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2nd Quarter Commentary

Los Angeles - June 30, 2007

Dear Fellow Investor:

After a volatile—but ultimately flat—first quarter, US stock markets enjoyed a very strong second quarter. The S&P 500 advanced 6.3% in the quarter and now stands up 7.0% year-to-date. Growth stocks outperformed value stocks and large cap stocks outdid small cap stocks, both reversals of long running market trends. Net of fees, and based on preliminary estimates, the average Large Cap Value account[1] advanced about 7.7% in the quarter, ahead of the S&P 500 in the quarter and year-to-date.

Short-term investment returns, even if they remain the ever-pressing topic of cocktail parties and pundits alike, are of little use when assessing success in achieving one's financial goals. Looking back five years, which now excludes most of the awful 2000 – 2002 bear market, the average Bristlecone Large Cap Value account increased 11.2% annually (compared to 10.7% for the S&P 500). Since April 1, 2000, the inception of Bristlecone's investment returns, our portfolios have increased 6.9% annually (compared to 1.7% for the S&P 500).

This period since our track record's inception neatly contains both the full bear market—the S&P 500 last peaked in March 2000 and hit bottom in October 2002—and the lengthy bull market that has brought the market back. It is a sobering reminder of the difficult aftermath of the 1990s' thoughtless speculation that only this June did this index return to its prior peak, marking a long seven years for indexers and many others. (The NASDAQ, a market dominated by technology issues is still 46% below its bull market peak.) Our goal is to outperform the US market over a full cycle—five to 10 years, and hopefully offer better downside protection during bear markets by avoiding overvalued investments. One can wish that the present bull market proceeds undeterred; regardless, we inch closer to marking a full cycle. Now the difficult part: following those simple shampoo instructions to rinse and repeat, perhaps this time without the lather.

The first day of the second quarter brought news that private equity firm Kohlberg Kravis Roberts would acquire portfolio holding First Data, and April seemed to be the month that buy-out firms at last discovered our portfolio. Just two weeks later, a consortium of private equity investors and banks announced their intent to acquire Sallie Mae. Thus, after idly watching a steady and rising stream of ever larger deals cross the ticker, our portfolios finally participated in what has been one of the more prominent trends in the market over the last year or two. Fueled by floods of inflows and easy access to cheap debt on favorable terms, private equity firms have played a considerable part in boosting market returns recently. From our vantage point (evaluating these two and other deals), these going private transactions have been done near or slightly above our estimates of fair value, and it is our sense that the surge in private equity will play itself out naturally as expected returns diminish, squeezed from both directions by higher cost debt (spreads between lower quality corporate and US government debt widened significantly late in the quarter) and higher acquisition prices. We are already seeing rumblings, even related to these two deals, indicating that debt investors are demanding

Quarterly Activity:

- **New Investments:**
  None
- **Increases in Existing Investments:**
  Bank of America (BAC)
- **Reductions in Existing Investments:**
  Apollo Group (APOL)
- **Investments Sold:**
  Kroger (KR), Molson Coors (TAP), and Merck (MRK)
- **Spin-offs Received:**
  Covidien (COV), and Tyco Electronics (TEL)

"(…) DEBT INVESTORS ARE DEMANDING HIGHER YIELDS AND GREATER PROTECTION FROM DEFAULTS. THIS COULD HAVE NEGATIVE IMPLICATIONS GOING FORWARD ON EQUITY MARKETS IN GENERAL."

[1] PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Performance quoted is that of the Large Cap Value Non Wrap Composite net of fees. Investment returns for the composite and the S&P 500 include the reinvestment of dividends and/or interest income. Inception is April 1, 2000. Prior to June 2004, the composite represents performance generated by the portfolio management team at a prior firm and includes wrap accounts. A list and description of all firm's composites is available upon request.

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higher yields and greater protection from defaults. This could have negative implications going forward on equity markets in general.

Those two acquisition announcements boosted returns, but unfortunately First Data and Sallie Mae weren't outsized positions in the portfolio, so the impact was muted. The three biggest contributors to performance during the quarter were Apollo Group, Intel, and Dell. Energy, to which the portfolio is barely exposed, and information technology were the strongest sectors in the broad market. Oil prices, after retreating in the second half of 2006, are back near record highs, up nearly 20% year-to-date. Rising interest rates—the quarter saw 10-year Treasury rates near five year highs— and further concerns about subprime real estate loans hurt financial stocks, and indeed two of the three biggest detractors from our performance were banks: Wachovia and KeyCorp. The third was IAC/Interactive.

Given the strong market advances and our contrarian tendencies, it probably won't surprise you that we were net sellers during the quarter, realizing further capital gains in the process. We sold long-time holdings Kroger and Merck, as well as Molson Coors, which we had purchased more recently. In each case, sticking to our discipline, we sold because we felt the stocks had reached our assessment of their intrinsic value.

We also trimmed Apollo Group, which spurted forward on the last day of the quarter due to a positive earnings announcement. It is common for us to reduce our investment as a stock approaches our intrinsic value estimate, but further commentary is helpful here. First, we make a deliberate effort to allocate more capital to issues trading at a greater price-to-value discount. This quarter's returns, during which some of our largest positions were also our best performing, showed the benefits of that effort. Although we expect that focusing the portfolio on our most attractive names should be a positive over time, we'll also see some periods during which our largest investments hurt returns. Second, we achieve greater position sizes by averaging down, i.e. committing more capital as the stock price declines. In our first year owning Apollo, we increased our position several times after our initial purchase to take advantage of lower prices and increase our investment as its discount to our intrinsic value estimate widened. Looking back, our experience is that doing so improves investment returns over time. This may all seem intuitive (it certainly is to us), but you would be surprised how many investors look to sell when prices decline.

We weren't able to put the proceeds from these sales to work immediately, so our cash level rose during the quarter. We did increase our investment in Bank of America as we now see the stock trading at a significant discount to its intrinsic value. The increased cash leaves us in a better position to take advantage of attractive new ideas.

We would also like to announce some additions to our team. We mentioned last quarter that Josh Graybill was promoted to analyst and that we were looking for someone to assume his responsibilities as well as an additional analyst. We're pleased to announce that, in June, we hired Charles No to fill the position of portfolio administrator. Charles is a graduate of the University of California at Berkeley and will be a key member of our client service team and handle important operations and trading functions. We're also pleased to announce the addition of Reto Aeberhard to our investment team as an analyst. Reto recently received his MBA from USC's Marshall School of Business and has extensive experience in both business and investing. In his previous position, he took personal time off to attend Berkshire Hathaway's shareholder meetings and listen to Warren Buffet. This is a strong indication that he has solid value instincts and we look forward to his research contributions.

With these positions filled, we mark our three-year anniversary as an independent firm in particularly strong fashion. From the beginning, our goal has been to shape the firm's development with the single-minded goal of improving our ability to deliver outstanding returns to clients. Size is not our ambition, though, and more than a record-sized staff, we're most pleased that we've been able to add high quality people to the organization to further that goal.

Thank you for your continuing trust in Bristlecone Value Partners.

Sincerely,

Your Portfolio Management Team.