

AVENIR CORPORATION

INVESTMENT MANAGERS

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In the midst of this extraordinarily turbulent market environment and uncertain economic outlook, we think it is an appropriate time to affirm with you several fundamental truths about investment values and how they are determined. For those of you who were clients of Avenir in the summer of 2002, a time of stock market volatility similar to the present, the following will sound very familiar.

As you know, we are long-term investors and strive to invest in good businesses with good management that will compound capital over time. We do not invest in the stock market per se; rather we invest in businesses through the stock market mechanism. Over time the stock market has been a very efficient mechanism for allocating capital where it will be employed most wisely. Occasionally the market gets out of whack and allocates capital inefficiently – and it can be very inefficient as evidenced by internet and “new economy” stocks in the late 1990’s, or by financial and housing related stocks more recently. However, in the long run, the stock market will continue to perform its function of allocating capital efficiently, wringing out any excesses and, ultimately, rewarding those businesses that create true economic value. It is clear, however, that the broad market can swing to extremes either way, and it is important in such periods of volatility and uncertainty to remain focused on the underlying economic values of specific investments and not on the day-to-day gyrations of the markets.

Focus on Intrinsic Value

The value of any investment, from treasury bills to common stocks, is determined by calculating the present value of the future free cash flows that will accrue to its owner. While fixed income securities such as bonds and treasury bills are generally priced to reflect interest rates at any given time, stock prices are often influenced by numerous factors that are not absolute and measurable and therefore have little or no relationship to business value. Indeed, in the latter days of the internet bubble, a lot of nutty reasons were given to justify high stock prices. (Similarly, during the recent housing and credit bubble, very silly assumptions and rationalizations were made by all participants at all levels.) However, in the words of Warren Buffett, “in the short run, the market is a voting machine, but in the long run, it is a weighing machine.” We cannot time the market and have no desire to pursue whatever happens to be popular at a given point in time. We are solely focused on the long term earnings and cash flow generating capabilities of our investments and continue to hold them because we believe they are intrinsically cheap, and in some cases, in light of recent events, much cheaper. As long as the businesses you own are operating to expectations defined by the intrinsic value standard, the current market price is irrelevant *except* to the extent an investor wishes to take advantage of low prices or is forced to sell.

Given our focus on free cash flow and intrinsic value, it may be useful to define what these terms mean. Free cash flow is nothing more than the real cash earnings of a business stripped of all accounting distortions and reduced for required maintenance of the enterprise. In essence, it is what is left of your take-home pay after you meet all your required bills. It is also occasionally referred to as discretionary cash flow or ‘owner’s earnings.’ After determining a company’s cash flow generating capabilities, we then assess management’s ability to reinvest that free cash flow, or more appropriately, to allocate capital. At the end of the day, this management skill is the most important for creating shareholder value. Capital allocation can take the form of growing the business internally, investment in new projects, acquisitions,

returning capital to shareholders via dividends, and stock or bond repurchases. A business can also simply allow the cash to pile up until an opportunity presents itself. The intrinsic value of a business is the present value of the free cash flows which takes into account their growth rate and the timing of when they are received. In its simplest form, intrinsic value is the current fair value of what one would pay to receive such a stream of cash flow.

Using these disciplines, we look for good returns with a margin of safety by trying to buy a good company at a discount to its intrinsic value. Ordinarily this works but sometimes we are early and have to endure price declines before the value emerges. This is part and parcel of value investing. Value investors do not follow the crowd, but the crowd – particularly a panicked crowd – is often responsible for dramatic price movements that have no relationship to the intrinsic value of the business. We want to reinforce the fundamental truth that over the long run, intrinsic value trumps sentiment and market psychology. At its essence, value investing is exploiting these gaps between market and intrinsic value. Yet, in some cases we may be wrong in our analysis and either pay too much for a good business or pay a fair price for a mediocre business. If we determine that the latter has occurred, we will take our losses and put the capital to work in more productive uses. We continually evaluate our portfolio to make sure our understanding of the businesses we own is sound.

On average, the large positions that drive our results trade for substantially lower multiples of free cash flow than the market as a whole. This means our portfolios generate substantially more free cash flow per dollar of market value than do the S&P 500 and other averages.

Housing and Credit

While the collapse of the housing market is garnering most of the recent headlines, we should point out that credit standards were relaxed significantly across the spectrum for several years. Indeed, many leveraged buy-outs of large, well-known companies were financed on flexible terms not all that different from the disastrous mortgage products provided to consumers. With respect to housing, the lack of accountability baked into the originate-to-sell mortgage system helped fuel the excesses and silly justifications for using ever increasing amounts of leverage. Not surprisingly, this same mentality infected corporate lending as well, as supposedly sophisticated investors who were willing to accept less restrictive terms to get deals done. Currently, we are in the midst of a credit crunch, and borrowing has become more difficult and more expensive on a relative basis. In addition, there is likely to be new regulation that may impact the cost of credit going forward. Credit markets will eventually normalize, but it may take a long time for housing and credit markets to clear.

Inflation and Interest Rates

The bursting of the housing and credit bubbles has led to several extraordinary actions by the Federal Reserve in its attempts to mute the crisis. Unfortunately, one by-product of the Fed's actions has been an increase in inflationary expectations which, in turn, could adversely impact asset prices. In our opinion there has been a heightened level of inflation in the economy for quite a while, which is only beginning to show up in government statistics. The decline of the value of the dollar and the corresponding increase in commodity prices reflect the higher level of inflation we perceive. One probable outcome of an inflationary scenario is higher long term interest rates, which would serve to further restrict growth and prolong the current economic slowdown. When we consider new investments, and as we continually reassess current investments, we do so with this economic outlook in mind.

Last Comments

We know what we own and why we own it. As in the period from 2001 to 2003, we are finding some terrific values in this market, both in businesses we own and in new ones under consideration. With stock prices in certain sectors at historic lows, we have a very constructive view of the opportunities available today, while giving due consideration to the long term effects of the bursting of the credit bubble. We are deploying capital in high return businesses we understand, know well and which are run by people worthy of our trust and your money.

We are very grateful to you, our clients and friends. Because we know so many of you well and are privileged to call you friends, we are especially sensitive to the wrenching effects of the recent market decline. As in previous times of heightened market volatility, several of you have even called in to see how *we* were doing. Thanks to all of you for your remarkable graciousness.

Remember that all of us at Avenir have the overwhelming majority of our liquid assets invested identically to yours so we fully experience your results. By all means, please call us with any thoughts or concerns you might have. We'd love to hear from you.

Our mission and values remain unchanged. We expect that over the long run, you will see us convert the current market environment to your permanent advantage.

Respectfully,

Charles G. Mackall, Jr.

Peter C. Keefe

James H. Rooney

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