

BLUE GRANITE CAPITAL

QUARTERLY MARKET REVIEW Third Quarter 2003

As the third quarter came to a close, the government reported one of the strongest economic numbers we have seen in quite some time. The August payroll report showed an increase of 56,000 jobs compared to an estimated negative 26,000. This report provided the strongest evidence in eight months that a "jobless recovery" may not impede economic growth and with it, a positive catalyst for the equity markets. Although one month does not make a trend, it does provide reassurance that a recovery is on the way. Another encouraging signal has been significant dividend increase announcements by major companies, many of which we hold in our portfolios (ex. Wells Fargo increased their dividend 50%).

The stock markets continued their upward momentum throughout the third quarter, but at a much slower pace than registered for the second quarter. The tremendous volatility in the fixed income market compounded investor confusion and increased market uncertainty. While the bond market lost as much as 15% during a three week span, rates on 10-year Treasuries moved from 3.91% to 4.66% before finally settling in around the 4.1% range. This gyrations in the bond markets caused huge losses for those speculating on the direction of interest rates. Needless to say, strategic decisions on investments became even more difficult to ascertain with a weakening dollar and gold reaching an eight year high.

Blue Granite Capital began to analyze several of the larger gold and precious metals companies. With low interest rates, a weakening dollar, and continued global terrorist activity, gold regained a portion of its relevance as a monetary standard. Reaching an eight year high of \$388.40 on September 24, gold broke out from a 22 year bear market. Our research has led us to three of the more stable companies to implement new investments: Newmont Mining, the world's largest gold producer; Anglo-Gold, the second largest producer; and XAU the gold and silver index comprised of twelve component companies.

As our last commentary stated, the second half began with a more positive outlook than we have seen in several years. Although the economic recovery has not been robust, it is trending in a more positive direction. Many troubling issues still remain such as: excess manufacturing capacity, lack of corporate pricing power, increased government spending, record federal debt levels and global terrorism. Blue Granite Capital is more positive than in previous years, but with a significant number of unresolved variables, we maintain a conservative approach to our investment strategies.

During the quarter we bought R.J. Reynolds Tobacco (RJR) because it offered an attractive value with a low P/E, high dividend yield, and a stock price that had declined on a host of issues. We felt that investors overreacted to low-priced cigarette competition and continued tobacco liability concerns.



Tactically, we saw upward momentum for the shares because the company disclosed their hiring of Goldman Sachs to sell their operations at an estimated value of \$45-50 per share. RJR shares have gained 13% since our purchase less than three months ago. After careful consideration, Blue Granite Capital decided to no longer invest within the tobacco industry until all liability-related issues are resolved. Despite compelling valuations and attractive fundamentals, the shares of tobacco-related companies have become too volatile. This has led us to sell our holdings in both RJR and Altria (Philip Morris, MO). BGC believes there are better investment opportunities outside the tobacco industry.

We also initiated a new position in Costco (COST) shares and added to current Costco positions at \$31.06 per share. Costco is not only the largest wholesale club operator, but also a premier business model that many attempt to duplicate. In what may be one of its most attractive attributes, Costco generates over \$950 million in annual membership fees before they even open their doors for business. With increasing membership, the company continues to open new stores and develop new merchandising concepts. As of this writing Costco has reported third quarter earnings that were better than consensus estimates, reaffirming our positive stance.

On the more speculative side we purchased Sun Microsystems (SUNW) for some portfolios. Although SUNW has yet to execute a turnaround, we firmly believe SUNW provides an attractive technology platform that will prove profitable for years to come. One hidden value that leads to our interest is the fact that SUNW holds cash and marketable securities valued at half its current price of \$3.40 per share. This reveals that the entire company is valued at only \$1.70 per share for an enterprise generating over \$11 billion in revenue. For that reason, we participate and wait patiently for a turnaround.

The key to fourth quarter market performance will be the strength of third quarter corporate earnings and whether these results will justify already lofty stock price valuations. Without the benefit of better earnings and a positive corporate outlook, the markets may take a rough and tumble ride. BGC has positioned portfolios conservatively, in the event that poor results and a further cloudy outlook for corporate profitability supply too much pressure and derail the market rally. To date, third quarter earnings reports have been reasonably positive, showing progress toward an improving economic environment. Please remember our investment discipline seeks to identify dominant, well-managed companies with strong balance sheets that are growing both their earnings and dividends.

As always please feel free contact us with any questions or concerns that you may have. We wish you and your family a healthy, happy and prosperous holiday season.

Sincerely,

Scott B. Shubert

Matt Daen

