



PRINCIPALS' LETTER

From: Founders Capital Management

2006: Uncommon Common Sense

Given today's uncertain economic environment—with low interest rates, high consumer and government debt, and ongoing geopolitical issues—we have emphasized caution over the past few years. In 2006, the stock market had a positive year, with the S&P 500 gaining 13.6%. Positive returns that outpace the market can create a euphoric feeling—but we should remind ourselves that the essence of investing is keeping the profit you make. Unfortunately, this principle tends to get lost on individuals who prefer to view investing through spectacles (speculative spectacles) and enjoy the sensation that comes from short-term paper gains rather than concentrating on the true bottom line—realizing long-term, *real* profits.

Assuming that businesses are purchased at a fair price, the future of one's holdings will grow only as fast as the underlying value of the businesses owned. In 2006, we are pleased to report that the underlying value of Founders Capital Management's portfolio grew at a pretty good clip. Nevertheless, although the businesses we own are very profitable and possess attributes that give them a long-term competitive advantage, our holdings are currently not selling at "bargain prices." In aggregate, we expect the operating earnings (and value) of our holdings to grow at around 7% annually over the next 10 years. Therefore, we remain cautious about expecting future returns that repeat our 2006 performance and adhere to Ben Franklin's maxim:

"An investment in knowledge pays the best interest."

2006 marked the 300th anniversary of Benjamin Franklin's birth, and so we dedicate this year's letter to him. In his time, Franklin was a printer by trade, a scientist, and a political activist who shaped American thinking. Any investor would do well to study his life as an entrepreneur, statesman, and philosopher. If Ben Franklin were an investor today, he would advise us to be knowledgeable about what is important and not attempt to become knowledgeable about what is unimportant or unknowable—even if the unknowable is important. In his words:

"Tis easy to see, hard to foresee."

Heeding this advice, we remain focused on an investment in knowledge that will pay the best interest on our capital, and endeavor to manage risk while understanding that we cannot control uncertainty.

Risk vs. Uncertainty

In this world nothing can be said to be certain, except death and taxes.”

— Letter to Jean-Baptiste Leroy, 1789)

During these uncertain times, a variety of unpredictable forces can impact the stock market and an individual’s investments. Many investors today believe that uncertainty can be controlled by managing risk. This way of thinking merits a discussion on the difference between uncertainty and risk in investing and brings to mind one of Ben Franklin’s advisements on marriage:

“Keep your eyes wide open before marriage; half-shut afterwards.”

—Poor Richard’s Almanack, 1738

Risk management requires eyes wide open to see and understand the variables that can impact an investment. For example, it is possible to recognize the importance of managing the risk of rising interest rates on a portfolio when the probability of rising interest rates is high. Uncertainty, however, requires eyes half shut, to manage unknown variables that can blindside an investor as unexpected events occur.

To illustrate the difference between uncertainty and risk, we can draw on a sailing analogy: The most seasoned sailor may understand and assess the risk of wind and tides at sea, but not even the best captain can predict the volatile nature of weather with accuracy. Risk, therefore, is manageable in situations that can be evaluated, but uncertainty is the prevailing condition when an unexpected storm blows through. The fear of uncertainty can cause an individual to attempt to control the uncontrollable, and in the process create a false sense of confidence that he is in fact managing risk.

Uncertainty in the market is probably a major reason for the rise in concentration of investor wealth in hedge funds, whose stated goal is to minimize risk while maximizing investment gains. A simple hedge fund attempts to evade the risk in a portfolio, for example, by selling certain stocks short (i.e., betting that these securities will decrease in value), while purchasing other stocks long (i.e., betting that the value of these securities will rise). The theory is that if the stock market goes down, one will make money on the companies that were predicted to drop in price. It is expected that the money made on the trampled companies will offset or even surpass the money lost from falling stock prices on companies that were predicted to go up. The reverse happens when the stock market goes up—the gains on the stocks that one bet would rise are expected to far exceed the losses from bets on the stocks that were predicted to fall. The endgame of a well-hedged portfolio is that, no matter what occurs in the market, an investor expects to lose little money and actually make some amount of money. This plan works well when stocks—those projected to go up as well as those projected to go down—behave as the investor expects. But in reality, the “heads I win, tails you lose” scenario is unlikely. The more probable scenario is that money is bet on the wrong stocks or other securities, either up or down, and investors are dealt a double-whammy blow, followed by their disillusionment over how a so-called “market neutral” portfolio can lose money.

In one of our 2006 quarterly letters, we cited a famous case of what can happen when things don’t go as planned. Long Term Capital Management (LTCM), a hedge fund founded in 1994 by a group of investment luminaries, went through a period of spectacular success from 1994 to early 1998. 1998 marked the year of this hedge fund’s downfall, the result of a \$4.6 billion loss in less than four months as Russia unexpectedly defaulted on its debt and the financial markets unraveled. No sooner had the ink dried on our 3rd quarter update when Amaranth, another Connecticut-based hedge fund, broke LCTM’s record and announced plans to shut down after losing more than \$6 billion in less than one month. Investors received a letter from Amaranth stating that it had lost roughly 65% of its assets in one month—never to be recovered. Amaranth is in the process of liquidating its fund and returning money (what little there is) to investors.

These two recent scenarios illustrate how attempting to manage risk in a world of uncertainty can lead to permanent destruction of wealth. (A footnote to the Amaranth fiasco: Amaranth money managers walked away with tens of millions of dollars in their pockets, after charging a 2% annual management fee and taking 20% of the previous profits, all the while borrowing large sums of money to leverage their returns—and their fees.) Nevertheless, large numbers of individuals and sophisticated institutions

continue to place money in the lightly regulated hedge fund industry: According to Hedge Fund Research in Chicago, in 2006 there were more than 8,000 hedge funds with \$1.2 trillion in assets, more than double the figure five years ago.

To add insult to injury, many Main Street Americans are participating in the hedge fund frenzy without knowing it. The 200,000 public employees of Ben Franklin's home state of Pennsylvania participate in a \$2.6 billion Institutional Fund of Hedge Funds—a fund that spreads money among hundreds of different hedge funds to mitigate risk. For the privilege of investing in this fund of hedge funds, the Pennsylvania State Employees' Retirement System gives up about 2% of assets and 20% of any profits to the money management firm and the management firms it hires—amassing fees upon fees. Through the 3rd quarter 2006, Pennsylvania's public employees made 5.1% on their retirement earnings when they could have earned 3.6% on a risk-free investment in U.S. Treasury bills. To pile insult on insult, the fees assessed against the Pennsylvania State Employees' investment total approximately 40% of the gains in the fund.

Ben Franklin had some advice for the type of individual or institution that would continue to invest in the plethora of unproven hedge funds:

“Being ignorant is not so much a shame, as being unwilling to learn.”

—Poor Richard's Almanack, 1755

Investment activity at Founders Capital Management remains deep-rooted in common sense. We manage uncertainty by trying not to be so smart that we end up doing unintelligent things. We strive to invest for the long term and to concentrate on a distinction between what is knowable and important as opposed to unknowable or unimportant. Guiding our decisions is a commitment to three broad corporate attributes that we feel are very knowable and important—*brand, brains, and brawn*.

Brand, Brains, & Brawn

One of the commonsense methods we use to protect our investment and establish a margin of safety is by acquiring companies with proven "**brands**." Although this technique is qualitative, we can illustrate the point without mentioning any company names. In the table below, the left column lists business sectors, with a corresponding right column that is blank. Fill in the blank with the first company that comes to mind:

Business Description	Company Name
Soft Drink	?
Home Improvement	?
Software Company	?
Fast Food	?
Family Entertainment	?

It is highly likely that most of us listed many of the same names on the right. This is attributable to "branding." Certain companies came directly to mind because they have created the perception of a superior product (or service, or value) in the collective consumer consciousness. The phenomenon of brand value is difficult to describe and even more difficult to measure, but we all know it when we see it: A company that has successfully created an image around its product—a "brand identity"—that transcends any actual quality but differentiates it from competing products in the mind of the consumer.

A brand that has become engrained in consumer consciousness is difficult to dislodge and can be passed on to future generations. To cite an example: we are working with DIC Entertainment on an animated series to teach children about saving, avoiding credit card debt, and basic investing. The show's mentor is none other than Warren Buffett. In the first episode, the children contemplate investing in a candy company that experiences trouble due to a fire in the factory (we'll keep you guessing about the plot). The Omaha Candy Company makes a well-known candy bar—The Omaha Barr. Prior to making an investment, the children learn that their parents and grandparents love Omaha Barrs as much as they do. The Omaha Barr has been around for several generations and generates

positive feelings around every purchase—grabbing a share of consumer emotion. The children learn that this circumstance creates “certainty” around the ability to predict the future of the Omaha Candy Company’s business and their famous product, the Omaha Barr.

This fictitious company is analogous to Mars Incorporated and its famous candy bar named after a favorite horse once owned by the Mars family. Snickers is the number one-selling candy bar today, has been the number one-selling candy bar in the U.S. for more than 40 years, and will most likely be number one 40 years from now. The Snickers brand has established what is called a long-term durable competitive advantage. This fact, which is knowable and important, can lead a potential investor to reasonably conclude that an investment in Mars Incorporated (which is privately held) will most likely yield a fair and rather predictable return on a long-term investment, provided the initial purchase was made at a fair price.

Many companies have the good fortune to be managed by an individual with an exceptional business mind. When this opportunity to invest in “**brains**” presents itself, investors should take notice. Founders Capital Management has several holdings in this category, including Warren Buffett of Berkshire Hathaway, Bill Gates of Microsoft, Brian Roberts of Comcast, and John Malone of Liberty Media. Each of these individuals has unique business talents that are difficult to duplicate.

We are often asked how we develop certainty around an investment that involves an individual manager’s emotional and intellectual IQ. We accomplish this by studying and following intellectual threads. For example, we are very enthusiastic about our long-term investments in Comcast and Disney. Although we are aware that the cable business is extremely competitive, we have tremendous confidence in the management team of Brian Roberts and Steve Burke. Brian Roberts, the current CEO of Comcast, grew up in the cable business. His father, Ralph Roberts, founded the company more than 40 years ago. Brian is tremendously talented at allocating capital within the cable and media industry and displays an excellent demeanor in managing the company. He continues to build value in Comcast and carry on the family legacy. (We like legacy vs. money as a management incentive.) In addition, Steve Burke, Comcast’s Chief Operating Officer, comes from tremendous media talent. Steve’s father is Dan Burke, who helped build Cap Cities/ABC into a media powerhouse prior to selling the company to Disney. Bob Iger, the current CEO of Disney, worked at Cap Cities/ABC for more than 20 years, and his mentor was Dan Burke. It is not a coincidence that Bob Iger has turned Disney around since becoming CEO a little over a year ago—he was prepared for the job. Following the thread of an outstanding executive’s career and the individuals he or she mentors can point out good investment decisions. We hold positions in each of these companies because of the talent and integrity of the individuals managing them and the abilities they pass on to the next generation of managers.

As a result of their business acumen, these individuals often move their companies into a dominant position within their industry—leading to what we call **brawn**. Once a company develops brawn, the enterprise possesses resources and staying power that can help it adapt to a shifting and challenging business landscape.

Our brand, brains, and brawn companies continue to gain value each and every day. Berkshire Hathaway, Coca-Cola, PepsiCo, Home Depot, Microsoft, Comcast, Disney, and our other holdings continue to grow their earnings at a rate faster than current inflation, regardless of the short-term gyrations in their stock quotations. Founders Capital Management will continue to acquire ownership shares of great business franchises, as opposed to engaging in speculative behavior and trading stocks like pieces of paper, attempting to buy low and sell high or “get in and get out” at the “right time.” It may be far more difficult to remain patient when investing, as opposed to gambling on the right direction of short-term movements in an individual company or the stock market. But positive business activity is what drives a company’s stock price, not the psychological feelings of individuals seeking to make money on a “paper trade.” Again, we subscribe to the wisdom of Ben Franklin:

He that can have Patience, can have what he will.

—Poor Richard’s Almanack, 1736

Greed is Good?

In the immortal words of Gordon Gecco, anti-hero of the movie, *Wall Street*: “Greed, for lack of a better word, is good.” Judging from their recent behavior, certain senior executives of publicly traded companies are singing from the Gordon Gecco songbook. The recent excesses we’ve observed in the executive ranks of many major companies come in three forms:

- 1) Executive Compensation
- 2) Stock Option Backdating
- 3) Private Equity Deals (discussed later in our letter).

Executive Compensation

Executive compensation is a controversial subject that often raises eyebrows among owners of public companies. We sometimes see instances of a CEO who is underpaid, given the wealth created for shareholders during his tenure. More often, however, a CEO is paid handsomely for delivering average or below-average results, or even for leaving a company due to shareholder dissatisfaction.

Many investors, including Warren Buffett’s business partner, Charlie Munger, believe that corporate management has become greedy about compensation. In Mr. Munger’s view, “about half of American industry has grossly unfair compensation systems where the top executives are paid too much,” a situation he attributes to simple envy. Senior managers feel entitled to compensation similar to that granted executives at companies of equivalent size (even if that compensation is inflated), and the compensation of senior managers actually increases with the size of the company. The CEO of a billion-dollar company, for example, usually earns more than the CEO of a half billion-dollar company. Of course, the size of a company’s sales has little to do with the size of its profits. Perhaps this explains the desire of many senior management teams to enhance their company’s sales through acquisitions, which translates into higher compensation for them.

Management compensation should reflect business performance, not size. If senior management achieves a return on capital that is below average, it follows that their compensation should be correspondingly below average. Nevertheless, many corporate compensation committees, which hire consulting firms to compare compensation schemes of various companies, approve plans that have little or nothing to do with the effective allocation of capital.

Let’s say that the CEO of ABC Company has been able to grow the return on \$1,000,000 of invested capital from 15% to 20% over a two-year period. The owners would feel comfortable compensating this CEO for the extra \$50,000 of potential owner earnings produced each year. Conversely, let’s say that, during this same time frame, the CEO of XYZ Company grew the company’s invested capital from \$1,000,000 to \$1,500,000, but the return on invested capital decreased from 15% to 10%. With no increase in potential owner earnings (assuming a constant cost of capital), this company’s owners would not feel any wealthier, with the calculated return for the business remaining stagnant at \$150,000. These owners would therefore feel less willing to compensate the CEO. Yet the CEO from XYZ Company will present to its board higher sales growth than that of ABC Company and expect equal—if not more—pay compared to his ABC Company counterpart. Now, watch out for the promise of future returns.

This scenario occurs more often than not and is harmful to shareholders. Many compensation schemes reward management for producing increased earnings that correspond with the increase in invested capital. Owners of companies with this compensation approach should consider increased executive compensation as additional invested capital. Further complicating the subject of executive compensation is the (ab)use of stock options, which over the past 20 years has had the effect of placing executive pay on steroids. Which brings us to our next topic....

Stock Option Backdating

The phenomenon of “backdating” executive stock options that emerged during 2006 has prompted much discussion about the use of stock options as part of the executive compensation package. Once again, many company executives were caught with their hand in the “shareholder cookie jar” as they issued stock options to themselves when the company’s stock was at a low-point, with the intent of

maximizing eventual gains in their wealth once the stock is exercised and sold. Some 200 companies have admitted to this practice to date.

[A side note: *Backdating* options is just one method of maximizing gains for executives. There is also the practice of *repricing* options (setting a new, lower price for the options), *reloading* options, (granting new options to replace those that are being exercised), *spring-loading* options (rewarding options just before positive news on a company), and *bullet-dodging* options (waiting to award options until after bad news is issued on a company). All these abusive tactics are designed to increase executive pay at the expense of business owners. Such methods of compensation should be referred to as “*shock options.*”]

To illustrate the impact normal stock options have on owners, we will share a family’s experience: When a wife and husband were expecting their first child, the husband’s company transferred them to upstate New York. The couple was anxious to “start their family” and proceeded to purchase their first house—a small cape with an unfinished second floor. A few weeks prior to closing, they encountered the usual unexpected costs. The wife’s grandmother offered the couple an interest-free loan to be paid back over time. They did not fully appreciate the significance of that loan—which in effect enabled them to invest unpaid interest to finish other parts of the house—until many years later.

Stock options used as part of an executive compensation program have characteristics similar to a grandmother’s interest-free loan—the strike price of the option remains fixed, and the executive delays payment for this fixed portion of the stock for many years. A grandmother may have felt good about her gift to her granddaughter, but we can guarantee that as a stockholder in a company, she would not have been happy to provide the same gift to the CEO—especially if the CEO requested a rear view-mirror discount.

Stock options grow in value even when executives manage invested capital in a mediocre fashion. Each year, management takes a portion of the retained earnings to support the future growth of the business. In the case of stock options, the more management takes, the more these give, even if the returns on retained earnings remain stagnant. Continuing with the analogy of a grandmother’s loan—this would be akin to the grandchildren asking for more of the grandmother’s earned capital and continuing the interest-free arrangement to grow their own wealth.

While there are instances in which management has earned options and the resulting compensation is equitable, in our opinion, stock options do not necessarily place management and owners in a similar circle of ownership. Business owners continuously have a cost associated with their invested capital, as well as a risk of loss. Managers who have stock options at a fixed price only share in the growing wealth of the company, with no risk of loss.

While we would not advocate a wholesale change to the executive compensation programs that exist today, certain alterations could be made to orient rewards toward owner value drivers. For example, a management compensation plan could be developed around the positive or negative long-term changes in growth and the return on invested capital. This would encourage management to truly participate in the growth of intrinsic value of the company. Once the compensation is determined, the payment could be in cash, with a portion required to be invested in the business through purchase of the company’s stock in the open market. If a portion of management compensation is stock options, the strike price should initially be set at a company’s intrinsic value and should grow at the company’s average long-term cost of capital. Of course, there are many potential variations to this type of approach; the goal is to place management and owners in a similar sphere when developing management compensation plans.

MANAGEMENT’S DISCUSSION & BUSINESS UNIT REVIEW

Equities

At this point in our annual letter, we normally review the operations for each of our holdings. This year, because of the uncertainty of the market, we have added something new: An explanation of *why* we have invested in each of our businesses.

Medical Devices Holdings

In 2006, we acquired a major position in *Medtronic*, the leader in implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. Medtronic's share of the U.S. market for ICDs is around 57%. Medtronic also manufactures and markets medical devices for neurological, spinal, and ENT surgery; cardiac surgery; and vascular diseases.

Why did we invest in Medtronic?

Medtronic receives 40% of its sales from cardiac rhythm management devices and depends heavily on revenues from pacemakers and ICDs, which are stopwatch-size implants that keep a heart in rhythm and can deliver a high-powered jolt to halt life-threatening arrhythmias. Medtronic stock was knocked down during 2006 when industry-wide product recalls flattened ICD sales. When this setback occurred, we evaluated the industry and Medtronic's long-term position, concluded that the offered price was fair, and decided to buy as much stock as possible. We believe Medtronic's market share could keep growing as the company finishes rolling out its new Concerto cardiac resynchronization therapy device and Virtuoso ICD. Both products are equipped with wireless circuitry that automatically reports on the device's functioning to a base station in the patient's home. Through Medtronic's CareLink network, the base station connects, in turn, to the patient's doctor. With almost 100,000 patients able to connect through CareLink, Medtronic can reassure ICD customers concerned about the possibility of product defects. Even more exciting, the next generation of Medtronic wireless devices will relay data through patients' BlackBerry devices, allowing them to go almost anywhere and remain under their doctors' care. Medtronic's remote-device monitoring could help the company gain incremental market share by easing doctors' fears of exposure to the risk of a single maker's device failure. In addition, as the baby boomer population grows grayer, Medtronic should see substantial growth of sales for devices that manage chronic diseases of the spine, pancreas, and even brain—perhaps as much as 15% annually over the next five years. We are excited about the prospects of Medtronic's business and think this well-managed company will do very well in the future.

Food and Beverage Holdings

PepsiCo and Coca-Cola both had a good 2006, and we expect positive results during the next year—and the year after that, and the year after that, and the year after that....

Why Coca-Cola and PepsiCo?

Both these companies have tremendous “brand and brawn” in the beverage and snack food industries. For example, Coca-Cola's \$50 billion supply-chain network is one of the largest and most complex of any organization on earth. Some astounding statistics: Coke uses 500,000 vehicles to distribute 2,400 beverage products through 16 million outlets every day (PepsiCo has similar distribution strength). These facts highlight the challenge of setting up a business system to compete against Coca-Cola: The Coca-Cola and PepsiCo castles are surrounded by tremendous moats that make it difficult to penetrate their businesses.

The usual approach to valuing a company is to estimate the cash that the so-called asset will produce over the rest of its life, and then figure the value of that cash today by discounting the long-term stream of owner earnings. Imagine how difficult it would be to project all the cash a business will generate over its lifetime—this is why stock prices fluctuate. To get around this difficulty, practitioners primarily use a 10-year forecasted time horizon to come up with a large portion of a business's future cash stream, then obtain a so-called terminal value for the company based on projecting the owner earnings for the rest of its life. But we still have the dilemma of predicting how much money a business will produce in 10 years, let alone next year (we would probably have better luck predicting the weather).

As you can see, business valuation is extremely challenging because it involves predicting the future—sometimes very far out. There are *very few* businesses for which one can predict an accurate picture 10 years out. Coca-Cola and PepsiCo are two of the exceptions. We can probably agree on what these businesses will look like in 10 years—and, for that matter, in 30 or 40 years. Using the normal valuation metrics of taking a large portion of Coca-Cola's or PepsiCo's owner earnings over a 10-year period can lead to a misjudgment in value. If an investor buys Coca-Cola or PepsiCo using the standard initial 10-year valuation time horizon, she will most likely receive a positive surprise in the

future since these businesses can generate a large amount of growth and cash for many decades beyond the initial 10-year forecast period. Of course, paying too high a price for this certainty can lead an investor to wait a long time to obtain a return on her investment. Coca-Cola is evidence of this. Coca-Cola's stock price is down more than 40% from a high of \$85 *eight* years ago. Ironically, the company's earnings and intrinsic value have increased significantly during this same time frame. The investment lesson: One must still pay attention to price in relationship to value.

In 2006, Coca-Cola grew its worldwide volume at approximately 4%, with operating income increasing around 6%. Coke's earnings increased approximately 9%, to \$2.34 per share. More of the same is expected in 2007.

Coke is undergoing a major transformation. Under Mary Minnick—Coke's President of Marketing, Strategy, and Innovation—growth means more than increasing sales of Coca-Cola. She is focusing on innovation beyond repackaging existing beverages and is jump-starting Coke's product development. Under her marketing leadership, Coke has launched more than 1,000 new drinks or new variations of existing brands worldwide in the past 12 months, including a new diet drink called Coca-Cola Zero as well as a coffee-flavored cola called Coca-Cola Blak. Mary Minnick is also transforming the company from a soda-centric business to a company focused on leadership in consumer beverages. She is pushing the edge of Coke's envelope by exploring new beverage products in areas such as beauty and health care. Prototypes of new products include new juices designed to help women with skin care, weight management, and detoxification. In the past year, Coke has launched 18 clinical trials to test the health benefits of different new ingredients that it hopes to use in future drinks.

Coke continues its explosive growth throughout China, where business increased 20% in 2006. Coca-Cola offers a wide variety of soft drinks in China, ranging from mineral water and fruit juice to tea and coffee. The sale of Coca-Cola's fruit juice drinks has grown by approximately 100% in the past 24 months. Moreover, in an effort to cater to different tastes and drinking preferences, the company has taken over Nestlé's coffee drinks business in China. Currently, Coca-Cola has more than 35 bottled-drink factories, 700 business outlets, and more than 7,000 local agents and partners across China.

Following are some statistics for Coca-Cola's products that we believe provide further clues about the company's future:

Territory	Annual per capita consumption of Coca-Cola products*	Population
North America	413 servings	336 million
Asia	25 servings (~10 servings in China)	>3.3 billion
* Including Coca-Cola, Minute Maid, POWERAID, and Dasani water		

Do we think Coke has more room for growth in the upcoming decades? Our answer is a resounding yes—somewhere between “a lot” and “a whole lot.”

PepsiCo is also firing on all cylinders. Worldwide volume growth was 7% in 2006, while net revenue increased 9% and earnings per share rose approximately 13% over 2005, to \$3 per share. In 2007, we are expecting more of the same. PepsiCo is also a beverage giant and is, surprisingly, larger than Coke within the U.S. Although Coca-Cola has a larger market share than Pepsi of the U.S. carbonated soft drink market (36% vs. 33%, respectively), PepsiCo's domination over Coke in the U.S. noncarbonated beverage segment (for example, 84% vs. 16% in the sports drinks sector) gives PepsiCo a larger overall market share when consolidating all nonalcoholic beverages—PepsiCo has a 26% market share of the U.S. beverage market vs. Coca-Cola's 24%. PepsiCo's real strength, however, lies in its broad brand portfolio, which spans beverages and snack foods in domestic and international markets. In North America, the company has 15 brands, each with more than \$1 billion in sales. PepsiCo has embraced the wellness trend ahead of many of its peers by focusing on healthier options, the elimination of trans fats, and a recent switch to even healthier sunflower oil in its Frito Lay's products. We believe that PepsiCo's focus on delivering an appropriate mix of products both domestically and overseas will continue to benefit revenue and profit growth in the coming years. Owning PepsiCo

gives an investor a one-two punch—participation in the largest beverage and snack-food company in the U.S., with untapped international opportunity as far as one can see.

PepsiCo's International Division currently accounts for more than 26% of total company profits and generates about half of PepsiCo's total profit growth. We believe that PepsiCo's international profits can be expected to grow in the mid-teens over the next five years. During 2006, PepsiCo's international snack volume growth was driven by high single-digit growth at Sabritas in Mexico and double-digit growth in Russia, Turkey, and Egypt. The beverage volume increase (7%+) was driven by mid single-digit growth in carbonated soft drinks and double-digit growth in noncarbonated drinks. Regionally, beverage gains were led by double-digit growth in the Middle East, China, Russia, and Argentina. We are very pleased with PepsiCo as a long-term owner and look forward to the company's continued great performance through 2007 and beyond.

Industrial Holdings

Tyco International, a large, diversified manufacturing and service company, is on track to earn approximately \$2 per share in 2006 and generate around \$4 billion in cash. This provides us around a 6.5% yield based on a \$31 share price.

Why Tyco?

Over the past few decades, a number of companies have attempted to grow by acquiring businesses with various economic attributes to create a conglomerate. This strategy arises from one of two beliefs:

- 1) The acquired company possesses great brands but is poorly managed and should be able to grow with minimal amounts of capital, or
- 2) The acquired business possesses poor economic attributes and is also poorly managed, but its lack of business results signals it as a cheap takeover target.

The common theme behind both assumptions is poor management. The conglomerate's management team is typically flush with adrenaline spirits due to success achieved in its own business and decides to take many bites from the acquisition apple. In this case, acquiring management ultimately believes that applying its magic spell to a newly purchased company will produce tremendous economic value for its shareholders. Unfortunately, management falls victim to the "Snow White Syndrome," falling asleep while the many business dwarfs go on their merry way waiting for Prince Charming to come along and wake up their princess. Tyco fell into this "bad apple" category.

The result: The Bashful, Sneezzy, Sleepy, (un)Happy, Grumpy, Dopey, and Doc(tored) entities became overwhelmed with the bureaucracy of the conglomerate. The businesses (and stock) of the conglomerate languished, leading to a situation in which the sum of the company's business parts became worth more than the whole. This scenario invariably leads to shareholder frustration and a restructuring of the company. In early 2006, Tyco announced the breakup of the company into three separately traded entities, effective March 2007. This represents an opportunity for patient investors, as the value of the separate businesses will eventually be realized once these companies shake loose from the spell of the conglomerate.

In the meantime, Tyco also has a long-term growth strategy that includes:

- 1) Expanding presence in high-growth markets where Tyco has significant upside potential, and
- 2) Investing in key emerging regions such as Asia (China and India in particular) and Eastern Europe.

Key growth markets include consumer electronics, mobile phones, health care, and military/aerospace. In consumer electronics, Tyco has seen a 28% annual sales growth over the last three years. With regard to emerging markets, so far this year, Tyco has added 200+ sales engineers to regions such as India and Eastern Europe (up 25% compared with last year). In China, Tyco has become one of the leading passive component suppliers, with more than \$1 billion in local sales and 30,000 employees (international expansion is where the money is).

Based on the current low valuation and excellent long-term growth prospects of Tyco's businesses, we are expecting to keep all three separate companies—Tyco Healthcare, Tyco Electronics, and Tyco Fire & Security and Engineered Products—once the breakup of Tyco is completed in 2007.

Technology Holdings

Speaking of investing in restructuring situations in 2006, *First Data Corporation* separated its fast-growing Western Union consumer payments business into an independent publicly traded company. The independent *Western Union* is the largest money-transfer company in the industry, offering customers the ability to transfer money or make payments virtually anywhere in the world. Western Union handles more than 275 million money transfers each year through more than 280,000 agencies located in more than 200 countries and territories (that's brand and brawn).

We will keep Western Union in our portfolio. We believe the company is worth more than \$20 billion (compared to its current \$17 billion valuation) with immigration trends around the world increasing demand for money-transfer services. Today, Western Union generates more than \$4.5 billion in revenues and 30+% operating margins and is expected to grow earnings at a rate of approximately 15% per year over the next five years. This franchise is very valuable—there are only four companies in the world with comparable size, growth, and profitability attributes.

Western Union is also in the early stages of growth in the Asia-Pacific region, which currently represents only 4% of Western Union's total revenues, despite accounting for 20% of Western Union's 270,000 locations. The company is adding about 6,000 locations every 90 days. The region is rather new for Western Union, with 82% of all Asia-Pacific locations having offered Western Union services for less than five years. Historically, agents in new locations become productive after their fifth year. So, increased productivity is expected in the future from these planted seeds. (A side note: In China, total transaction volume exceeded one million in 2006, representing growth in excess of 120%; and in India, the company has agreements with seven of the country's top 10 banks.)

We will also maintain the newly separated *First Data* within our portfolio. First Data owns the largest debit-processing network, including acceptance at 1.6 million Point-of-Sale locations and 141 million cards carrying the STAR logo. STAR is the brand/logo associated with the 281,000 ATM locations. More than 5,700 financial institutions use the STAR network to process ATM transactions, and more than 140 million debit cards carry the STAR logo. Within the payments industry, debit remains the growth story, and First Data controls the largest PIN debit network within the U.S.

First Data generates a lot of cash by collecting a fee on every transaction processed through its system. The new First Data should earn \$1.36 per share in 2007. At the current selling price of \$25.50, we think First Data represents a fair investment opportunity. We are thrilled about the prospects for the new First Data and consider the payment-processing business a long-term growth story as cash transactions lose ground to debit and credit card transactions.

Our largest technology holding, *Microsoft*, continued to experience positive results in 2006. The company increased revenues by more than 10% this year and is expected to repeat this performance in 2007. During the next 24 months, Microsoft should generate almost \$30 billion in cash for shareholders, on top of the approximately \$32 billion of cash and equivalents that currently resides on its balance sheet. Over the next three to five years, Microsoft will return this large cash treasure to shareholders through an aggressive share buyback program. We are excited about this development and believe this buyback will prove very beneficial to owners at Microsoft's current share price.

Microsoft also announced that it is on track to release its new operating system—Vista—with worldwide availability slated for January 2007. We expect the release of Vista and the new Microsoft Office to act as positive catalysts for Microsoft sales and profits in 2007. In addition, there is considerable pent-up demand for the new Office product, as many organizations did not upgrade to Office 2003. We are very bullish on Microsoft's business prospects throughout 2007 and beyond.

Why Microsoft?

Two words: Business Brains. Bill Gates (and Microsoft) is viewed as the inventor of Windows and is also credited with the introduction of the many productivity products we use today—Word, Excel, PowerPoint, etc. Actually, Bill Gates (and Microsoft) did not invent any of these products. In fact, Xerox was the actual inventor of the personal computer, the graphic user interface (GUI) that led to Windows, and the popular mouse. When Xerox's board deemed the PC and its associated software to be “something not worth pursuing,” Steve Jobs (Apple) copied and brought to market much of what

was developed at the Xerox Palo Alto Research Center, and Bill Gates (Microsoft) then copied Apple. But, of these three technology companies, guess which is the most valuable today? Microsoft.

When Microsoft and Apple first developed their respective operating systems, Apple chose to compete in a closed environment. The company offered its software only in conjunction with the purchase of its hardware—relying on a strategy of permanently locking in the consumer by “tying” its hardware and software products together. Microsoft took a different approach, recognizing that the operating system and complementary software were the middle components between an ongoing relationship with the consumer and computer manufacturers. If consumers developed a “habit” of using a particular software program, then they would most likely seek this software program with their next purchase of a computer—any computer. With this in mind, Microsoft decided to license its operating system to all computer manufacturers, creating tremendous scale and leverage by which to sell consumers other software products—Microsoft’s Office products, that is.

Bill Gates and his management team are highly adept at applying a chess strategy to control the middle of the business board—a business maneuver we refer to as “playing to the middle.” Executing this strategy has led Microsoft to a virtual monopoly that may actually increase as the company’s stranglehold migrates from the PC (which was at the center of the so-called business chessboard) to the network.

The industry has moved over the past decade, and the operating system is no longer considered the “center,” or middle, of the computer chessboard. As a result, most business analysts have written off Microsoft as an investment, and the stock price has languished over the past five years despite the company’s continued growth. But we don’t believe Microsoft has lost its way. Bill Gates and the Microsoft team understand that the middle of the chessboard has morphed from the operating system to the “computer network,” encompassing consumers’ television sets, PCs, notebooks, phones, and PDA’s. Accordingly, Microsoft is aggressively pursuing the extension of its software into television set-top boxes, computer gaming, phones, PDA’s, etc. Networking these products together with Microsoft software products creates a strong competitive moat around Microsoft’s fortress.

Bill Gates is applying a similar “play to the middle” strategy in his philanthropic efforts, allocating money to charitable ventures in a way that ensures that governments and others are equally invested in world health and education programs. One should probably invest in Bill Gates if he decides to get into the hotdog stand business.

Financial Service Holdings

Berkshire Hathaway, managed by Warren Buffett (brains), experienced a fantastic 2006. Mr. Buffett announced that the increase in Berkshire’s book value—a measurement of the company’s net worth—would be a record \$14 billion.

After seven costly hurricanes in the past two years, insurers were evaluating how much risk they were willing to take on in vulnerable coastal areas. As a result, there was a shortage of available coverage in the reinsurance sector, in which insurers buy coverage against the policies they write. The Berkshire Hathaway Reinsurance group took a large increase in premiums earned during 2006 related to the catastrophe business. At Berkshire’s annual meeting, Mr. Buffett stated, “We will do more than anyone else if the price is right.” Well, the price was right, and Berkshire Hathaway stepped up to the plate and bet big on reinsurance as other investors pulled back. Mr. Buffett says, “If you like to watch football, you probably enjoy the game a little more if you have a bet on it. I like to watch the Weather Channel.” As a result of a virtually uneventful hurricane season, Berkshire Hathaway achieved a once-in-a-lifetime year, whereby premiums earned during 2007 virtually fell to the bottom line.

Why Berkshire?

Warren Buffett is an investment genius who has transformed Berkshire Hathaway into an insurance juggernaut over the past decade. He is an expert at allocating capital and patiently sits on his hands until the right opportunity comes along. And Warren Buffett is currently sitting—Berkshire has a loaded gun of more than \$40 billion in cash and cash equivalents. If the market goes down, we should cheer, as Mr. Buffett will most likely buy companies at a great discount. We estimate that Berkshire’s earnings on an annual basis could increase as much as \$250 per share (or 5%) for each 1% (after-tax) increase in the investment return on this cash portfolio.

In the meantime, Berkshire continues to gush cash, and Warren Buffett maintains a passionate desire to continue growing the company. He has been actively investing, adding whole businesses to the Berkshire portfolio through an ongoing acquisition program. Berkshire Hathaway might even be likened now to a large “private equity fund”—which happen to be in vogue at the moment—but with one big difference—Berkshire buys a business to hold it forever and does not participate in the “gin rummy” behavior that prevails among private equity funds. A private equity fund typically buys a business only to “financially reengineer” the company and flip it to unsuspecting buyers—usually back to the public. A recent case demonstrates this point:

The Hertz Corporation, started in 1918 in Chicago by Walter Jacobs with a dozen Model T’s, is now the world’s largest car rental company, with 1,900 locations in the U.S. and 5,100 locations worldwide. Over the years, the company passed through a number of hands, including General Motors, RCA, and United Airlines, and eventually became a public company until the purchase of its outstanding stock by Ford Motor Company in 2004.

Under a struggling auto industry, in 2005 Ford Motor Company announced it had sold Hertz to an investor group of private equity firms. The group, composed of Clayton Dubilier & Rice, The Carlyle Group, and Merrill Lynch Global Private Equity, purchased the equity of Hertz in a transaction valued at approximately \$15 billion including debt—putting up \$2.3 billion of its own money and loading up Hertz with more than \$12 billion of debt to pay the balance.

Here’s the interesting part of the story: Less than a year after the three private investment funds bought Hertz, the group announced that the company would be brought public again. In the meantime, Hertz’s three owners had each paid themselves a \$1 billion dividend and planned to use more than \$400 million of the \$1.6 billion in anticipated Public Offering proceeds to pay themselves another one. In total, the private equity firms withdrew more than half of their initial investment in the form of dividends and fees. And, after the stock sale, the three investors will still own nearly three-quarters of Hertz, which is valued at about \$18 billion, including about \$12 billion of debt. This type of transaction proves that no one washes a rental car before it is returned—in this case, to the public. Maybe the new public owners should rename this deal *Hurts*.

There is currently so much money sloshing around private equity firms that the total amount of merger and acquisition transactions announced in 2006 exceeded \$3.5 trillion—more than the total volume during the Internet bubble of the late 1990s. And the deals keep getting larger. It was recently rumored that Home Depot was being targeted by a group of private equity firms to complete a record \$100 billion business deal to acquire the company.

Retail Holdings

And on that note: Our major retail holding, *Home Depot*, is currently undervalued—perhaps by a significant amount. We would be extremely disappointed if Home Depot were to be purchased for the rumored \$50 per share. Short-term, we could pat ourselves on the back, since this would lead to a gain of over 25% from Home Depot’s current stock price. However, a so-called long-term bargain transfer would actually occur, as we would be giving up a company that is worth at least \$50 per share, with the possibility of growing 10% to 12% per annum over the next 10 years. One could spout about what a good (lucky) stock picker he was, but this thinking would be shortsighted—focusing on counting short-term results vs. what really counts—long-term gains in intrinsic value. We would be hard-pressed to find a replacement for Home Depot if this transaction occurred and most likely would have to sit on the sidelines—perhaps for a long time—before we found an equal investment.

In the meantime, Home Depot continues to produce lots of cash and return it to shareholders through dividends and share repurchases. The company recently announced that its board of directors has authorized the immediate repurchase of \$3 billion of outstanding shares through an accelerated share repurchase agreement. Including this announced repurchase, Home Depot has returned approximately \$6.7 billion of cash to shareholders this fiscal year by repurchasing more than 173 million shares. This brings the total number of shares purchased since 2002 to more than 450 million, or approximately 19 percent of the outstanding shares. (This is somewhat like a shareholder private buyout.)

It should be an investor’s hope that Home Depot’s stock price stays at a depressed level as the company carries out its stock repurchase program—current owners are actually buying out the

company at a 25% discount from its intrinsic value, and from what a group of private equity funds would offer. A rising stock price would create an environment whereby fewer discounted shares are repurchased under this program. If the stock price declines, more shares are purchased and greater wealth is created for owners that remain with the company. In many ways, it pays to have a contrarian thought process when investing.

Why Home Depot?

Home Depot and Lowes currently enjoy a combined 20% share of the U.S. do-it-yourself home improvement market. Over time, the market share of these two organizations will probably increase significantly. Many analysts are currently negative on the home improvement sector due to the housing slowdown. We agree with the short-term housing outlook, which is likely to remain depressed. However, it is our experience that this is the type of environment that actually strengthens Home Depot's long-term position in the marketplace. A tremendous amount of competition develops in a slow market, and the larger companies usually take a substantial amount of business from the small hardware stores, which currently constitute the bulk of the do-it-yourself-market. So, our first insight is that Home Depot still has a lot of room to grow within the U.S. home improvement market.

Our second insight is Home Depot's expansion in "Home Depot Supply" (the services, professional, and maintenance and repair markets). Home Depot Supply, which currently represents approximately 10% of the company's sales, is projected to have 2006 combined sales approaching \$12 billion. Home Depot Supply today has a national presence, with more than 900 locations, and the company has targeted more than 1,500 locations by 2010, in conjunction with its plan to grow Home Depot Supply to a \$23 billion–\$27 billion business by that time. Home Depot Supply has tremendous growth opportunities within the estimated \$410 billion professional supply market.

Our third insight is the large international opportunity that exists for Home Depot. The company is taking advantage of opportunities in the \$275 billion international do-it-yourself home improvement market. In the past two years, Home Depot added 38 stores in Canada and more than 10 new stores in Mexico. In addition, Home Depot recently announced an acquisition in China, aggressively expanding its presence in the large and growing Chinese home improvement market. In early December, Home Depot purchased a majority stake in HomeWay, one of the three largest do-it-yourself chains in the fragmented China market. HomeWay, started in 1996 by entrepreneur Du Sha, operates 14 do-it-yourself home improvement warehouses in northern China. Home Depot now operates a very large sourcing business in China, with a network of more than 500 suppliers.

Home Depot's earnings growth exceeded 5% in 2006 and is expected to grow another 5% in 2007. With this growth, we anticipate additional opportunities in years to come (despite the temporary slowdown in housing sales and construction) considering the company has only a 12% market share of the do-it-yourself market. Home Depot has restated its goal of growing annual sales 9%-12%, driven by 400 to 500 new store openings over the next five years, and by significant growth in its international business, services business, and Home Depot Supply. As you can see, we are very enthusiastic about Home Depot's long-term prospects.

Media Holdings

Founders Capital Management's Media Division continues to grow and supply great content to customers. We believe that a concentrated investment in content providers will pay handsomely in the future. Disney, Liberty, Comcast, Viacom, CBS, Time Warner, and Gannett are all media companies that supply the daily news, stories, and shows that we read or watch each day.

Why invest in media content providers?

Some \$260 billion is spent annually on advertising in the U.S. All media companies that we mentioned, as well as Internet aggregators such as Google and Yahoo, are fighting for these advertising dollars that grow approximately 3% to 4% per year. And advertising revenue is what drives media stock prices. The current combined market capitalization of Google, Yahoo, Sirius Satellite Radio, and XM Satellite Radio is around \$180 billion, which equals the combined market capitalization of the established media companies that provide great content—Disney, Viacom, and Time Warner. The so-called new media companies are trading as if they will get close to 100% of all future advertising revenues. Although their stock prices may still go up, the economics do not warrant

the current speculative behavior around these new media companies. We will stick with investing our money in established media companies that provide great content as we think this is where the advertising dollars will fall.

A development at *Disney* this year reflects our strong belief that great content is a magnet for advertising. Disney announced its intent to offer some of its most popular ABC and Disney shows on the Web free of charge. This move sets in motion a complete change to the current business model. As part of this offering, advertisers will have the opportunity to reach Disney consumers via the Web by sponsoring the various shows. Specially designed ads, which will be much shorter than traditional television spots, will accompany shows downloaded for free to consumers (and the advertisements cannot be skipped). Large advertisers such as AT&T, Toyota, and others have already signed up. Although this is a large shift from the previous TV advertising model, we do not think it is too far off. Advertisers have always been attracted to great content, no matter where it is offered to the consumer. Our belief is that this will hold true in the future.

Why Disney?

In 2006, Disney completed its acquisition of Pixar, the animation studio that introduced a new generation of computer-animated feature films including *Toy Story*, *A Bug's Life*, *Monster's Inc*, *The Incredibles*, *Finding Nemo*, and *Cars*. This acquisition broadens what we call "the Disney vault." To give an indication of the power of Disney's animated films over the past 70 years, each year we ask college students in our investing course to name 10 Disney films. The answers come back quickly: *Snow White and the Seven Dwarfs*, *Pinocchio*, *Bambi*, *Cinderella*, *Alice in Wonderland*, *Peter Pan*, *The Little Mermaid*, *Beauty and the Beast*, *The Lion King*, *Aladdin*, *101 Dalmatians*.... The amazing part occurs when we ask the same students to name 10 films from another studio. They usually struggle to come up with three. From this exercise, the students learn one thing that's certain: Our grandchildren's grandchildren will most likely be watching these famous Disney films over the next 70 years (plus new Disney films), no matter what medium the content is delivered on—movie theater, computer, 3D television, etc. The value of the Disney vault is incalculable because of the 100-year annuity associated with reissuing many Disney films as new delivery mediums emerge.

Of course, Disney is much more than a movie studio, and divisions such as ESPN have been significant growth drivers. We estimate that ESPN's annual operating income has grown at 20% over the past five years, from \$799 million in 2001 to an estimated \$1.97 billion in 2006. We are excited to be owners of Disney.

Why Liberty?

In 2006, Liberty Media began trading as two tracking stocks—Liberty Capital (NASDAQ: LCAPA) and Liberty Interactive (NASDAQ: LINTA). Liberty Capital has vast holdings in media conglomerates such as News Corp. and Time Warner. Liberty Interactive is a fast-growing company, with 98% ownership of QVC, 22% ownership of IAC/InterActive, and 20% ownership of the travel distribution service, Expedia.

Liberty is another case in which the sum-of-parts is worth more than the whole. We believe that Liberty Capital and Liberty Interactive are selling at a 30% discount to their value, and John Malone and his management team continue to make strides in closing this so-called valuation gap. Many ask why this valuation gap occurs. Much of the difference is attributable to the tax implications of the capital gains inherent in Liberty Capital's portfolio of media assets: Investors discount the stock by the taxes that will need to be paid on these investments once they are sold. We believe John Malone will strike deals to exchange (sell) these assets in tax-efficient or tax-free transactions that will provide an eventual benefit to shareholders. In fact, the first of these tax-efficient transactions took place in the 4th quarter, 2006.

For our readers interested in following a tax-efficient transaction: Liberty Capital recently announced an exchange for its \$11 billion stake in News Corp. for News Corp.'s stake in DirecTv, Regional Sports Networks, and \$550 million in cash. Given that the cost basis for Liberty's News Corp. position is \$1.7 billion, this asset swap provides a "step up" to the cost basis, reflecting the cost associated with the assets when News Corp. made the initial acquisition of DirecTv for \$6.78 billion. The same holds true for the other investment—the cost basis for the Regional Cable Networks is

around \$200 million. (Liberty does not pay taxes on the \$550 million cash component that it receives in the transaction.) In summary, Liberty Capital will benefit from a step up in the cost basis of an estimated \$6 billion, thus avoiding a large tax obligation on the sale of these assets. This shareholder-friendly transaction is expected to close in mid-2007.

We believe Liberty Capital is also close to a similar type of transaction with Time Warner. Liberty may swap its Time Warner shares for Time Warner assets and cash in 2007. In this deal, the speculation is that Liberty Capital would swap a portion of its Time Warner stake (approximately \$3.6 billion) for the Atlanta Braves Baseball Team and \$1.5 billion in cash under a tax-free exchange. In this potential deal, the cash is the most important element, since it would likely be nontaxable and the company could use the proceeds to benefit existing shareholders.

Why Comcast and Time Warner?

Around 23 years ago, AT&T, commonly referred to as "Ma Bell," was broken up on the order of Judge Harold H. Greene of the U.S. District Court in Washington, D.C.

Since the breakup, there has been a tremendous shake-up in the telecommunications industry, and consumers now have an overwhelming range of choices, not only for local and long-distance phone service but also for a multitude of other services including cellular service, DSL, and Internet and cable-based telephony.

All this choice is no doubt what Judge Greene envisioned. His initial ruling was based on a finding that AT&T had such a stranglehold on all aspects of the telecommunications business that newcomers weren't able to compete on a "level playing field." This famous ruling and the resulting breakup of the telecommunications industry led to what we refer to as a state of "disinter mediation" (a situation in which a competitive "free for all" is unearthed in a fast-changing industry). Enter the likes of Comcast, Time Warner, Cox, MCI, Sprint, and Nextel into the fray of competition. Of course, the investment trick is to pick the new winners.

Consolidation is not only taking place among telecommunications companies but also within communications itself, as evidenced by the combination of cable, Internet, and telephone services. We have taken positions in both Comcast and Time Warner, because these entities become more valuable as consolidation takes place in the nascent telecommunications industry.

As an example: In 2006, Comcast and Time Warner Cable jointly completed the acquisition of the Adelphia cable assets. Comcast quickly integrated its Adelphia assets into the organization and now serves more than 23 million subscribers. The company is reporting growth—driven mainly through the addition of digital voice subscribers through Comcast's "triple-play package"—cable, high speed Internet, and phone. This combination is having a positive impact on the bottom line as Comcast obtains greater efficiencies from its entrenched cable network (brawn). Comcast Corporation has become the largest U.S. pay-TV operator and accounts for 32% of all basic cable subscribers in the U.S., reaching 40 million homes in 22 of the top 25 U. S. metropolitan markets.

Over the past year, TimeWarner also increased its cable subscriptions by 3.5 million, to a total of 14.5 million subscribers. Once the integration of Adelphia takes place in 2007, TimeWarner Cable will spin off as a separately traded company. We think this is a positive development that should unleash additional value for shareholders of TimeWarner. We believe that the full value of TimeWarner's cable, online, and media assets has not been reflected in TimeWarner's stock price, and we will maintain this position until this value is realized.

We have concluded that the \$99 per month triple-play package offered by cable companies such as Comcast and TimeWarner essentially provides phone service for free! This will make it very difficult for primary phone companies such as AT&T, which averages \$55 per month from phone line customers, to compete profitably against cable's free phone service. Of course, many business analysts point out that the phone companies are bolstering their offerings to include Internet and television broadband service to their customer base. But the reality is that by the time the phone companies fully invest the more than \$25 billion required to upgrade their infrastructure to accommodate this offering, the cable companies could have 50% of its customers buying phone service through the bundled triple-play package. As the Comcast and TimeWarner examples illustrate, disinter mediation can represent an opportunity for investors.

Commodities

Barrick Gold Corporation, Central Fund of Canada, and Chevron all had a very good year. Barrick continues to build a new generation of mines around the globe and maintains the lowest total cash costs among the major gold producers. In 2006, Barrick completed its \$10.1 billion acquisition of Placer Dome, with a smooth integration of Placer Dome's assets into Barrick's existing operations. Barrick Gold has indicated annual savings of \$200 million from the merger of the two companies. It now seems Barrick's initial estimate was conservative, however, and the annual savings as a result of this merger may approach \$300 million.

In 2006, Barrick produced some 8.8 million ounces of gold and 350 million pounds of copper. Total cash costs were in the range of \$275–\$290 per ounce of gold and \$0.75 per pound of copper. Barrick Gold also announced the pricing of \$1 billion copper-linked notes comprising \$400 million of 5.75% notes due 2016 and \$600 million of 6.35% notes due 2036. The first three years of funding of these instruments is to be repaid from the sales proceeds of approximately 324 million pounds of copper (equating to approximately \$3.08/lb. and 30% of Barrick's copper production over the next three years) and is to be replaced by \$1 billion of funding in conventional 2016 and 2036 interest-bearing notes by September 2009.

So what does this all mean? In a nutshell, Barrick's copper-linked note is an imaginative way of leveraging the company's "non-core" copper assets to benefit its gold project development pipeline and aggressive gold and silver exploration strategy. We remain pleased with Barrick Gold's management and the value that is being created for shareholders.

We also maintain a sizable investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately \$975 million. This significantly changed during the year as the company raised additional funds and purchased large amounts of gold and silver. Central Fund's currently has 52% gold bullion and certificates, 47% silver bullion and certificates, and 1% cash, marketable securities, and other working capital amounts. Our collective holdings now represent approximately 0.12 % of the total gold and silver within the vault. This makes us a smaller shareholder of Central Fund of Canada but increases the liquidity of our position if we intend to sell this security in the future.

Our investment in Chevron, a leading international integrated oil and gas company with operations worldwide in a variety of energy segments, continues to do well even as energy prices stabilize. We reiterate our continued interest in Chevron. It is our opinion that the price of oil is going to plateau at a higher level in the future than it has in the past as the growth of economies such as China and India increases energy demand. We believe the current valuation of Chevron does not reflect higher long-term energy prices.

Why invest in commodities?

One of the reasons we initially purchased gold and silver was our belief that the value of the U.S. dollar will deteriorate over the long term, and we have not changed our view on this principle. Gold has now risen to more than \$600 an ounce during a period in which the dollar has maintained its relative strength against the Euro and other currencies. While changes in the dollar's value will continue to be an important factor in determining the price of commodities such as gold and silver, in the future it will not be the only driving issue. Concerns regarding the geopolitical landscape and the economic implications stemming from higher oil prices are other factors that support higher long-term gold and silver prices. Finally, gold and silver are being viewed by investors as a hedge against inflation, as rising commodity prices increase the costs associated with making all goods, and governments run their currency printing presses to keep up with rising prices. With this said, the case for low inflation is still being made despite commodity prices rising at a rapid clip.

We have a simple thought about the debate regarding higher commodity prices and the mass printing of money that leads to inflation: The average automobile has 17 pounds of zinc in the form of galvanized steel for rust-proofing. Another 20 pounds goes into die-cast parts such as door handles, locks, and trunk latches. Each tire contains about a half-pound of zinc that is used to cure rubber. A car battery contains 18 pounds of lead, and another nine pounds is used in soldering and other

components. There's 42 pounds of copper in a car in the radiator and wiring. The average passenger car also contains 267 pounds of aluminum. Nickel provides a few pounds as catalyst supports exhaust systems and safety belt springs. Now that we've established the substantial and various commodities used in manufacturing a car—and by the way, notice that we haven't even mentioned steel—where is the demand coming from? There are currently 826 cars per 1,000 individuals in the U.S. and only 15 cars per 1,000 individuals in China. The Chinese people are carrying out a vision to modernize and improve their standard of living by purchasing automobiles. Imagine the ongoing demand for various commodities, including oil, as China (and India) increase the number of cars for each 1,000 individuals. It is possible that the higher demand for commodities and the mass printing of money (and inflation) is just beginning.

Fixed Income

We continue to emphasize several points about fixed-income instruments that concern us. In the past, we discussed several risks associated with this “secure investment vehicle,” including issues about bonds such as the possibility of rising interest rates and greater chance of default. The first issue of rising interest rates has *temporarily* subsided, leading to a positive impact on bond prices. Notice our emphasis on the word “temporary”—and that the second issue of default has yet to rear its ugly head.

Bonds have remained rather volatile, with the Vanguard Intermediate-Term bond index down 0.7% at the end of the 1st quarter, off another 1.2% in the 2nd quarter, up 4.6% in the 3rd quarter, and finishing the 4th quarter with a gain of 1.3%—leading the average fixed-income investment to gain 3.9% in 2006. During the year, we had several large tranches of U.S. treasury, municipal, and corporate bonds come due. We continued our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and placed the majority of the proceeds in a mix of short-duration, fixed-income securities (one to three years) earning approximately 5.25% to 6%. (We are very happy with the increase in returns on our short-term, fixed-income investments).

At this point, annual returns earned on short-term, fixed-income investments still remain higher than those available on longer-term, fixed-income investments. While due in part to the market's long-term expectation of lower inflation, the major reason for the low returns offered on long-term, fixed-income investments is the speculative behavior of investors “betting” that long-term rates will continue to fall. Hedge funds continue to borrow large amounts of foreign money at cheap rates (Japanese Bonds at around 1% interest) and purchase U.S. Treasury Bonds at yields of 4.7%—making money on the difference, or “spread.” (This sounds great unless everyone tries at once to reverse this transaction.)

We have stated that we will not speculate, and we apply this attitude to fixed-income investments as well. It is better to be safe than sorry, and we will continue to reallocate money to short-term, fixed-income instruments to maximize our annual “earnings” on these investments. (This is especially true if inflation continues to rise.)

Our first principle in investing in fixed-income instruments is to protect principal. Given that the principal on fixed-income securities moves in the opposite direction of interest rates, we are extremely concerned that rising interest rates would significantly impact the value of long-term bonds. To us, it does not make sense to accept the paltry 4.7% yield offered on 10-year government securities, and we are unwilling to risk losing significant sums of money on rising interest rates, especially when we can obtain a “higher” yield on shorter-duration, fixed-income investments. We think longer-term fixed-income instruments carry far greater risks than the returns being offered, as low inflation over the next 10 years becomes less of a possibility. Therefore, we will continue to be patient and remain on a disciplined path until we find longer-term opportunities in which to place money to achieve higher returns, in exchange for a “fair risk.”

As Ben Franklin said:

Diligence is the mother of Good Luck.

—Poor Richard's Almanack, 1736

WHAT'S CHANGING AT FOUNDERS?

Changing Nothing & Remaining Balanced

The “Greed is Good” philosophy that ultimately cost Gordon Gecco his freedom has cost many investors their fortunes. Investors obsessed with an excessive desire for fast wealth and quick returns lose their perspective on the true value of things.

Ben Franklin relays the importance of understanding the value of things through a childhood story about his paying too much for a whistle:

“When I was a child of seven years old, my friend on a holiday, filled my pocket with coppers. I went directly to a shop where they sold toys for children; and being charmed with the sound of a whistle, that I met by the way in the hands of another boy, I voluntarily offered and gave all my money for one. I then came home, and went whistling all over the house, much pleased with my whistle, but disturbing all the family. My brothers, and sisters, and cousins, understanding the bargain I had made, told me I had given four times as much for it as it was worth; put me in mind what good things I might have bought with the rest of the money; and laughed at me so much for my folly, that I cried with vexation; and the reflection gave me more chagrin than the whistle gave me pleasure.

As I grew up, came into the world, and observed the actions of men, I thought I met with many, very many, who gave too much for the whistle.

When I saw one too ambitious of court favor, sacrificing his time in attendance on levees, his repose, his liberty, his virtue, and perhaps his friends to attain it, I have said to myself, This man gives too much for his whistle.

If I knew a miser, who gave up every kind of comfortable living, all the pleasures of doing good to others, all the esteem of his fellow-citizens, and the joys of benevolent friendship, for the sake of accumulating wealth, Poor man, said I, you pay too much for your whistle.

If I see one fond of appearance, or fine clothes, fine houses, fine furniture, fine equipages, all above his fortune, for which he contracts debts, and ends his career in a prison, Alas! say I, he has paid dear, very dear, for his whistle.

In short, I conceived that a great part of the miseries of mankind are brought upon them by the false estimates they have made of the value of things, and by their giving too much for their whistles.”

—Letter to Madame Brillon, 1779

There is something at Founders that never changes: Maintaining our perspective on the true value of things. In this age of uncertainty, it is our opinion that to be successful at the investment game it is important to focus on value, as opposed to price. We will continue to attempt to avoid irrational decisions that are influenced by emotions—including fear of failing to meet desired returns for investors, fear of lacking intelligence and overanalyzing a situation, and being greedy when prudence should prevail. In short, we will adhere to Ben Franklin’s advice and attempt to avoid paying too much for our whistles!

In summary: We continue to be comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and feel the returns are fair for the minimal risk we are taking. We want to assure you that we continue to be mindful of the risks in today’s markets and will allocate capital in a way that minimizes any long-term effects on the value of our holdings.

We leave you with this adage from Ben Franklin’s autobiography:

Human felicity is produc’d not so much by great pieces of good fortune that seldom happen, as by little advantages that occur every day.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2007.