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1st Quarter 2006

CAZ CORNERSTONE PORTFOLIO
Performance Update

Volatility Returns

Well, the market did its very best to make us right in one respect, volatility did return in the 1st quarter of 2006. The market's gyrations were not dramatic, just higher than expected by most investors. After two starts and stops, the market ended the quarter with a solid gain of approximately 4%, depending on which market index is surveyed.

We have talked at length about valuations and will not dwell on that subject in this letter. Suffice it to say, earnings continue to come in at or slightly above expectations for the vast majority of our companies. Stock prices have appreciated at roughly the same rate as the growth of cash flow experienced by companies. This means valuations are roughly the same level they were at the start of the year. To us, prices are reasonable, and we continue to expect solid cash flow performance from the businesses we own.

Interest Rates On The Rise

One area we continue to focus on is the level of interest rates. It seemed we were a broken record as we predicted that interest rates would increase, and that has now occurred in fairly dramatic fashion. The 10-year U.S. Treasury has seen its interest rate go from 3.8% in June of 2005 to more than 5%. While this may seem immaterial, when you consider that this is a 32% increase in rates in less than a year, it is very important. Not only do rising rates increase the borrowing costs of companies and consumers, the level of valuations for stocks is affected as well. We must try and determine how the level of interest rates will impact the cash flow multiples investors will pay for the businesses we own. As rates rise, multiples inevitably must come down as investors have more investment options. We have seen some impact on valuations and this explains why, as a general rule, stock prices have not gained by as much as the underlying cash flows of the business have grown.

Interest levels are now at the forefront of our attention. I reiterate that we look at companies first, and their individual fundamentals drive our decision-making process. With that being said, it is imperative that we try to accurately determine what our target valuation is for the company in order to project what our opportunity is with that company. Interest rates have a direct relationship to those valuation targets.

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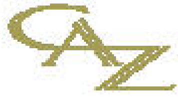


Additionally, the increase in interest rates has created a different opportunity set for investors in fixed income securities. After keeping our average maturities very short, in a defensive position, we think there is justification for lengthening maturities in a moderate manner. Municipal bond spreads are particularly attractive on an after-tax basis now as well.

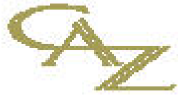
We will keep you posted on how we expect valuations to change with the higher interest rates. We have said for over a year that we expected the 10-year Treasury to go to 5%, but not much higher. We are there and, for the moment, we are staying firm with our expectation. We certainly feel the rate could increase to 5.5%, but we would be surprised to see rates go above that. If they do, we will become more concerned about market valuations and the sustainability of economic growth. Stay tuned…

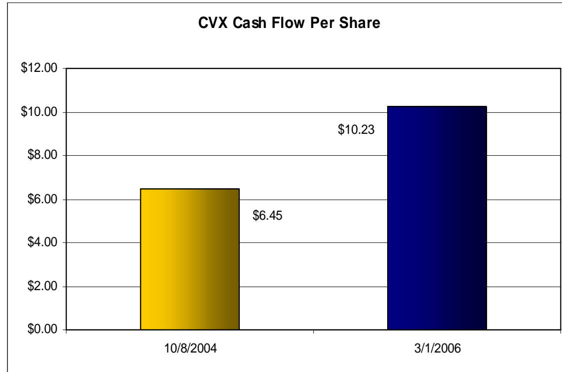
Don't Judge A Book By Its Cover

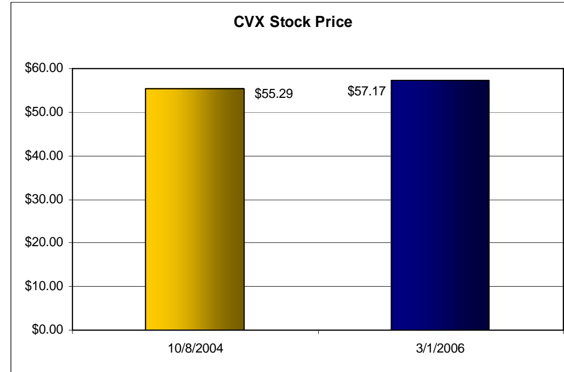
Many investors get hung up on the price of a stock. Many times, we hear investors of all types make comments related to how "expensive" a stock is. By which they mean the price is high relative to where it has been. Now, that certainly is true to a point, but it is a very small piece of the puzzle. What is vastly more important is how the valuation compares to other periods. We have heard all too often an investor say, "The stock has gone from 20 to 10, it must be cheap." Or, more frequently, "The stock has gone from 10 to 20, it must be expensive." This is a dangerous way to view stock prices and can result in dramatic damage to one's investment dollars. Risk and return is determined by how expensive or inexpensive the valuation of the stock is, not the price of the stock!

To illustrate this point, we will detail the dramatic valuation change that has occurred in Chevron Texaco (CVX) over the last year and a half. It is well documented that energy companies have seen spectacular increases in their cash flow over the last couple of years as a result of the increase in commodity prices. The hard part of investing is determining at what level an investment makes sense based on the risk and reward. Looking at CVX, as a classic example, we are going to flash back to October 8, 2004. At that time, the stock was trading at $55, and the company had earned roughly $6.45 in cash flow per share over the previous 12 months. Therefore, the stock was trading at approximately **8.5** times cash flow. After the dramatic increase in energy prices, as well as an increase in the stock price from around $35 to $55 in just over a year, we felt the risks were higher than the rewards and chose not to invest in the stock.

Fast forward to March 1, 2006, and look at the stock again. The stock was trading at $57, and the company had earned just over $10 per share in cash flow over the previous 12 months. Therefore, the stock was trading at approximately **5.5** times cash flow. The dramatic change in the valuation can be seen clearly on this chart:







Even though the company had increased cash flow by more than 58%, the stock price had only increased by 3%. This valuation contraction gave us a much more compelling risk/reward picture, and we chose to invest in CVX. The better valuation does not guarantee success. The success of the investment will be determined by the ability of the company to continue to generate cash flow and the multiple to cash flow that investors will be willing to pay for the business. What is a certainty is we are much more comfortable buying the company at 5.5 times cash flow, compared to 8.5 times cash flow 16 months earlier.

This illustration is just one example of how an investor cannot “judge a book by its cover” by just looking at the stock price. The multiple to cash flow is what really matters.

We appreciate your business, and we would love to hear how we can serve you better. All our very best to you and your family.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer