Bristlecone Value Partners, LLC
10880 Wilshire Blvd., Suite 880
Los Angeles, CA 90024
T. 877.806.4141
F. 310.806.4140
info@bristlecone-vp.com

3rd Quarter Commentary

Los Angeles - September 30, 2007

Dear Fellow Investor:

During the 3rd quarter, the portfolio's returns – both absolute and relative – were clearly disappointing. While the S&P 500 – a proxy for the US market – rose by about 2%, preliminary estimates indicate that the large cap value portfolio performed meaningfully worse and actually declined by more than 5% (net of fees)[1]. Year-to-date, the portfolio is up about 2% and is now trailing the 9% return for the market. Over the last five years, the average Bristlecone Large Cap Value account increased 14.4% annually, compared to 15.5% for the S&P 500. Since April 1, 2000, the inception of Bristlecone's investment returns, our portfolios have increased 7.3% annually on average compared to 1.9% for the S&P 500.

The turmoil in credit markets triggered by rising mortgage delinquencies explains part of this quarter's underperformance, as financial issues represent the largest percentage in the portfolio. Returns were also hurt, though, by a wider variety of holdings, some of which are unrelated to credit or housing. What we did not own, or not own enough of, also played a role as energy and commodity stocks performed the best during the quarter.

Such poor short-term results obviously do not satisfy us, but they do not overly concern us either. We've found ourselves in this situation before as professional investors – 1998 and 1999 come to mind – and view such periods as a side effect of our contrarian, value-based investment process. Our discipline requires investing only in shares of companies that we consider undervalued in relation to our appraisals of their long-term worth. This discount between price and value invariably comes from some form of challenge facing these corporations. Righting themselves takes time, and such divergence in performance between the portfolio and the market is not unusual.

Typically during market declines, though, the most expensive stocks – the so-called "glamour" stocks – decline the most. But it's not always true, and sometimes value stocks lag. In 1998 there were similarities to today's turmoil in that financial stocks declined sharply, that time following a crisis in Asian financial markets that triggered first a default in Russian debt and later a hedge fund collapse in the US. During the 3rd quarter of 2007, stocks of financial services companies underperformed dramatically again, and value stocks lagged growth stocks. Granted, we realize that these can be difficult times to some of our investors, especially more recent ones, but if history is any guide, this is a good time to consider adding to your account.

How Were Our Investments Affected?

The stocks that made the biggest positive contribution to the quarter's investment returns were Intel, Emerson Electric, and Exxon Mobil. The three that detracted the most were all related to the housing market: Countrywide Financial, Washington Mutual, and Home Depot (for our original thesis for investing in the first two and our explanation of mortgage loans, we refer

[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.

Quarterly Activity:

- **New Investments:** American Express (AXP), Motorola (MOT)
- **Increases in Existing Investments:** Countrywide (CFC), Home Depot (HD), Liberty Interactive (LINTA), Legg Mason (LM), and Western Union (WU)
- **Reductions in Existing Investments:** Apollo Group (APOL), Intel (INTC)
- **Investments Sold:** First Data (FDC), Tenet Healthcare (THC)

"Consistent with our "stocks-are-small-pieces-of-businesses" philosophy, we work hard at making decisions based on knowable, verifiable facts rather than emotions."

Bristlecone Value Partners, LLC
10880 Wilshire Blvd., Suite 880
Los Angeles, CA 90024
T. 877.806.4141
F. 310.806.4140
info@bristlecone-vp.com

you to our 1st quarter comments). Going forward, we do expect that these companies will continue to face strong revenue headwinds.

In the case of Washington Mutual and Countrywide Financial, they share some responsibilities in what currently ails them. Although both started making adjustments to their business models in 2005 and 2006 in preparation for the downturn, they vastly underestimated how fast mortgage default rates would start rising. We anticipate that credit losses will likely peak sometime between now and the end of 2008. Home Depot's revenue and earnings are also affected by slowing residential construction. In other words, it is possible that it will get worse for all three before it gets better. However, we feel that each company has the balance sheet not only to survive, but to thrive once the market improves. Importantly, their stock price more than reflects the problems that the companies are likely to face in the next few quarters. Although we couldn't anticipate the short-term price drop, our assessment of these companies' intrinsic value has not changed dramatically, even with the summer's new information. Even though at this stage it is impossible to differentiate being too early from being wrong, remember that we anticipate the potential upside to be several years off – not months.

Among our other financial holdings, the earnings impact will be proportionally smaller. Citigroup, Bank of America, JP Morgan Chase, Wachovia, and Keycorp will feel some pain from the current difficult credit environment, but their business models are a lot more diversified. We also expect American Express to face increasing losses as well off recent cyclical lows, but again, we feel that the stock price already reflects it.

The end result of this summer's turmoil on the economy and our companies will most likely not be fully known until long after it is over. We cannot tell whether share prices will decline again and how low they might ultimately go, or when the housing market will eventually recover. Answering these questions should not matter though. What should matter is that the long-term value of the businesses held in the portfolio has not been permanently impaired, and that we are confident that sooner or later the market will recognize their worth as greater than current prices reflect. The key is to be selective by owning stocks of companies that we believe can survive difficult economic times, and we will reassess our views and appraisals as relevant new information becomes available.

Being Greedy When Everyone Else Is Fearful

Consistent with our "stocks-are-small-pieces-of-businesses" philosophy, we work hard at making decisions based on knowable, verifiable facts rather than emotions. We seek to understand the business of companies considered for investment and we attempt to come up with conservative appraisals of their value. Knowing our companies' economic drivers and being confident in our appraisals gives us the fortitude not only to weather market turmoil but also to seize opportunities.

In down markets, we are more likely to be buying rather than selling to take advantage of share prices being on sale. To paraphrase Warren Buffett, we tend to "be greedy when everyone else is fearful." Remember that when stock prices decline, *long-term expected returns increase*. So not surprisingly, during the 3rd quarter, we bought more overall than we sold. Where appropriate, we also realized losses in order to offset some of the capital gains taken earlier in the year. Although the result of these tax-motivated trades does not show in the performance that we report, we are keenly aware of the importance of *after-tax* returns to compounding wealth over time.

First, we added to two of our holdings in financial service companies whose price declined sharply during the quarter: Legg Mason and Countrywide. We also increased the portfolio's investment in Western Union (a payment processing company), Liberty Media Interactive (a conglomerate whose main asset is QVC, the home-shopping channel), and Home Depot. We also initiated new investments in American Express and Motorola. On the sell side, we disposed of First Data, whose stock price reached our assessment of its value following its purchase by a private equity group, and Tenet Healthcare. We also reduced the portfolio's holdings in Intel and Apollo.

In past letters, we promised you to be candid in discussing the portfolio, so we will not sweep the permanent loss we suffered on Tenet under the rug. We made the original investment four years ago and added once in 2005. It may seem hard to imagine now, but we actually purchased Tenet after substantial signs of trouble had already surfaced and, we believed, been reflected in a stock price that had lost nearly 80% of its value *before* we purchased it. We knew, therefore, to expect substantial litigation costs and a difficult operational turnaround. In these regards, Tenet was not so different than other investments we have made. A few factors outside of the company's control (among them hurricane Katrina and the rise in uninsured patients) exacerbated the situation and ultimately further eroded the value of the company. The end result was that despite decent efforts by management, Tenet has not made nearly enough pro-

Bristlecone Value Partners, LLC
10880 Wilshire Blvd., Suite 880
Los Angeles, CA 90024
T. 877.806.4141
F. 310.806.4140
info@bristlecone-vp.com

gress in restoring profitability. The absence of excess cash flows is made even more critical by the company's high level of indebtedness. We no longer had the necessary confidence that future free cash flows would ensure a meaningful value for the stock, and we decided to sell.

"Financials" Is Not a Four-Letter Word!

We are frequently asked why we have such a high percentage of the portfolio invested in financial stocks? The first part of the answer is that financial service companies represent a significant part of the economy and the stock market, comprising between 20% and 30%, depending on the measure. As of September 30th, about 33% of the portfolio was invested in this sector. Financials are also attractive to us for other reasons. Not surprisingly, we consider ourselves to be fairly knowledgeable about most of these businesses. Each member of our research team worked in one capacity or another for financial institutions (commercial and investment banks, asset management, or mortgage companies) before becoming analysts. One of our key tenets as investors is to stick to our circle of competence, to invest in companies that we understand. It is also comforting to us that, in many cases, financial service companies are some of the oldest operating businesses around, implying durable competitive advantages and protection from obsolescence. Furthermore, most financial services businesses need little resources to grow or fund their on-going operations. It is a very attractive characteristic because what's left of the profits, the so-called free cash flow, accrues to shareholders in the form of share buybacks or dividends.

Contrast for instance two of our holdings, American Express and Exxon Mobil. In order to increase revenues, American Express does not need new plants, stores or distribution centers. Exxon Mobil, on the other hand, needs to spend billions every year just to keep revenues constant. Oil and gas reserves are a depleting asset, so the company needs to find new fields all the time and build very expensive infrastructure to produce, refine and market its products. Exxon Mobil is the most profitable company in the world in dollar terms, yet its returns on capital – while in excess of its cost of capital – are dwarfed by those of American Express.

To conclude, financial service companies frequently offer economic characteristics that are attractive to long-term investors. The sector is vast and diverse and our investments are made across industries with very different business and risk profiles: property and casualty, life insurance, retail or investment banking, thrifts, asset management, and credit cards.

It also came to our attention that we are probably not using one of our best research resources to the extent that we should, the expertise of some of our clients. We've mentioned in the past how we sometimes discuss our investments with those of you with specialized industry knowledge and we thought that we should extend a special invitation across our client base to contact us directly. You may be a doctor with an understanding of the issues faced by hospital or pharmaceutical companies, or own a business that competes with, sells to, or purchases from, one of the portfolio companies. If you do, we encourage you to send us an email, share your business knowledge to improve ours and hopefully help us make better investment decisions. We are looking forward to your correspondence.

Thank you for your patience and your trust in Bristlecone's investment philosophy. We always welcome your referrals, comments, or questions (call 877-806-4141or email us at clientservices@bristlecone-vp.com).

Sincerely,

Your Portfolio Management Team