



LATEEF

INVESTMENT
MANAGEMENT

July 14, 2008

Dear Client:

We have said that investing is a marathon, not a series of sprints. In this Olympic year, the economic and market conditions have tested the resolve, patience and endurance of investors. But, like the athletes preparing for the Summer Games, we believe focus, discipline and persistence will differentiate us in the long run. While we are disappointed with our performance for the first six months of 2008, we have been through similar performance downdrafts four times before in the last 10 years and have ultimately recovered. Our process has been time-tested for 34 years. The rationale supporting the investments in your portfolio of stocks has been vetted through the same filter and we continue to retest our rationale with ongoing visits with management as well as their constituents such as distributors and customers. The portfolio today is consistent with our history of owning the best businesses with characteristics that are superior to the market. For instance, the composite return on equity of our companies is 28% compared to the long-term average of 12-15% for the S&P 500 and the consensus earnings growth for 2008 is 14% for our companies compared to no growth for the S&P 500.

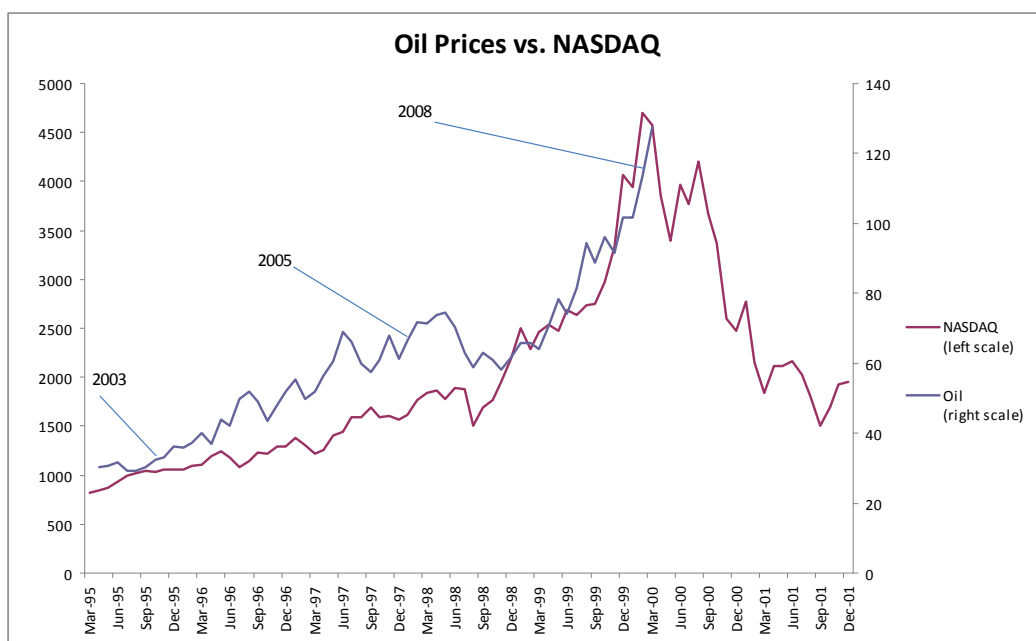
In the second quarter, the S&P 500 fell 2.7% and for the six months, declined 11.9%. Excluding Energy, the S&P declined 15% for the first six months. Since reaching its record in October 2007, the S&P has fallen over 18% in price and is on the threshold of a bear market 20% correction. The Dow Jones Industrial Average touched this level in late June following the Nasdaq's toe-tip in March. The primary reasons for the correction are concerns for the health of consumer spending in light of declining home prices and gas prices nearing \$5/gallon, and the health of business spending due to higher energy costs and the continuing fallout from lax lending standards. Worries over high energy costs and its impact on inflation are not lost on overseas markets. European indexes are down 20% at the mid-year mark and last year's darlings, India and China, dropped 30% and 50% respectively this year.

Today, investors are faced with several challenging questions. How will consumers react to single family home prices which, according to Standard & Poors' Case-Shiller national index, declined 15% in April 2008? Are our investments resilient to the effect of consumer confidence at its lowest level since 1992? How do we invest if we are in a recession? How is our portfolio positioned if we are facing inflation or stagflation (no growth coupled with inflation)? How exposed are we to the continuing aftershocks of financial crises induced by lax credit from last year and much tighter credit now? With oil prices



soaring past \$140/barrel, what are the opportunities and threats for investors? More importantly, do our investments have the ability to thrive even if the economy experiences a sustained slowdown? We will address these important questions in this letter.

We suspect that the primary driver of the worldwide market declines, the doubling of oil prices in the last 12 months is itself a bubble, not dissimilar from the technology bubble of 2000 and the housing bubble of 2006-7. At their respective peaks, advocates argued that the internet would forever change technology and that continuing immigration would forever sustain higher U.S. home prices. Advocates for higher energy prices argue that voracious demand from developing countries such as India and China and mature oil fields will forever result in higher oil. As the chart below indicates, the price of oil has eerily tracked the development of the bubble in technology stocks.



Oil is a commodity and as such, is not immune to repeat its more than 100 year history of cycles, albeit at perhaps a higher trough level. In late June, Saudi Arabia pledged to increase production. Global demand is likely to ease in reaction to higher prices. Indeed, China recently lowered its subsidy of oil by 18% to curtail demand. Substitution is already occurring with natural gas and hybrid cars. For the first time since 1979, the number of miles driven in the U.S. this year is falling. When the Federal Reserve begins raising rates to combat inflation, the dollar will rally and, because oil is traded in U.S. dollars, it follows that oil should decline. U.S. regulators are gearing up to limit the role of speculative oil traders including hedge funds, pension funds and investment banks which now account for 70% of trading of oil on the Nymex compared to 37% eight years ago. Commodity index funds have grown more than 20x in the last five years from \$13



billion to \$260 billion. Congressional democrats have proposed increasing commodity margin requirements from less than 10% currently to 50%, the same margin as stocks. The point is that a commodity that has tripled in the last five years and doubled in the last year, is ripe for a correction, and when it does, is bullish for the stock market.

We do not have exposure to energy or commodity materials companies which were the only sectors with positive returns in the S&P 500 index so far this year. One of our criteria for investing in a company is that it has a sustainably high return on invested capital. This means that the company has a unique product or service characterized by high and growing profit margins and is not subject to external forces beyond their control such as commodity prices or regulation that can victimize the company. We want to own companies that can control their destiny with a differentiated product and has pricing power. We expect to own companies that can power their way through a general economic slowdown.

We agree with Warren Buffett when he said that preserving capital in an inflationary environment is best achieved by owning businesses that can price adequately and require relatively low capital investment. He added that he is nervous if a company is labor intensive and produces a commodity product. On that note, Apollo Group which is the holding company for the University of Phoenix for profit schools for working adults, announced it will raise tuition by 10% for associate level students and 5% for bachelor and masters students effective July 1 because Apollo's tuition levels were below the recently raised government guaranteed loan limits. Colgate intends to raise prices on toothpaste by 9% this fall and its primary competitor will follow its lead. For consumers, the effective \$.30 price increase is easily tolerated over a typical two month usage of a tube of toothpaste and there is no meaningful private label under pricing toothpaste as is so common in other consumer products. In the first quarter of 2008, Berkshire Hathaway priced its first \$400 million of insurance premiums for municipal bonds (a new business for BRK) at a 2% rate. Investors in munis were willing to pay for true AAA quality bond insurance on top of the customary 1% for what was then considered AAA coverage by MBIA or Ambac, but now is considered at risk. Apollo, Colgate and Berkshire are just three examples of companies in our portfolio that have pricing power with a differentiated product and capital strength.

We do not own any banks or brokers. Our only exposure to consumer credit losses is with American Express but we believe the exposure is contained due to the higher quality of the customer base, the strong business spending component and its international breadth. The financial sector was the worst performing sector in the S&P 500 with a six month drop of 30%. We are encouraged that the peak of subprime loans that are scheduled to reset from a low teaser rate to a fully indexed rate is this Summer and that related credit losses should abate with this cohort.



With the sell-off in the market we have taken the opportunity to add Expeditors International, Costco, Colgate and Starbucks to accounts with available cash. They possess the “tollgate/all weather” business characteristics we admire along with strong brands, first rate management teams, history of excellent business performance, strong cash flow and attractive stock prices. Starbucks is more of a turnaround situation but, having recently met with the CEO and CFO, we are convinced they have the right recipe for long-term growth with new products, new store format, renewed growth overseas and an improved incentive compensation system that rewards store managers for store level performance and senior managers for return on capital.

At this leg of the investment marathon, there is a headwind to be sure, but we have navigated this turbulence before with success. It is times like these that we are reminded to “be greedy when others are fearful, and fearful when others are greedy.” We have personally met with or spoken with all our owned companies in just the last few months and our overall conviction is high that they retain the leading competitive advantages and ability to increase cash flow and intrinsic value that led us to invest with them originally.

We continue to invest internally to better serve you with our investment and client service and operational capabilities. We recently added James Tarkenton, CFA MBA to our portfolio management team whom we have known for three years and who shares our investment philosophy. We terminated our relationship with portfolio manager Matt Ankrum who had relocated back to his home town in Colorado for family reasons and we strongly believe that a collaboration of team members is most effective in the same physical location. James is not a replacement for Matt, but a continuation of our efforts to strengthen our team when we identify talented individuals. We added Conni Brinkman and Jacqui Musgrave to our marketing and client service team. Lastly, we added four members to our operations group to boost our reconciliation and reporting capabilities.

Thank you for your confidence and please don't hesitate to contact us if you have questions or comments.

Sincerely,

Lateef Investment Management