CAZ INVESTMENTS
A Wealth Management Firm

2nd Quarter 2007

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

A pleasant surprise indeed!

After the "warning shot across the bow," stock markets around the world had powerful moves upward in the 2nd quarter. The S&P 500 rallied by more than 6% for the quarter, stretching its gains to approximately 7% for the year. The main driver for the strength was substantially better than expected earnings from companies when they reported Q1 results in April and May. As we write this, the market is attempting to make new all-time highs.

This is yet another illustration of how cash flow and earnings drives stock prices. In spite of significant concerns related to housing and the sub-prime mortgage market, the stock market focused on earnings and rallied. Earnings for the 2nd quarter are starting to come out and they will be the primary determinant for market direction for the next month or so. The question that investors are grappling to understand is how much the housing slowdown will impact corporate profits. The tone and guidance that companies give in the next 30 days will be critical to the performance of the markets for the second half of the year.

Personally, we would be ecstatic if the markets finished the year right where they are today. To reflect on our outlook for the year that we stated in January, we felt that cash flows from our companies would grow by 9-10% for the year and that valuations could contract by 3-5%. While we were pleasantly surprised by the cash flow growth our companies generated in the 1st quarter, we are not ready to raise our estimates for the year. The reason for this is that we are concerned that the second half of 2007 will be more challenging than the first.

Did somebody say the sub-prime mess was over?

That was the question I was repeatedly asked in April and May. The general perception was that the "wash out" of the loan originators in February and March was the end of the story. As I indicated in multiple media interviews, that was just the tip of the iceberg. In June we started to get a glimpse of the rest of the iceberg when two Bear Stearns funds went into distress and forced their parent to allocate more than a billion dollars to assist in cleaning up the mess. I wish I had time to elaborate on this topic of how those funds met their demise (and how many more will do so in the near future), but space simply will not allow it.

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Suffice it to say, we are not even close to seeing the final chapter in this sub-prime saga. The things we are confident in are as follows:

1. Thousands of homeowners will lose their homes to foreclosure or forced liquidation in the next year.
2. Thousands more who are able to keep their homes will face mortgage payments that are 20-50% higher each month as their adjustable rate mortgages (ARM's) reset (approximately $50 Billion in ARM's will reset in the month of October alone).
3. Housing prices, in most of the country, will continue to be pressured by the supply/demand imbalance that will exist for the next year or two.
4. Home lending standards will continue to tighten and most likely will never again be as lax as they were in 2005 and 2006. This will reduce the number of borrowers who can buy homes and also reduce the ability of existing homeowners to use their home as a "piggy bank."

Now, at this point what is unknown about the sub-prime debacle?

1. How much damage will spill over to the rest of the credit markets? (more on this in a moment related to private equity)
2. While it is certain that the housing slowdown and lack of a "home piggy bank" will reduce consumer spending, we don't know the extent or timing of the impact.
3. How much does this fiasco translate into a slowdown in corporate profits?

Is there a "silver lining" in this cloud? I am not sure I would call it a silver lining, but there are some things we should take comfort in:

- Sub-prime mortgages make up only approximately 10% of all outstanding mortgages.
- The majority of the riskiest loans were made in specific geographic areas, where speculation in real estate was the highest (i.e. Florida).
- When housing prices stabilize, the borrower base will be much stronger. (Yes, I know that is a stretch but I really wanted to find three pieces of good news to list!)

Due to the fact this is probably only month three or four of a multi-year unraveling of this mess, it is still early to try and predict how far reaching the impact will be. So far in July, we have seen VERY conflicting reports. Some of these reports indicate that the impact is starting to have a material impact on the economy. Others indicate the influence is not that great. This is part of what has created more volatility in the markets. One day we hear that retail sales are being affected in a substantial way, and the market drops by 150 points. Two days later we get a piece of good news, and the market rallies by more than 250 points. If the market seems schizophrenic to you, you're not alone in your analysis.

But what about private equity? Isn't that the savior of the market?

Private equity purchases continue to be an almost daily occurrence. Yes, this is a large positive for the market in the short term, especially for the shareholders of the company being acquired. The amount of capital that these firms have available to put to work is unprecedented, and the desire for many companies to go private in order to escape the rigors and cost of Sarbanes-Oxley is extreme. That will continue to translate into massive numbers of companies going private, as long as the capital is available to borrow in order to complete the transactions. Most of the private equity transactions involve 70-80% of the purchase price being borrowed (some even more), thus the name "leveraged buy out." Therefore, the transactions rely on the availability and cost of money to borrow. Up to this point, money has been awash in the system, and there has been a near bidding war among banks and investors to lend money for these transactions. This bidding war has become so extreme that the amount of loans made in the last 18 months with very loose covenants has been greater than the previous TEN YEARS COMBINED! This is the fuel that makes the "private equity engine" go.

Private equity has been a large supporter of this latest bull market move. The very mention that XYZ might be a target will drive the stock higher. The fact that every company, regardless of size, could be the next target has provided a supporting bid under many a stock. The impact of a shrinking supply of public equity causes money to chase a smaller number of available companies. All of these reasons demonstrate how important the private equity "bid" has been to the market for the last year or so.

What could cause the "engine" to run out of gas? Quite simply, if interest costs go up or the availability of capital is reduced, the number of transactions will drop dramatically. It is important to understand that interest costs can go up in two ways. The first and most obvious reason is that central bank interest rates (as set by the Federal Reserve) or market rates (as set by the market) can go up. The second reason, and the one that is not obvious to most investors, is the impact of **spreads** on the cost of borrowing. As an example: If borrower X was able to secure a 10-year loan to buy a company, he would pay some level above the 10-year U.S. Treasury yield, because there is risk in making a loan not backed by the U.S. government. For illustration purposes, let's say that spread is 200 bps (2%) and the 10-year Treasury is at 5%. The cost of that loan to the borrower would be equal to approximately 7% (5% + 2%).

Now, let's suppose that the investors willing to lend capital to borrower X determine that the risk they are taking is high, and they feel they need to charge a bigger spread. To illustrate once again: Let's say that spread is 500 bps (5%) and the 10-year Treasury is at 5%. The borrower would have a cost of that loan equal to approximately 10% (5% + 5%). It is apparent that the cost of capital will have a material impact on the price that a buyer can afford to pay for the target company. The difference between 7% and 10% is enormous. It would create a situation where many of the deals that are being done today would be unfeasible. Additionally, this assumes that general market rates stay the same. If other pressures cause the 10-year Treasury to rise, the problem is compounded further.

This is what we feel may occur in the near future. Remember the chart we had for you last quarter? In that chart we showed how credit spreads were at historic lows. That chart illustrated how corporate spreads had declined from 350 bps to 150 bps from mid 2002 thru early 2007. High yield market spreads are an even more dramatic story, and that is the classification that many of the private equity transactions fall into. In high yield, spreads have narrowed from over 1000 bps (10%) in 2002 to approximately 250 bps (2.5%) today. I am not saying that high yield debt spreads are going back to 1000 bps, but as the illustration above shows, if spreads widen to 500 bps (which is approximately the average of the last 20 years) it will have a dramatic impact. We believe that the sub-prime mess will cause spreads to widen as the market begins to re-price risk, and that there could be substantial impact to areas outside of housing.

Can Nirvana last?

It is no secret that we are cautious. I have been quoted in the media as saying that I am as cautious today as I have been since 1999. That is a true statement, but it is not an exact comparison between then and now. The reasons for caution are much different today. I will not belabor the differences, but suffice it to say valuations were extreme then compared to now. The reasons for my caution today have to do much more with the fallout from the sub-prime and housing debacle along with slowing profits, a slowing economy and potential headwinds developing over the next year and a half. Therefore, our outlook for the rest of the year is tepid at best. I have also been quoted as saying that we would be more comfortable if the market was 10-15% cheaper. This is not meant to scare people. The facts are that we would be much more attracted to the general level of valuations if they were lower. We also would feel that valuations were discounting the risks that we see in the world.

We may be pleasantly surprised, though, just as we were last year and the first half of this year. What would cause this surprise? As always, earnings and cash flow. If companies report 2nd quarter earnings above expectations and give strong guidance for the year, the market will go higher. We are extremely pleased with the way our companies are being run and the profits they are generating.

The key theme for our portfolios at this point in history is risk control. We are concerned about the items listed above, and we are positioning the portfolios accordingly. Just like we said in 1999, “We don’t know when the pullback will take place, but we know it will happen.” Our job is to manage the portfolios the best we can in light of those risks. In 2000 we were substantially rewarded for that caution. As we are again very watchful, the portfolios are conservatively invested in our view. Does this mean they cannot go down if the market drops? Of course not! What it hopefully means is that, if the drop does occur, we will be in a position to attempt to defend capital. We feel confident that we will get our share of the gains if the market does continue higher. Our cautious approach means we simply may not make as much as we could if the “nirvana continues.”

The critical action step for all clients to consider is how your allocation will fare in this potential environment. We have said it in the last three quarterly letters, and we will say it again. If you have not closely considered your asset allocation to make sure it is appropriate for your comfort level, it should be reviewed immediately. Not only is it not too late, the opportunity is substantially better today than it was at the start of the year. One of my favorite sayings is “sell when you can, not when you have to.” We use this saying primarily with individual stocks, but it is also very true in the asset allocation decision. Whether you have too much fixed income or stock exposure, or exposure to a particular style or sector, the choice to trim your holdings should be a proactive conclusion, not a reactive one.

On the housekeeping front, we are sad to report that Debby Singleton has left the organization. Debby was called to work in her family business, and we strongly encouraged her to put those needs first. We know that she will be very successful in her new endeavor. In order to fill her very sizable shoes, along with other needs we have in the organization, we have added three people to the CAZ team. Joe Ceasar, Jane Luciano and Sylvia Sheppard have all been added to the roster in the 2nd quarter. We look forward to you meeting them.

As always, we appreciate the trust that you place in CAZ Investments, and we welcome any questions that you may have. Please let us know if there is anything we can do for you.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer