Suncoast Equity Management, Inc.

July 2, 2008

Dear Client:

This is a difficult stretch. The economy is in a cyclical decline and the stock market accelerated towards "bear territory" in the last week of June. It's not the end of world but it feels like it for some participants. We discuss the current challenges below and put into perspective the support for the next permanent advance that we have experienced over and over again in this country's long history. We also identify how our portfolio companies handle the hard times and take advantage to strengthen their long term prospects.

Stagflation?

Concerns during the second quarter shifted from worries over the rate of growth in the economy to inflation. Stagflation (combination of no growth and inflation) is the prognosis du jour. The main culprits of inflation have been the surge in food prices and the price of oil to $140 a barrel, up 40% just since March 31st and double the price from this time last year. While the price of gas and food *climb,* apparel prices *fell* 0.6% in May from one year ago. What makes this inflation so glum is that we're spending more on things we have to buy, food and gasoline; and less on what we want to buy, trips to the shopping mall to buy clothes. The backdrop for slower growth has been the battered housing market and tighter credit.

The last bleak stretch of stagflation in the U.S. occurred in the 1970s. What is different so far today versus the oil shock of the 1970's is that we are far more fuel efficient, requiring half as much energy to product a unit of economic output. Productivity keeps gaining as nonfarm business was up 3.2% in the first quarter of 2008 from the prior year, the biggest jump since the second quarter of 2004. The U.S. economy continues to benefit from a weak U.S. currency, which has increased demand for American products and grown our exports. Interest rates are far lower today than they were then, though we keep a watchful eye if it were to go much higher from here.

We could use a better structure, such as a national and sustainable global technology plan, to address needs in energy, food and water. In this day and age of the internet we have an improved probability of getting there. The global economy transforms today at an astonishing rate. Policies and their consequences, good or bad, travel the world in an instant. Food prices are certainly rising because of a long term trend of greater interest in protein filled diets from folks in China and India. Yet the fuel to the fire, and the reason for the recent lift in prices at our local grocery store, are the ethanol mandates. These mandates presumably reduce our dependency on foreign oil. Not so in our belief. This poor policy decision is attracting greater opposition much quicker today than the feedback mechanism of many decades ago. Hopefully it will be reversed soon and that could lead to lower food price inflation immediately.

Should we feel so down?

With layoffs at the newspapers (as digital disrupts print), it's hard to read anything positive. The media always emphasizes the negatives. The headlines are always the same. For a little perspective consider the October 14, 1974 cover of *Time* magazine with President Ford with rolled-up sleeves and the headline "Trying to Fight Back: Inflation, Recession, Oil." As columnist Nick Murray recently observed, this could very well describe today's market. So should we feel as down as most journalists or the general public does? No, we will grow through this as we have through the many economic cycles of the past. If you keep the big picture in mind, you will realize there are many things to be positive about. We have included a step back point of view from a Wall Street Journal article by Gregg Easterbrook, author of the "The Progress Paradox: How Life Gets Better While People Feel Worse."

<u>Wall Street has the answer – Buyer Beware</u>

Since World War II, there have been twelve "bear" markets with an average decline of 25% in the S&P 500 index. From its October record, the S&P 500 is down 20%. Year to date the S&P 500 is down 12% and absent the energy and materials segments, which are in positive territory, the S&P is down in excess of 17% (See the chart of the S&P at the end of our letter).

The strong rise in the price of oil and commodities has of course spawned Wall Street to introduce lots of ways to "get in on the game." And as tempting as it can be, we urge great caution and share with you examples to consider. In mid June, Direxion Funds opened a new fund consisting of 16 commodities, in which it can take either long (betting the price will rise) or short (betting the price will decline) positions. Direxion started out placing 10% of investor's assets shorting soybeans. Two days after the fund started, prices of soybeans soared to a record high with the news of severe flooding in the Midwest. A Direxion representative said they will reevaluate their holdings each month to determine whether to adjust the positions. That doesn't give me a whole lot of comfort that they are indeed true investors, more like true speculators.

How about this recent quote by Kevin Rich, managing director of Deutsche Bank's Global markets as reported by the Wall Street Journal. "The rising interest in shorting commodities shows a better understanding of the sector among investors". Really? The United States Oil Fund, the biggest exchange traded fund (ETF) tracking the price of crude oil, was recently among the most shorted funds. During the first five months ending in May, the fund's short interest, again betting oil would decline, soared 140% to 16.26 million shares, about two times the fund's total shares. On June 6th the price of oil increased nearly $10 to $135. That one day price rise undoubtedly hurt all those betting oil would decline. Remember, Wall Street will help you roll the dice either way and they don't care which side you take (they get the fee either way). Deutsche Bank just scheduled a launch of eight new exchange traded notes (ETN), four of which bet on crude oil and base metals to fall, and four bet them to rise. Don't risk it. The long term returns from ownership of solid businesses may be a bit less exciting but it beats the higher risk and potential permanent loss of capital from commodity speculation.

<u>Portfolio Update</u>

Our portfolio companies make every effort to adjust to the current operating environment by stepping up innovations, implementing greater efficiencies and putting to work price elasticity. Each of our companies will engage a varied mix of these levers. During the quarter we sold our position in **Medtronic** in favor of an initial position in **Abbott Labs**, a like medical products company with a stronger growth profile. We also added **Disney** as the successful management and growth of that business under the relatively new leadership of Robert Iger, who replaced Michael Eisner three years ago, continues to blossom. During difficult times many of the high quality businesses we own invest opportunistically to further strengthen their business and deepen customer relationships and roster. **Hewlett-Packard** has expanded its sales force recently and purchased EDS, a systems technology and consulting services company, at a very reasonable price. The weak markets also create greater opportunity for **Berkshire Hathaway** and its war chest of $35.6 billion in cash. As this quarter's earnings are reported, we will closely examine if a business is just slowing (we are generally ok with that during a soft economy) or if a structural change or weakness has developed (that requires us to take action). We still anticipate earnings to grow, in the aggregate, this year for our portfolio companies, especially if the economies outside the U.S. maintain recent levels of demand for products and services.

Risk Management

As you know, it is our goal to incur less risk as we strive to generate returns above the market average (S&P 500). Our risk reward rating from inception to March 31, 2008 is enclosed. As you can see we are in the preferred quadrant – more return, less risk. This quarterly report is prepared by an independent performance measurement firm, Informa/PSN, who prepares the ranking for all managers' gross of fees.

The U.S. is a resilient and productive economy. We still have the largest market in the world. As the economy slowly works itself back towards growth, the stock market typically advances ahead of the recovery. The bumps along the way will be rocky but the main rule of thumb is stand there, don't do something. It is a good time to keep an open dialogue so please call at any time. And as you may already know, our company savings plan and personal assets are invested along side of yours in the same portfolio. Thank you for your continued confidence.

Sincerely,

Donald R. Jowdy
President

**Standard & Poor's**

| June 30, 2008 | # of Companies | Market Cap. ($ in Millions) | Level | Performance 2nd Qtr. | Year-To-Date |
|---|---|---|---|---|---|
| **S&P 500** | 500 | $11,170,076 | 1280 | -3.23% | -12.83% |
| Total Return (Includes dividends) | | | 2031.47 | -2.73% | -11.91% |
| | | | | | |
| **Components** | | | | | |
| Energy | 39 | $1,810,558 | 652 | 16.92% | 8.12% |
| Materials | 29 | $435,622 | 260.34 | 3.88% | 0.19% |
| Industrials | 55 | $1,241,809 | 302.64 | -10.59% | -14.59% |
| Consumer Discretionary | 84 | $905,809 | 223.57 | -8.12% | -13.86% |
| Consumer Staples | 41 | $1,204,097 | 273.97 | -5.92% | -8.54% |
| Health Care | 52 | $1,330,586 | 354.53 | -1.73% | -13.47% |
| Financials | 89 | $1,590,743 | 270.95 | -19.01% | -30.89% |
| Information Technology | 71 | $1,835,144 | 356.34 | 2.29% | -13.43% |
| Telecommunications Services | 9 | $370,808 | 136.46 | -5.09% | -18.90% |
| Utilities | 31 | $444,901 | 206.74 | 7.10% | -4.34% |

# *Suncoast Equity Management, Inc.*

Performance results versus the Standard & Poor's 500 Index

| **Time Period (Ended 06/30/08)** | **SEM % Return*** | **S&P 500 % Return** | **SEM - Value of $1,000,000** | **S&P 500 - Value of $1,000,000** |
|---|---|---|---|---|
| 1st Half of 2008 | -14.13% | -11.95% | $ 858,700 | $ 880,500 |
| One-Year | -9.52% | -13.19% | $ 904,800 | $ 868,100 |
| Three-Year | +1.38% | +4.83% | $ 1,042,000 | $ 1,136,900 |
| Five-Years | +4.95% | +7.56% | $ 1,272,800 | $ 1,438,900 |
| Seven- Years | +3.73% | +2.44% | $ 1,291,400 | $ 1,183,100 |
| Ten Years | +5.40% | +2.87% | $ 1,691,000 | $ 1,326,300 |

* Composite results of all SEM managed accounts, net of all fees.
Note: Results for the three, five, seven, and ten year periods represent the annual average rates of return.

SEM Composite Account
vs. the Standard & Poor's 500

| **Year** | **SEM*** | **S&P 500** | **Relative Results** |
|---|---|---|---|
| 1998 | 26.19% | 28.57% | -2.38% |
| 1999 | 24.10% | 21.03% | 3.07% |
| 2000 | 4.50% | -9.15% | 13.65% |
| 2001 | 0.35% | -11.91% | 12.26% |
| 2002 | -10.98% | -22.15% | 11.17% |
| 2003 | 20.12% | 28.62% | -8.50% |
| 2004 | 12.52% | 10.96% | 1.56% |
| 2005 | -0.51% | 4.86% | -5.37% |
| 2006 | 8.20% | 15.77% | -7.62% |
| 2007 | 10.13% | 5.48% | 4.65% |
| 1st Half 2008 | -14.13% | -11.95% | -2.18% |
| | | | |
| Since Inception (Overall Gain) | 101.16% | 56.01% | 45.15% |
| Average Annual Gain | 6.90% | 4.34% | 2.56% |

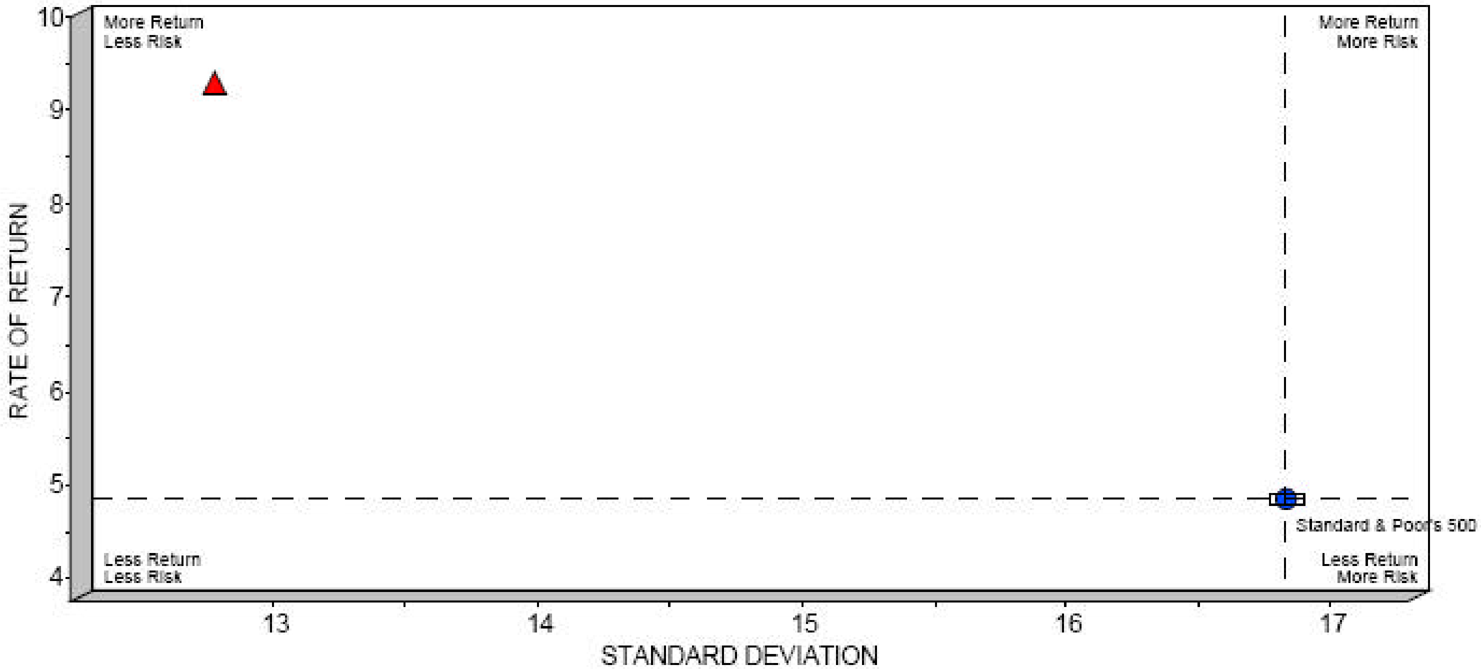
**Suncoast Equity Management's (SEM) performance is Net of All Fees.**

Highlight denotes years of meaningful underperformance.

**5550 W. Executive Drive, Suite 320, Tampa, Florida 33609 * Tel: 813-963-0502 * www.SuncoastEquity.com**

# SUNCOAST EQUITY MANAGEMENT VS. S&P 500
# TOTAL RISK REWARD

## DECEMBER 31, 1997 TO MARCH 31, 2008




| | ROR | Std Dev | Alpha | Beta | R-Squared |
|---|---|---|---|---|---|
| Suncoast Equity Growth/Value | 9.18 | 12.73 | 4.49 | 0.66 | 0.75 |
| Standard & Poor's 500 | 4.74 | 16.79 | 0.00 | 1.00 | 1.00 |

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# Life Is Good, So Why Do We Feel So Bad?

By Gregg Easterbrook

The Democratic National Committee recently ran an ad blasting John McCain for saying the country is "better off" than in 2000. Yet, arguably, except as regards the Iraq war, Mr. McCain's statement is true. In turn, Mr. McCain is blasting Barack Obama for suggesting that international tensions are not as bad as they've been made to seem. Yet, arguably, Mr. Obama is right.

> The latest form of political incorrectness: positive thoughts.

Democratic attacks on Mr. McCain and Republican attacks on Mr. Obama both seek to punish impermissibly positive thoughts. At a time when there exists a sense of crisis over the economy, fuel prices and many other issues, this reinforces the odd, two realities of life in the United States today: The way we are, and the way we think we are. The way we are could use some work, but overall, is pretty good. The way we think we are is terrible, horrible, awful. Possibly worse.

The case that things are basically pretty good? Unemployment is 5.5%, low by historical standards; income is rising slightly ahead of inflation; housing prices are down, but the typical house is still worth a third more than in 2000; 94% of Americans do not have threatened mortgages, and of those who do, most will keep their homes.

Inflation was up in 2007, but this stands out because the 16 previous years were close to inflation-free; living standards are the highest they have ever been, including living standards for the middle class and for the poor.

All forms of pollution other than greenhouse gases are in decline; cancer, heart disease and stroke incidence are declining; crime is in a long-term cycle of significant decline; education levels are at all-time highs.

Sure, gas prices are up, the dollar is weak and credit is tight—but these are complaints at the margin of a mainly healthy society.

Yet the mood of public discourse is four-alarm panic. A recent CBS News/New York Times poll showed "Americans' views on the economy and the general state of the country have hit an all-time low," with 81% saying the nation is on the "wrong track"—the worst-ever number for this barometer.


Chad Crowe

Some 78% told pollsters the U.S. is worse off today than five years ago, the highest percentage to say this since the CBS News/New York Times survey began tracking the question in 1986. Watch any news channel, listen to any political debate, read any pundit. The consensus is we're headed to hell in a handbasket.

Campaigning in Pennsylvania in April, Hillary Clinton said "We need to go back to the prosperity of the 1990s," a comment that drew loud, enthusiastic applause. Converted to today's dollars, Pennsylvania per capita income in the Keystone State is 23% higher than in 1990. People may think Pennsylvania was more prosperous in the past, but the state is better off today. The same can be said for most (needless to say, not all) parts of the country and most demographics. Most are, right now, the best-off they have ever been.

Some of the current gloom-and-doom may be explained by the human propensity to romanticize the past. Just what past would we return to, anyway? The 1950s, when there was systemic prejudice against African-Americans, women and gays? The 1960s, when inflation-adjusted per capita income was far lower than today? The 1970s, when high inflation rates wiped out paychecks and high interest rates made home buying difficult? The 1980s, when investors and people with pension funds were rooting for the Dow Jones to break 2000?

Of course a long, bloody and costly war being fought for no clear purpose depresses the national mood—as it should. The rest of the negativity is hard to fathom. Economic growth is slow, but even if a recession has begun, occasional cycles of slow or no growth are the price we pay for the much-longer cycles of boom. Since 1992, the percentage of Americans who tell pollsters of the Pew Research Center they "can afford what they want" has risen steadily—from 39% in 1992 to 52% today, the highest ever. So why do we think the economy is failing?

Increasing pessimism from the news media is surely a factor—and the media grow ever-better at giving negative impressions. Now we don't just hear about threats or natural disasters, we see immediate live footage, creating the impression that threats and disasters are everywhere.

Whatever goes wrong in the country or around the world is telecast 24/7, making us think the world is falling to pieces—even when most things are getting better for most people, even in developing nations. If a factory closes, that's news. If a factory opens, that's not a story. You've heard about the factories Ford and General Motors have closed in this decade. Have you heard about the factories Toyota, Honda and other automakers opened in the U.S. in the same period? The jobs there have solid, long-term prospects.

The relentlessly negative impressions of American life presented by the media, including the entertainment media, explain something otherwise puzzling that shows up in psychological data. When asked about the country's economy, schools, health care or community spirit, Americans tell pollsters the situation is dreadful. But when asked about their own jobs, schools, doctors and communities, people tell pollsters the situation is good. Our impressions of ourselves and our neighbors come from personal experience. Our impressions of the nation as a whole come from the media and from political blather, which both exaggerate the negative.

The latter has never been thicker. Democrats insist Republicans are ruining domestic policy, Republicans insist Democrats are ruining foreign policy. Neither claim is true, but both reflect what we've been conditioned to believe: that America is in much worse circumstances than it actually is.

*Mr. Easterbrook, a fellow at the Brookings Institution, is author, most recently, of "The Progress Paradox: How Life Gets Better While People Feel Worse" (Random House, 2004).*