LATEEF

INVESTMENT MANAGEMENT

Lateef Fourth Quarter 2008 Commentary

As a steward of your capital we want you to know how disappointed we are with our results last year. Despite remaining steadfast to our investment philosophy and criteria, which has served us well for over thirty four years, our portfolio of companies stock prices declined with the market despite their superior financial strength. As we reflect on 2008, which was the worst performance for the S&P 500 index in 77 years (since the Great Depression in 1931) with a decline of 37.0%, the surest way to preserve capital in hindsight would have been to avoid stocks altogether. With that said, our equity composites outperformed the S&P 500 last year as we avoided troubled banks, brokerage firms, and the oil/commodity frenzy. Instead, we invested in solidly financed companies that we know and understand with trustworthy and owner-oriented management teams. Despite owning superior companies, the overwhelming and devastating market and economic environment led to a fire storm of fear and uncertainty, creating a "nowhere to hide" situation where even the best companies faced difficult if not impossible headwinds. The remainder of this letter will discuss the rationale for our portfolio activity in 2008 as well as our current positioning. We will also share our perspective on the events of 2008 that, we believe, set the backdrop for the current market environment.

While timing the market may have helped preserve capital in 2008, we believe market timing is futile in the long run. Market timing is less tax efficient, and requires being right about the timing of **re-entry** into the market. According to Fidelity, the S&P 500 return over the past 28 years ending September 30, 2008 was 12.2%, but would have been only 4.4% by missing the best 50 days, which represents only 0.7% of the time. Superior wealth creation occurs with focused investments in outstanding businesses held for many years. This is the model that we have consistently applied at Lateef for over 34 years and that we note is a common trait in many of the greatest wealth creators. We approach investing from a businesslike perspective and evaluate investment candidates through a process whereby we assess whether their competitive advantage that they currently enjoy is intact and sustainable. Once a company passes through our assessment, and we buy the stock at a reasonable price, the compounding of its high return on capital and cash flow will create more value and, over time, a higher stock price. We have no idea how the overall market will perform in the near to intermediate future, so we focus on what we can control. We invest with companies that control their financial and operating destinies by virtue of their durable competitive advantages as reflected by their superior return on invested capital (ROIC), transparent balance sheet, and track record of generating free cash flow. We avoid companies that must rely on the goodwill of strangers to fund their daily lifeblood of capital. **All of our invested companies generate free cash flow and are self-funding. They have a ROIC more than double that of the S&P 500 at 24% vs. 12%, and they generated earnings growth of 16% in the first nine months of 2008 compared to a decline in earnings of 24% for the S&P 500**.

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Expeditors International, a company that we have owned since 1994 and still find attractively priced, delivered 15% earnings growth in the third quarter (13% year-to-date), and its Chairman and CEO Peter Rose commented, “There are no short-term, 'financially-engineered' profitability gimmicks in these numbers that will unravel over time because they lack economic substance. The irony of reporting record quarterly profits in such tumultuous economic times is certainly not lost on us. We have great sympathy for those who have been victimized by the greed, avarice and deliberate desertion of time-proven principles of sound financial management that caused this mess in the first place. If a silver lining is to come out of all this turmoil, hopefully it will be a return to the realms of financial sanity where companies that manage prudently are differentiated from those that don't…Here at Expeditors, we don't need to go 'back to basics', because we've never left them."

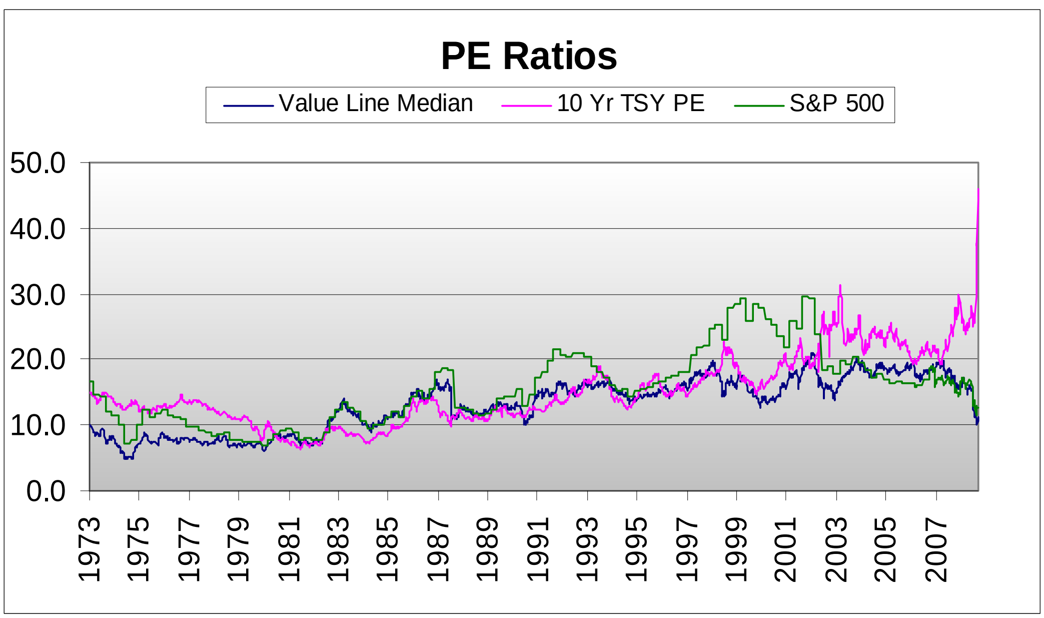
A case in point is Berkshire Hathaway which finished the year down 32% and during the quarter traded below the $87,000/A share liquidation value of its cash, fixed income and equity investments at September 30, 2008. The market price of the stock largely ignores the value of its 70+ wholly-owned businesses such as Geico, Net Jets, Flight Safety International, Sees Candy, Shaw Industries and Fruit of the Loom which employ over 200,000 people, and the value created by Berkshire’s investments this year. Berkshire made $224 million for the promise to insure the state of Florida against a catastrophic hurricane which will be recorded in the fourth quarter. Berkshire will more than double its $1 billion investment in Constellation Energy in less than one year. Despite being an “all star” provider of liquidity in a capital starved economy, Berkshire’s stock price performance was not much different than the broader S&P 500 decline which of course, included many third stringers.

As an investment manager “coach”, we had often wished we could draft our dream team of companies but were hindered because the best ones were often too pricey. One benefit of an undifferentiated market sell-off, is that we have a golden opportunity to draft our dream team since so many companies are now attractively priced. We have adjusted our initial purchase percentage allocation to 5% from 6% to allow for the upper end of our targeted 15-20 company portfolio holdings.

During the quarter we sold Starbucks (SBUX) and American Express (AXP) and, where appropriate, bought Fastenal (FAST) and added to Affiliated Managers Group (AMG). Starbucks disappointed us when their CFO abruptly resigned after less than 18 months on the job to become the Chief Administrative Officer of Hewlett Packard. We doubted SBUX’s commitment to adopt certain new financial incentives that the former CFO crafted, and the company’s store sales show no sign of bottoming. We believe AXP’s business model is structurally weakened because 1) U.S. central bank federal regulators adopted tougher restrictions which will restrict AXP’s ability to raise interest rates on its credit cards loans which is the biggest change to the industry in a generation, and 2) by choosing to become a bank holding company, AXP is trading access to the government’s Troubled Asset Relief Fund program for more costly compliance costs, tougher regulation, higher capital requirements which will structurally lower its ROE. Also as consumers and businesses continue to deleverage and consume less for what could be a longer than expected cycle, their spend-centric business model becomes less effective.

We bought Fastenal as we became convinced that the company's Pathway to Profit initiative, which is a shift in its growth model to add more sales people per existing store and moderate store growth, will offer more flexibility to achieve its goals. Among these goals are an increase of operating margins from 18% to 23% by 2012 and an increase of ROIC to the low 30% range from the low 20s despite current near-term macro-economic headwinds.

In the fourth quarter of 2008, the S&P 500 fell 21.9% which was the fourth worst quarter since 1929. Investors did not lack for things to worry about, from the length and depth of the recession to toxic subprime mortgage loans just to name a few. Panicked investors stampeded to the safety of U.S. Treasury bonds and, for the first time, were willing to accept no return for three months. Yields on 10-year Treasury bonds fell to just 2.2% by year end which, after taxes and inflation, will likely result in a negative real return. The implied P/E of the 10-year Treasury bond (inverse of its yield) is an outlandish 45x. In recent years, we have lived through bubbles bursting in technology and telecom stocks, housing, energy and commodities, and it now appears, Treasury bonds are setting the stage for their own bubble. Stocks are a relative bargain with a P/E of 11x according to the Value Line index (a proxy for mid-cap stocks) and 13x for the S&P 500 index (a proxy for large cap stocks). Clearly, there is more uncertainty in the "coupon" for stocks, but stocks have not been this cheap in modern history without high inflation.



For the ten years ending 2008, the S&P 500 average annual return has been a negative 1.4%, which has only happened twice, in 1938 and in 1939, despite earnings that are over 50% higher than 10 years ago even after the massive write-offs by financial companies in 2008. Yet, for the 80 years ending 2008, the S&P 500 has returned 10.6% on average annually despite two World Wars, a presidential assassination, impeachment and resignation, a major depression, double-digit inflation, 9/11 and major foreign currency devaluations. The pertinent question is whether investors have recently lost permanent value through a structural impairment, or whether this historic selloff is yet another unpleasant but recurring bear market and an opportunity for investors to accumulate bargains. Sir John Templeton advised, "Buy at the point of maximum pessimism" By any measure, U.S. pessimism is pervasive. Adding salt to the wound of the severest stock market decline in 77 years, the U.S. Consumer Confidence index fell to an all time low in December 2008 to 38.0. Home prices continue to fall and are down 25% from peak levels in mid-2006 according to S&P Case-Schiller. Unemployment, currently at 6.7%, will probably exceed the average recession levels of 7.8% and may even surpass 10% as it did in 1982. The credit virus has infected worldwide economies, many of which are deleveraging at the same time, and are prolonging the downturn. Yet there are reasons to be optimistic about stocks.

First, valuations for stocks are compelling with attractive P/Es in the low teens. The dividend yield of 3.1% of the S&P 500 is higher than the 10 and 30 year treasury yields for the first time in 50 years. The peak-to-trough decline in stock prices of 45% from October 2007 is equal to that of 1974 which was the worst decline in modern time and proved to be a terrific time to buy. Volatility has been extreme as the number of days the market had intraday moves of at least 5%, was over 40 in 2008 compared to just 27 for the 50 years from 1950-2000! Inflation is dormant. Oil prices began 2008 at $96/barrel, peaked at $147/barrel in July driven by speculative buying, and then collapsed to $45/barrel by year end. This decline since July is an effective $265 billion stimulus to the consumer. There is huge pent-up buying power as $9 trillion is parked in cash, bank deposits and money market funds. This amount is a 20-year high and represents 75% of the value of the entire stock market. In October, Warren Buffett wrote an editorial where he said, "If prices (of U.S. stocks) keep looking attractive, my non-Berkshire net worth will soon be 100% in United States equities…Equities will almost certainly outperform cash over the next decade, probably by a substantial degree."

There are distinct winners and losers in this environment. While the media breathlessly decried the headline public equity disasters that were structurally impaired such as AIG, Freddie Mac, Fannie Mae, Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia, MBIA, and GM, which we avoided, nary a word was heard in the media for our unsung heroes who are powering through this slowdown, gaining share and will emerge even stronger when the economy rebounds.

Buffett has said that "If you lack knowledge, fear will drive you out at the bottom." We travel about one week/month visiting our owned companies as well as other competitors and customers to build our knowledge and conviction. It is this conviction that is the foundation for our belief that this is not the time to be fearful with others, but to be opportunistic to take advantage of others' fear.

Like Expeditors, we believe we have never left the basics of how we operate, which include trust and transparency. One of our 25 criteria for investing in a company is whether we like, trust and admire management, and could even envision working for the CEO as a test for integrity. We expect to be treated as equal partners/owners and insist on clear-cut transparent financial reporting. If we don't understand the company or its financials, we will pass. Unfortunately, the credit crisis has been a classic breach of trust on the part of lenders, regulators, rating agencies, and investors in the name of greed and a short-term performance focus. More recently, the alleged fraud by Bernard Madoff whose Ponzi scheme is estimated at $50 billion and has resulted in at least one suicide, is an egregious example of a company veiled in secrecy who provided suspiciously ultra-consistent returns. The fallout will hopefully reward investment firms like ours who are transparent.

The markets of 2008 tested the resolve of every investor. In these times of stress we are reminded of the simple basics of investing: invest only in what you understand, don't invest funds that you will need in 3-5 years, use leverage prudently, if at all, as it can enhance returns but significantly increase risk, and keep the proper temperament for investing by avoiding the herd mentality. At Lateef, we are committed to continue investing in what we understand, operate with trust and integrity, and communicate with transparency.

We discussed the importance of integrity earlier with regard to the companies we own in your portfolio. We want to remind our clients of our focus on integrity with our business as well. Our performance is CFA Institute compliant, we are verified annually by an independent CPA firm and we are examined by the SEC on average every five years. We expect the highest integrity of each other and we are transparent in our communication. We issue quarterly letters updating our investment strategy, we conduct webcasts which elaborate on our quarterly letters, and we are available by phone or in person to answer any of your questions.

Late in 2008, Lateef sold a minority stake to Rosemont Investment Partners, a private equity firm focused exclusively on making investments in asset managers. Rosemont has tracked our firm for many years and respects our investment process and transparency, making them an ideal partner to assist us in recapitalizing a minority interest. Rosemont's investment does not constitute a change in control and there are no changes to the daily operations, the portfolio management process, the team, or management structure at Lateef. The structure of the Rosemont investment gives either party an option to unwind the investment after four years and we anticipate that the minority interest will be repurchased in year five.

As usual, our website (www.lateef.com) has been updated with our current ADV Part II and privacy policy. Both documents are also available in hardcopy format upon request.

For additional insight into your portfolio, our Q408 webcast is available at www.lateef.com. Thank you for your trust and confidence and as always, if you have any questions, please contact us.

Sincerely,

Lateef Investment Management

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