Founders Capital Management, LLC

2007 Annual Report:

"Perspective is Everything"

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PRINCIPALS' LETTER
From: Founders Capital Management

2007: Perspective is Everything

In 2007, the stock market experienced a great deal of volatility, and after all the dust settled, the S&P 500 had gained 5.5%—not much. As the year progressed, the subprime mortgage meltdown and surrounding pressure on securities associated with these high-risk loans spawned investor uncertainty. This uneasiness elevated concern about a possible financial earthquake—which generated a market roller coaster ride. Ultimately, 2007 was a year to make money simply by avoiding various types of financial investments that were bound to lose money.

And although the overall market ended the year on a higher note, looming risks in the financial arena will likely continue to create random price movements in both the stock and fixed-income markets during 2008, along with a high degree of volatility. Ironically, much of the market uncertainty comes from today's excesses within the investment community, reflecting the notion that individuals who have a propensity to race for riches only end up going to the poor house in a sweat.

> *"We have no idea how long the excesses will last, nor do we know what will change the attitudes of the government, lender, and buyer that fuel them. But we do know that the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."*
>
> —Warren Buffett

This leads to a statement that we will continue to reiterate in our letters until conditions change:

> **In today's uncertain environment of low(er) long-term interest rates, opaque financial markets, rising commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues—we do not expect the stock and fixed-income markets to perform in the future as they have in the past.**

Founders Capital Management is pleased to report that again, over the past 12 months, the underlying value of our holdings grew as the businesses we own remained profitable and continued to exploit attributes that give them a long-term competitive advantage.

Nevertheless, many individuals are understandably expressing uncertainty about the general stock market, so we thought it would be a good idea to evaluate successful investing by regarding today's economic world against the backdrop of lessons from the past.

The theme of this year's letter is: "Perspective is Everything." Norman Rockwell based his painting shown above, which was featured on the cover of *The Saturday Evening Post* in 1956, on a photo he took at Harvey & Lewis Opticians in our own Hartford, Connecticut.

What does a Norman Rockwell picture taken at Harvey & Lewis more than 60 years ago have to do with our discussion about successful investing? Nothing and everything. Rockwell's paintings have stood the test of time and depict subjects (including a business) that represent timeless American themes such as simplicity, hard work, and the enduring value of family and friends. His adherence to the "old values," skill at relating these values to the events and circumstances of a rapidly changing world, and ability to provide a commodity that people could rely on made him one of the best known of all American artists. It usually pays to apply investment practices and entrust one's money to companies that mirror these same qualities.

Through four generations of family management, Harvey & Lewis Opticians has stood the test of time and blossomed amid tremendous competition from national optical chains such as LensCrafters and Pearle Vision. What attributes does a business like Harvey & Lewis possess that are difficult to duplicate and allow the organization to survive and prosper over 100 years?

During the course of this letter, we will look through the lenses of history and consider the viewpoint of successful business owners as we discuss:

- **randomness and its influence on human behavior,**
- **how to build a business to survive and prosper over many generations**,
- **how to govern a business over the long-term**, and
- **the most important attribute a business can possess.**

2007 in Perspective

In last year's annual report, we discussed the concept of risk vs. uncertainty. In our 2007 report, we will expand our discussion of risk to include the concept of **randomness and its influence on human behavior**—in particular, when it comes to the stock market. Over the short term:

> *"The market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion."*
>
> —Ben Graham

Believe it or not, there is scientific proof that our ability to both detect and avoid risk lies in the emotional as well as the rational part of our brain. It may sound counterintuitive, but to assess risk, one must allow one's emotion to participate in the decisionmaking process. This concept is compelling, since rational and/or logical thinking alone does not help one to avoid risk. Now, couple this thought of allowing certain emotion to influence our evaluation of risk along with the sensation we experience when we lose money—any money after we have perceived making it. On a rational level, we understand that every day, and during both so-called bull and bear markets, the market goes up 50% of the time and down 50% of the time. And we know that over the long term, the market has increased in value beyond inflation. However, we *feel* as if the market is in freefall during a bear market, and on a permanent upswing during a bull market. The roller coaster ride of a volatile market causes even the most dogged among us to experience some level of stress—especially if our portfolio is temporarily down. The daily random movement of our portfolio causes us to focus on short-term volatility versus long-term returns:

> *"People only see what they are prepared to see."*
>
> —Ralph Waldo Emerson

Countless individuals have had the experience of selling all their securities at the bottom of the market, only to buy them back when “things got better”—and securities were much higher. Why do individuals practice this irrational behavior?

The answer lies in our emotional response to loss. Psychologically, the “feeling” of a loss is magnified by much more than the feeling of a gain, and we are naturally wired to avoid this emotional freefall. Successful investing involves developing a logical and disciplined structure to manage this part of human nature. To remove “negative emotions” and bring discipline to investing, Ben Graham, a famous investor and teacher at Columbia University, used the following allegory in his investment class:

> *Imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his. Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him. Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you. But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy.”*

Another story about the patsy, repeated from our 2nd quarter letter. In the first part of the 17th century—especially 1636-1637—the demand for Dutch tulip bulbs was so great in Europe and especially the Netherlands that the price of common tulip bulbs rose exponentially, boosted by competition between members of the upper classes for possession of the rarest tulips. The market and trading of bulbs in Holland blossomed so fast that at one point, a single bulb of certain varieties could cost as much as a house. “Tulipomania” enveloped merchants, tradesman, doctors, lawyers, and even clergy—everyone was captivated by the trading of this flower. Eventually, in 1636, tulips were traded on the Dutch stock exchanges, a development that encouraged trading in tulips by all members of society, with some speculators cultivating large profits while others lost substantial sums. Some traders sold tulip bulbs that they *intended* to plant—introducing the innovation of the “tulip futures contract,” by which individuals would purchase tulips on margin and accept delivery of their bulbs at a future predetermined date. Sound familiar?

We all know how this story will end: The tulip market wilted in 1637 when several lots of tulip bulbs were to be auctioned off at the still-inflated prices, but there were no buyers to be found. People had begun to suspect that the demand for tulips could not last, and as this notion spread, so did panic. Most investors (the patsies) lost all their money and ended up planting their tulip bulbs in an investment graveyard.

There is another side to this story that many do not know, however: There truly are tulip bulbs whose combination of beauty, scarcity, and reproducibility have always fetched exorbitant prices from wealthy individuals throughout the world who regard them more as art (as well as status symbols). In fact, these rare bulbs continued to trade at their "fair value" even after the crash of the common tulip market. Thus, tulip investors who understood the true value of what they were buying actually continued to profit after the crash.

Another story that illustrates how the frenzied activity of the market can impact even the brightest individual:

"I can calculate the movement of the stars, but not the madness of men."
—Sir Isaac Newton

Isaac Newton stated those words in 1720 as he bailed out of South Sea Company stock. After making a 100% profit on 7,000 pounds, he *sensed* that the risk in this stock was too high and took his money off the table. The ironic part of this genius' intuitive assessment of risk is that, shortly thereafter, as he nervously watched the stock climb in price from his position on the sidelines, he decided to jump back into the action. Newton placed all his money into the South Sea Company and then proceeded to watch the stock nosedive—taking most of his fortune (£20,000—around $6 million today)—with it. Mr. Market, and his emotional problems, even got the best of the genius Newton.

The South Sea Bubble (as it was eventually named) is worth reviewing, since it is one of history's worst financial debacles. The craze started in 1711, after the War of the Spanish Succession left England in debt to the tune of £10 million. The English government granted an English financial institution, the South Sea Company, a deal whereby England's debt would be financed through the firm in return for 6% interest (a lower interest rate on its debt). The government added another incentive to sweeten the deal: Exclusive trading rights with South America. The South Sea Company readily agreed to the monopoly trade arrangement in the South Seas, believing that Mexico and South America would enthusiastically trade gold and jewels in exchange for wool and fleece clothing made in England.

The South Sea Company issued stock, and the new shares were swiftly snapped up by investors who had hastily perceived value in South Sea Company's government-backed debt and future trade monopoly in the South Seas. After reaping the success of its first issue of shares, the South Sea Company quickly issued more stock at higher prices (nothing changes over history). The stock was rapidly consumed by insatiable investors who apparently had no qualms about the company or its inexperienced management team—all they could see was a stock that was headed for the stratosphere. Many investors were also dazzled by the lavish corporate offices of the South Sea Company, which cemented its image of success and wealth. Inevitably, owning shares in South Sea Company became a status symbol, the subject of high-society party chatter.

Although gold dust is precious, when it gets in your eyes it obstructs your vision.
—Hsi-Tang

For its part, the South Sea Company management team fed investors' illusions of grandeur and hyped the stock. It was generally believed that the South Sea Company "could never fail," given its implied government backing.

In 1718, a new picture began to emerge. Britain and Spain were at war again, bringing all chances for trade in the South Seas to a grinding halt. Believe it or not, investors were still not daunted and kept clamoring for South Sea Company stock. Making matters worse, investors from other European countries had started frantically scrambling for South Sea's shares, driving the stock up even further. All this despite the fact that throughout this seven-year time frame the South Sea Company had not generated any profit from its operations.

Management, realizing that the company's shares were substantially overvalued relative to the (lack of) profits, decided to sell at exorbitant prices, while other investors remained unaware that the business was profitless. When word got out that the management team had sold out completely, investors who were left holding the bag panicked and immediately began to sell their worthless shares, causing many others to lose their fortunes in a heartbeat. Regrettably, the corporate management of the South Sea Company fled to other countries with their own fortunes intact.

> *"The only thing worse than being blind is having sight but no vision."*
>
> —Helen Keller

Our intention in highlighting these stories is not to prognosticate that the markets are headed for a major setback. Such a prediction would be difficult to make, as it is not possible to ascertain whether the overall market will be overvalued or undervalued (though individual companies are a different story). It is also difficult to conjecture market forces, as some trends persist longer than we might have predicted (the rise in home prices over the past five years provides an example).

One market force that is currently impacting investors is the continuing proliferation of hedge funds—9,000 of them at last count. Last year, we stated that hedge funds have been popular due to their so-called market-neutral objective—which means that an investor can expect to make a fair return regardless of whether the market moves up or down. To meet a market-neutral goal, however, most hedge funds end up with a high percentage of hard-to-value opaque securities, including derivatives. Hedge funds utilize an assortment of derivatives to hedge their portfolios to make them "market neutral." The concept of utilizing derivatives to cover risk is not new and can be useful in certain circumstances. The overuse of these exotic instruments, however, can subject a portfolio to counterparty risk. When utilizing derivatives, investors are essentially betting against other investors—usually hedge funds that are taking positions in opposition to their own. It is in this zero-sum game, whereby one investor has to lose for the other investor to win, that the potential danger lies: In a dynamic and volatile market, if the person who loses is unable to pay the person who wins, then even the person who wins can lose. We repeat: Even the person who wins can lose. So essentially, the market-neutral portfolio can in fact melt down due to the losing investor's inability to pay. This is what is meant by "counterparty risk."

It is reasonable to assume that, over the centuries, people would learn from the investment mistakes of their predecessors. Yet the downside risks of speculative behavior, brought about by the blinding desire to get rich quickly, repeatedly are forgotten.

> *"Nothing is more terrible than to see ignorance in action."*
>
> —Johann Wolfgang Von Goethe

Let's review the current investment environment and why it leads some to believe that all is not quite normal: Over the past five years, investors have experienced a significant reduction in the cost of trading, allowing them to get in and get out of stocks easily and cheaply. The average investor, acting like a bee that jumps from flower to flower, now only holds a stock for nine months. In addition, as Wall Street firms feed new products to the investment world such as sliced CMOs (collateralized mortgage obligations), CDOs (collateralized debt obligations), CDSs (credit default swaps), ETFs (Exchanged-Traded Funds), intricate derivatives, and other so-called roll-up products, the complexity of investing increases exponentially. (Things get even more complex as many Wall Street firms also lend money to hedge funds at high interest rates to invest in these products, then cover their exposure to these loans by purchasing derivative contracts to counter any losses that could result from the loans going bad—again, counterparty risk). Now, imagine a situation in which an individual borrows heavily to invest in a multitude of different investments that are increasingly intertwined, such as ETFs, derivatives, stocks, hedge funds, and fixed-income instruments that trade like stocks. Add to this scenario hyperbolic trading activity and elevated leverage—and miscalculation and error are likely to result.

We don't know what will happen in the market, but we do recognize the signs of difficulty. Leverage, overtrading, and complexity are signs of trouble when individuals are not viewing the markets as investment vehicles, but rather as casinos in which to gain some quick profits. This type of investor seems to be following Mark Twain's advice:

"Go to Heaven for the climate, Hell for the company."

The heavenly climate of chasing short-term gains may lead many of these investors straight to Hell—and, unfortunately, they will have a lot of company.

A few lessons from history and successful businesses that investors should heed:

Lesson #1: What goes around, comes around. Each time you find yourself thinking that a new company is going to change the world, or that financial innovations such as ETFs, complex derivatives, and hedge funds will permanently change the market landscape, remember that companies and products such as these have been introduced throughout the centuries.

Lesson #2: Know where your money is. Sounds logical enough, but most investors do not understand that many fancy investments are not fully backed by "real assets," but instead represent virtual contracts that "correspond" to underlying assets. In addition, many investors do not understand that new companies positioned to "change the world" often are not backed by concrete profits, but rather by elusive profits that initially look solid but can vaporize quickly.

Lesson #3: Understand the value of the assets you own. The fool knows the price of everything and the value of nothing. When an untimely market event unfolds—and an unexpected episode always will, somewhere down the road—it is essential that you are holding assets in which rational investment behavior will eventually drive these securities to trade around their intrinsic, or true, value.

During the frenzied trading environment of 2006, investor complacency set in as most investments, including those in opaque securities, increased in value. Investors seemed to have forgotten Lesson #2 to making money: Knowing where their money is. So at the end of 2006 we decided to take advantage of investor complacency and made a rather large investment in S&P 500 "puts"—which is an option contract that gives us the right to sell, or put, a certain quantity of an underlying security (the S&P 500), and places upon the writer of the option an obligation to purchase a specified number of shares, at a specified price (strike price), up to a specified date (the expiration date). In layman's terms, when you purchase a put, you are betting that the market will go down, or that fear will enter the market and investors will "bid up" the put to insure against any further loss on their portfolio.

Derivatives are not typical of the types of investments we make—so why did we do this?

A few years ago, we emphasized that market volatility has been lower than the historical norm. Over the past 100 years, the stock market has demonstrated a 70% chance of moving greater than 10% (up or down) in any given year, and a 50% chance of moving greater than 16% (up or down) in a given year. The tight trading range of the past 2.5 years, in which the S&P 500 moved within an annual 12 percentage-point range from January 2004 to October 2006, was therefore anything but the norm.

Our thought was that the odds were high for volatility to return, given the growing uncertainty around the credit markets, which in many ways underlie the equity markets. This assumption happened to work out, as investors became schizophrenic when credit markets deteriorated and the stock market gyrated erratically during the last half of the year. (From January 1 through June 30, 2007, the Dow Jones Industrial Average moved more than 100 points in a single day 21 times, while in the second half of 2007, the famous index had daily 100-point moves greater than two times the amount experienced in the first half—i.e., market volatility had returned.) Professional investors—mostly hedge funds—scrambled for portfolio insurance to cover future losses, and our puts responded accordingly. We were thus able to take advantage of investor folly and sell our position to investors who were fearful of unrelenting market volatility.

You may ask, Why not keep the puts, given the possibility of greater market volatility in the future? Our answer: We did not want to subject ourselves to an outsized exposure to counterparty risk on our put contract—that is, winning on paper, but losing in our ability to collect.

At Founders Capital Management, our activity remains deeply rooted in time-tested principles of investment simplicity—seeking investments in securities that we know and understand, and in assets whose intrinsic value we can estimate. We also manage our portfolio to avoid excessive trading. We strive to identify developing risks—even in areas that have not yet erupted. We invest for the long term, and we concentrate on the distinction between what is knowable and important, versus what is either knowable and unimportant, or important and unknowable. We understand that emotional stability and thinking independently from the crowd eventually lead to success, despite "innovative new investment products" and random price fluctuations in the market.

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

New Equity Holdings

Winston Churchill was one of the greatest orators of the 20th century. What many do not know is that for every one minute of a speech, he prepared for approximately one hour. We honor the concept of hard work and preparation when investing and are willing to wait patiently for a few opportunities to emerge. Now the good news: Through the recent market volatility, a few opportunities surfaced in 2007!

Procter & Gamble
During the 2nd quarter of 2007, we added a consumer products company to our portfolio: **Procter & Gamble.** Incorporated in 1905, Procter & Gamble Company (P&G) is the world's premier consumer products company, with sales in more than 180 countries. The company is organized into three global business units: Beauty and Health, Household Care, and The Gillette Company. The company's brands include Gillette®, Tide, Crest, Charmin, and Duracell. Other successful consumer products owned by P&G include Pringles, Folgers®, Iams, Vicks®, and Olay.

Why did we invest in P&G?
Over the past five years, P&G has transformed itself from a primarily household products company confined to lower-margin, lower-growth products such as laundry detergent, toilet paper, and diapers in North America and Western Europe, to a truly diversified consumer products manufacturer with global reach and opportunities for above-average growth. P&G accomplished this by introducing well-known products such as Swiffer ® and Febreze ®, as well as by acquiring dominant global brands such as Gillette®. During this five-year time frame, it was our opinion that the increased value the company had created was not reflected in its stock price—so we decided to buy. Simply put, we believed that the company was not getting the respect it deserved for its ongoing transformation and global growth opportunities, and we purchased P&G at what we believed to be a discount to its intrinsic value.

In 2007, Procter & Gamble continued to execute a global growth and cost-saving/efficiency improvement program to ensure that the company would be delivering double-digit earnings growth into the future. P&G derives 54% of its revenues from outside the U.S. (compared with 41% in 2001), and over the next five years, the company is expected to generate as much as 30% of its sales from emerging markets (up from 27% today). Over the past six years, P&G's international sales growth has exceeded 15% per year, and we expect high overseas growth in the upcoming decades for P&G.

P&G's international success can be explained by the company's talent for adapting products to local customs and income levels. Many P&G products that are offered in multiple lines in developed markets are available in their simple, original version in the developing world. A perfect example is Gillette® razors. Only a small segment of the population in a developing country is able to afford the Fusion razor—Gillette®'s innovative five-blade shaving system. The advantages of the two-bladed Gillette Trac II®, however—versus an old-fashioned double-sided razor—are easily communicated,

and the product is more affordable for consumers in a developing country than is a Gillette Fusion®. In addition, once Gillette "hooks" a new customer in a developing country on the Trac II razor, it is just a matter of time before they will be trading up to superior Gillette® products. This so-called product-ladder opportunity sets up increased profits for P&G far into the future.

P&G should produce approximately $3.70 per share in earnings in 2008, most of which can be distributed to shareholders. We feel our purchase represents a fair deal for a company that is growing long-term annual earnings in excess of 10%. As you can probably guess by our description, this is a company with such tremendous global opportunity that we will be holding it for a very long time.

Burlington Northern Santa Fe Railroad

Why Burlington Northern?
Energy demand has been growing worldwide as emerging countries with massive populations such as China and India rapidly develop. We do not see an end to this trend, and we suspect that energy prices will remain higher than most expect in the coming years. An analysis of the movement of goods around the U.S. reveals that more than 70% of the transportation of merchandise revenue is accomplished via trucking. Since rail transportation is approximately three to five times more fuel-efficient than truck transportation, what is likely to happen to the percentage of goods transported via truck vs. rail over the next decade—especially if we experience inflation in the transportation of goods? Most likely, rail transportation will begin to play a much larger role in the transportation of goods throughout the U.S. The growing use of rail, along with the expansion of railroad services via "double track" (vs. single track) and "double stacking" of containers, could drive a large expansion in railroad use, revenues, and profits.

We had a choice among four dominant railroads within the U.S. and chose Burlington Northern, which has the second-largest rail network behind Union Pacific Railroad. Burlington Northern's 32,000-mile rail network spans the western two-thirds of the U.S. Through marketing agreements with other railroads and its own network, Burlington Northern serves the Midwest, West Coast, Southwest, and Southeastern regions of the U.S. In total, the company operates in 28 states and two Canadian provinces. Of all the large railroads, we believe Burlington Northern is best positioned among the major railroads to take advantage of growth in freight—especially coal, agricultural, and intermodal (i.e., combining more than one method of transportation, such as railroads to trucks) traffic.

Burlington Northern is the railway with the highest proportion of its total sales derived from intermodal traffic: More than $5 billion, representing 35% of total revenue. Burlington Northern controls the lucrative transcontinental route from Los Angeles to Chicago, which positions the company to capture a large share of the international goods shipped between Asia and the U.S. Chinese exports to the U.S. have grown more then 100% in the past five years, and we do not envision a long-term slowdown of U.S. trade with the Far East.

Burlington Northern is currently one of only two railroads (the other is Union Pacific) that provides rail service into the Powder River Basin, a large coal deposit located in Wyoming. This low-cost, low sulphur-content coal resource has created significant demand among utilities, – and the outlook for future coal shipments from this resource is very positive. This has led to a strong rate of growth within Burlington Northern's coal shipment business—around 20% of revenues.

A short-term negative: The portion of Burlington Northern's revenue that is the most economically sensitive and highly impacted by the downturn in the housing sector is the company's industrial products business, which accounts for 25% of Burlington Northern's revenue. The building products business has experienced a 10% decline as a result of challenges in the housing market. Despite the volume declines, however, pricing has remained strong and has allowed overall revenue to remain steady.

Burlington Northern is expected to earn approximately $5.15 per share in 2007, and $5.75 per share in 2008. We believe the company will be able to grow earnings in the double-digit range over the next

five to 10 years. Although we‘re not exactly sure how far the Burlington Northern train will go, we decided to get on for a ride. Our intent is to be long-term investors in this company.

Walgreen Company

Walgreen Company ("Walgreens"), incorporated in 1909, operates a retail drugstore chain, with 5,997 stores located in 48 states and Puerto Rico. On the "front end," Walgreens sells general merchandise including beauty care, personal care, household items, candy, photo finishing, greeting cards, seasonal items, and convenience foods. On the "back end," Walgreens customers can have prescriptions filled at the drugstore counter as well as via U.S. mail, telephone, and Internet. Prescription sales constitute a major portion of the company's business—Walgreens filled more 575 million prescriptions in 2007.

Although these are the facts behind Walgreens, one has to ask how a neighborhood drugstore that opened in Chicago in 1901 measuring just 50 feet by 20 feet became the national retail pharmacy chain it is today—especially when, at the time, there were more than 1,500 competitors sharing the same geographic area as Charles Walgreen's store.

The Walgreens story provides another illustration of how to build a business that will survive and prosper over many generations. And although their sizes are different, Walgreens and a private business such as Harvey & Lewis, which we introduced at the beginning of our letter, share a number of "beyond the numbers" attributes that reveal some of the secrets to successful investing:

Both companies grew from a strong base of knowledge about their respective industries—the managers grew up in the business and possessed **relevant experience.** In addition to being knowledgeable, the Walgreen and Lewis families were dissatisfied with what they saw as old-fashioned, complacent methods of running a business. Where was the **passion** to provide excellent customer service? What **innovations** were being introduced in merchandising and store displays? What **selection** of affordable goods did patrons really want, and how best to **communicate** the availability of these goods to the customer? Where was the sense of **caring** to please and serve each customer? And, most of all, where was the **commitment** to provide the customer **genuine value**?

Jim Lewis, President of Harvey & Lewis, fights complacency in his company by catalyzing change throughout his organization. At both Harvey & Lewis and Walgreens, the leaders of the business create an environment for constant change, knowing that the greatest danger for a company is the complacency that can develop from not shifting with the times.

Here's a great example of how Walgreens has changed with the times: By 1910, the soda fountain had become key to virtually every American drugstore. In the 19th century, charged soda water was considered an important health aid, making it a natural fixture in drugstores. To dispense the icy-cold, charged water, a tin pipe and spigot were attached to ornate fountains, with onyx countertops and fixtures of silver and bronze and lighting by Tiffany. Soon, flavored syrups and eventually ice cream were added to the fizzy water. As sodas grew in popularity, the "soda fountain" became an important revenue source for the drugstore.

Walgreens soda fountains were among Chicago's most beautiful. All the same, the reality was that the items soda fountains served—ice cream and fountain creations—were invariably cold. And cold items sold only in hot weather. This meant that during the fall and winter seasons, drugstore owners everywhere were resigned to mothballing their soda fountains until warm weather returned. Thus, drugstores missed out on an important revenue stream for more than six months of the year.

Charles Walgreen's response to this dilemma was an idea that benefited his customers as much as his company: Serve hot food during the cold weather. Beginning with simple sandwiches, soups, and desserts prepared by Myrtle Walgreen in their home kitchen, Charles was able to keep his fountain open during the winter and provide his customers with affordable, nutritious, home-cooked meals.

If you take a look at Walgreens or Harvey & Lewis, what you will see are management teams that strive to learn and change with the times. They actively practice what can be called "creative

destruction"—looking for new products, systems, and ways to do business in a dynamic environment. (Notice that Walgreens was willing to practice creative destruction to the point of eliminating the soda fountain concept entirely as it moved to meet the changing demands of the modern drugstore consumer.)

The practice of creative destruction notwithstanding, there are certain core business attributes that never change for these companies. Jim Lewis states that Harvey & Lewis Opticians seeks to maintain "who we are"—placing an emphasis on human interaction and "touching" the customer. Associates do not approach their job as a typical salespeople, but as people who care about the other person. Jim says: "Don't worry about doing everything right or about doing something wrong; worry about being genuine, warm, and friendly."

Charles Walgreen also instilled the value of human interaction in dealing with customers. Whenever a local Walgreens customer telephoned with an order for nonprescription items, Charles always repeated—loudly and slowly—the caller's name, address, and items ordered. That way, his assistant, Caleb Danner, could quickly prepare the order in the background. Then Charles Walgreen would prolong the conversation by showing an interest in the customer, discussing everything from her family, the weather, or current events. Invariably, Caleb would be at the caller's door before she was ready to hang up. Many times, the customer had to excuse herself and return to the phone—amazed at the incredible speed with which her order had been delivered. Walgreens understands customer service.

Although customer service and an emphasis on quality are important to Walgreens and Harvey & Lewis, both companies understand that the products they offer are not unique. Each organization seeks to hire well-trained employees that show consistent positive behaviors. Jim Lewis says: "Hire the right people that fit your value system, give them the flexibility to think, and the freedom to act. Do not micromanage, and provide a checklist that will result in rote service." (30% of Harvey & Lewis employees have been with the company for more than 25 years.)

Charles Walgreen would often remark that one of his greatest talents was his ability to recognize, hire, and promote people that he considered smarter than he was. In fact, his uncanny ability to hire extended even as far as the people who manned his soda fountain, including the man who created Walgreen's sensation—the milkshake. Walgreens employee Ivar "Pop" Coulson invented the popular drink by adding two scoops of vanilla ice cream to the standard malted milk drink recipe (milk, chocolate syrup, and malt powder). This trivia nevertheless illustrates the importance of hiring the right people and giving them the freedom to think and act on their innovations.

Why Walgreen Company?

Now, we could have stated that our reason for investing in Walgreens was its mammoth size: In addition to the drugstores, Walgreens operates three prescription-drug mail-service facilities encompassing some 252,000 square feet, of which approximately 133,000 square feet is owned and the remainder is leased. The company also owns 17 strip shopping malls of approximately 605,000 square feet, of which approximately 442,000 square feet is leased to others. Walgreens owns a lot of property, including a large portion of land underneath its stores that is a hidden asset. The real story, which lies outside these statistics, however, is about how Walgreens built a great company through an unwavering focus on human interaction, hiring the right people, embracing change, and adaptability to a new environment.

The retail prescription drug business is undergoing tremendous change as generic and specialty drug prescriptions, along with mail-order prescription programs, proliferate the market. In addition, as the baby boomer generation matures and the demand and complexity of prescription drugs rises, prescription drug retailers and wholesalers may evolve into patient data warehouses that become a focal point for managing health care across the nation. Walgreens' new computer system for filling prescriptions, Intercom Plus, links all its stores into a single network and serves customers' needs better than any other pharmacy company. In fact, Walgreens is the largest private user of satellite technology—second only to the U.S. government.

With 425 new stores opening each year and 7,000 planned by 2010, combined with the company's expansion into health care services, Walgreens continues to innovate. We believe Walgreens has as much a future now as it did when the company went public in 1927—just prior to the Depression. Incidentally, while Walgreens was impacted by the effects of a shattered economy in the early 1930s, the company continued to come up with new, important ways to serve customers undergoing a period of extreme economic distress. The true testament to the continuing quality and stability of Walgreens was its stock price, which continued to increase throughout the Depression. Walgreens is one of those rare tulip bulbs and will be much more than a "retail drug store" in the future. We are excited about this long-term investment.

Other Equity Holdings: 2007 Highlights

The remainder of our portfolio encompasses "real" assets: Companies trading at fair prices that continue to gain value each and every day.

Berkshire Hathaway, Coca-Cola, PepsiCo, Microsoft, Comcast, and our other media holdings continue to grow their earnings (at a faster rate than current inflation) independent of the short-term gyration in their stock quotations. The investor who attempts to get in and get out at the "right time," however, or who aims to purchase volatile securities that derive their value from various entities, is engaging in speculative behavior—exactly what should be avoided. When investing, it is far more difficult to be patient as opposed to gambling on the right direction of short-term movements in stock market prices.

We repeat:

> **Eventually, positive business activity is what ultimately drives a company's stock price, not the psychological feelings of individuals seeking to make money on "paper trades."**

Food & Beverage Holdings

Coca-Cola and **PepsiCo** had an excellent year, and we expect fantastic results in 2008. Coca-Cola has enjoyed a wonderful turnaround over the past few years that is worth reviewing. A decade ago, Coca-Cola was delivering stellar performance as the company separated its bottling operation from concentrate (syrup) production. This action focused the company on the higher-margin concentrate business. Like most good ideas, however, it was taken too far, and Coke strayed from its bottling network, losing contact with the market and its distribution system. As Coke moved away from its bottlers, the distributors began to think the company viewed them as profit centers rather than as partners. For instance, if Coke was anticipating an earnings shortfall, it would simply raise concentrate prices, an unwelcome proposition to bottlers who were unable to pass the price rise on to consumers. This profit-destroying action gave bottlers the impression that they were captive and submissive income sources for Coke—and resentment and resistance ensued.

Compounding that problem: As Coca-Cola became inwardly focused, the company was slow to see the changing beverage landscape as consumers moved away from colas to noncarbonated drinks. For example, the company passed up the chance to buy Quaker Oats, owner of the Gatorade® brand, and watched PepsiCo pick up this growing international brand that currently owns 82% of the sports drink market.

As a result of these missteps, a few years ago Coke was written off by much of the investment community, which believed the company was in a permanent downward spiral. Our view, in contrast, was that Coke had a great beverage franchise and would eventually find its way. And Coke has found its way!

In 2004, Coke made a bold decision to hire Neville Isdell as CEO, an operator with 35 years of experience at Coke. Mr. Isdell took swift action to fix Coke, implementing a plan that included slightly lowering the bar on its long-term growth targets to allow the company to focus on improving the health of its bottling system. Fundamentally, Coke needed to invest in its bottlers and allow them

to be more profitable. Accompanying the new plan was a broad call for growth, and the company spent $400 million in incremental marketing to support and reinvigorate its brands. While the company continued to stress that it needed to grow its carbonated beverages business, Mr. Isdell also recognized that Coca-Cola was weak in the noncarbonated drinks market. He aggressively pushed Coke into the noncarbonated beverage segment through the recent acquisition of Glaceau, maker of VitaminWater® and other "enhanced water" products. The integration of the Glaceau product line into Coke's network will begin to provide significant growth opportunity for Coke over the next few years as the company pursues its strategy to become a "total beverage company." Mr. Isdell also began a drive to attract top talent to run the Coca-Cola Company, emphasizing a focus on building distribution partners. The bottom line: By becoming closer to its bottlers, who manage individual markets and are in constant contact with retailers and consumers, Coke is back on track.

Coca-Cola's earnings will increase approximately 13%, to $2.68 per share in 2007, and an additional 13% in 2008, to $3.03 per share. (Coke's ongoing share buyback program causes earnings per share to grow higher than operating income, as fewer shares are outstanding.) For all of 2008, Coca-Cola should generate approximately $6.5 billion in cash, which will support its expansion, as well as the shareholder dividend and share buyback program.

Our other food and beverage business, **PepsiCo,** continued a strong performance in 2007. Our ownership of PepsiCo may appear to be a duplication of our investment in Coca-Cola, but this is not quite true. While both companies are leaders in the beverage business, Coke is a pure global beverage company that has 80% of its franchise overseas. On the other hand, PepsiCo is largely a snack food company, with roughly 62% of its total revenue generated by Frito-Lay and Quaker Oats. In addition, PepsiCo has tremendous opportunity to grow its brands worldwide, with only 60% of its revenue based in North America. PepsiCo International represents nearly 40% of the company's revenues and more than 60% of its growth.

PepsiCo's snack business and international profile are the areas to discuss, since that's where the growth potential is. We expect exponential growth from snacks as global consumers continue the shift toward on-the-go, convenient products. PepsiCo's international snacks business is rooted in three brands—Sabritas, Gamesa, and Walkers—and the company has been busy making acquisitions to add to its global snack franchise. The Duyvis acquisition in Benelux and France provided PepsiCo with the category leader in nuts and seeds, one of the fastest-growing salty snack categories in Europe. Several other recent acquisitions are also exciting: Bluebird—a salty snacks business in New Zealand and Australia that has the leading brands in fruit and snack bars; Sakata—an Australian maker of rice-based snacks (e.g., rice cakes, chips) is top in its category; and Star Foods—an Eastern European salty snack company that gives PepsiCo a dominant position in the salty snack segment in that region, particularly in Poland and Romania.

Beverages are becoming a bigger component of PepsiCo International's business, but largely through noncarbonated drinks such as Gatorade® and teas. Pepsi has understood that it cannot win solely by expanding Pepsi-Cola® and will drive carbonated soft drink growth only in markets with favorable demographics in which it can be competitive against Coke. Instead, Pepsi has expanded its worldwide presence in other faster-growth categories, such as Gatorade® and teas via its Lipton joint venture with Unilever. By combining the scale of snacks with beverage, and by developing noncarbonated drinks, Pepsi is in position to increase its competitive clout.

And let's not forget Asia: Asia's emerging markets represent the largest potential for PepsiCo to expand its business. This area is quickly growing and accounts for less than 20% of PepsiCo International's total sales, presenting a wealth of opportunity in the years ahead. China is the most lucrative market for salty snacks in the Asia-Pacific region, representing approximately 35% ($5.5 billion) of the region's market revenues. The country's booming economy has led to significant changes in consumer lifestyles and consumption patterns, increasing snack sales in many cities. PepsiCo currently holds a 22% share in China and has cornered the chip market (53% market share) by adapting to local consumer preferences and tastes.

By 2010, the Chinese salty snack market is estimated to generate more than $6.5 billion—and PepsiCo has a clear advantage to grow its market share via its scale and operational excellence. China has 30 provinces and a population of roughly 1.3 billion. The more products PepsiCo layers onto its system, including local brands, the better it can penetrate the markets that represent much of China's growth.

In 2007, PepsiCo is on track to deliver a worldwide volume increase of more than 6%, with net revenue increasing approximately 10% and operating earnings increasing more than 12% year after year. We expect more of the same in the upcoming year. PepsiCo should grow its net income per share approximately 11% in 2008, to $3.75 per share. PepsiCo has a pristine balance sheet and very little debt, which allows the company to return more than $5 billion of its annual free cash flow to shareholders. PepsiCo is a growth company, and we have not changed our plans to hold on to this investment over the long term.

Technology Holdings

Our primary Technology holding, **Microsoft,** experienced positive results in 2007. Since Microsoft released its new Vista operating system to users in January 2007, wide-scale adoption of the new product has been pushing sales upward. Additionally, Microsoft's software sales are tied to PC sales, which have grown steadily over the past few years, from 164 million units in 2004 to 260 million units in 2007. Worldwide PC demand is expected to remain solid in the upcoming year, with industry unit growth forecasted to be around 11% in 2008. The wide adoption of Microsoft's Vista and Office products, coupled with growing PC demand, should provide growth for Microsoft in the consumer business over the next several years.

Microsoft could also see an additional $2.5 billion in incremental revenue in the next 24 months due to its anti-piracy movement. For instance, Microsoft has been working diligently with the Chinese government to enact changes that will better enable the company to monetize the world's second most important PC market. In the past, Chinese PC manufacturers would sell PCs with no operating system installed, which enabled individuals to purchase pirated copies of Microsoft Windows on the street for a fraction of the cost of the genuine product. In 2006, the Chinese government mandated that all PCs sold in China must come preinstalled with an operating system. At the same time, Microsoft realized that high Windows pricing was an overwhelming barrier to genuine Windows adoption in China, and in August 2007 cut Vista list prices up to 70% for the consumer edition, and 15% for business edition. Microsoft has also started to cut deals with Chinese PC manufacturers to preinstall Windows. In November 2007, Steve Ballmer, Microsoft's CEO, personally signed an agreement with Founder Technology Group, the second largest PC maker in China, that required Founder to pre-install genuine Windows Vista on laptops and desktops sold to businesses.

Microsoft's business segment is slated to issue product releases in 2008 and 2009 as enterprise adoption of Vista/Office 2007 hits its stride. "Windows Server 2008" will include basic virtualization tools, better security, a simplified IT infrastructure, and management tools to help maximize flexibility. The company expects to release Windows Server 2008 in February 2008, along with other products such as "Visual Studio" and "SQL Server" database, which competes directly with Oracle's database software platform. Most of the financial impact from new enterprise sales will occur over the next two years.

During the next 24 months, Microsoft is on track to generate more than $30 billion in cash for shareholders, on top of more than $20 billion of cash and cash equivalents that currently reside on the balance sheet. The company will return this large cash hoard to shareholders over the next three to five years through an aggressive share-buyback program. Microsoft has purchased more than $15 billion of stock over the past four quarters. (We remain excited about these share repurchases and believe the company's actions will be very beneficial to owners at Microsoft's current share price.) We are very bullish on Microsoft's business prospects for 2008.

Financial Services Holdings

Berkshire Hathaway, managed by Warren Buffett, experienced another fantastic year. At the end of 2007, the increase in Berkshire's book value—a measurement of the company's net worth—should be around $14 billion.

Berkshire has produced tremendous results over the past few years that have yielded a permanent increase in the company's value. Over the past 24 months, Mr. Buffett showed a willingness to cover large catastrophic risks when other insurance companies hesitated after the high hurricane activity of 2005. Following the virtually nonexistent 2006 and 2007 hurricane seasons, Berkshire Hathaway achieved once-in-a-lifetime back-to-back results, whereby premiums earned virtually fell to the bottom line. Mr. Buffett stated at last year's annual shareholders meeting that in 2007, he had scaled back the company's coverage of catastrophic events such as hurricanes. We believe that in 2008, Mr. Buffett will continue to pull back on Berkshire's hurricane coverage as catastrophic risk pricing continues to soften, but this should be largely offset by insurance premiums earned in new categories.

Warren Buffett maintains a passionate desire to continue growing Berkshire Hathaway. In the last few weeks of 2007, Mr. Buffett worked diligently to deliver a few gifts to shareholders. Berkshire announced that the company is starting a bond insurer that would help state and local governments lower their borrowing costs. The new insurance unit, Berkshire Hathaway Assurance Corporation, will guarantee the debt issued by municipalities to finance infrastructure such as hospitals, road construction, schools, sewer systems, and sports facilities. This action will allow Berkshire to lure business from established insurance rivals that are struggling to survive the credit market turmoil as they extend debt guarantees to mortgages and other esoteric securities. Mr. Buffett stated that the new insurance unit will avoid investing in any structured products, including bonds backed by assets such as mortgages and credit-card receipts.

Berkshire also announced two acquisitions during the holiday week. The company agreed to buy the NRG NV reinsurance unit of ING Group NV for about $441 million—adding to its own reinsurance unit. Berkshire also agreed to buy 60 percent of Marmon Holdings from the Pritzker family for $4.5 billion. Marmon produces various products including railroad tank cars, pipes, wiring, and water treatment systems. Berkshire plans to buy the remainder of Marmon by 2014.

Even with an aggressive ongoing capital allocation program, Berkshire Hathaway is gushing cash. Berkshire still maintains more than $40 billion in cash and cash equivalents on its balance sheet, and the company is leveraged to grow earnings when Mr. Buffett invests this large cash position.

The BIG question is: What will happen to Berkshire without the management talent of Warren Buffett?

This opens a discussion about how best to govern a business over the long term. Corporate governance is many times dwindled down to a few areas. For instance, Mr. Buffett states that it is important to choose a complement of corporate directors that are independent, interested, and business-minded. Directors should recognize their fiduciary responsibilities and take accountability as business owners. Companies appoint independent directors to act on behalf of shareholders regarding compensation issues, to evaluate the members of a company's management team, and to ensure an orderly succession plan. A company's board of directors also evaluates the productivity of current capital and monitors the allocation of new capital aimed at growing shareholder wealth.

From a legal perspective, the responsibility of directors is the same in all cases, but different relationships exist between owners and managers that impact the directors' behavior. The directors' ability to effect change depends on the particular "blend" of ownership and management in a publicly held company. If a corporation, has a controlling shareholder who is an active manager, as is the case with Berkshire, the directors' behavior will be different than if no controlling shareholder exists (which is the case with the majority of corporations), or if the controlling shareholder is passive (which is the case when a foundation is a major shareholder).

Mr. Buffett is shaping the durability of Berkshire in a way that is very agreeable to owners. As large as Berkshire is, in many ways it can be compared with a smaller, intimate enterprise. As we previously mentioned, Harvey & Lewis has lasted through four generations of management—more than 120 years. Jim Lewis states: "Every generation in a family business has to be the first generation to run the business." The new generation has to look forward to and anticipate change, and it would be a mistake for the person who replaces the previous CEO to mimic previous management. Jim also believes in the importance of holding on tightly to core traditions that have become engrained in the company's fabric over time, including, in Harvey & Lewis' case, a caring culture that strives to service employees and customers.

When Warren Buffett no longer manages Berkshire, the controlling shareholder will become the Bill & Melinda Gates Foundation, since Mr. Buffett has contributed the majority of his shares to this charity upon his death. Oftentimes, capable, handpicked directors can be ineffective when a passive foundation holds a majority ownership and has the ultimate say regarding any changes to the business. However, in Berkshire's case, the Bill & Melinda Gates Foundation will be anything but passive. Mr. Gates' Berkshire directorship and large personal investment in the company complement his foundation's ownership in Berkshire, providing an incentive to work on shareholders' behalf.

In addition to his involvement with the company and his business savvy, Mr. Gates is a long-term owner of Berkshire and a friend of Mr. Buffett's that understands his special criteria for corporate governance: Cultivating and retaining the "spirit" of Berkshire's values will be the key to its future success. This is what counts in corporate governance, as opposed to relying on a checklist of corporate governance criteria. Mr. Buffett realizes the necessity of cementing a legacy of values, or core traditions, for Berkshire in the upcoming decades. Things like Berkshire's management, business mix, and systems will change. What will not change is the company's emphasis on what is important to employees and customers—effectively judging people and emphasizing an environment of positive human interaction. We are pleased with Berkshire's progress as a large, so-called family-run corporation, and we plan to remain long-term shareholders.

Retail Holdings

Our major Retail holding, **Home Depot,** had a tough time in 2007, with home repair and remodeling slowing while the company was in the midst of a transition. As part of a corporate overhaul, Home Depot completed several large transactions during the year that are noteworthy: First, the company completed the sale of its Supply business to a private equity consortium of Bain Capital Partners, The Carlyle Group, and Clayton, Dubilier & Rice for $8.5 billion. Home Depot used the proceeds to finalize the first phase of a $22.5 billion share repurchase program. The company accomplished this through an initial modified tender offer that included the purchase of almost 290 million shares at $37 per share, for a total cost of $10.7 billion. This repurchase represented 14.6% of shares outstanding at the time, and with the completion of the tender offer, Home Depot had approximately 1.69 billion shares outstanding. A temporary delay has been announced to complete the $22.5 billion recapitalization plan (of which $11.8 billion is now remaining). Given the economic challenges facing homeowners, along with increased borrowing costs associated with the credit market deterioration, Home Depot will repurchase additional shares in the open market and/or make additional tender offers when greater certainty returns to the markets.

What does this all mean for existing shareholders? Home Depot's recapitalization and ensuing share-buyback program, which represent a total purchase of ~30% of the company's outstanding stock, frankly does nothing for the company's fundamentals, as it is merely a shift from equity value to debt. Nevertheless, this series of transactions provides an opportunity for the company to focus on its core retail business, while at the same time giving shareholders an opportunity to retain a tremendous long-term investment.

The larger issue: Over the past few years, Home Depot lost sight of the most important attribute a business can possess, and we were admittedly slow to see the depth of this troubling situation. Jim Lewis of Harvey & Lewis explains that the most important attribute a business can possess is to truly *care* for its employees and customers. He states: "Harvey & Lewis employees are instructed to view

themselves as agents for the customer rather than agents for the company." While management should be mindful of internal issues such as operational efficiency and product innovation, they should not lose sight of their employees and customers in the process. Home Depot did just that—the company overemphasized efficiency to the point that employees and customers no longer felt the company "cared."

> **The most important attribute a business can possess is caring for its employees and customers.**

A turnaround to rectify this severe myopia of Home Depot is under way by current management, and significant progress is being made. Home Depot is focusing on fixing stores, including the shopping experience; merchandising (including the company's relationship with vendors); and customer service. The company is investing $1 billion per year on its stores with a focus on remodeling, resetting merchandise, adding store hours, and localizing merchandising and marketing. In addition, employee morale at Home Depot Stores is on the upswing as the company recommits to employees and customers. Home Depot has hired more than 2,000 Master Trade Specialists who are experts in specialized areas such as electricity and plumbing. These higher-paid specialists support associates and customers with difficult questions and provide higher-level service by sharing their expert knowledge. Finally, Home Depot's new management team is encouraging local store managers to listen to employees and is providing latitude for them to take risks and make necessary store changes to meet local needs. These caring actions are bringing Home Depot back closer to its employees and customers.

We think the company is doing the right things under difficult economic circumstances, and we remain excited owners of Home Depot. We believe the company is severely undervalued and our plans have not changed: We will be holding onto Home Depot for the long term.

Media Holdings

Our Media division continues to grow and supply "great content" to customers. We strongly believe that a concentrated investment in content providers will pay handsomely in the future. Liberty, Comcast, Disney, and Gannett are all media companies that supply the news, stories, and shows that we read or watch each day.

Our investment in **Liberty Media** consists of two tracking stocks—Liberty Capital (NASDAQ: LCAPA) and Liberty Interactive (NASDAQ: LINTA). Liberty Capital is capitalizing on its vast holdings in media conglomerates such as News Corp. and Time Warner. Liberty Interactive is a fast-growing company, with 100% ownership of QVC, 24% ownership of IAC/InterActive, and 23% ownership of the travel distribution service, Expedia.

Over the past two years, Liberty Media has simplified its company by monetizing media assets within its portfolio. For example, Liberty swapped almost one-third of its stake in Time Warner in return for the Atlanta Braves, Leisure Arts, a group of craft magazines owned by Time Inc., Time Warner's magazine division, and $1 billion in cash.

Liberty Capital continues to pursue simplification as a way to unleash shareholder value. A pending transaction soon to be completed is the exchange of Liberty's 17% economic (19% voting) interest in News Corp for that company's 38.5% economic interest in DirecTV. Once this transaction is completed, Liberty Capital announced a further restructuring and tax-free monetization of public equity interests. John Malone and his management team decided to create two new tracking stocks—Liberty Entertainment and Liberty Capital—that will most likely begin trading during the first quarter of 2008. We feel this is a positive development as Liberty Entertainment is expected to house the 38.5% interest in DirecTV, as well as Starz. Liberty Capital will continue to hold other assets and equity stakes in public holdings such as Motorola and Sprint. What will this separation move accomplish? It will provide Liberty Entertainment acquisition currency to gain greater economic control of DirecTV (currently at 38.5% ownership) and will offer both Liberty Capital and Liberty

Entertainment an opportunity to purchase other content assets that will add shareholder value in the future.

We remain excited owners of Liberty's portfolio of businesses, and we plan to maintain our interest in Liberty Entertainment once the tracking stock begins trading in early 2008.

We also hold a major position in **Comcast,** the largest cable provider in the U.S. Comcast had a challenging year as the company announced lower-than-expected earnings due to weaker-than-expected advertising revenues and softening video demand. In addition, the company increased capital spending to upgrade acquired systems. This one-two punch will reduce expected near-term owner earnings available to shareholders. Despite the challenges the company faced in 2007, our long-term view has not changed regarding an investment in Comcast. Over the past decade, Brian Roberts and his management team have consistently demonstrated an ability to deliver superior financial results, and we expect this track record to continue into the future.

Comcast continues to aggressively roll out its "triple play" package, which combines cable, phone, and Internet service. The additional revenue from this strategy virtually falls to Comcast's bottom line as the company's cable infrastructure remains practically intact. With penetration of just 50% of U.S. households today, we do not think the broadband market is nearing a saturation point. In addition, Digital voice subscriber should continue to accelerate as the acquired Adelphia properties come online in the next six months.

Regardless of its near-term setback, we expect Comcast to continue leveraging its cable assets. This will grow free cash flow at a rate of approximately 25% per year over the next five years—from $2 billion to $6 billion. In 2008, Comcast should generate approximately $1 per share in cash that can be distributed to owners. We anticipate the company to return this excess cash to shareholders by repurchasing stock at an accelerated rate. Comcast will retain a long-term position in our portfolio.

Commodity Holdings

Barrick Gold Corporation continues to build a new generation of mines around the globe and maintains the lowest total cash costs among the major gold producers. Barrick is executing a strategy that should differentiate the company in the investment marketplace. The company has completed the following during the past 24 months:

1) removed the corporate gold hedges to expose itself to higher gold prices
2) accumulated large gold (and non-gold) mining deposits that will allow the company to have sufficient replacement ore bodies in the future
3) positioned the business for the highest earnings per share in the industry.

A focus on "earnings" and returning cash to shareholders will eventually yield an economic benefit to owners. This strategy is unusual for a mining company, as most competitors attempt to spend profits on finding the next "gold strike." It is our opinion that Barrick's value has increased as a result of these actions.

In addition to Barrick, we maintain a sizable investment in gold and silver bullion through our interest in **Central Fund of Canada,** a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately $1.2 billion, represented by 50% gold bullion and certificates, 48% silver bullion and certificates, and 2% cash, marketable securities, and other working capital amounts.

One of the reasons we initially purchased gold and silver was our belief that the value of the U.S. dollar will deteriorate over the long term, and unfortunately this has proven to be a correct assumption. We have not changed our view and believe that our country's current loose monetary policies will result in a continuing deterioration of the U.S. currency. Gold has now risen to around $850/oz. during a period in which the dollar continues to lose its relative strength against world currencies. While changes in the dollar's value will continue to be an important factor in determining the price of gold, in the future it will not be the only driving issue. Continuing concerns regarding the

geopolitical landscape and the economic implications of higher oil prices are other factors that support an argument for higher long-term gold prices, along with a growing world money supply—which leads to inflation.

Our investment in **Chevron,** a leading international integrated oil and gas company with operations worldwide in a variety of energy segments, continues to do well as energy prices increase. We restate our continued interest in Chevron due to the company's increasing focus on deep-water projects, climbing from around 5% in 2007 to a sector-leading 20% by 2011. This portfolio shift allows Chevron to increase the cash received per barrel of oil (at today's prices) since development expenses for the deep-water sites have already been completed. Deep-water oil fetches higher prices on the open market. It is also our opinion that the price of oil will "plateau" at a higher level in the future than it has in the past as the growth of economies such as China and India lead to increased energy demand. We believe the current valuation of Chevron (and other oil companies) still does not reflect higher long-term energy prices.

Fixed-Income Holdings

The Vanguard Intermediate-Term bond index was up 7.6% in 2007, as the Federal Reserve aggressively reduced short-term interest rates and investors clamored for safe government securities in response to the swift deterioration of many mortgage-related investments. Investors anticipate lower interest rates in the future, with the expectation that the Federal Reserve will continue reducing rates to save individuals and institutions from the subprime mortgage meltdown. Lower interest rates help individuals renegotiate their adjustable rate mortgage loans with banks, given that they are unable to meet rising monthly payments under the environment of higher interest rates. Conversely, the mortgage renegotiation process with homeowners helps financial institutions avoid reporting large losses as write-offs from defaulting loans within mortgage pools is averted (for now). In the end, the Federal Reserve's future interest rate-lowering actions and added liquidity dealings in the upcoming months will not change the reality that there are hundreds of billions of dollars in loans that individuals will not be able to repay, and financial institutions will ultimately have to write off these bad debts. Most likely, we will need some form of a federal bailout to unfreeze the debt markets and relieve many financial institutions from an ongoing credit crunch. And the bailout will eventually be paid for by citizens through higher taxes. Nevertheless, the more important discussion is how we got into this so-called credit crunch in the first place. And so, a little history….

Credit Crunch: A 100-Year Anniversary

A conservative Republican with supposedly high moral values was President. War was the talk among citizens, and immigration was creating tremendous debate as an influx of foreigners attempted to enter the U.S. Technological changes were rapidly altering society, and Wall Street executives were earning exorbitant fees for bringing new companies to the market and advising corporations on a wave of merger and acquisition activity. At the same time, the U.S. government was investigating corporate corruption and prosecuting well-known executives. A young prosecutor from the state of New York led the team that pursued greedy high-paid executives. An extreme extension of credit had led to tremendous investment abuse, and banking complications ensued. Investors lost confidence in the financial system, and a negative public view of business and the market resulted. Eventually, the U.S. government was forced to intervene to bring things to order in the markets.

You may think this is a description of 2007, but it is actually 1907. The Panic of 1907, known as the 1907 Bankers' Panic, marked a turning point in the development of the U.S. banking system. A credit debacle was directly precipitated by the Heinze brothers, who had used money borrowed from the New York bank they headed, Knickerbocker Trust, to corner the stock of United Copper Company. Despite their aggressive accumulation of United Copper, the stock did not act as the Heinze brothers had anticipated—it fell. Once it became known that the Heinzes had used depositors' money for their stock scheme, individuals fearing that their funds would evaporate began to pull their money from Knickerbocker Trust. In the dawn of this credit crisis, Heinze was forced to resign as Knickerbocker's bank president, and the National Bank of Commerce (a bank clearinghouse) ceased to honor checks of Knickerbocker Trust. This action erupted into a full run on the Knickerbocker Trust Bank, with people

literally lining up for days to pull their money out of the failing bank. Within a few days, panic had spread, sparking a domino-type run on nearly every trust in New York and throughout the nation.

To relieve the situation, then-U.S. Treasury Secretary, George Cortelyou, contributed $35 million of Federal money to "add liquidity" and quell the credit storm. This was not enough, however, and a complete meltdown of the national financial system was averted only when J.P. Morgan (whose family, incidentally, is rooted in our own Hartford, CT) stepped in to meet the crisis. Morgan organized a team of bank and trust executives and redirected money between banks, secured further international lines of credit, and bought plummeting stocks of healthy corporations. Within a few weeks the panic had passed, with only minimal effects on the country. However, the severity of the credit crunch was so intense that the U.S. Congress was eventually pressured to enact the Federal Reserve Act, giving birth to the Federal Reserve.

> "*History does not repeat itself, but it does rhyme.*"
> —Mark Twain

Today's credit crunch, though different from 1907, has similar attributes, since it has been brought about by widespread speculation among individuals and institutional investors. Over the past five years, individuals have watched their homes rise in value at an exponential rate. The rising tide of homeowner wealth caused many folks to purchase a second home as an investment, hoping to use the home as a vacation spot for five or so years and then "flip" the house for twice the purchase price—making a handy 100% profit. In the meantime, feeling flush from their growing wealth, people also decided to borrow against the growing equity in their homes.

Financial institutions, which make money off mortgages associated with new-home purchases and from the refinancing of previous mortgages, were more than happy to feed the growing speculative fervor of homeowners. Banks and mortgage companies took advantage of a new money-producing machine—securitization. It is essential to review the concept of securitization to understand how it contributed to the current credit crisis.

In the old days, when a bank lent money to a homeowner, the loan was kept at the bank and serviced over the life of the obligation. Today, banks package their mortgage loans (along with auto and credit card loans) and sell them to the investment community—only to take the money they receive from the sold loans to repeat the process. The so-called securitization of assets and ultimate sale to investors produces bank fees and supposedly transfers the loans from the bank's balance sheet to the investor—spreading risk throughout the investment "world." Unfortunately, what began as a simple solution for managing risk while producing extra bank fees quickly became abused by Wall Street. Financial institutions began to aggressively extend loans to individuals who were not creditworthy, knowing that they could make a quick profit and "dump" the higher-risk loans on unsuspecting investors. Wall Street even had an innovative way of dealing with the growing speculative pool of loans—by slicing the mortgage and other types of loans into various securities called "collateralized mortgage obligations" (CMOs) and "collateralized debt obligations" (CDOs). These debt obligations can have 10 or more slices, with the highest-rated pieces obtaining first priority on the loan pool, appealing to very conservative investors. The lowest pieces can literally trade like a stock, since these loans offer a higher interest rate to the investor but have a greater probability of ending up in default. These speculative slices attracted higher-risk investors (think: Hedge funds).

Imagine a situation in which more than 11,000 investment pools exist, each having thousands of loans and thousands of investors. Taking it further, imagine that many of the loans that were issued to individuals who were not creditworthy received ratings from the ratings agencies that placed them into the highest AAA-rated CMOs and CDOs. As a collapse in housing prices and the corresponding loans occurs, the warts of many CMOs and CDOs comes to light, and investors scramble for the exits. The loan pools are now so convoluted that experts can't follow the money to decipher what the pools are worth. Making matters worse, many banks throughout the world decided to engage in "lazy banking" and purchase CMOs and CDOs with customer deposits in lieu of going through the procedure of loaning out money in the traditional way.

The global banking system is now teetering as scores of bad loans are beginning to regurgitate. Investors holding the dreadful loans passed on to them through securitization by fee-gathering financial institutions feel they have been sold a bill of goods and are demanding that the banks stand up and take full ownership for the mounting losses on the loans they haphazardly made. In response to this demand, banks are now afraid to lend out any money (to individuals or to one another) to reserve the cash they may need to support the burden associated with these deteriorated loans—thus precipitating a credit crunch. Pair this concept with the fact that banks throughout the world also purchased these loans with depositors' money and are also unable to value them with a high degree of certainty since the investment pools are too convoluted. John Stumpf, CEO of Wells Fargo Bank, stated: "I don't know why banks had to find new ways to lose money when the old ones were working so well." Once again, banks have found a new way to lose money.

What is at the heart of the current credit crisis? J.P. Morgan summed up the situation decades ago, when he was asked if commercial credit was based primarily on money or property. Said Morgan: "No sir, the first thing is character. Before money or anything else. Money can't buy it." The great banker realized that any financial system is built on trust, and when trust wanes, the financial system is vulnerable to collapse.

A loss of trust between banks and investors occurred during 2007, and our financial system began to freeze—and remains frozen. The Federal Reserve is stepping up to the plate and attempting to unfreeze the credit markets by aggressively lowering interest rates, while Central Banks throughout the world are adding liquidity by flooding the market with almost $1,000,000,000,000 (yes, trillion). At the end of the day, despite the opportunity to obtain free money, investors are unwilling to risk buying convoluted securities whose value they are unsure of. The government, along with Central Banks throughout the world, will uniformly need to restore trust and character in the markets. Until a so-called bailout occurs that involves government backing, it is likely that the credit markets will remain frozen.

In the past few years, we emphasized several points about fixed-income instruments that concerned us. Several risks associated with this so-called "secure investment vehicle" still loom, including issues surrounding bonds such as the possibility of rising interest rates and greater chances of default. The issue of rising long-term interest rates is surfacing due to the aggressive lowering of short-term interest rates and the widespread printing of money, which ultimately may fuel inflation. Unfortunately, the second issue of default is just beginning to rear its ugly head—in a big way. During the next 12 months, more than $600 billion of homeowner mortgages are due to be reset at higher rates. Many households will not be able to meet their increased payment obligation and will be forced to default on their loan – despite government intervention. Stay tuned for home equity, auto, and credit card loans.

In the past 12 months, Founders Capital Management had several tranches of treasury, municipal, and corporate bonds come due. We continued our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and placed the majority of the proceeds in a mix of short-duration, fixed-income securities (i.e., one to three years), earning approximately 5.5% to 7.5%. (We are very happy with the increase in returns on our short-term fixed-income investments). At this point, annual returns earned on short-term fixed-income investments still remain higher than those available on longer-term fixed-income investments. While due in part to the market's long-term expectation of slower economic growth, the major reason for the low returns offered on long-term, high-rated, fixed-income investments is the continued speculative behavior of investors "betting" that long-term rates will continue to fall as the Federal Reserve lowers short-term rates, leading to a short-term increase in the principal of these bonds. We have stated that we would not speculate, and we will maintain this attitude toward our fixed-income investments. It is better to be safe than sorry, and we will continue reallocating money to short-term fixed-income instruments to maximize our annual "earnings" on these investments. (This is especially true if inflation continues to rise.)

WHAT'S CHANGING AT FOUNDERS?

Remembering MARGIN OF SAFETY and Changing Nothing

If there is one section of this year's letter that should be in **bold**, our discussion on the "margin of safety" would win, hands-down. The margin of safety is nothing more than an assurance that we protect the principal of our investment and cover our "downside risk." On the whole, we hate to lose money. This concept is probably the most difficult but most important part of investing.

Intuitively, investors understand the concept of obtaining a margin of safety when they purchase an investment-grade government bond, which comes with sound assurance that the government receipts supporting the issue are more than sufficient to cover the interest payments connected with the bond. The experience of an entity (government or non-government) to produce a sufficient amount of earnings to cover the interest payments on their debt obligation provides a margin of safety that protects an investor from a loss on his fixed-income investment if an entity's income happens to fall.

In the case of a corporate fixed-income security, the bond investor is always in line ahead of the equity investor and is the priority on any distribution of income. This investor can be viewed as a somewhat conservative investor as he does not believe that the future earnings of the corporation will turn out to be what is forecasted. In essence, the primary feature the bond investor is purchasing is a "margin of safety" that covers an unexpected decline in earnings that would impact an equity investor to a greater degree.

If it is possible to identify a margin of safety when purchasing a fixed-income investment, is it also possible to identify a margin of safety when purchasing common stocks? We believe the answer is yes, but our view on the margin of safety has to be expanded. There are two dimensions to measure when seeking a margin of safety on a purchase of common stocks:

1) When *valuing a business*, an investor should seek the following margin-of-safety criteria:
   - acquire a business that is selling below its intrinsic value, that
   - receives a major portion of future owner earnings (free cash flow) during a viewable business period, and
   - has acquired a competitive advantage through an established franchise that is difficult to duplicate.

The concept of obtaining a margin of safety by purchasing a business at a discount to its value (what we refer to as a "fair price") that shows consistent growing profits and has an advantage in the marketplace is common sense. We believe, however, that the largest risk associated with purchasing a business does not lie in the so-called discount to the business' intrinsic value, as this is a best guesstimate. *The largest risk resides in purchasing lower-quality businesses that look good today but in the long run have products that are highly susceptible to competition and an erosion of the business franchise.* In this case, the business purchaser oftentimes associates the short-term earnings (or sales) growth of a business with long-term earning power. The buyer thinks that the current success of a business is equal to a future enduring franchise, and that this *is* the margin of safety in the investment. It is under this type of investor psychology that we see many public offerings of less-than-quality businesses.

2) When *valuing the safety of a common stock investment*, an investor should seek the following margin-of-safety criteria:
   - A predictable earnings yield that is greater than the present risk-free yield and will be more than twice the average risk-free long-term yield in a 10-year period
   - A predictable owner earnings yield that is equal to the present risk-free yield and will be at least twice the average risk-free long-term yield in a ten-year period
   - Total debt (short-term plus long-term) that is no more than five times annual owner earnings
   - A sustainable earnings growth of 8% per year, along with a minimum return on equity of 15% (given a reasonable amount of debt)

The concept of obtaining a margin of safety by purchasing a sufficiently compounding common stock investment that provides a better yield than a risk-free yield, both short-term and long-term, also makes sense. For example, if a common stock is currently trading at $40 per share, and an investor believes that the associated business will annually produce $2.50 per share of cash that is available to be distributed to owners, then the investor will achieve an owner earnings yield of 6.25% upon an initial investment ($2.50/$40). If the current risk-free yield on a government bond is 4%, then the better investment alternative would most likely be in the common stock. Finally, if the owner earnings of the business were able to grow predictably at 8% per year in the next decade, and the stock price remained at $40, then the owner earnings yield would be approximately 13.5% in 10 years—twice the *average* yield on a 10-year government bond of 6.25%. Thinking in terms of short- and long-term yields is important when investing.

In our opinion, however, the largest risk coverage associated with purchasing an investment does not lie in the so-called premium to a risk-free yield, whether short- or long- term, because this can also be a best guesstimate. *The largest risk resides in purchasing lower-quality businesses that look good today but in the long run have products that are highly susceptible to competition and an erosion of the business franchise.* The business purchaser many times associates short-term earnings yield (and subsequent growth) for a company with long-term yield power. The buyer again thinks the current success of a business is equal to a future enduring franchise, and that this provides the margin of safety in the investment.

A couple of quotes from Ben Graham's book, *The Intelligent Investor:* "Investment is most intelligent when it is most *businesslike*" and "Know what you are doing—know your business." It is important for investors to remember that they are purchasing an interest in a business, as opposed to a piece of paper they hope to see trading at a higher price due to another person's faulty thinking. This is not to imply that we will be operating under different market dynamics from everyone else who is allocating money. Rather, it implies that while we consider ourselves operating under the same conditions as other investors, we choose to think and act differently. We are committed to purchasing *businesses* (at a fair price) that possess strong products, an enduring franchise, strong management, and excellent economics.

A reflection in closing out 2007:

There is something at Founders that will never change: Looking through the lenses of successful investing, we want to see where our money is placed and maintain a view on the intrinsic value of things. In this age of high uncertainty, it is our opinion that to be successful at the investment game, it is important to focus on long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid irrational decisions that are influenced by emotions—including fear of failing to meet desired returns for clients, fear of lacking intelligence and overanalyzing a situation, and being greedy when prudence should prevail.

> *"Ya gotta keep your eye on the ball, son! Just keep your eye on the ball, boy, and you'll do just fine."*
>
> —Foghorn Leghorn

We are comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and feel the returns are fair for the risks we are taking. We want to assure you that we continue to be mindful of the risks in today's markets and will strive to allocate capital in a way that minimizes any long-term effects on the value of our holdings.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2008.