



## GREENFIELD SEITZ CAPITAL MANAGEMENT

### *2005 Annual Letter*

*January 15, 2006*

#### **2005 Review**

It is with great pleasure that we are writing Greenfield Seitz Capital Management's ("GSCM") first annual letter. We are pleased with the organizational transition that GSCM undertook in 2005 with our change in custodian to Raymond James, Inc. As always, our primary focus is the investors of GSCM. We believe our structural transformation allows us to better serve our investors, which ultimately benefits everyone.

In late 2004, GSCM's commented "more of the same" to our investors regarding our outlook for the equities market in 2005. Our call was for a continuation of rising oil prices and a sideways stock market with continued leadership from the Energy sector. This proved to be accurate with 2005 being similar to 2004 in these regards. The S&P Energy sector gained 29.48% in 2005 to cap off a 3-year gain of 104.9%.

While oil stole the show again, the broader markets were tame with the S&P 500 garnering a 4.90% gain for the year. We are pleased that the GSCM Core Composite gained 16.62% after-fees for 2005.

#### **2005 Performance**

GSCM achieved a 16.62% gain for 2005, compared to a 4.90% advance by the S&P 500 Index. 2005 was GSCM's 6<sup>th</sup> consecutive year to surpass the S&P 500 Index on a gross basis (2000, 2001, 2002, 2003, 2004, and 2005). According to *The Wall Street Journal* (12/10/05), among the 12,000 U.S. stock funds, only two have a record of beating the S&P 500 Index for more than 6 years in a row.

Over the past five years, GSCM has achieved an average annual return after-fees of 8.90%, compared to an average annual return of 0.54% for the S&P 500 Index. According to *Standard & Poor's* (10/14/05), only 36% of active managers have beaten the S&P 500 over the last 5 years. We are pleased that our hard work, independent thought, and patience have allowed us to beat the S&P 500 by a wide margin of more than 8.35% annually, over the last 5 years.

We are realists and longtime students of the market, thus we are cognizant that (1) very few professional investment managers beat the market over the long-term; and (2) that regression to the mean is a mathematically high probability for GSCM's returns. There are always exceptions to widely accepted rules and we point out that Warren Buffett's 12-person investment firm, Berkshire Hathaway, has achieved an average annual return of 21.90% from 1965 – 2004. With this in mind, we will continue to work diligently towards finding attractive investments, one at a time.

GSCM's investment process has been performed successfully for over 40 years, and we have no intentions of altering our methods. We remain confident in our investment methodology and

optimistic about the future, as evidenced by the fact that our family continues to be the largest investor in GSCM.

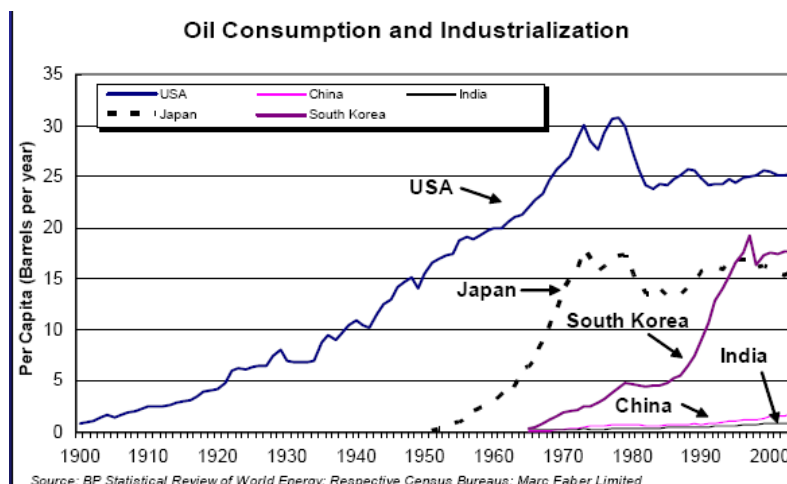
## Energy

In early 2003, GSCM concluded that there was a supply/demand imbalance with oil becoming increasingly difficult to find and demand increasing with the growth from India, China, and the rest of the world. With this mindset, we took a greater than 15% weighting towards the Energy sector for our investors. This was significant when compared to 5.8% weighting for Energy in the S&P 500 in 2003. We have maintained this massive overweight since that time, and it has obviously been rewarding.

Our primary investment in the Energy field has been in the tar sands of Canada, which hold 175 billion barrels of proven recoverable reserves, according to Raymond James Energy Research. We have invested in the Canadian tar sands since 1996 and continue to believe that oil reserves are an increasingly critical asset, as global supplies become more difficult to obtain. We continue to see energy companies dealing with extreme conditions to find new reserves such as; politically unstable countries, ultra deep water, and the high arctic. Lastly, we are attracted to the oil sands proximity to the U.S. market and its stable democracy.

To a lesser extent, we have invested in offshore drilling companies. We are attracted to the long-term nature of lease contracts. A typical semi-submersible rig is contracted on a 3-4 year period providing long-term cash flows. As oil prices have increased, drilling activity increases, which leads to increased demand for offshore rigs. To compound this effect, we believe there is a supply constraint due to considerable under-investment in offshore rigs over the last decade while oil prices languished. We note that manufacturing a typical semi-submersible rig costs more than \$350 million and may take more than four years to build.

There are numerous fundamental factors responsible for driving the prices of energy commodities higher. OPEC capacity utilization is now at 92%. Russian oil production grew just 2.5% in 2005. Chinese and Indian oil consumption/capita is less than 1 barrel of oil per person annually, which compares to U.S. consumption/capita of more than 20 barrels a year (see chart). As India and China become more industrialized, we expect them to follow a similar pattern to the U.S. increase in oil consumption since 1900, albeit faster.



We are long-time advocates of Warren Buffett and the idea of selling what is in favor and buying areas with low investor sentiment. Following this rule, we are now growing less enthusiastic about our Energy holdings.

## **Alternative Energy**

For more than a decade, GSCM has owned Japanese automakers as a way to participate in hybrid electric vehicles. We continue to believe the Japanese automakers have a clear head start in this industry. Higher gasoline prices are speeding the adoption process. In addition to our interest in hybrid electric motors, we are also investing in wind power and solar power. We note that in Denmark, wind generates about 20% of all electricity. According to the August 2005 *National Geographic*, wind power now costs \$0.06 per kilowatt hour, which compares to \$0.05 for coal, \$0.055 for natural gas, and \$0.07 for nuclear.

## **International Equities**

In 2005, GSCM maintained our heavy exposure to securities of international issuers. Traditionally, we have owned international equities for diversification, attractive valuations, and secular growth opportunities.

Last year in a rare interview, Sir John Templeton said, he is less interested in U.S. stocks and is now invested primarily in Russia, Japan, and India. GSCM continues to be invested in all of these countries as we continue to find impressive profit growth at attractive valuations.

At GSCM, we are okay missing some individual stock winners, but successful investors don't want to miss big investment themes. In our lifetime, we believe people will look back and say Russia's transition from a communist country to a capitalist society was a major investment theme. Russia is an enormous country, spanning 11 time-zones, populated by an intelligent work force and containing tremendous natural resources (#2 exporter of oil in world). In 2005, the Russian market continued to have little correlation to the U.S. markets. The Russia Index posted a gain of 69.49% for 2005 as Russia continues to benefit from higher oil prices, a gradual shift towards capitalism, and GDP growth of 6% (2<sup>nd</sup> only to China). Since 1998, the Russian Index (RTS) has appreciated 1,902% versus a gain of 101% for the S&P 500 Index. Despite considerable media attention, we have always maintained zero exposure to Chinese companies. We continue to be wary of the Chinese government and concerned about unrealistic valuations. Avoiding China proved worthwhile in 2005 as the Chinese market appreciated much less than other emerging markets (15.93%). In addition to Russia, Canada also outperformed the U.S. in 2005 largely due to gains of Canadian Energy Companies. Japan's turnaround continues with a 26.32% increase for 2005, hitting a 17-year high. The privatization of Japan's \$3.3 trillion Postal Savings System should have meaningful positive effects on Japan's capital system and economy. Additionally, Japanese citizens maintain less than 10% of their savings in mutual funds, preferring cash and bonds. We are optimistic that this low allocation to equities represents possible pent-up demand for Japanese stocks. India also continues to grow and shares of the Indian index gained 35.37% last year. We maintain our Bullish outlook on the Indian equities market.

## **Globalization**

Our strong belief in globalization has been, and continues to be, that advances in technology make the world a smaller place. Countries like India and China are quickly becoming industrialized and raising the standards of living for their massive populations. We maintain our belief that corporations are profit-driven and therefore eager to seek cheaper sources for similar quality goods/services, which fuels globalization. The demographics are powerful with India and China comprising more than half of the world's population. India is one of the youngest populations in the world, which equates to a large work force and a long time-horizon for growth. According to the last national census, half of India's population is below 21 years of age. Furthermore, India's middle class (people earning \$4,545 - \$23,000 a year) has tripled to 300 million in the past 20 years, according to the National Council for Applied Economic Research. We think the maturation process will be significantly faster than other previously developing countries, as India and China rapidly transform from agrarian economies to modern industrial economies. Any job that can be done remotely, by

computer or phone, is a job that can be done by an Indian worker. Mundane jobs, such as data input or an operator at a call-center, are considered drudgery for college graduates in the U.S. According to the August 22, 2005 *Businessweek*, these business process outsourcing (BPO) jobs are now employing over 300,000 people in India and paying roughly \$7,000 a year, which is enough to afford a car. The wages in this new economy are significantly higher than farming wages and are driving consumer expansion. Last year, the BPO industry in India grew more than 40%. We continue to believe the industrialization and modernization of these countries will be a long-term event with powerful effects on companies based there and on overall global business and investment.

### **Technology Sector**

GSCM is still significantly underweight the Technology sector. We believe the current fundamentals do not deserve premium valuations. To highlight technology fundamentals:

- Commodity markets (margins pressured)
- Continually declining prices
- Limited product differentiation
- Capital-intensive
- Cyclical in nature
- Typically pay no dividends
- Aggressive accounting
- High management compensation
- Stock Option Expensing expected to cut 2006 earnings more than 20% (WSJ 10/19/05)

We do not believe this combination of fundamentals warrants a premium valuation. We believe a likely cause for this valuation phenomenon is that the excesses of the Tech Bubble have still not been removed. Lastly, we have always said the leaders of the last Bull market are usually not the leaders of the next Bull market. With this frame of mind, GSCM plans to continue our longstanding underweight position in the Technology sector.

### **Airline Industry**

At GSCM, we are often attracted to areas that are currently out of favor with investors. Clearly, the airline industry has myriad problems (fuel, healthcare, fixed costs, competition, wages). However, many of these negatives have caused the airlines to streamline their business and cut costs. Now these leaner businesses may have a reversal of fortunes with a tailwind from: (1) lower fuel costs, (2) lower industry capacity, (3) higher ticket pricing, (4) higher load factors, and (5) higher traffic levels (2005 was an all-time record).

### **Alternative Assets: Gold & Timber**

We continue to own gold mining stocks for their negative correlation to the U.S. Dollar and the U.S. equities market. It is our hope that gold may provide a hedge against our equity positions. Additionally, we note that many individuals and central banks are now diversifying into gold as a safety asset. Gold experienced a 20-year Bear market from 1980-2001. During this time period there was little capital investments into new mines. Lastly, GSCM continues to maintain a negative outlook for the U.S. Dollar and we are attracted to gold's negative 94% correlation to the Dollar. We expect further Dollar weakness due to (1) the U.S. record trade deficit, (2) record budget deficit, and (3) record foreign holdings of U.S. treasuries.



GSCM added another tangible asset to our model portfolio in 2005, which was timber land. We believe equity returns will be compressed in the long-term and that timber may afford us a relatively stable asset class with attractive returns. From 1950-2000, timber returned 15.73% a year, which is superior to S&P 500's 10.51% return.

### **Water Scarcity**

According to *The Wall Street Journal*, as the world's population has tripled over the last century, the use of water has increased seven-fold. The World Commission on Water predicts water use will increase 50% during the next 30 years. Last year, about 1.8 million people died from diarrhea and diseases related to unsanitary drinking water. As the world becomes increasingly industrialized, the need for water increases. According to Raymond James Research, one ton of steel takes over 20,000 gallons of fresh water to produce. With the increasing industrialization of the world and the increasing pollution of the world, we believe significant investments in water purification and transportation must be made. We don't disagree with the idea "Water will be the oil of the 21<sup>st</sup> Century."

### **Aging Population Demographics**

The population of the U.S. is becoming older through lower birth rates, longer life spans, and aging Baby-Boomers. According to Goldman Sachs, over the next 40 years the ratio of persons over the age of 65 to individuals aged between 20 and 64 in the EU will roughly double, reaching around 55%. We are increasingly attracted to medical device companies that can give the elderly the quality of life they expect. In this broad theme, we are also attracted to areas such as pets, travel, and cosmetic procedures.

### **Housing Market**

In the summer of 2005, GSCM officially took a negative stance on the U.S. residential housing market. The increasingly speculative nature of this area is worrisome to us. According to the Federal Reserve, the average home equity in the U.S. is at an all-time low of less than 55%. Simultaneously, household debt as a percent of assets is at a record high of 18%. With our negative stance, we own no housing stocks. As with the technology bubble, we say, "I've read this book and know how it ends....I just don't know when."

### **Management: a thank you**

As usual, we sincerely appreciate the efforts of the corporate management teams running the companies that comprise the GSCM Core Portfolio. Without their effort, the growth that many of our portfolio holdings produced would not be possible. Successful management is crucial to our long-term success. As Warren Buffett says in rule 4 of his acquisition criteria, "we need strong management in place....we can't supply it."

## 2006 Outlook

According to the CFA Institute, the total compensation for sell-side research analysts is down more than 30% from the peak in 2000. With this decrease, there are significantly fewer research analysts and significantly less companies followed. The decrease in Wall Street research of public companies creates an opportunity for GSCM to find attractive investments that are not widely followed. GSCM has always formed all our investment ideas internally, free from Wall Street and the herd mentality of many money managers.

In 2006, we still see little reason to invest in technology shares. From our fundamental analysis, we conclude that many technology companies do not deserve their premium valuations. As always, we believe many technology companies are increasingly competing in commodity markets and margins will be pressured downward as competition is based largely on price. GSCM plans to continue our longstanding underweight position in the technology sector.

In the foreseeable future, we think international markets may continue to perform well and are attractive on a growth/valuation basis. By our calculations, foreign stocks trade at a discount to their U.S. peers. In many cases, these foreign stocks actually have superior growth outlooks and recent earnings growth. Additionally, continued weakness in the U.S. Dollar could make international companies a more attractive investment to worldwide investors. Furthermore, we are attracted to their low correlation with our U.S. holdings. We are wary of the over-leveraged U.S. consumer and the possibility that we are in a credit-driven rally in a secular Bear market. We believe our foreign holdings are a nice hedge against potential risks in the domestic market.

In the domestic market, we are increasingly concerned about consumer debt and its effects on consumer spending, which drives three quarters of U.S. GDP. The domestic consumer is already strapped with record household debt and now faces increasing gasoline costs, winter heating costs, and increasing adjustable mortgage payments tied to higher interest rates. In this cautious backdrop, we believe 2006 will be a stock-picker's market with alpha (superior performance for a given measure of risk) generated from security selection. GSCM has always based our investment decisions on fundamental analysis; therefore we are cautiously optimistic for continued success.

Sincerely,

  
Greenfield Seitz Capital Management

Greenfield Seitz Capital Management's ("GSCM") returns are calculated using daily valuation, are time-weighted and include cash in the total returns. For GSCM disciplines, performance is based on a size-weighted (asset-weighted) composite of all fully discretionary, wrap-fee accounts managed by GSCM in the Passport Investment Program, with the following accounts removed from the composites: i.) restricted, and ii) remit check paying accounts. Terminated accounts remain in the composites including last full quarter. GSCM seeks to apply a consistent management style across all accounts managed within a particular strategy. However, because individual accounts contained in the composite vary by size and cash flows, the specific securities held and rates of return achieved may differ among accounts. Net results reflect the deduction of investment management fees and any other expenses that may be incurred, but not domestic taxes. Performance includes reinvestment of all income, dividends, and capital gains. Total return is reported using accrual accounting except for dividends. GSCM's portfolios are individually managed and opened at different times and no inference should be drawn that new or existing accounts will achieve similar investment performance in the future. Rather, the above returns are presented to illustrate GSCM's portfolio management experience generally. GSCM performance measurement processes and procedures have been verified by an independent auditor. Any revisions will be promptly published.



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The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

Special risks are involved with global and international investing related to market and currency fluctuations, economic and political instability, and different financial accounting standards.

The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence.