



LATEEF

INVESTMENT
MANAGEMENT

April 2, 2008

Dear Client:

It is our privilege to serve as a fiduciary steward of your capital. We take that role very seriously. We believe one very important requirement of our job is to communicate with you, our client. We strive to be as open and honest as we possibly can. In these letters, our goal is to educate and inform you not only about our investment philosophy and process but also discuss current events and how they impact your portfolio and our thinking. In the end, we hope that you will understand our philosophy, process and people to make an informed decision about your association with Lateef for the long-term.

The first calendar quarter of 2008 has been a very challenging start to the year, to put it bluntly. The S&P 500 Total Return Index is down 9.44% and volatility increased during the quarter (radically, up) over 40% from the end of 2007 (as measured by the volatility index, also referred to as the VIX). The price correction has been driven by the continued struggles of the housing market, Bear Stearns precipitous fall (and eventual “take-under” by JPMorgan Chase) and realization of an impending recession. **For long-term investors like Lateef, this market is bittersweet as it can provide some phenomenal opportunities for our clients to own great businesses at better prices but at the expense of short-term poor performance (on paper, at least).** Long-term investing requires enduring some peaks and valleys in the stock prices of the companies we own. The intrinsic value of our companies may progress at a relatively steady rate, but the stock price may fluctuate wildly around that intrinsic value at any given point in time. In fact, stock prices often gyrate nearly 50% or more in a given year. At Lateef, our process reinforces our understanding that the intrinsic value of the companies we own is not nearly as volatile as the stock price may suggest.

A look at history provides some empirical evidence for remaining steadfast in our commitment to long-term investing. We did a study of the S&P500 over the past two decades ending 2007 to identify the top 10 best performing stocks over each 10 year history. These were stocks that compounded their stock price anywhere from nearly 30% to over 60% per year for the full 10 years – these literally are the best of the best during their respective time horizons. They included such well-known names such as Microsoft, Apple, UnitedHealth, Best Buy and Amazon.com. What we learned is that every single one of these stocks had, at minimum, a 36% decline in their stock price sometime during their 10 year run. In fact, the smallest pull-back was approximately 36% but the average decline was in excess of 60%. There were several stocks that fell over 75% during their remarkable run, including Apple Inc which fell nearly 80% in the year 2000. Yet, as we mentioned, if an investor had the conviction to hold onto these stocks even during a harrowing pull-back, they would have been rewarded by owning the best returning stocks in the S&P 500 over that 10 year period. Our interpretation of this information is that patience truly is a virtue and conviction is paramount if you own value-creating companies purchased at a substantial discount to intrinsic value.

In this volatile market, nominal price moves can sometimes be associated with actual fundamental value changes. This is a mistake to assume that price always equates to value, in our opinion. As Warren Buffett has said: “price is what you pay, value is what you get”. Although we investigate and are mindful of any new “news” (even simply a large price change), at Lateef, we focus on what we can control – understanding a company’s competitive advantages and appropriately valuing the businesses in which we



invest our client's capital. We do not attempt to "predict" changes in investor sentiment nor do we try to "know" the psychology of the millions of market participants that vote on the value of a stock on any given day. Long-term, it is our strong belief, and a cornerstone of our investment philosophy, that stock prices will reflect the underlying value of the sustainable cash flow generation of the company. We focus on the fundamentals of the businesses we own, or are considering purchasing, to comprehend what the future cash flows will be. If the stock price is trading at a substantial discount to the risk-adjusted intrinsic value, we unreservedly purchase a piece of that business. With time, if we are correct in our valuation, our clients have a true margin of safety with limited downside and significant upside.

A central tenet of our investment philosophy is our long-term investment horizon (we define as a minimum of three to five years). We believe this is one of our true competitive advantages in the investing world. We can consider investment opportunities that many of our peers cannot due to their focus on short-term performance. In essence, a longer-term time horizon allows us to be true contrarians and purchase out-of-favor or over-looked businesses whose stock should rebound as the temporary, or non-structural, issue is resolved. However, **having a long time horizon also means that, by necessity, we will have to endure volatility** – over a three or five year plus holding period, our owned stocks will experience meaningful price changes (and not always to the positive). These changes, particularly to the downside, can truly test one's patience and conviction. That is why we invest in outstanding businesses with attractive financial metrics (we define as sustainably high return on invested capital), run by competent and tenured management teams in rational and growing industries. We forego numerous companies that do not meet our stringent criteria for investment. This has served us extremely well to avoid many of the implosions that have occurred over the years. Nevertheless, your portfolio has not been immune to the overall market decline with many of our owned names declining since the beginning of the year. In the short-term (we define as less than six months) during very strong or very weak markets, most stocks move in-line with the indices. Thus, in dramatic downdrafts as we have witnessed, most stocks participated in the decline. Our job is to find those companies that, over the long-haul, will demonstrate their cash flow/earnings power through numerous economic environments. Over-time, this sustainable cash flow generation will ultimately be reflected in an appropriate valuation in-line with their intrinsic value. Or, to put it more brusquely, in market downdrafts, we are looking for the tennis balls and trying to avoid the eggs.

One company that we believe will emerge as a tennis ball is NASDAQ OMX Group. NASDAQ's stock was down 21.9% in the first quarter of 2008 versus a decline of 9.5% for the S&P500 Index. NASDAQ operates the Nasdaq Stock Exchange, a leading provider of securities listing, trading, and information products and services. In our opinion, the company has aggressively established numerous future value creating opportunities through their acquisitions of OMX, Boston Exchange and Philadelphia Exchange as well as building their option and 144A trading platforms. These activities are highly additive to the company's core operations. The primary value creator for any exchange is driving highly profitable volume growth. Longer-term, we believe NASDAQ should be able to capitalize on its scale and network advantages by aggregating more volume through their electronic trading platforms with better liquidity and lower prices than their competitors. The more trading they can aggregate at their exchange due to better pricing and enhanced liquidity will lead to a virtuous cycle of a stronger need for customers to conduct business on the NASDAQ platforms. Lastly, NASDAQ is a major beneficiary of the fear/greed cycles that occur in the market. During these cycles, volatility increases dramatically and that produces more volume to the exchanges. For NASDAQ, we are very comfortable with our investment and anticipate the market will reward it as it continues to execute on its growth strategy.

One characteristic that the NASDAQ OMX Group exhibits and is required of all of our owned names is the stability and sustainability of the company's franchise. When evaluating any business for an investment, one must be able to confidently believe that that business will be viable long-term and be able to make a reasonable estimate of the economics of that business over time. The past is often prologue for



gauging the future of a business. We only invest in businesses that have a proven track record of success and have a business model that can weather economic instability. For example, most of our businesses have been in operation more than thirty years with at least one in operation over 150 years. As relevant as the past is to understanding a business, the future is the determinant on the direction of the stock. Thus, we spend our entire focus on identifying and monitoring the key value drivers of a company's future cash flows and why they are sustainable with time. These competitive advantages need to be protected and nurtured by the company. Any deterioration in these competitive advantages is a cause for concern. Tying together the earlier comment on how current price declines do not necessarily reflect value deterioration, if a company's competitive advantages remain in-place and the long-term growth drivers have not changed, then our owned names are poised for sizable stock price out-performance as the businesses compound value with time (assuming we were correct in our value assessment at time of purchase).

Another criterion required for investment is that a business be a long-term cash producing asset and conservatively financed. This should go without saying for any long-term investment; but, needless to say, many traders are willing to speculate that a stock can be a 'trading tuna' and that someone else will pay more for the name. We refer to this as the greater fool theory, of which we are not believers. Our investments generate cash (the more the better) upon which we can make reasonable assumptions to value the company. In fact, the median free cash flow yield of our invested companies is approximately 5% and we believe they will be able to compound this free cash flow at high rates for the foreseeable future. These businesses have demonstrated the ability to generate sufficient cash to fully pay for internal growth as well as external uses such as paying a dividend, buying back shares or making an acquisition. In other words, our companies are self-funding and thus are not held to the whims and idiosyncrasies of Wall Street to supply them with capital at critical junctures in their corporate lives. We do own some companies that hold a net debt position (total debt minus cash), but these companies do not carry principal risk (i.e. their debt is not due for many years in the future and their core businesses generate enough cash to self-fund current operations). Most of these companies have used the debt to provide a higher return on equity ("levered return") without incurring undue risk to their operations. This is in contrast to numerous examples you may have read about in the past three months. Maybe the most prolific example is Bear Stearns, the investment bank founded in 1923 which traded as high as \$93/share in February this year, and recently agreed to be acquired by JP Morgan for \$2/share (eventually raised to \$10/share) in mid-March. Similar to most investment banking firms, the company's entire business was built on credibility, confidence and capital; of which the storied financial firm ran out of all three at the same time.

Given the market volatility and drastic swings we have witnessed this first three months of the year, a reasonable question from a client might be why does my account carry so much cash? Or, another client may be asking why don't we have a larger cash position? At Lateef, we are not macro-economists nor do we try to time the market by making broad macro calls. We build your portfolio one stock at a time. Each stock is a mutually exclusive decision and must stand on its own merits for it to be purchased for the portfolio. In our company-specific analysis, we include scenarios of various potential economic environments as well as changes in the economic markets in which our companies operate to fully encapsulate the potential risks and rewards of that investment. We are focused on a concentrated group of select investments whose businesses we believe should succeed over the long-haul through various economic cycles.

Another central tenet of our investment philosophy is our absolute return focus. Specifically, we strive to preserve our client's capital in down markets and grow your capital in excess of broad market indices over a long time horizon. We have two primary tools to preserve your capital. The first, and preferred method, is to invest in great companies at substantial discounts to their underlying intrinsic value and which the investment exhibits an attractive risk/reward tradeoff. Unfortunately, the market does not always provide sufficient investment opportunities that provide a substantial margin of safety for our



client's funds. In this case, we utilize our second method of capital preservation – we hold cash until we find a great investment. **Cash is purely a residual of our investment process.** If we do not find great investment opportunities, we are very comfortable holding interest earning cash. Many market pundits have questioned holding cash with the assumption that investment managers should invest 100% of their client's assets in the market all the time. The theory goes that the client is funding their investment manager with capital that is their equity portion of their capital allocation. Thus, the manager should invest 100% of their funds to ensure the client has this equity exposure. We believe that our clients invest with us to grow their capital in excess of broad market indices over a long-time horizon. Through our experience, we have found the best way to make money is first not to lose it. Ultimately, remaining 100% invested all the time is an opportunity cost for our clients - oftentimes, the best time to buy is not the best time to sell and vice versa. If we are fully invested in a dramatic downturn in the market, we will not be able to take advantage of investing in some great opportunities. Consequently, you have our assurance, we are working as hard as we always do to find new ideas and will enthusiastically invest when we find great opportunities that will generate exceptional risk-adjusted returns; but we will only deploy your capital when we have found the best and highest use (including cash as a consideration).

We would like to end this letter on why we remain very positive on the long-term opportunities for our clients. We recognize the market may remain very challenging for the foreseeable future; or, as markets have been known to do, we may have reached a bottom on which we can move higher. We do not attempt to forecast market movements, nor do we try to pretend to know how the market will “act” in the next quarter. We focus all of our efforts on investing in great companies, operated by outstanding management teams with powerful business models that have sustainable competitive advantages. We then wait patiently to purchase these businesses at significant discounts to their intrinsic value. Our patience and discipline should be rewarded with time as these companies execute on their strategy. We believe we have built an outstanding portfolio of companies that you, our client, will be proud to own over the long-term.

As usual, we will be mailing your *Client Status Report and Summary of Investment Results* for the quarter ending March 31, 2008 around the fourth week of April.

Thank you for entrusting us with your confidence. We appreciate your support and look forward to communicating with you in the future. As always, if you have any questions or comments, please feel free to call.

Sincerely,

Lateef Investment Management