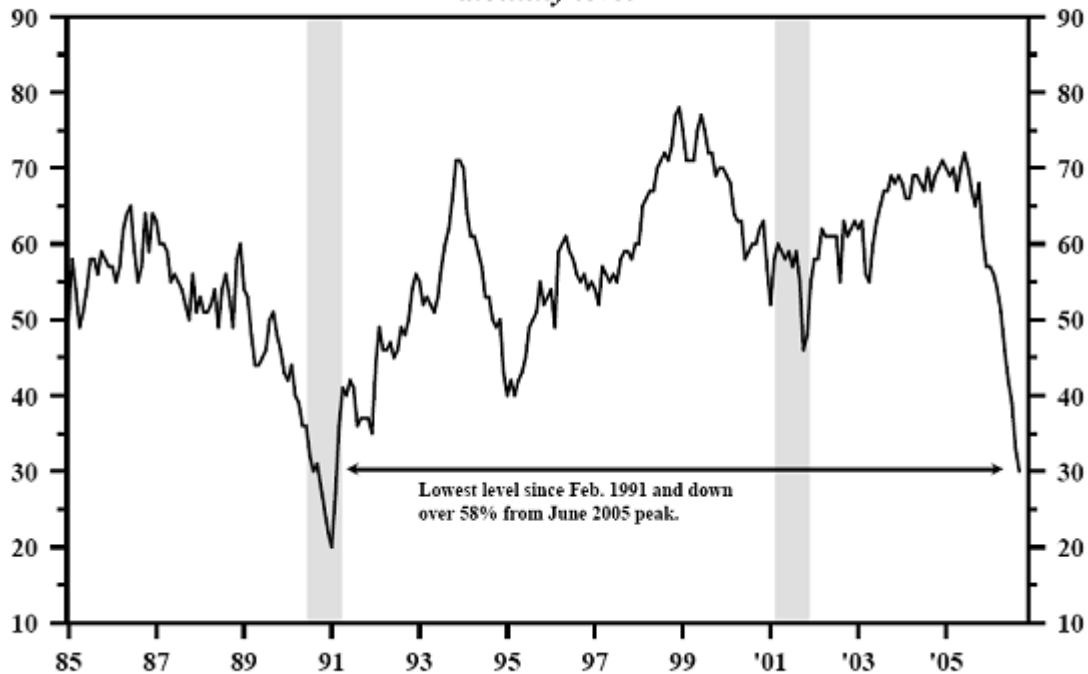


## WEDGEWOOD VIEW. 3<sup>RD</sup> QUARTER 2006

### NIGHTMARE ON ELM STREET

## Housing Market Index

*monthly level*



Source: National Association of Home Builders. Through September 2006.

Much has been written (as well as prognosticated) of late about the state of the U.S. housing market. In our last Client Letter, in which we presented our case for a sharp deceleration of corporate profits (and the concomitant emergent market leadership of Large Cap growth stocks); we only briefly mentioned the impact of a deflating housing market as a potential economic headwind. This matter deserves more commentary.

The more we have come to learn about the outsized impact of the 2000-2001 U.S. housing expansion-boom-bubble on the U.S. economy, the more we have come to the view that the now unfolding housing decline-recession-bust will once again have an

outsized (but unpleasant) impact on U.S. economic growth over the course of the next few years.

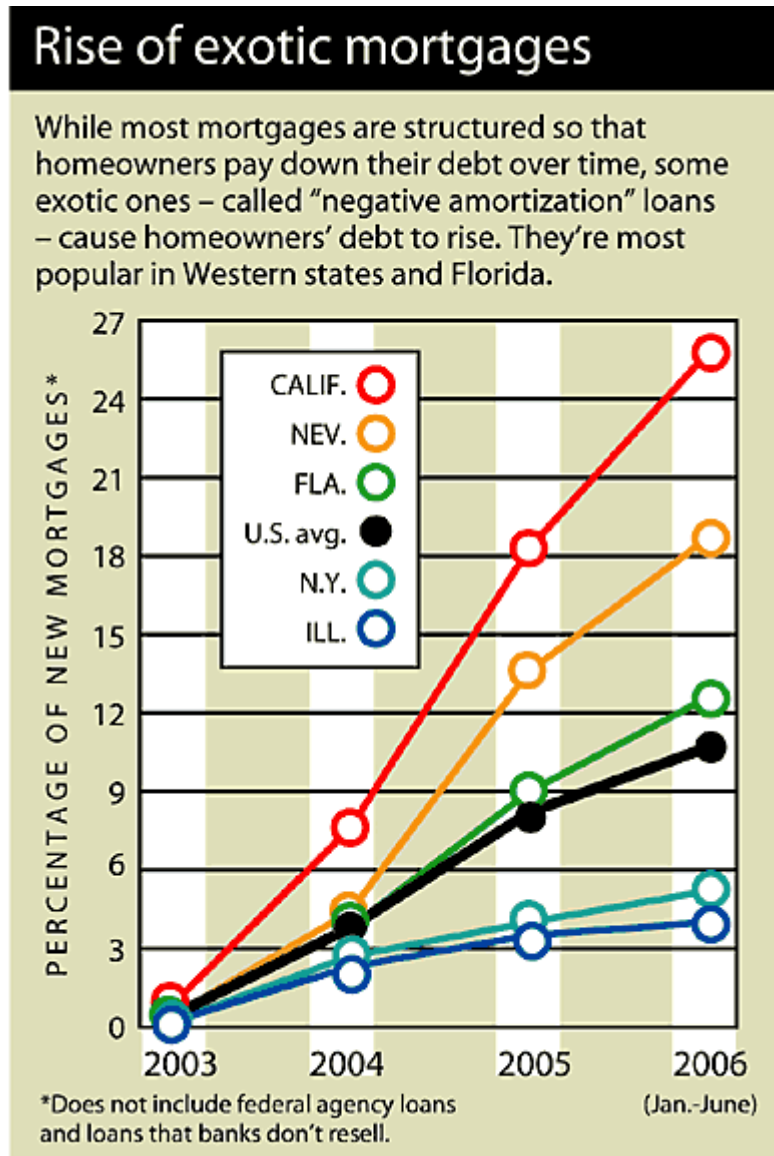
A sage once retorted that economic history never perfectly repeats itself, but the future most surely rhymes with the past. We expect such will be the case with the remarkable tale of the U.S. housing market during this decade thus far. The never-before-seen combination of 40-year low interest rates, combined with esoteric and exotic mortgages, served up a witches-brew fuel to propel the U.S. housing market into uncharted territory.

The bursting of the Tech-Telecom-DotCom bubble is no distant memory for investors. For those who care to recall, specifically in terms of duration, it seemed dreadfully slow. The NASDAQ fell -65% from March 2000 through October 2002. Compared to the glacially slow movements of housing markets, such stock market corrections will seem nearly instantaneous.

The current state of the housing market is no doubt in a sharp correction. Housing is an inherently slow asset to liquidate. We expect the current downturn to be longer than most expect or predict. We are assuredly not experts of the U.S. housing market, but in terms of the potential depth, breadth and impact to the U.S. economy we offer the following factoids and estimates as clues and guideposts to where it may be heading:

- 90% of GDP growth since 2001 is accounted for by incremental consumer and residential construction spending.
- 42% of job growth since 2001 is housing related.
- 70% of the rise in household net worth since 2001 is from home appreciation.
- Real estate values have doubled since 2000, peaking in the spring of 2005 at \$22 trillion – or 155% of GDP.
- The market value peak of the Tech-Telecom-DotCom boom in the spring of 2000 was \$12 trillion – or 140% of GDP.
- During the last housing correction in 1990, less than 10% of home loans were adjustable rate mortgages. At current interest rates, more than \$2 trillion in ARM's are set to adjust higher through 2007. In dollar volume, 46% of home mortgages in 2006 alone were adjustable rate mortgages. The Federal Deposit Insurance Corp. estimates that as much as 63% of ARMs taken out in 2006 have been exotic "option ARMs." First American Real Estate Solutions estimates that \$368 billion in ARMs originated in 2004 and 2005 are at risk of default due to the "payment shock" associated with higher payment resets. In terms of the number of potentially affected households - 1.8 million families are at risk of default and another 500,000 families are likely to go into foreclosure.

- The repercussions of home owner/home speculator behavior under the auspices of exotic mortgages are simply unknowable, yet we do know that their usage has been profligate.



Source: Business Week

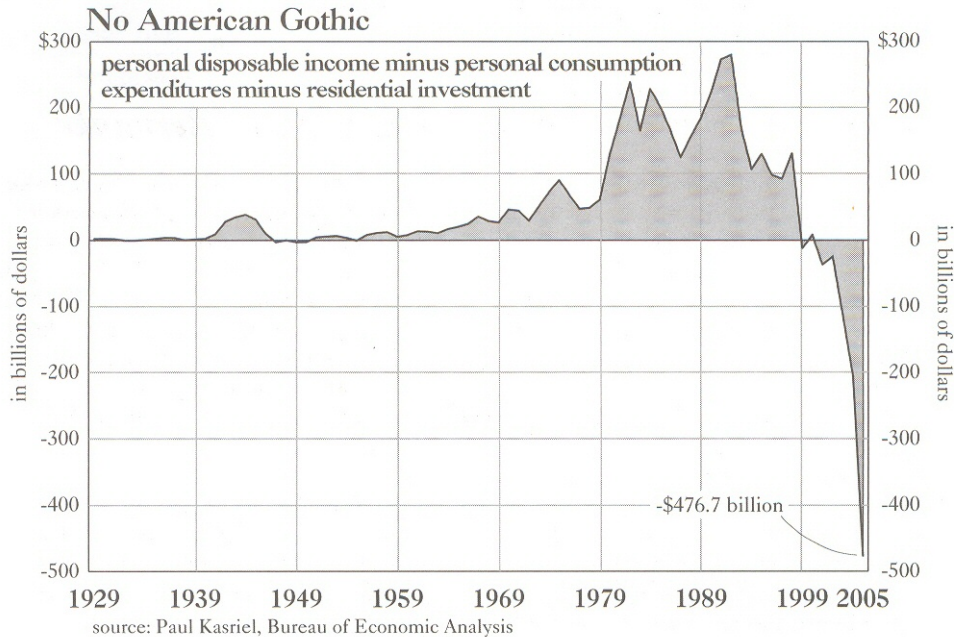
32% of new mortgages and home-equity loans in 2005 were “interest-only” loans – up from 0.6% in 2000.

Mortgage equity withdrawals (the infamous “housing ATM”) peaked on a quarterly basis at \$180 billion during the third quarter of 2005.



- Over the past five years, mortgage equity withdrawals are estimated to have increased GDP by at least 30% and as much as 60% per year.
- Current household equity (which peaked at 70% in 1987) has fallen to a record low of 54% - this includes the 34% of homeowners with zero debt.
- 43% of first time home buyers in 2005 put no money down.
- Between 2000 and 2004, membership of realtors of the National Association of Realtors increased 26% to 1.2 million real estate agents. In May 2006, one out of every 55 adults in California (500,000) held a realty license.
- The inventory backlog of unsold single-family homes and condominiums has risen 40% over the past 12 months to 4.4 million units.
- Residential building permits have declined seven months in a row - plunging 22% year-over-year to levels not seen since 1991.
- In August alone, Florida existing home sales and condo sales fell -34% and -41%, respectively.
- According to the National Association of Realtors, builders have cut home prices -22% since April.
- The median ratio of newly refinanced mortgage rates to previous rates has only been at such high levels twice in the last two years – each previous time the increase in the debt-servicing burden was great enough to throw the economy into a recession.

- The University of Michigan consumer sentiment survey of home buying intentions has fallen to the lowest level since 1990.
- The National Association of Home Builders traffic of prospective buyers of new homes index has fallen to the lowest level since 1991.
- The Mortgage Bankers Association new mortgage purchase index has fallen -25% from its previous peak set in the spring of 2005.
- Housing affordability (determined by housing prices, mortgage rates and personal income growth rates) has fallen to 20-year lows.
- Cancellation rates at the nation's three largest homebuilders have risen between -30% to -40%.
- Potential homeowners (and real estate speculators) are walking away from new construction commitments in droves. The percent of homes sold that are currently under construction has increased more than 30% on a year-over-year basis. Since 1965, when housing witnessed such activity the economy headed for a hard landing.
- At the nation's largest mortgage broker (Countrywide Financial), insiders have executed 105 stock transactions over the past six months. These insiders have bought zero shares and have collectively reduced their holdings -58% (or 6,200,000 shares) by \$217,000,000.
- The U.S. consumer is running out of means to be a resilient spender in the years ahead. U.S. consumer debt-to-income ratio has risen 30 percentage points over the past five years – or as much as it has risen in the previous 15 years.
- Household debt as a percentage of household assets is up to 19% - a record high.
- Household debt as a percentage of GDP has increased 40% over the past 15 years to 88% - a record high.
- Mortgage debt as a percentage of GDP has increased 100% over the past 20 years to 63% - a record high.
- In 2005, U.S. consumers ran a record deficit of \$477 billion. Through the first half of 2006, U.S. consumers are on a pace to a \$525 billion deficit.



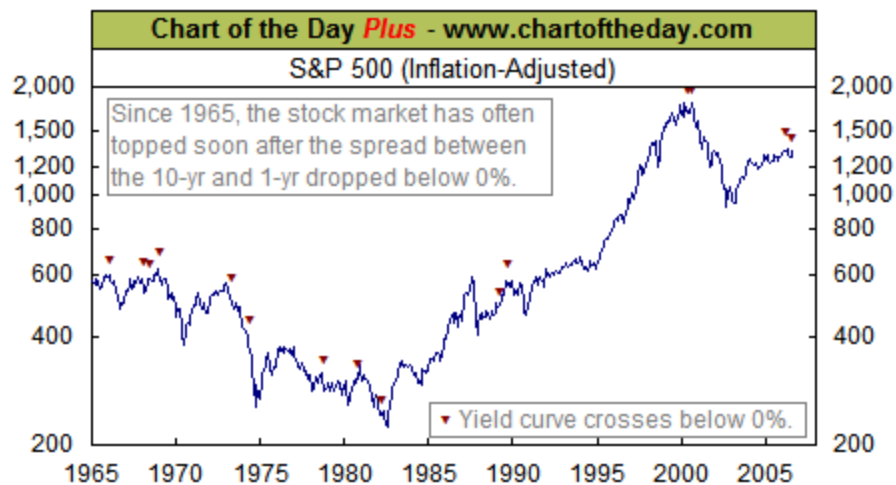
Economic growth rates are a “first-order” rate of change variable. Corporate earnings growth rates are a more volatile “second-order” rate of change variable. The relationship of underlying economic growth rates influencing corporate earnings is akin to the movement of a whip handle snapping the tip of a whip.

While we at Wedgewood Partners do not fancy ourselves as economists, we do, however, try to be students of economic history. Furthermore, when the “weight of economic history” signals an inflection point in the current economic environment, we do pay attention.

The following are four compelling Clift Notes on economic history. We have taken notes as well!

- The Federal Reserve has raised the Federal Funds Rate seventeen times since 2004. In terms of duration, nominal cumulative rate increases and relative cumulative rate increases, this most recent tightening cycle has been one of the most restrictive in Fed history. Over the past 50 years, the Fed has tightened monetary policy on ten occasions. Eight of those occasions led to recessions. The periods of soft economic landings were in the mid-1960’s and mid-1990’s.
- Changes in the yield curve have been one of the most accurate leading indicators of future growth-rate changes in the economy. The yield curve is now inverted (i.e., short-term interest rates are higher than longer-term interest rates). Over the past 40 years, the yield curve has inverted on seven occasions. Six of those led to

a recession - with a lead time averaging nine months. The single exception was in 1989 when the Fed quickly cut rates when the collapse of the egregiously levered Long Term Capital Management (a hedge fund founded and managed by more collective Nobel laureates and individual high IQ's than to be found at a Mensa convention) threatened to send shockwaves through the U.S. financial system. It is worth noting that the current generation of investors has experienced just two (brief) yield curve inversions over the past 23 years. Many may not realize that historically yield, curve inversions have been a notable headwind for the stock market.

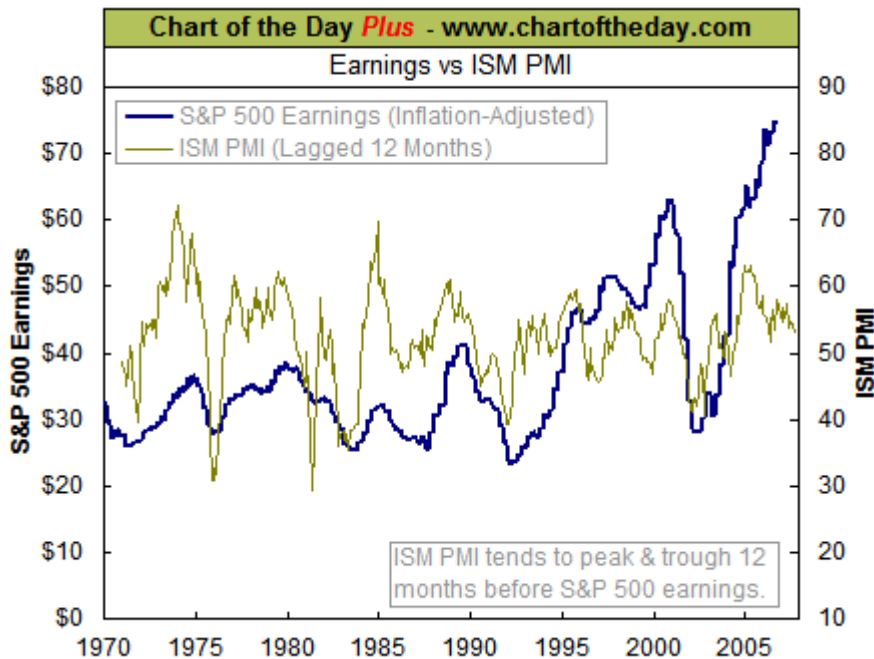


- There have been ten housing downturns over the past 50 years. Seven of those instances have led to recessions - with an average lead time of 24 months. The current housing expansion (bubble) peaked in the spring of 2005. *The three instances of soft economic landings seem to be the exception, not the rule: Mid-1960's – President Johnson's Great Society guns-and-butter, double-digit government spending; mid-1980's – President Reagan's tax cuts and oil falling from \$30 to \$10 a barrel and mid-1990's – bond yields fell 200 basis points and the Fed cut rates three times.*
- The Conference Board has compiled a well known statistical series called the Leading Economic Index. The LEI is made up of ten different economic indicators. Since 1952, this Index has declined (on a rolling six-month basis) on just thirteen occasions. Nine of these occasions have led to a recession and the other four have preceded an economic slowdown. Furthermore, a combination of both a decline of the LEI - with a simultaneous inversion of the yield curve - has only occurred six times since World War II. In all six cases the economy was heading for a recession within nine months. The seventh simultaneous occurrence of these two prescient indicators took place this June.

Given the weight of such historical evidence, we believe that investors are not accessing the growing probability of a hard economic landing, much less a recession.

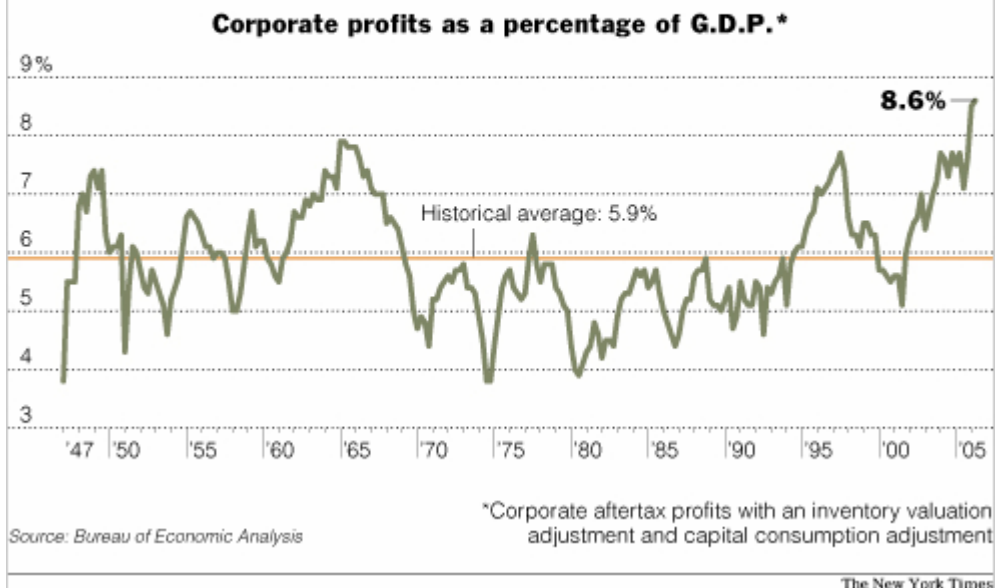
We believe that we have prepared your portfolio to outperform if economic history does indeed rhyme in the near future. Once again, history speaks to a change of stock market leadership during economic and corporate profit inflection points.

The following two graphics illustrate just how robust both corporate profit margins and earnings have been during this economic cycle – literally off the charts!



## An Earnings Surge

Corporate profits as a percentage of gross domestic product reached 8.6% in the second quarter of 2006, the highest level in the last 60 years.



In the heady profit environment of the last few years, the stocks of consistent corporate earners underperformed their more cyclical brethren by a substantial margin. Even a minor reversion to the mean between these two groups would produce new stock market leadership. The table below is self explanatory and compelling:

### Market Performance During Periods of U.S. Economic Recession: (Average Annual %: 1921-2001)

<b>Standard &amp; Poor's 500 Index</b>	<b>2.2%</b>
Health Care	28.3%
Consumer Staples	28.2%
Consumer Discretionary	17.8%
Financials	16.8%
Technology	11.3%
Basic Materials	9.2%
Industrials	3.9%
Telecom	2.7%
Utilities	1.1%
Oil & Gas	-15.0%

Source: Merrill Lynch

Our poor performance this year is part and parcel of having zero exposure to cyclical and energy related industries (as well as errors in stock picking). However, our current portfolio is entirely invested in the first five industries listed above – with considerable exposure in the first two (health care and consumer staples). We believe our current portfolio has the two necessary ingredients to begin to outperform the market and our benchmark once again – very attractive relative valuation, plus considerably better relative fundamental growth.

Thank you for your continued confidence in Wedgewood Partners.

*Note: Sources referenced in this Letter include Merrill Lynch, Barry Ritholtz, Northern Trust, Grant's Interest Rate Observer, and Comstock Partners*

October, 2006

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Ms. Dana L. Webb, CFA  
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