As of 9/30/2003	
3Q 2003:	3.48%
YTD:	17.97%

CAZ CORNERSTONE PORTFOLIO

Performance Update

A Pause to Refresh?

The third quarter was characterized by stabilization. The stock markets were relatively benign, and finished slightly higher. Interest rates saw lower volatility and gradually rose during the quarter. Corporate profits were fairly consistent and are beginning to show signs of improvement. Economic indicators came in more or less as expected, again showing some signs of a healthier economy. The geo-political landscape, while still uncertain, was free from any large-scale disruptions. During this period, the S&P 500 rose by 2.65%. The CAZ Cornerstone Portfolio performed better than the market and stretched its sizable advantage vs. its benchmark. We are extremely pleased with the performance of the vast majority of the companies that we own. Valuations are richer than they were six months ago, but for most of the portfolio we still feel the market is placing reasonable prices on our companies. There are some stocks that have outpaced their fundamentals. We are watching those positions very carefully, and in some cases reducing our exposure. Our overall posture is that of "cautious optimism." For clients that have been with us for a long time, you will recall that the last time we had this stance was in 1998. We feel the market still has room to the upside, but we also feel the risk profile of the market has increased. There are still many companies with good valuations in the markets, and we are excited about our portfolio. It is a simple fact, though, that compelling ideas are harder to find.

As we stated in our last letter, this is a critical juncture for the markets. Valuations have risen dramatically and earnings have to match or exceed expectations for these valuations to hold. As of October 20, 159 members of the S&P 500 had reported earnings for the 3rd quarter. Of those, 81.1% had met or beaten expectations. This is an improvement over the 2nd quarter when 75.5% had delivered results above expectations. This is encouraging, and we will be watching for the results versus our expectations of each company we own. The most dramatic results have come from companies that have seen significant benefits from cost cutting measures. As we illustrated in our last letter with Merrill Lynch, when the revenues begin to improve for companies that have trimmed expenses dramatically, the profitability expansion is magnificent. The challenge for these companies is to find a way to accelerate revenue growth in a still sluggish economy. Almost all of our companies have begun to see fairly consistent increases in demand, but they are not increases that we would consider dramatic. This top line growth will be one of the most important metrics that we will watch in coming quarters as we know the cost cutting benefits are close to fully utilized.

The news on the job front is starting to improve and has garnished a tremendous amount of attention. The September employment report showed a nice gain in jobs, and manufacturing work hours increased. A forward indicator that we like to watch, temporary employment, experienced its fifth straight increase. At some point companies will stop hiring temporary help and add to their permanent payroll. We also feel that it is important to take a step back and look at historical rates of unemployment. During the 1982 recession, unemployment reached 11%. In 1992 the highest level was 8%. Therefore the current level of 6.1% is not outside of historical norms, and one could argue that this figure is very mild compared to past recessions. This is why we are not more concerned about the apparent lack of job growth, but it is a statistic that stays firmly planted on our radar screen.

<u>Psychology and the "three P's"</u>

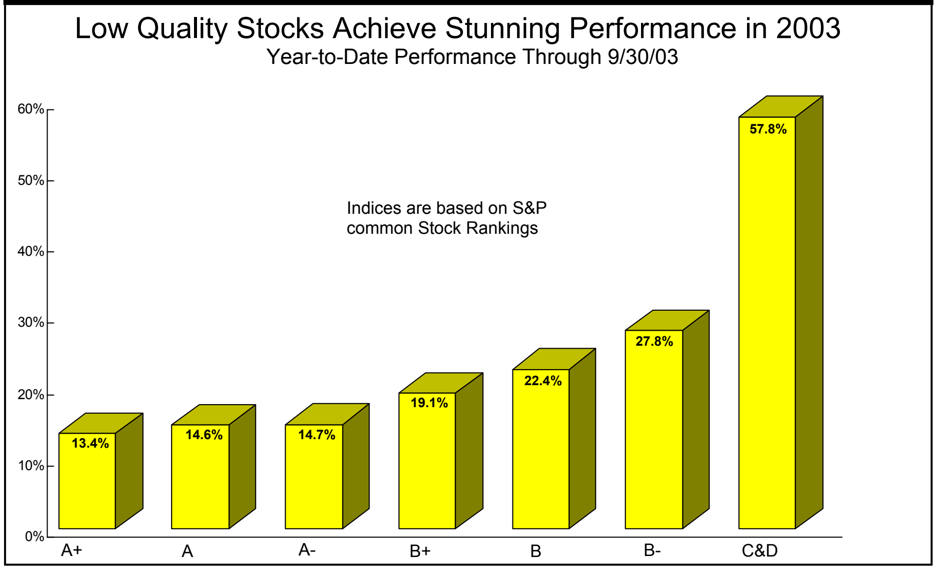
The bigger question is, "What is the outlook for job creation going forward?" We feel that there will be two factors that will dramatically affect job growth over the next few years: psychology and productivity maximization. As many companies began realizing that they needed to reduce their cost structures, they immediately began to take aggressive measures to achieve this goal. This mind set is difficult to stop, and even more difficult to turn around. Employers must be confident in the turn in their business in order to stop cutting, and extremely optimistic about the future to start adding staff. Usually the actual increases do not occur until well after the recovery is under way. There is a very clear pattern in the investment banking/brokerage business. It seems they are always clamoring to add more people when the market is hitting all time highs, and then they seem to finish laying off people right around the time the market bottoms. This last cycle was no exception. Corporate America, across all industries, seems to suffer the same fate. It is an interesting psychological study, as it repeats itself like clockwork.

The second area that is going to effect job growth is productivity maximization. In times like this the main question on everyone's mind is, "How do we save money?" First, this causes companies to make "easy cuts." We refer to this as "the three P's"… people, perks and palaces. Employers cut payroll, as well as excessive expenses from travel, rewards, luxuries and real estate. After these cuts are made, saving money becomes more ambiguous and companies begin to seek savings from technology projects and outsourcing. These are all good steps for a company to take, and it definitely improves profit margins, but none of these steps require new hires. In many cases these actions drive more payroll cuts as companies learn that computers can do even more, and employers realize they can often farm out a task for less than they can hire it to be done internally. We are on record in the early 90's stating that one of the biggest challenges we saw for general employment in the future would be the fact that more and more companies would be able to replace people with machines. Machines that are driven by more sophisticated technology can work longer and cheaper than many employees. They also are easier to deal with…they don't get sick, take vacations or demand a raise. We think we are in the mid stages of this phenomenon. The other issue that continues to affect job growth in the U.S. is the continued movement to relocate jobs offshore, particularly in technology. In many cases companies can hire workers internationally that literally are a fraction of the cost of a domestic employee. As investors we love the effect this practice has on profit margins, but we are concerned about the long-term effects this will have on the job market and the economy of the U.S. We believe that these factors will continue to be a drag on job growth. We will watch closely how this drives end-demand for goods and services, and therefore revenues of the companies we own.

<u>The Worse the Better</u>

The market's appetite for risk has continued to expand, and we thought it would be helpful to update the chart we posted last quarter. Many clients were shocked to see how dramatically the "worst" companies outperformed their peers. Nothing in the 3rd quarter changed this phenomena; it actually expanded. As you can see from the chart below, the lowest quality companies, as measured by financial strength, have increased in price by 57.8%. Compare this to the "best" companies whose stock prices have risen by only 14.5%.

Chart 1



Source: Merrill Lynch Quantitative Strategy

This is very disconcerting and creates some concern in our minds that investors are returning to speculative behavior. How perverse has this become? As of October 9th there were approximately 195 companies in the S & P 1500 (the 1500 largest companies in the U.S. tracked by Standard and Poor's) that had operating losses in the previous four quarters, and there were 1305 companies that had operating profits. During this period from the market lows in October the profitable companies have rallied substantially. This can be expected in a market recovery. What is shocking is how the companies that lost money in their business rose by more than **100%.** This is a very bizarre statistic and one that cannot continue for an extended period of time. In the short run the market can be irrational, but over the long-term profits and cash flow drive stock prices. We have delivered superior results without changing our approach, and we will continue to stand firm in our investment philosophy.

The focal point of the next six months will be profits, profits and profits. Companies, so far, are delivering the results. As long as the expectations continue to be met, this market can move higher. We continue to be very pleased with our portfolio companies, and we look forward to what they will achieve in this improved geo-political and economic environment.