

→ First Quarter 2007 Performance Review

A Turbocharged Quarter

By Mariko Gordon, CFA

Founder, CEO and CIO

We reversed 2006's entire underperformance in the first quarter, with our composite up 7.15% versus 1.95% for the Russell 2000. We are proud to have beaten our benchmark quarterly by over 500 bps 12 times since 1995, while trailing by that amount or more only 3 times. Better yet, we were up when the Russell was down in February. Momentum for our portfolio built as the quarter progressed, culminating in an exceptionally strong March, up 4.94% versus 1.07%.

As bottom-up investors, our performance is built stock by stock. We seek to pick some good-sized winners, minimize our losses, and have the rest of the portfolio in aggregate beat the benchmark. We were glad to see the normal drivers of our performance reappear after a frustrating 2006; almost every position earned its keep this quarter. While we won't turn down turbocharged performance from a super-sized winner or two, returns generated by the entire portfolio are less ephemeral and of higher quality.

We had only one real fourth quarter earnings disappointment: Hot Topic, the teen retailer. Sales were anemic as back-to-school merchandising improvements failed to carry through the holiday season. The stocks of Macrovision (digital content protection) and Bio-Rad (life science diagnostic equipment) both took a hit when they lowered near-term earnings guidance because of

acquisitions. The acquisitions make long-term business sense, and we believe the stocks will recover.

We had an interesting run-in with Wall Street this quarter – one that makes our relentless focus on research worthwhile. A classic “cheap and changing for the better” Daruma stock, Warren Resources (WRES) is an oil and gas company with operations in Los Angeles and Wyoming. The L.A. basin produces oil from mature but long-lived acreage and is a cash cow. L.A.'s revenues are funding a big drilling program in the Washakie basin in Wyoming, Warren's new growth engine.

Once Wyoming comes on line, earnings, cash flows, and net asset value will grow faster. Each year, Warren also drills one or two wildcats (exploratory wells drilled in land not known to have oil or gas). We bought the stock when it reflected the value of the California properties, paying next to nothing for Wyoming's upside.

Like many a company reinventing itself, Warren had a setback. Late last year, the company lowered its 2007 production guidance, and investors punished the stock. Warren's efforts to modernize and wring faster revenue growth from its L.A. operations were taking longer than expected. We went out to meet with the new head of operations and his team to learn what went wrong and whether it was fixable.

When a stock is down, we give ourselves a strict 90 days to sell or to add more – in either case we make a decision after a dispassionate review of our initial investment

Composite returns are stated gross of fees. Please see Notes to Performance on the website.

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thesis. In the case of Warren, we became more confident that L.A. would meet its targets, and we added to our position.

A few days ago, just as we got wind of a short seller stalking Warren, a broker breathlessly told us that mysterious sources suggested that the company's South Seminole wildcat was a dry hole. That day, an article appeared in the *Rocky Mountain Oil Journal*, which concluded that because Warren had released its drilling rig, South Seminole was a bust.

Did it matter to our investment thesis? Of course not. Wildcats are high risk/high reward, and it's imprudent to base an investment case on what is essentially an educated guess by a group of geologists. Were we spooked? Of course not. We knew that Warren refused to pay \$20,000 a day for a rig made idle by the testing required to put a price tag on South Seminole. The value of the discovery can only be calculated once its size and gas flow rates are measured.

In the end, the *Rocky Mountain Oil Journal* issued a retraction, and the broker claimed we'd misunderstood him. We still don't know exactly what South Seminole is worth (no one does yet), but we know it's sitting on top of gas. Wildcat or no wildcat, if Warren puts up the production numbers from L.A and Washakie, investors will flock to the stock.

In a world flooded with information, at times spurious, we add value by doing our own research. Not every quarter will feel as good as this one, but we are pleased to report that being disciplined and persistent paid off once again. We continue to scour our investment universe for those stocks with 50% potential upside that are scorned, misunderstood, or seeking redemption from Wall Street.

Erratum

"In last week's issue of the RMOJ, the headline article regarding Warren E&P plugging its deep Hanna Basis test at the Ferris Fee 2285 NE 13 ne-ne 13-22n-85w, Carbon County, Wyo. was incorrect. Warren E&P has, in fact, drilled this hole to the Pennsylvanian Tensleep at a depth near 16,190' and has set production casing near total depth for testing procedures.

Although inexcusable, the erroneous report was due to a misinterpretation of the source data. We apologize for this error and any inconvenience it may have caused.

In a related matter, when eating crow, remove breast meat, beat with mallet, dip pieces in beaten egg and then in bread crumbs or flour. Fry in oil in hot skillet. Leave inside a tad pink."

Source: The Rocky Mountain Oil Journal, April 6, 2007