HUSIC CAPITAL MANAGEMENT

INVESTMENT OUTLOOK

The First Half of 2008 Was Tough for Equities

June was another difficult quarter for the equity markets, with most markets around the world finishing the first half of the year in negative territory. Despite this, the Husic portfolios have performed well this year.

Due to the volatility in the markets since quarter's end, it is appropriate to review our theme for the decade, "The Industrialization of the Emerging World" and the sub-theme of coal as a key component to that process. This theme continues to be the driving force for global growth. According to the IMF, during 2000-2007 over half the world's GDP growth came from the emerging world and over 60% could come from there over the next five years.

The fundamentals of coal may be better than those of oil. For the fifth consecutive year, coal has been the fastest growing fuel globally. In the U.S., over 50% of our electricity needs are powered by coal. Over the next two decades, coal is expected to gain market share as its growth is expected to outpace all other energy forms.

The lion's share of electricity needs in China and India are met with coal. Certainly coal and oil have benefitted from "The Industrialization of the Emerging World" trends, driving prices higher. These trends have been so strong that they outpaced the world's ability to grow coal supplies. Economic growth tends to be linear and infrastructure growth is lumpier. Infrastructure growth, necessary for sustained rapid economic growth, takes commitment, time and money. It has fallen behind economic growth and will take an extended period of time to catch up.

World coal consumption grew 4.5% in 2007 versus a paltry 1% increase in supply. In fact, the world coal market has been undersupplied for the last several years. The supply interruptions this year were floods in Australia, snowstorms and earthquakes in China and power shortages in South Africa. Interruptions are merely a symptom of the fact that the markets are undersupplied. Higher prices will continue to be the mechanism for rationing this resource.

In 2007, global demand outstripped supply by 42 million tons. We could see an even larger supply shortfall in 2008, despite global growth slowing, as coal supply interruptions compound the coal market imbalance. Low inventories at the generators are currently forcing sporadic shutdowns.

Despite this, coal fired plant capacity continues to rapidly come on line - China added more coal burning plants last year than Britain built in its entire history. Having doubled capacity since 2000, China has 50% more coal-fired generation capacity than the U.S.

We see rising nationalism at work as countries try to manage this situation. Many of the large coal exporting nations are trying to keep more coal available for domestic needs. China, Indonesia, Russia and Poland are keeping much more coal than they once exported.

At Husic Capital we have always been attracted to buying shortages and selling surplus. The Internet stocks are a good example. Back in the mid-to late 1990s, the Internet grew rapidly and there were a limited number of stocks to buy. That is when investors captured most of the gains. Venture capital firms then set about fulfilling the demand for internet stocks – creating companies run by newly minted MBAs. By 2000, investors were deluged with supply - huge numbers of internet initial public offerings (IPOs) every week. That was the time to sell.

The U.S. Coal market is a good example of a market in shortage. It is a very small market for investors to be involved with. The market capitalization of the U.S. Coal companies at June 30, 2008 represented under $100 billion. Higher exports, strong steel demand and increasing domestic generation needs are driving the U.S. markets. In 2008, coal consumption is up 13 million tons, exports are up another 10 million tons and yet production has only increased five million tons.

The higher-priced contracts coal companies have been signing in the first half of the year will have a limited impact on 2008 financials. Though partially offset by higher costs, they will have a larger impact on future years as higher per ton realizations boost revenues and profits.

A market in surplus can handle supply disruptions much more easily than one in deficit. In 2009, a large amount of coal fired plant capacity is coming on line. U.S. exports are expected to increase in 2009. We expect the markets to remain in short supply for the foreseeable future.

Despite the economic attractiveness of the market, coal production has not been increased in a rapid fashion. It has been and is expected to continue to be constrained by regulatory and permitting issues, long lead times for new mines and labor shortages. Strong visibility, high profit growth and limited market capitalization makes for disproportionately attractive returns for investors.

Consolidation of the industry is another driver for stocks. As investors look to 2009, multiples are trading to the low end of historical ranges, resulting in many attractive opportunities. In addition the U.S. assets are on sale, in part, due to the low value of the U.S. dollar. We now have evidence of this continuing.

Following consolidation of the steel market by international players, expectations were for more of the same for the coal markets. That is why it is somewhat surprising that the U.S. based Cleveland Cliffs made a bid for Alpha Natural. Thus we think there could be other interested buyers.

Sporting multiples in the range of 5x 2009 enterprise value to EBITDA or 10 times earnings, even public U.S. resource companies find these valuations compelling. On a BTU equivalent basis, coal stocks trade at a fraction of their oil and gas exploration and production (E&P) brethren. We think there could be other interested buyers and equity market investors will be compelled to bid up prices.

The U.S. continues to benefit from its position as the swing producer of coal. Coal stocks are a scarce asset with rapid growth attributes. That will remain the case for the foreseeable future.

Outlook
The market has faced headwinds from the credit crisis, a slowing economy and high energy prices. The surprise is that the economy has continued to grow this year. The Federal Reserve interest rate cuts were started a year ago and should help improve economic growth. This is an election year and the government will do its best to keep the economy growing.

The multiple is the most important determinant of stock prices. The current view on coal companies is that they are highly cyclical companies where earnings tend to fluctuate between profit and loss, and thus they should be valued at low multiples. We believe the profit streams from these companies will show rapid, consistent growth, thus investors will pay a handsome multiple for them over time.

From a valuation perspective the market is reasonably valued at a low-to-mid teens multiple on forward earnings. The earnings yield on equities is below the 10-year U.S. Treasury bond yield. Sentiment remains quite bearish, which as a contrarian indicator is bullish for the markets. Investment newsletter writers have not been this bearish since 1994. Short interest is at record highs.

Another rare occurrence is when the dividend yield of the S&P 500 Index is below the three-month U.S. Treasury bill yield. This is only the third time it has happened in the last 50 years. The first time was in 1990 and the Index rallied 60% in the next three years. The other time was during the last bear market which occurred earlier this decade. That was followed by an 80% rally through last year's highs.

We remain underweight financials believing that they continue to show credit losses, and any capital raises they do will be highly dilutive to shareholders.

Our theme for the decade is "The Industrialization of the Emerging World." This continues to be the driving force for global growth. The population of the developed world is less than one billion people and economic growth is low. Meanwhile there are three billion people, experiencing faster growth in emerging countries including BRICs (Brazil, Russia, India and China), and a number of smaller countries.

We continue to see opportunities in companies that will benefit from this process. These countries place a higher priority on growth than on environment or inflation. Sectors benefiting from this include basic materials, energy and industrials.