. Alley Company Commentary
The Case for Quality

"The goal should be to find an outstanding business at a sensible price, not a mediocre business at a bargain price." -- *Warren E. Buffett*

Over the past few years, investment performance has favored *riskier* asset classes such as international (especially emerging markets) and U.S. small capitalization stocks over the less risky asset class of U.S. large capitalization stocks. Even within U.S. large capitalization, cyclically-dependent and commodity-driven companies have been favored over stable growth companies.

At Alley Company, we believe that over time, as history has proven, the best *risk-adjusted returns* in the stock market will continue to be found in the U.S. large capitalization asset class. Within this universe, our research focuses on identifying high quality investments, which we succinctly define as companies with **proven track records and strong prospects for sustainable future growth.**

Specifically, in our first Commentary, dated December 1999, we highlighted our preference for **Walgreens**, a company believed to have a strong outlook for sustainable growth, over **General Motors**, a company believed to have far more dependence on cyclical factors. Since our Commentary was published, Walgreens has achieved compound annual earnings per share growth of 16 percent and appreciated by over 50 percent while General Motors stock price has *declined* by over 50 percent. The message here is that over time, stock prices tend to follow earnings growth; hence our philosophy of investing in quality companies with sustainable growth prospects.

A Look at Historical Performance

The table below shows the 61-year (modern times) performance record of six major asset classes and the corresponding risk as measured by the standard deviation of returns. As illustrated by the Sharpe Ratio (excess return per unit of risk), the best risk-adjusted performance has been found in U.S. large capitalization stocks. The table also highlights that despite the aforementioned outperformance of riskier asset classes in recent years, the 10-year performance history still reveals very competitive returns for U.S. large capitalization equities.

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Asset Class	1945-2005 (Modern Times) Annualized Return	Standard Deviation	Sharpe Ratio	1996-2005 Annualized Return
U.S. Large Capitalization Equities	11.7%	17.1%	.421	9.1%
U.S. Small Capitalization Equities	14.4%	25.6%	.387	9.3%
International Equities (EAFE) *	11.7%	25.5%	.282	5.8%
Emerging Markets Equities	13.4%	31.7%	.281	7.0%
U.S. Long Treasury Bonds	5.7%	10.3%	.117	5.5%
90 Day U.S. Treasury Bill	4.5%	3.1%	N/A	3.2%

Source: Morgan Stanley, Alley Company

* EAFE is Europe, Australia, and Far East

Be Aware of Risks

While there has been fundamental justification for the recent performance of riskier asset classes, history teaches us that momentum factors can increasingly impact the investment decision making process, potentially driving market segments to extreme expectations. True to form, money flow data reveal that riskier asset classes have recently garnered the lion's share of the public's money flow into funds. For example, year-to-date through April 15th of 2006, emerging markets equity (highest risk of the six major asset classes) funds had inflows of $9.7 billion, exceeding their *combined* inflows for 2003-2005. This tendency of the investing public to extrapolate price trends and "chase performance" is nothing new. The most recent example is the technology-related stock fad of the late 1990s, which, of course, ended badly for those chasing performance in higher risk companies with unsustainable business prospects.

A critical question today for riskier asset classes is: what is the sustainability of underlying business results and how lofty are market expectations for continued growth? Of particular relevance is the current tightening of monetary policy that is taking place on a global basis. This has the potential to crimp global demand, leading to slower economic growth and disproportionately slowing the earnings growth of higher risk and more cyclically-dependent companies compared to quality companies with sustainable growth characteristics.

Quality Offers Attractive Value

Relative to current levels of inflation and interest rates, U.S. large capitalization companies are currently trading at attractive valuations in the marketplace. Additionally, compared to their small capitalization counterparts, large capitalization stocks are now trading at a *discount* based on current price-to-earnings (P/E) ratios of 2006 and 2007 estimates. Historically, large capitalization stocks trade at a *premium* to small capitalization stocks. When economic growth moderates, the relative earnings growth of higher quality companies will likely outstrip the more speculative sectors of the stock market and act as a catalyst to return their valuations to *premium* levels.

In addition to **Walgreens**, we highlight **Medtronic** and **General Electric** as other examples of quality companies that have proven track records and strong prospects for sustainable future growth. Currently, all three of these companies are trading at the low end of their historical P/E ratio ranges and are guiding investor expectations to annual earnings growth of approximately 15 percent for each of the next two years. In the case of Medtronic and Walgreens, this level of growth may be sustainable for a much longer period of time while General Electric's long-term growth rate may settle in the range of 10-12 percent. Our feeling is that these stocks have potentially reached a bottom in their respective P/E ratios, and that given the solid fundamental situation at each company, the stocks could generate returns of 15 percent plus their dividend yields, or 15-18 percent total returns annually, if the stocks just track expected earnings performance.

Importantly, these three companies encapsulate our objective of generating attractive *risk-adjusted returns*. The stocks present the opportunity to invest in growth at reasonable valuations, while the companies continue to command leadership positions in their respective markets. Our research continues to seek out high quality companies as a means of compounding money tax efficiently while managing risk.

July, 2006