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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2008

"In times of economic challenge there are three types of companies: those who will not survive, those who will tread water and will be left in a weakened state when things turn around and, those who will use their strengths to improve their position in their market."

– Warren Eisenberg, Co-Chairman, Bed Bath & Beyond 2007 Annual Report

The first half of 2008 has ended, and with it, the worst half-year performance for global markets in more than five years.

We are pleased to report that although not immune to declines, client portfolios – bolstered by cash and no exposure to emerging markets – fared comparatively well. As usual, a detailed tabulation of your holdings and individual results are enclosed for your quick reference.

For the six-month period ending June 30, 2008, the total returns for the Dow Jones Industrial Average and the Standard & Poor's 500 were -13.38% and -11.91% respectively, while in Canada, the S&P/TSX Composite gained 6.0%.

On the whole, equity markets in the Americas fared better than their international counterparts with resource-heavy markets like Canada and Brazil the few to post gains. Elsewhere, markets dropped on average 20%, with emerging markets, like China and India, down considerably more posting losses of 47.24% and 33.29% respectively.

With the exception of the Energy and Materials sectors, the five-year-old global bull market came to a grinding halt last summer when news emerged that two Bear Stearns-sponsored hedge funds that were invested in subprime mortgages collapsed. That, metaphorically was the day the music died and, against a backdrop of negative headlines related to a faltering U.S. housing market, rising gasoline and food prices, and a softening economy, global markets have experienced heightened volatility and declines ever since.

We were well positioned for this difficult environment having warned in previous commentaries of a worrisome degree of confidence and complacency among investors. We did not know then exactly when the music was going to end, just like we don't know when the music will resume. One thing is certain however, we are confident that we will look back on this period as an opportunity to buy into good businesses at very attractive prices. Good thing we have the cash to do so.

BUYING INTO GOOD BUSINESSES

Our investment success is directly related to the strength of the businesses that we own.

As you know from our interaction over the years, at Commodari Antinori Group our investment approach is to think of common shares as representing fractional ownership in a business. We approach each purchase as if we were buying the business in its entirety and look for many of the same things you would look for if you were making a similar purchase in the private market. We buy into businesses that have dominant competitive advantages, consistent histories of profitability, strong financials, honest and competent management, and, most importantly, a reasonable price relative to their intrinsic or private market values.

This approach means that the economy, interest rates, elections and other current events — although often thought-provoking — are nothing more than costly distractions and do not impact our investment decision-making process. Outside of what price to pay for a company's common shares, our primary concerns are determining the competitive advantage of a business and, above all, assessing the durability of that advantage.

If we ascertain that a company has such an advantage in the marketplace, albeit through brand-name products or services, a distribution network, buying power, etc., and that advantage is sustainable, its stock price may go up or down at times, but it's a near certainty to perform well over the years. Why? Because the more durable a competitive advantage, the less a business has to spend to maintain it, the more it would cost a potential competitor to adversely impact it, and the easier it is to increase the price of its products along with inflation — without experiencing a decline in demand. This equates to higher earnings and additional cash to be either paid as a dividend or reinvested in the business, which in turn leads to an increase in the value of the business.

A Practical Example

To illustrate, consider Bed Bath & Beyond which we highlighted in our July 2007 Investment Commentary. In the quarter ended May 31, 2008, when overall home furnishing sales in the U.S. fell significantly, Bed Bath & Beyond's comparable store sales increased 0.8%. Its earnings per share dropped only $0.08 from $0.38 in 2007 to $0.30 in 2008. Because Bed Bath & Beyond has a very strong brand, thrift-like culture, outstanding management and no debt, it has been able to strengthen its network — opening 10 new stores in the fiscal first quarter, including its first in Canada — and increase market share despite the industry slowdown. Contrast its position with that of nearest competitor Linens 'N Things who, lacking similar attributes, was forced into bankruptcy protection. Inevitably, the weakened state of its competitor can only strengthen an already strong Bed Bath & Beyond, as they continue to add to their market share and expand into new markets.

THE GREAT DIVIDE

As the share prices of financial and housing-related businesses get punished, commodity stocks, which have been the focus of momentum investors, continue their meteoric rise. With some commodity names up as much as 64% year-to-date and most non-commodity names posting losses, the divide between these two segments continues to widen — not only in terms of share price performance but valuation as well.

Using price-to-book as a measure, current valuations of commodity stocks are rich. Consider the historical valuation of oil and gas stocks against that of banks using this metric. According to data from

Thomson Reuters Financial, in 1980 — the peak of the last commodity boom — the price-to-book value ratio of the Oil & Gas Index minus the price-to-book value ratio of the Bank Index was +1. This means that on a price-to-book value basis, oil and gas stocks traded one multiple point higher than bank stocks. Recently, oil and gas stocks have been trading at +2. This means they are now trading two times higher than during the last commodity boom and four times higher than the 30-year average of +0.50.

As in earlier cycles, investors have bought into a story about the market to justify their disregard for valuations. In the early 70s, the Nifty Fifty were going to make money forever. A few years ago, the Internet was going to make traditional industries irrelevant. Today, the world seems to have completely adopted the China/India growth story, believing it means a *permanent* shortage of commodities. At the same time, the subprime crisis is thought to have undermined the world's financial system. So, momentum players have piled into energy and commodity stocks and punished almost everything else. In our experience, such extreme views are rarely lasting investment themes.

With the price of underlying commodities now at speculatively high levels, our view is that the prices of commodity stocks are too rich and offer little margin of safety. We feel that the divide between price and value will eventually close, favoring the companies that we have been adding to portfolios.

COMPANY DEVELOPMENTS

A key to our long-term success has been our ability to look beyond many of the important but unknowable factors that are commonly featured in day-to-day news headlines and to focus instead on what is important and knowable. That brings us squarely back to the fundamentals of the businesses we own. We took advantage of recent price declines and added to several of our holdings that have competitively entrenched franchises, capable management and materially discounted prices.

In the U.S., one of those companies was Walgreen. Its credibility was shaken and share price punished after reporting its first quarterly earnings miss in roughly a decade. This does not phase us as we are long-term thinkers and don't believe Walgreen's recent numbers are caused by competitive dynamics as much as a lull in blockbuster generic drug introductions — where margins are fattest — and overall market conditions.

Walgreen continues to perform very well both in front store sales (sales of everything other than prescriptions) and pharmacy, where, despite a recent industry wide decrease, they managed to increase the number of prescriptions they filled by 11% in the second quarter. Walgreen's proximity to its clientele — over 176 million Americans live within two miles of a Walgreen — its ability to attract first-rate pharmacists, the absence of long-term debt and presence of an experienced management team make it a formidable competitor poised to gain market share as weaker independent pharmacies (owning roughly 50% market share) close up shop.

Temporary factors causing people to skip or split drug doses have depressed Walgreen's share price to a point where they have been excessively discounted. Add to this the nearly 80 million aging baby boomers and the fact that prescription drugs will be increasingly called upon to control total healthcare costs and you get a great investment. We continue to add to our position and think that Walgreen is a great business that will perform exceptionally well over the long haul.

CONCLUDING THOUGHTS

The short-term is always filled with important but unanswerable questions. The longer one's perspective however, the easier it becomes to see the ultimate outcome. For instance, although we don't know when, we are confident that home prices in the U.S. will eventually stabilize, liquidity will return to financial markets and the economy will grow again.

In the current environment, the danger is that investors will be tempted to sell businesses that they own so as not to have to worry anymore. While that may bring psychological relief for the moment, making such adjustments in times of pessimism can be very costly to long-term wealth.

We face the future with confidence knowing that the businesses we own are durable and well run. They have been through rough patches in the past and, using their competitive strengths, emerged stronger than before and will do so again.

As always, if you have any concerns or questions about your portfolio, please do not hesitate to contact us. We are at your service and we will continue to work hard to maintain your confidence in us.

Enjoy your summer — make sure you wear lots of sunscreen and be sure to buy it at Walgreen!

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