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4TH QUARTER COMMENTARY

Los Angeles - December 31, 2007

Dear Fellow Investor:

The second half of 2007 was one we would rather soon forget, but will long remember. Following a strong first half of the year—and four years of good absolute returns before that—performance over the last six months fell well below market benchmarks and our own expectations. Net of fees, and based on preliminary estimates, the average Large Cap Value account fell nearly 10% in the quarter[1], offsetting gains from earlier in the year and leaving the accounts down about 8% for the full year. The S&P 500 fell, too, by about 3.3% in the quarter, but managed a 5.5% gain for the full year. In fact, indices of many stripes were slightly up in 2007, masking great volatility and widely disparate returns beneath the surface among styles, sectors and individual stocks.

The downturn that began for financial stocks in the third quarter, and for the rest of the market in the fourth quarter, has accelerated in the first few weeks of 2008, with the S&P 500 down nearly 10% year-to-date as of this writing and 15% off highs hit in early October. There is no shortage of bad news and—perhaps more importantly—uncertainty, that is fueling this decline. What began in Spring 2007 as a sharp deterioration in mortgage-related areas of the financial markets, has now spread into a much broader credit contraction affecting nearly all financial institutions, from banks to brokers to bond insurers.

Over the last few weeks, it has become more obvious that the slump on Wall Street is hitting Main Street, too. There is growing evidence, not just in the form of housing-related woes but also in recent job numbers, that the U.S. economy is slowing down. Throw in a little domestic political uncertainty (who knew nominating contests could be competitive?) and anxiety over international developments (Pakistan, Iran), and you have more than enough ingredients for the current broad sell off.

Quarterly Activity:

- **New Investments:**
  Cemex (CX)
- **Increases in Existing Investments:**
  American Express (AXP), Electronic Data Systems (EDS), Motorola (MOT), Progressive (PGR), & Washington Mutual (WM)
- **Reductions in Existing Investments:**
  None
- **Investments Sold:**
  Apollo (APOL) & SLM Corp. (SLM)

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Portfolio Returns From Inception Through December 31 2007*

	Annual % Change		
Year	**Non Wrap Composite Net of Fees (1)**	**S&P 500 with Dividends Reinvested (2)**	**Relative Results (1) - (2)**
2000	15.0%	-11.1%	26.1%
2001	-6.5%	-11.9%	5.4%
2002	-19.2%	-22.1%	2.9%
2003	25.9%	28.7%	-2.8%
2004	10.5%	10.9%	-0.4%
2005	5.2%	4.9%	0.3%
2006	18.9%	15.8%	3.1%
2007	-8.1%	5.5%	-13.6%
*Average annual gain/loss since inception**	*4.3%*	*1.4%*	*2.9%*
Cumulative gain/loss since inception	*38.9%*	*11.5%*	*27.4%*

* Inception date is April 1, 2000. Data are for full calendar years with the exception of 2000.

[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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Before getting carried away with things that have gone, or could go, wrong, it is helpful in times like these to pause to answer a few questions so as better to set a course of action. Why has our recent performance been so poor? How bad can it get? What should we do now?

Why The Poor Performance?

In two words: mortgages and commodities. In just one word: momentum. Although we mostly foresaw the reversal of the housing boom and the contracting credit cycle, we vastly underestimated the stock market's reaction to these developments, and our exposure to financial stocks hurt the portfolio. The biggest contributors to the negative return were Countrywide Financial and Washington Mutual, and Countrywide now deserves special mention since we've closed out that position in the New Year and thus locked in a significant capital loss. The danger that we failed to recognize early enough in Countrywide was that this was a company that did not control its own destiny. We spent significant time analyzing loan performance (stress testing the portfolio using data from California's real estate debacle in the early 1990s) and believed the company had sufficient capital, a growing deposit base, and access to non-market funding sources such as Federal Home Loan Bank advances. We still don't know the full story, and might never, but Countrywide's decision to sell to Bank of America at such a low price either foretells deeper problems that were not obvious, at least to us, from publicly available information, and contradicts the company's own reassurances, or was a tremendously poor example of corporate stewardship. Short of outright bankruptcy, this was the second worse outcome possible for shareholders.

Altogether, the S&P financial sector was the worst performing sector of the market, by far, down 19%, followed by consumer discretionary, down 13.2%. Outside of financials, other significant individual contributors to negative performance in the quarter were Sprint and Home Depot.

On the other end of the spectrum, we continued to judge oil and commodity-related stocks unattractive and these stocks were under-represented in the portfolio. Yet commodity prices barreled ahead in 2007, driving the price of oil up another 57% in 2007. This marks the fifth year in a row of rising oil prices and the third year in the last five that the price of oil has increased more than 40%. It is widely believed that emerging economies are driving an unprecedented surge in the demand for oil. The reality is a little less dramatic. Global demand for oil increased 1.1% in 2007 according to the International Energy Agency. This followed a 1% increase in demand in 2006. In fact, while the price of oil has increased more than five-fold over the last ten years (from $17 to $96 a barrel), global demand for oil has increased only 16% cumulatively (from 74 million barrels a day to 86), indicating a view that supply will remain tight. Many other commodities (e.g., precious metals, agricultural products) followed suit and the S&P Energy (+34%) and Materials (+22.5%) sectors led the market.

It is not the first time, and it won't be the last, that a sector we judge unattractive has continued to go up while stocks we find attractive have gone down. It is the very nature of a momentum market to do just that. Just think back to the late 1990s, when it seemed technology stocks had no ceiling and boring, old economy, industrial and financial stocks seemed only to get cheaper and cheaper. Our portfolios, which are contrarian in nature and comprised of stocks at the lower end of the valuation spectrum, will nearly always underperform in this type of market. We believe the sin of short-term underperformance will prove an acceptable price to pay in order to avoid the more significant consequences of emphasizing sectors with higher built-in expectations.

How Bad Can It Get?

This is an impossible question to answer with any certainty, partly for the same reason outlined above: fundamentals drive short-term stock performance only so much, with changing consensus expectations and mass psychology playing a far greater role. But we can, at least, provide some context. The current downturn (a 15% drop in the S&P 500) is a correction, so far, of middling magnitude, painful to be sure, but something to be expected regularly when investing in stocks. The decline in the Large Cap Value portfolio, now about 25% below its high near the end of the second quarter of 2007, has clearly been worse. In contrast, the same portfolio outperformed the broader market during the last downturn in the aftermath of the technology bubble, falling about 22% from April 1, 2000 through October 31, 2002, while the S&P fell nearly 44%. That two-and-a-half-year market decline ranked as one of the three worst of the last 100 years (with the other two coming in 1929–1931 and 1973–1974). We bring up these three more severe multi-year losing streaks not because we believe this is the trajectory we're on today, moreso to emphasize their relative rarity.

Most investors' concerns today center around macroeconomic issues, not stock valuations. We believe that the important distinguishing factor between more and less severe bear markets is the starting point of valuation. When the S&P 500 peaked in March 2000, it

"(...) ALTHOUGH IT DOES NOT GUARANTEE ANYTHING, YOUR PORTFOLIO MANAGERS HAVE A SIGNIFICANT PORTION OF THEIR INVESTMENTS IN THE SAME STOCKS."

traded at the unprecedented high earnings multiple of 30x earnings, meaning that the aggregate earnings of the index constituents was just over 3% of its market value. This compared to the yield on U.S. Treasury bonds at the time of 6%. The valuation of the overall market entering the current downturn was much closer to the long-term historical market average of around 15x to 17x and the earnings yield on stocks now sits substantially higher than the yield on treasury bonds (a 10-year treasury today offers a 3.6% yield).

Averages exist because of higher *and* lower data points, so a 15x - 17x multiple for the market is certainly no hard floor. Indeed, we've seen that market multiple contract already to about 14x today (our portfolio trades at a lower P/E). One other note of caution is that the level of corporate profitability (the denominator in the P/E calculation) is above historical averages, meaning a stable P/E with declining earnings would still yield lower stock prices. Indeed, our process, which relies extensively on forecasting mean-reverting profitability, shows many of our holdings with declining near-term profitability.

Beyond the usual value investor's caveat that things can always get worse, here are a few points that offer comfort in the current situation. We don't own the whole market, but rather a portfolio of 37 companies that, in aggregate, trades at a very reasonable valuation of about 12x expected earnings. Even if we believe near-term earnings may be lower than the market expects for some companies, we judge our current portfolio to be unusually attractive (more on that later). Furthermore, despite the humbling reminder that our analyses can be wrong (and these, such as Countrywide, are seared deeply into our institutional memory), the portfolio is comprised of financially strong, cash generating companies, with solid competitive franchises trading at significant discounts to our appraisals of their worth because of issues that we believe to be fixable or temporary.

What To Do Now?

While our portfolio was plainly poorly positioned for the last three to six months, we believe it is well positioned for the next three to six years. That statement might require some of you to re-assess your investment horizon. We make every effort to explain our process so that our investors allow us to act based on what we think a business will be worth several years down the road, rather than what stock prices will be in a quarter or two. For those truly long-term investors, we believe today's market holds opportunities that could end as quickly as they appeared. The price to value discount of the portfolio, at its highest level since the aftermath of the technology bubble, supports this outlook, whether or not the US economy experiences a recession in 2008. Most of the stocks in the portfolio already price in such a scenario; the same may not be true for the more momentum-driven sectors of the market.

This is certainly not the first time our investment process resulted in lagging the broad market, even to this degree. The last time was when financial stocks underperformed following the Asian currency crisis and the collapse of Long-Term Capital Management in the late 1990s, underperformance that was stretched by outperformance in another sector largely avoided, technology. If history is any guide, being out of step with the market in the short-term is sometimes a necessary evil to be able to deliver long-term performance. At the same time, we continually reassess our companies' appraisals and balance sheet strength and are willing to take action when necessary. To illustrate, although we regret not having sold Countrywide's shares earlier, we were happy to have liquidated our investment in SLM Corp before the stock price declined dramatically.

It is easy, of course, to ask for patience and a long-term view in the good times; it is in the difficult times that such attributes inure most to your benefit. In this respect, and although it does not guarantee anything, your portfolio managers have a significant portion of their investments in the same stocks. We eat our own cooking.

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Finally, for those of you with taxable accounts, please note that included in your enclosed quarterly report you will find a full-year realized gain and loss report to assist you with tax preparation.

Thank you for your continued trust in Bristlecone Value Partners' investment process. One of our firm's values is to provide frequent, candid communications about the portfolio. At all times, but especially in times of increased anxiety, please feel free to call us with your questions and concerns so that we can better meet your long-term investment needs.

The entire team at Bristlecone joins us in wishing you and your families a happy and successful 2008.

Sincerely,

Jean-Luc Nouzille, CFA
Portfolio Manager

David Fleer, CFA
Portfolio Manager

CAUTIONARY STATEMENT

One of Bristlecone Value Partners' principles is to communicate frequently, openly and honestly. We believe that our clients benefit from understanding our investment philosophy and process. Our views and opinions regarding the investment prospects of the portfolio are "forward looking statements," which may or may not be accurate over the long term. While we believe we have a reasonable basis for our appraisals, and we have confidence in our opinions, actual results may differ materially from those we anticipate. Information provided in this report should not be considered as a recommendation to purchase or sell any particular security. You can identify forward looking statements by words like "believe," "expect," "anticipate," or similar expressions when discussing prospects for particular portfolio holdings. We cannot assure future results and achievements. You should not place undue reliance on forward looking statements, which speak only as of the date of this report. We disclaim any obligation to update or alter any forward looking statements, whether as a result of new information, future events, or otherwise. Our comments are intended to reflect trading activity in a mature, unrestricted portfolio and might not be representative of actual activity in all portfolios. Portfolio holdings are subject to change without notice. Current and future performance may be lower or higher than the performance quoted in this report.

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