AMARILLO OFFICE

320 South Polk, Suite 301
Amarillo, Texas 79101
806-371-9233

3rd Quarter 2005

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

The Tug of War Continues

The tug of war between solid earnings and the uncertainty of external forces continues in the markets. During the 3rd quarter, earnings growth won this battle and the S&P 500 (S&P) rallied by 3.1%. It should not surprise most investors that over 1.6% of this gain was a result of the strong rally in energy related stocks. Year to date the S&P is now up 1.4%. Energy related stocks accounted for a return of approximately 3% of the return of the S&P. The market outside of energy continues to be down for the year.

Our portfolios delivered strong absolute results for the quarter, despite our underweighted position in energy, and they are solidly ahead of the indices for the year. We are very pleased with these results and look forward to a more balanced market, less focused on energy, for the remainder of the year.

It's all about the P

As everyone should recall, we have been focused for the last few quarters on the tug of war between cash flow growth and valuations. The P (valuations) is where the market is focusing its attention. The E (earnings) continues to satisfy investors. The majority of reported results are in line with expectations, if not surprising on the upside. For much of the 3rd quarter, stock prices were rallying based on the continued solid results we are seeing from companies. Corporate profitability is still strong and the stock prices were advancing as a result. By early September the S&P had rallied by more than 4.5%. But macro economic factors would not allow that to continue. With the disaster and disruption caused by Katrina, closely followed by Rita, the market focused its attention on valuations once more and prices began to soften. The markets quickly gave some of the earlier gains back, but we were able to see a solid quarter nonetheless.

So far October has been less than kind to investors, which is really an understatement, with the S&P down by more than 4% and many market averages down by more than 6% in less than two weeks. Now the obvious question on everyone's mind is how much will the disruption in energy supply, and the subsequent increase in energy prices, weaken the economy. This uncertainty is the reason valuations continue to contract. While it is obviously a factor on the markets, it is nonetheless the most difficult thing to forecast. Predicting what valuation investors are going to be willing to pay in the future is a stretch at best.

For us the more important question, and the one we think we have a high probability of being able to answer is, “What effect will the higher fuel prices have on corporate profitability?” The only thing we feel confident predicting is what companies are going to earn and what kind of return that will deliver to us over time, based on reasonable estimations of what the market should be willing to pay for an anticipated stream of cash flows. Fortunately, we are beginning to see a large number of companies that are very attractive to us, even when we use very conservative valuation estimates. For the first time since early 2003, we actually have what we would consider a full compliment of ideas that we feel are truly compelling. This is encouraging to us and is reflective of the fact that cash flow has grown substantially over the last year while stock prices are basically flat. Does this mean the market is going to go up dramatically? Not necessarily. What is does mean is that we think the companies we own will give us rates of return, over the next 3–5 years, that are far superior to what we expect other asset classes will offer. It also means the risk of owning these great companies is substantially less as a result of the lower valuations. We believe many of these companies, most of which are household names, are trading at the most attractive valuations we have seen in nearly a decade.

The most important thing that we will be watching in the next few quarters is the sustainability of cash flow growth that we see at our portfolio companies. As we have stated many times, the cost savings and productivity gains have lead to large increases in cash flow and extremely healthy balance sheets. Now we need to see companies develop top line revenue growth in order to create predictable cash flow increases in the future. So far this year, we are very pleased with what we are hearing from our companies. Third quarter earnings are going to be critical, and so far they have been in line with expectations.

As we move toward the close of the year, we will begin making adjustments to the portfolios for our taxable clients in order to minimize the tax bite of 2005. As always, we will never let the “tax tail wag the dog” but where opportunities exist to reduce taxes, we will do so.

Today we are more comfortable with our portfolio of companies than we have been in quite some time. The portfolio consists of truly great companies trading at compelling valuations and we look forward to seeing some of the uncertainty in the marketplace dissipate. When it does, we expect a more stable valuation environment which should lead to stock prices that reflect the growth of cash flows at the underlying businesses. Please do not hesitate to contact us if there is anything we can do for you. Our very best to you and your family.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer