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AMARILLO OFFICE

701 South Taylor, Suite 320 Amarillo, Texas 79101 806-371-9233 2nd Quarter 2003

CAZ CORNERSTONE PORTFOLIO Quarterly Update

My, what a difference a quarter makes! The market never ceases to surprise people. There is an old saying on Wall St. that the market will always find a way to hurt the largest amount of people it can. While at first glance it appears to be a very cynical statement, it makes a very clear point about investor psychology. In the 2nd quarter the market gave us a very clear lesson in market psychology. In March, it was almost impossible to find anyone bullish, and many professional investors were carrying large short positions. The war was in full force, the economy was lousy and corporate profits were disappointing. What did everyone want? Bonds or cash. Well, as you now know, the masses were completely The stock markets around the world staged one of the most substantial rallies in modern history. We need to go back to the fall of 1998 to find a more substantial single quarter rally for the S&P 500, which rose by more than 15%. We are very pleased to report that our Cornerstone portfolios significantly outperformed the market and our Concentrated Cornerstone portfolios nearly lapped the broad market.

Let's go back to our 1st quarter letter and pull a direct quote.

"We feel there are three main factors that will benefit U.S. stock prices in 2003-2004:

- 1. Continued stabilization of geo-political events
- 2. Fiscal stimulus out of Washington, including possible dividend taxation relief
- 3. An increase in corporate profitability as the economy recovers"

Now let's see what happened in the 2nd quarter. First, the war ended positively. Next, our government passed sweeping tax relief measures, including a reduction in the double taxation of dividends. Finally, in spite of a still sluggish economy, corporate profits have improved sharply. All of these factors, plus the incredible amount of buying demand from short covering, asset allocation adjustments, and cash moving from the sidelines allowed this massive market rally to occur.



"Show Me The Money"

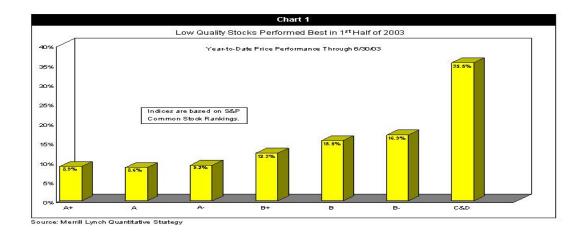
Here is where it gets difficult. We are at a critical juncture for the economy and the stock market. While the outlook for corporate profits and the economy has improved, most of what has changed has been just that, the OUTLOOK. This has allowed stock prices to jump dramatically through multiple expansion. Over time stock prices must be supported by corporate profits. An illustration will make this point. Toys "R" Us (TOY) was one of our top performing stocks in the 2nd guarter, rising by more than 48% in just three months. You would expect that the company must have reported tremendous earnings, fantastic guidance or both. None of these occurred. In actuality, the company reported nothing positive during the quarter. Earnings were reported for the period ending May 3rd that were very weak as they typically are in any quarter other than the Christmas guarter. Same store sales for the guarter were down 1.5% in the U.S. Total sales grew by only 3.6%. Inventory levels grew by 9% which was much faster than sales. They did make some reassuring comments about their balance sheet and reaffirmed guidance for this year of \$1.15 per share, but nothing eye popping. When the stock was at \$8 the company was expected to earn \$1.15, but why did the stock go to \$12 in just three months? Simple, investors were ready to look at the glass as half full instead of half empty. Instead of assuming the company should trade at 7X earnings, investors were willing to pay 10X. That is psychology. The same story was repeated in company after company, industry after industry, and this caused some stocks to skyrocket.

The movie "Jerry Maguire" made the phrase "Show me the money" famous. That is what we think of when we look at the stock market today. Valuations have grown by more than 20% from the lows. Corporate profits have to rise just as dramatically in order to justify these stock price gains. If they do not, people will realize that we have gained too much too fast. Let us be clear, one of the points we made in the last letter was that we felt our portfolio was very reasonably priced compared to what we think these companies can generate in cash flow. That was one of the factors for our optimism. We still feel that way about our portfolio, but the market in general is not as reasonably priced after this move.

There was a VERY disconcerting side effect of the huge rally. Investors started chasing stocks, but the lowest quality companies went up the most. This is bothersome. As the chart below shows (Chart 1), companies with the worst balance sheets saw their stock prices rise the most in the first half of 2003. Companies rated C and D, by S & P, went up by an AVERAGE of **35.5%.** The average A rated company stock went up by an average of **9%.** There were many companies near bankruptcy that rose by 50, 100, even 200% during the QUARTER. This is not healthy for the market. It shows a return to speculative behavior and also indicates how much of the rally was driven by short covering. Company profits now need to "show us the money" or else we will suffer a correction of the recent gains. Although we do not think a major correction is



around the corner, it would not surprise us to see a consolidation of the market, which we would view as very healthy.



The economy is the next area that we feel must "show us the money". So far the economic results have been mixed, at best. While capacity utilization and industrial production has been better, the employment picture has not really improved. One thing is very clear to us, without job growth, economic growth will be muted. The economy can still improve in what is known as a "jobless recovery," but it is much more tenuous and not as stable. We are confident that the monetary and fiscal stimulus that we have seen will help job growth, but it needs to happen soon.

We have been very pleased with the performance of our companies in the latest earnings cycle. As a general rule, our portfolio companies are continuing to manage their businesses as well as possible in the difficult environment. One example of a company that is truly "showing us the money" is Merrill Lynch (MER). We did a complete write-up last year on our expectations for this company and why we bought it. We are pleased to report that they are exceeding our expectations. In the quarter just reported, they demonstrated how they have been able to grow revenues while at the same time cut expenses. We truly witnessed the leverage they have in their operations to a better revenue environment. MER reported earnings of \$1.05 vs street expectations of \$.70, a 50% surprise. Additionally, this was their second highest quarterly profit in their history. They also achieved the highest quarterly pre-tax profit margin in 25 years. These earnings represented a jump of 61% over last year. Not all companies are reporting results as dramatic as MER, but we are consistently pleased with the performance of our companies.



Interest Rates

Last quarter we stressed how negative we were about the bond market. Interest rates now appear to have bottomed and have staged a MASSIVE increase in a very short period of time. Ten-year treasury yields have increased from their lows of 3.2% to more than 4.2% in six WEEKS. This rise is almost unprecedented and dramatically illustrates the old Wall Street saying we quoted above. EVERYONE wanted more bonds, and those who were late to the party are being severely punished. Again, this market may have moved too far too fast, but it is clear that rates probably should not have been so low to begin with (just as the Nasdag should never have been at 5000 in early 2000). While we do not pretend to be economists, it would not surprise us if rates begin to stabilize near these levels. We stress again, monitor your asset allocation. If the rise in stock prices and drop in bond prices have taken you away from your targets, make adjustments. Our very short maturity focus in fixed income portfolios has allowed us to avoid most of the pain of this move. We are not moving our durations significantly, but if rates continue to back up, we will begin to take advantage of the higher yields and lock in slightly higher rates.

Outlook

We remain cautiously optimistic. There can be no question that we are less bullish today than the last time we wrote you. We grow less bullish when companies become expensive and more bullish when they become less expensive. Therefore, it would not surprise us to see a consolidation of prices as earnings catch up to valuations. What we can say is that we are very pleased with the performance of our portfolios. The earnings results we are seeing from the companies we own are very encouraging. Barring any economic or geopolitical surprises, we believe this new bull market will continue in a modest way in the second half of the year and into 2004. As you know, we will not try to time the market. We will continue to pick stocks, and we firmly believe that this bull market, unlike the last, will best reward stock pickers.

We are pleased to report that we have added a market presence in Dallas. Dan Sheedy has joined CAZ as a Vice President of Marketing. Dan has spent over 12 years in marketing, portfolio management and client service. His professional career includes marketing investment management services to large institutional pension funds, endowments, foundations and high net-worth individuals for Sanford C. Bernstein & Co. Inc. and as a portfolio manager for JP Morgan & Co. Inc. and Barrow, Hanley, Mewhinney & Strauss, managing over \$1 billion of US Equity portfolios. Prior to his finance career, he served as an officer in the United States Marine Corps. He is a graduate of Auburn University with a degree in Finance, earned an MBA from Golden Gate University. Additionally, he is a Chartered Financial Analyst (CFA), and a member of the Dallas Society of Investment Analysts.



We are committed to providing you with the service that you deserve. Please know that you are appreciated as a client, and please let us know what we can do to better serve you.

All my best,

Christopher Alan Zook Chairman and Chief Investment Officer