



LATEEF

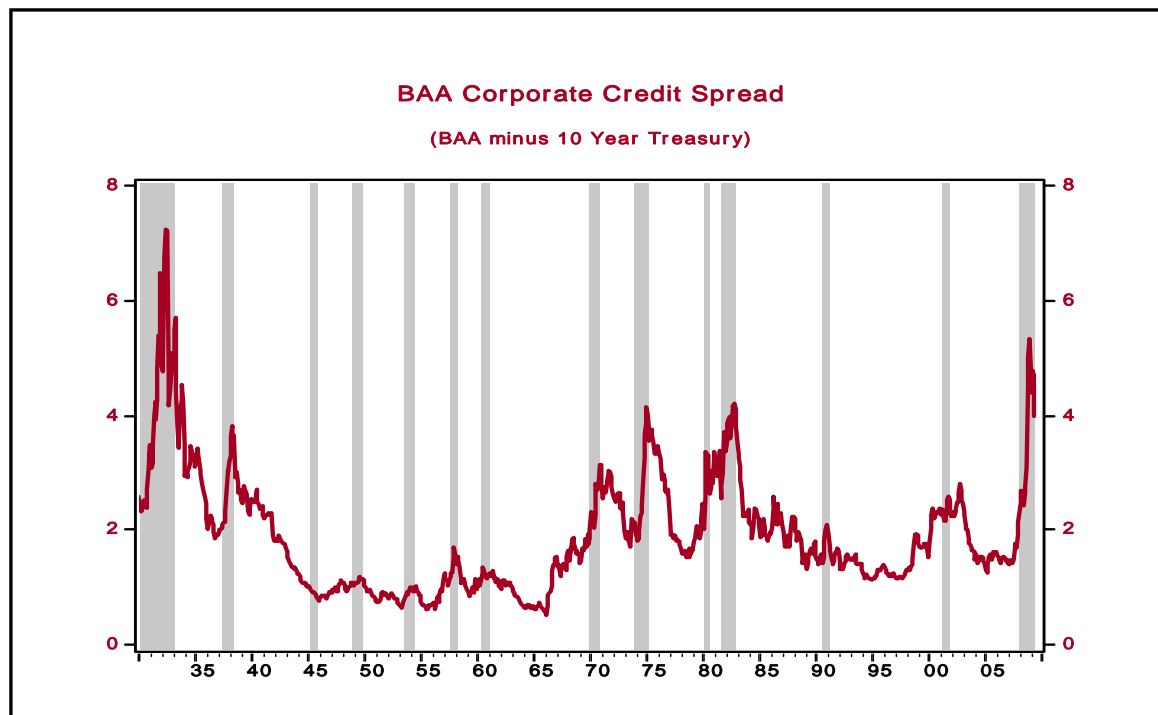
INVESTMENT
MANAGEMENT

Lateef Second Quarter 2009 Commentary

Throughout 2008 and into the first quarter of 2009, investors demonstrated an increasing aversion to risk as reflected by the declining values of stocks, corporate bonds, and real estate. During the second quarter of 2009, the pendulum of risk tolerance began to reverse direction as investors became more willing to embrace risk for the prospect of long-term returns. Attracted by low prices and signs that the worst of the credit crisis is behind us, investors drove the S&P 500 higher by 15.9% during the second quarter and the index is now 3.2% ahead through June 30th. Although the current business climate is by no means robust, with national unemployment nearing 10%, GDP down nearly 6% in the first quarter, and oil prices climbing 50% this year to \$70/barrel restraining a consumer recovery, there are several more forward-looking signals that the economy is becoming healthier, which support the market's recovery.

Among them:

- Ten banks, including JP Morgan, Goldman Sachs, and U.S. Bancorp, repaid their bailout funds under the Troubled Asset Relief Program totaling \$68 billion.
- Investors were more receptive to investing in financial institutions. Banks raised \$85 billion in equity, primarily from selling new stock, all in the second quarter.
- Since March, 36 REITs have raised \$13 billion in equity from public equity markets.
- Recent cargo data indicate monthly sequential improvement. In May, container volume at Los Angeles and Long Beach ports increased 8% from April. This change surpassed the 4% increase from April to May in 2008.
- The U.S. Purchasing Managers Index (PMI) in June rose for the sixth consecutive month to 44.8 and is approaching an expansionary level of 50 while China's PMI index has been over 50 for four months.
- The Conference Board's Consumer Confidence Index in June is sharply higher at 49 than 2009's initial level of 39.
- Emerging markets are rebounding with many Asian stock indexes higher this year by 20%-60%.
- Credit spreads are narrowing from recent levels, reflecting reduced fear (see below).



The chart above is a long-term picture of the difference between the yield on high-quality corporate bonds and the yield on 10-year U.S. treasury bonds. High credit spreads indicate investors' concerns about default risk and their demands for higher interest rates to compensate for it. High spreads are a measure of heightened fear and risk aversion while low credit spreads reflect the reverse. In late 2008, credit spreads spiked to levels approaching the Depression era, but have since turned the corner, reflecting growing investor confidence about the health of both the banking system and the economy.

One way that we minimize risk in our process of investing in stocks is to continually evaluate the business risk in our owned companies and new candidates. Because we invest in 15-20 stocks, we can afford to be selective and choose only those outstanding businesses that we believe have a lasting competitive advantage with minimal business risk, led by an admirable and owner-oriented management team, and whose stock is attractively priced. We define an outstanding business as one with a sustainably high return on capital (ROIC). A business that can sustain a high return on its capital invested by bondholders and shareholders indicates that the business has a product or service that is uniquely valued in the marketplace. Companies that deliver sustained returns on capital below their cost of capital ultimately will lose permanent value. The latest notable casualty is General Motors. This is why we believe ROIC is important and what distinguishes us from many investors who are attracted to companies that report strong earnings growth but do not analyze how much capital is needed to achieve that growth.

We recently evaluated a medical waste services company whose initial appeal was that it was 15x the size of its nearest competitor, had 95% renewal rates on long-term contracts from customers, and had reported a five-year compound earnings growth rate of 17%. After digging deeper however, we found that their ROIC was just 12%. We also evaluated the return on



incremental capital recently invested, and found that it was even lower at 9% due to excessive goodwill generated by many acquisitions. The company has acquired 150 businesses since 1993. Additionally, the company had more debt than equity, and was expensive at 25x projected 2009 earnings. While the company has some appealing qualities, by emphasizing a high return on capital, we concluded that the business does not generate a high enough return for us, so we passed. We believe our standards are high and when all three elements of an investment; the business, the management and the stock price are compelling, we act. In the second quarter for appropriate accounts we bought MasterCard, added to Affiliated Managers Group (AMG) and Expeditors International. We sold Nasdaq OMX Group, Liberty Global and finished selling Apollo Group.

We mentioned in our last letter that we began buying Suncor in March. While we were buying Suncor, the company announced a friendly merger through an exchange of stock with Petro-Canada. The arbitrage opportunity to effectively buy Suncor at nearly a 9% discount to the agreed upon exchange price was attractive, so we switched our purchases from Suncor to Petro-Canada stock. Shareholders have approved the merger and the deal should close in the third quarter at which time Petro-Canada stock will convert to Suncor stock. The merger with Petro-Canada will offer Suncor the benefit of a steady source of cash flow from conventional oil to fund Suncor's growth projects to monetize its rich 70 year reserve life of oil sands.

We bought MasterCard because we believe they will benefit from the secular shift of payments from cash to plastic and, since they should grow expenses at a rate less than revenues, they should be able to increase operating margins meaningfully. We also believe the stock was attractively priced at 16x expected 2009 earnings. Furthermore, MasterCard does not bear credit risk; rather the banks who issue the cards bear the risk of loan losses.

We brought AMG to a full weight from a half weight as we became convinced that AMG's business model is intact and their pipeline for acquiring money managers is full. As many as four dozen banks and insurance companies are looking to sell their internal investment management divisions to raise capital. AMG is uniquely positioned with \$1 billion of buying power to selectively acquire best-of-breed asset managers, retain their cultures, and add value through AMG's centralized resources such as marketing, compliance and distribution.

We sold Apollo Group because it was fully priced. However, we added to our position in ITT Educational Services as we believe ITT offers better growth and a lower valuation. Apollo currently has approximately 400,000 students compared to 66,000 for ITT. We are increasingly concerned that it will be difficult for Apollo to continue to grow at a double-digit pace long-term. We also question management's capital allocation strategy of investing in online high schools and international schools, which will generate a lower ROIC than the core domestic schools. These investments support our belief that growth will inevitably slow and that core domestic growth opportunities may be limited for Apollo.

We also sold Nasdaq OMX Group due to losses in key management and market share. Nasdaq's privately held competitors are owned in part by brokers and private equity firms who have a vested interest in steering trades to their own networks at the expense of traditional public



exchanges like Nasdaq. We now believe that execution speed and price are not necessarily the primary factors that determine where trades occur and that Nasdaq's competitive advantage is compromised. Private competition is global and therefore geographic expansion has not been the benefit we expected.

We sold Liberty Global as it was not meeting our expectations for growth. When we bought Liberty, the company was targeting operating cash flow growth of 15%. When Liberty reported their Q408 results in late February, they guided 2009 cash flow growth of just 5-7%. We believe the slowdown in growth is more secular than cyclical given penetration levels that Liberty has achieved. We also became concerned that Liberty would extend its debt maturities from 2014, which was already long-dated, to 2018 and pay a higher interest rate for the new debt, unless it felt that there was a cash flow risk to retiring the 2014 debt. The stock appreciated 68% after they reported Q408 earnings and we felt it was fully valued given the current lower growth rate.

In the first quarter we trimmed our position in Expeditors to a half weight due to poor fundamentals and in the second quarter, raised our position back to a full weight. At the time, our research showed it was prudent to reduce our position. In hindsight this was a mistake; we trimmed the stock at a lower price than where we repurchased. Expeditors' monthly airfreight volumes, were deteriorating rapidly from a decline of 10% in October 2008 to sequential monthly declines of 22%, 24%, 32%, 19% and 30% through March 2009. Ocean freight volumes showed similar trends. Despite this, sell-side analyst consensus expectations for earnings were \$1.43 for 2009 which represented a 4% increase from 2008. So, given the combined threat of negative volume trends and higher earnings expectations, we believed there was downside risk for the stock price. After our trim, the consensus 2009 earnings estimate have declined to a more realistic \$1.28/share, and Expeditors' reported first quarter earnings of \$0.27/sh which was \$0.03 short of consensus expectations and 10% below last year. Expeditors explained that the "March quarter end rush did not materialize to the extent that we've experienced it in the past...We obviously would like to have reported higher quarterly earnings. However, we saw no long-term benefit in resorting to short-term measures, like employee layoffs or other actions which could severely damage the value of our network by compromising customer service capability, just to pick up a couple of cents per share." We met with the company twice in the second quarter and learned that 1) industry fundamentals are improving as recent monthly volume data have increased on a sequential monthly basis, and 2) Expeditors is benefitting from market share gains due to customer concerns about the financial viability and staying power of some of their freight forwarding service competitors who have excessive debt, whereas Expeditors has no debt. We have long admired Expeditors for its results-oriented culture that rewards ingenuity and accountability, its competitive strengths, and growth opportunities with its 3% industry share, so we brought our holding back to a full weight in the second quarter.

In addition to meeting Expeditors' management, **in the second quarter alone we personally met with two-thirds of our owned companies** as well as many other companies in our ongoing research to assure ourselves that we are positioned with the "All Stars" who will navigate this economic storm with success, and emerge with a stronger competitive position by virtue of their unique products, clean balance sheets and superior management teams. We attended the



Berkshire Hathaway annual meeting again in May and found the following observations interesting:

- Berkshire Hathaway's Mid-American Energy Division owns HomeServices of America, which is the second largest real estate brokerage company in the U.S. Warren Buffett said that in the last few months, there has been a real pick-up in bidders and activity, although prices are still down. The environment is improving and interest rates are low. In the U.S., new household formation grows 1.3 million per year (marriages, immigration). New home construction that was running at 2 million annually is now at 500,000/year. He added that we are now consuming excess inventory though it will take time to reach equilibrium.
- The four investment managers Buffett selected as successor candidates for the CIO role at Berkshire performed no better than the S&P 500 during 2008. Vice Chairman Charlie Munger commented further, "They all got creamed. We do not want a manager who wanted to go to cash and hop back in. We would exclude them."
- In response to a shareholder who asked for Buffett's reaction to the market's (under)valuation of Berkshire, Buffett commented, "The marketable securities (that Berkshire owns) are understated. The fair value is much higher. The earnings power of the wholly-owned businesses (ex. underwriting earnings) is not as good as normal this year and last year. A few of the businesses will become sensational...The two variables will count (market value of investments and operating earnings of subsidiaries). We will report them regularly. The long-term float of \$58 billion with a cost below zero is a big advantage." Charlie Munger added, "What matters is this; the property and casualty insurance business is the best in the world. The utility company (Mid American) is the best. The carbide cutting company (Iscar) is the best in the world. It is not easy to get in Berkshire's position (of a dominant leader). After September 2008, GEICO's phone rang more. Many thousands came to the website. For the entire year 2008, there were 665,000 new GEICO policyholders compared to 505,000 new policyholders in just the first four months of 2009. GEICO is the low cost producer with the best value. It is now the third largest auto insurer with a market share of 8.5% vs. 2.5% in 1992 when Tony Nicely took over."

We also met with the following companies in our portfolio and found the following developments interesting:

- Visa reiterated their comfort with earnings growth of at least 20% in 2009 and 2010 citing many cost cutting opportunities and strong growth in debit cards.
- Fastenal plans to grow its international business, which currently represents just 8% of revenues, from \$200 million to \$1.5 billion in revenues in ten years, a level Fastenal as a whole achieved in 2005.
- Aflac is targeting operating earnings growth of 13-15% in 2009 (excluding foreign currency) and an additional 9-12% in 2010. This would imply earnings of at least \$5.00/share in 2010, and with the stock at \$30 (about 50% higher than our average cost in March), results in a price/earnings ratio of just 6x 2010 earnings.
- We met with management and separately toured one of ITT Educational Services newest schools during the second quarter. We are confident in its ability to efficiently execute its proven growth strategy and the company recently increased their guidance for 2009 earnings from \$6.50-\$6.67 to \$7.00-\$7.25. At \$92/share, the stock is priced at less than 13x 2009 earnings.



We believe our composite portfolio's valuation is very attractive. **The free cash flow yield of our invested companies is 6%, the price/earnings multiple is below the S&P 500, our growth and ROE are much better than the market, and the return potential to our estimate of fair values for our companies is over 30%.** The pendulum will eventually swing to a more rational market valuation. As we said last quarter, stay tuned. The reception is getting better.

We hope you enjoy the summer months ahead and encourage you to contact us with comments, requests or questions.

Sincerely,

Lateef Investment Management
Lateef Investment Management