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3RD QUARTER COMMENTARY

Los Angeles, September 30 2006

Dear Fellow Investor:

US Stock markets roared back in the 3rd quarter and the broader averages—namely the S&P 500 and the Dow Jones Industrials—approached their old all-time highs reached more than 6 ½ years ago. Stocks of larger companies outperformed their smaller brethren in the 3rd quarter, continuing a trend begun in the 2nd quarter. Among the S&P sectors, health care, telecommunication services and information technology led the way. Energy, materials, and industrial related shares retreated on the heels of a pullback in oil and commodity prices, a move that helped your portfolio. All other sectors saw an increase. The S&P 500, a widely used measure of market investment returns, was up 5.7% during the 3rd quarter of 2006. Net of fees, and based on preliminary estimates, the average Bristlecone Large Cap Value account[1] was up about 6.4% for the quarter.

More relevant to long-term investors, the average Bristlecone Large Cap Value account increased by almost 44% (7.5% annualized) net of fees over the last five years[2]. This is slightly better than the cumulative return of about 40% (about 7% annualized) for the S&P 500. Since April 1, 2000, the inception of Bristlecone's investment returns, our portfolios have increased on average by approximately 43% (about 5.7% annualized) versus minus 1% return for the S&P 500 index (0% annualized) over the same period.

We were net purchasers during the quarter (i.e., we bought more than we sold), bringing our cash position to historically low levels. Prices during the quarter were once again volatile. Short-term volatility is the friend of the long-term investor, and we took advantage of price gains in the quarter to sell Alltel, PNC Financial, and Embarq (a small spin-off from Sprint). We also trimmed Newell Rubbermaid and Kroger as their stock prices neared our assessment of fair value. On the buy side, we added to Dell, Sprint (twice) and Wal-Mart. Finally, we initiated a position in Home Depot, another 1990s stock market darling that we were able to purchase at an attractive valuation following investors' concerns about the health of residential housing markets.

The stocks that made the biggest positive contribution to the quarter's investment returns were DirecTV, AT&T, and Pfizer. The companies that penalized returns the most were Dell, Apollo and Washington Mutual.

Quarterly Activity:

- **New Investment(s):** Home Depot (HD)
- **Increase in Existing Investment(s):** Dell (DELL), Sprint (S), and Wal-Mart (WMT)
- **Reduction in Existing Investment(s):** Kroger, (KR), Newell Rubbermaid (NWL)
- **Investment(s) Sold:** Alltel (AT), Embarq (EQ), PNC Financial (PNC)

Beating The Market Over The Long-Term: A Look at Successful Investors

The almost 4-year period since the market bottomed out in October 2002 has been rewarding for your portfolio. But increasing portfolio value is no justification in itself for hiring a manager if he or she trails the market over time. Investors pay active professional investment managers to outperform, that is, to deliver risk-adjusted returns in excess of what a passive index fund would provide after accounting for expenses. At Bristlecone, we understand this and our goal is to outperform the market over a 5 to 10-year time horizon. Why such a long period? And, what can other successful investors teach us?

Interestingly, managers who achieve great long-term investment records also tend to share some well-documented characteristics. First, they have a significant portion of their own net worth invested in the same portfolio that they manage for clients. They also have a well-defined philosophy, a disciplined investment process, a willingness to concentrate the portfolio in their most attractive ideas, and the conviction to stick with their process in the face of adverse performance.

This last point is important, and since your portfolio is experiencing good returns so far this year, we felt that it was probably timely

[1] PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Performance quoted is that of the Large Cap Value Non Wrap Composite net of fees. Both net of fees and benchmarks' investment returns include the reinvestment of dividends and interest.

[2] Investment returns prior to June 1, 2004 pertain to portfolios managed at a prior firm and include both wrap and non-wrap accounts. For a full disclosure presentation and/or a description and complete list of composites, please contact Client Services at clientservices@bristlecone-vp.com or call (877) 806-4141.

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to manage expectations. Our experience is that in order to have a chance at delivering good absolute and relative returns in the long run, an investor must be willing to trail the market over shorter periods of one to three years. This may seem counter-intuitive to many of you, but it is consistent with a couple of studies we've seen, including one by Davis Advisors (*The Inevitability of Underperformance*, 2004). The authors looked at investment records of 116 large-cap equity managers whose returns ranked in the top quartile (or top 25%) during the 10-year period ending December 31, 2004. It showed that almost all the managers (110 out of 116, or 94%) *spent at least one three-year stretch in the bottom half* and *two-thirds* (65%) *were in the bottom quartile for at least three consecutive years,* yet they outperformed the market over those 10 years.

Such findings shouldn't be surprising since, by definition, the market represents current consensus. An investment can only represent a good value, and potentially deliver superior returns, if the consensus about the stock is wrong. Outperforming the market, therefore, not only requires seeing something that others don't, *but also requires being right more often than not.* It can take some time (months or even years) for the market to come to the same realization. Longer periods, then, tend to smooth out these inevitable times when a manager's investment process is out of favor with the broader market.

"Bristlecone's partners, employees and their families have almost $3 million invested in the same portfolio, right alongside yours, because we believe that this is the best way to build wealth for our own families."

Not surprisingly, in the age of instant information about benchmarks and returns (or lack thereof)—what we jokingly call the performance treadmill—sticking with one's conviction is easier said than done. Most managers are concerned that they'll lose their job before they are proved right. For instance, how many professional investors feel comfortable averaging down (i.e., buying more shares of a company as its stock price keeps declining)? The answer is very few. Most believe that the market must know something that they don't. Yet, at Bristlecone, we average down almost systematically, sometimes adding to an initial investment 2 or 3 times as the stock price declines further. Why? Our reasoning is that if a stock represents a good investment when it trades at $50, it's an even better value at $40. Our attitude with investing is no different than those of bargain shoppers: we love greater discounts. Since we accept that we'll never pick the exact bottom, we see a declining stock price as an opportunity to improve the portfolio's future returns by lowering the average cost of our investments.

Are we always right? Of course not! How do we know that we're not "throwing good money after bad" as some pundits put it, or falling into the so-called value trap? We can't know for sure. What we do know is that investing is not unlike most card games. You can be the best player and yet lose a hand. In other words, an occasional bad outcome, especially a short-term one, does not validate or invalidate an investment process. Over longer periods, however, skill will trump luck. If our process is sound, we are confident that it will show *over* time but definitely not *every* time.

One way that we minimize the odds of a bad outcome is by using a routine similar to what airline pilots go through before take-off. We run any prospective investment through a checklist before committing capital. It is very comprehensive, but can be articulated into three areas of focus: 1) we invest in good businesses; 2) run by competent managements; 3) at a significant discount to what we think they're worth. Checking off each of these items requires work, experience and extensive reading of financial reports, trade magazines and other (exciting!) publications. As an illustration, a good business, among other things, generates cash for its owners, has a history of attractive returns on invested capital, and possesses a good balance sheet (either low debt or very marketable and fungible assets with a value that we're pretty comfortable with).

Bristlecone's partners, employees, and their families have almost $3 million invested in the same portfolio, right alongside yours, because we believe that this is the best way to build wealth for our own families. Although we cannot guarantee that we'll achieve our investment return goals, we can promise you that we have a strong incentive to try very hard.

We take this opportunity to thank you again for the trust you show in us. We always welcome your referrals, comments, or questions (email us at clientservices@bristlecone-vp.com or call 877-806-4141).

Sincerely,

Your Portfolio Management Team

PS: We have included with your quarterly statements a tally of realized gains and losses year-to-date. For those of you who pay estimated taxes, this information may be important to consider in your tax planning for the year.