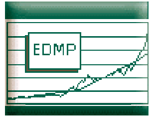


Great Companies, Inc.
Quarterly Review 1st Quarter 2007

The Sea of Tranquility

Volatility returned to the marketplace in the first quarter of 2007 at much higher levels than we have seen over the past couple of years. With a one day 400 point decline and several days of 200 point advances in the closely watched Dow Jones Industrial Average, those who follow short-term market movements most certainly had their nerves jangled. We at Great Companies suffered no such stress. First, it is clearly illogical that the business prospects for our portfolio holdings, and thereby their underlying valuations, could change so rapidly. More importantly, our focus is always on these business prospects for the next three to five years; not the next quarter or two. What really keeps us calm is believing we have assembled a portfolio of high quality industry leaders with superior financials that were purchased at reasonable prices. What a great way to sleep at night!

When all is said and done, we are pleased to report that we had solid returns for the quarter, and were comfortably ahead of the market averages overall. It would appear investors began to appreciate many of the high quality, high growth businesses that we own. Although the earnings growth rates achieved by our portfolio companies in 2006, and more importantly the general consistency of these earnings growth rates over the past ten years, are well above average, investors had more of a bunker mentality last year fearing both recession and inflation, neither of which materialized. The higher growth names were ignored in 2006; instead investors poured money into commodity stocks (no long-term consistency or predictability) or consumer staples such as food stocks (generally lower long-term growth rates), or utilities (may as well buy a bond). In the first quarter, investors returned to our higher growth names. We stand confident that over time great companies with high rates of earnings growth will outperform the market averages. History bears this out, and is the founding principle of our firm, i.e. "earnings determine market price" over time. This is why we discourage you from worrying about the short-term, and refocus on the long-run objective.

We are invested in technology, a sector that has not cooperated over the last twelve months (the short-term), inclusive of the first quarter of 2007. None of our technology holdings generated positive returns in the quarter. With beaten down earnings and valuations, this is the sector we are most excited about and have averaged down our cost basis where possible. We did this in anticipation of outsized returns when these companies return to more normalized operating conditions. Despite the technology debacle at the turn of the century, which we were able to avoid with our strict and unwavering focus on valuation, technological change is inevitable, often improving at geometric rates. In order to stay competitive, companies must eventually adapt and adopt; it is only a matter of time.

The technology companies you own were carefully selected. Each is an industry leader, with strong and deep management, recognized for innovation, generates higher financial returns than their peers and are inexpensive versus their future earnings prospects. As has been our historical strategy, we are patient investors, and this patience has more often than not been well rewarded. With this in mind, our feature company this quarter is Broadcom Corporation, a leading provider of semiconductors for wired and wireless communications. The significant growth potential of its addressable market is dramatic, and if executed properly, we would expect very solid returns on our investment over the next several years. We feel very fortunate to be able to accumulate these shares for you at a very reasonable valuation. As you read our "Thesis for Growth" and "Outlook by the Numbers" found on Page 3 of this newsletter, we believe you will feel the same excitement that we do over its prospects.

Despite the drag of technology, we needed to have some excellent returns by our other portfolio holdings in order to beat the averages during the quarter, and we did. Three of our portfolio companies returned in excess of 20%; these being generic drug maker Teva Pharmaceuticals, business process outsourcing company Affiliated Computer Services, and orthopedics maker Stryker Corp. Five other holdings returned in excess of 10%, these being luxury goods maker Coach, Inc., drug distributor Cardinal Health, diversified industrial Illinois Tool Works, department store Kohl's Corp, and flooring manufacturer Mohawk Industries. These outsized returns are not only a reflection of investor recognition of the earnings power of these companies, but more importantly, our purchasing these fine businesses when they were trading at or below their True Worth™.

As the guardians of your wealth, we work very hard to try to find the best companies possible at the best possible purchase price. We understand our companies and do thorough analysis. This is why we entitled this quarter's letter **"The Sea of Tranquility,"** because understanding what you own is far more comforting than trying to predict short-term stock price movements. The only time we might become cautious is when most investors feel there is nothing to worry about. In these rare instances, investors become complacent and prices are usually too high. Fortunately for investors, the world is most commonly filled with plenty of things to worry about, thereby, inevitably creating an opportunity somewhere in the market to find businesses trading beneath their intrinsic value. The first quarter of 2007 was no exception. Investors are currently concerned about the ongoing war in Iraq, a rather "offbeat" president of Iran continuously making provocative comments that cause skittish traders to bid up oil prices, and a takeover of the U.S. Congress by the Democrats which makes some investors want to run for the hills. Ironically, we draw much comfort from the fact that the government is now divided among political parties. This usually means far less gets done, thereby allowing our productive economy to run with less interference, which is usually in all our best interests.

The latest and greatest scare that cropped up this quarter is the problem with "subprime" loans. These are mortgage loans given to new homeowners with poor credit histories. It would seem that people never seem to grasp the danger of chasing a "hot" market. What seems like a bonanza usually turns out to be a bonfire as the real money is made by those who have the intestinal fortitude to invest in areas which are currently out of favor and thus cheap. Unfortunately, most jump on the bandwagon far too late and end up getting burned in the process. As it was with the real estate market over the last several years, home prices in certain markets became detached from reality, and as with any bubble, people (in this case some mortgage lenders) find any way to make money off of other people's folly. Thus, all sorts of bizarre mortgage products hit the market, including teaser rates or no money down, no-credit-check products. This "I'll worry about it tomorrow" attitude is now coming home to roost in the form of high foreclosure rates as the initial low teaser rates are adjusted upward and the buyers can no longer meet their monthly payments, with several of the subprime lenders now on their way to bankruptcy court.

There are two lessons we take from this latest debacle. First, history is replete with unpleasant events, yet if you overlay a chart of the S&P 500 over the history of the last 100 years, you will see a long-term trend of stock prices that ultimately continues to move higher. If we worried about all the things that prove to be "distractions," as Warren Buffett would say, it would cause us to make inappropriate long-term financial decisions. We, as your managers, take this advice seriously and look for opportunities where others see disaster. Second, avoid the temptation to invest in anything where everyone is convinced the sky is the limit since you are flirting with danger. We also follow this principle with your wealth as dangerous overvaluation is something for which we are constantly on guard. There is no better proof than

THESIS FOR GROWTH

Broadcom Corporation is a leading provider of semiconductors for wired and wireless communications. It sells into many of the fastest growing markets including broadband access, wireless networks for business and homes, satellite and digital TV, wireless communications, internet telephony and data storage networking. With its wide ranging product portfolio, the company believes its addressable market will grow at a compounded annual growth rate of 35%, from $27 billion in 2006 to $68 billion in 2009. The fastest growth is anticipated to be in mobile and wireless, broadband communication and enterprise networking at annual growth of 43%, 29% and 25%, respectively.

> Its unique focus on engineering innovation and execution are key drivers of future growth.

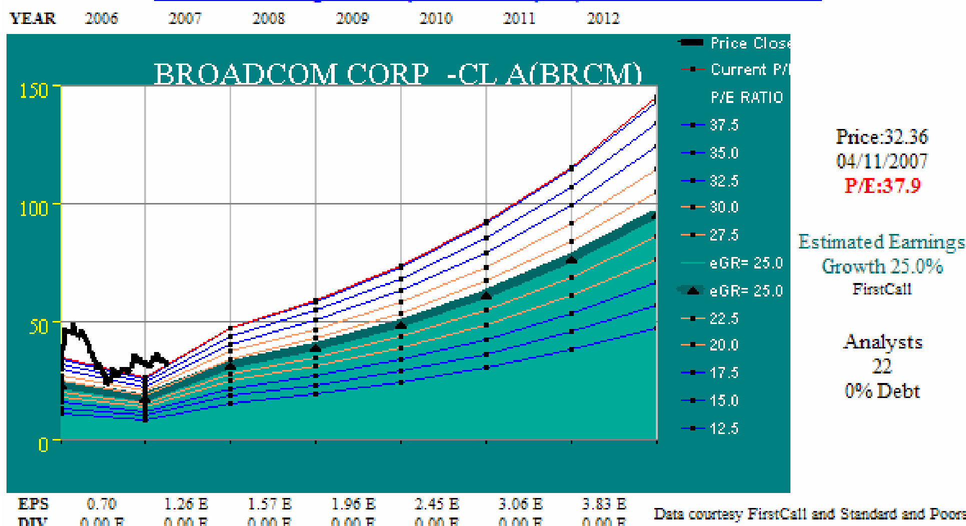
In wireless connectivity, Broadcom is the market leader in "Bluetooth" technology for handsets, voice over internet and wireless corporate networks. Bluetooth technology has achieved global acceptance and is intended to replace connecting cables while maintaining high levels of security for a wide range of devices. The key features of Bluetooth are robustness, low power and low cost. This is currently the fastest growing division within Broadcom, growing 78% in 2006. In broadband communication, the company's strategy is to offer end-to-end products allowing its customers to offer unique connected digital home solutions to end customers. In addition to internet access, the fastest areas of future growth are expected to be digital TV and next generation set top boxes. In enterprise networking, key products for continued growth will be in the areas of networking, data storage over the internet and security processors.

Although competition in the sector is intense, Broadcom's diverse and cutting edge technology offerings position the company extremely well for continued leadership. Its unique focus on engineering innovation and execution are key drivers of future growth. The company's patent portfolio has significantly increased over the last few years with over 8000 patents pending. We expect its strong growth and innovation to continue as 72% of its total headcount is engineers, with over 400 PhDs.

Forecasting future earnings growth, bought at sound valuations, is the key to sound, and profitable performance.

OUTLOOK: GROWTH BY THE NUMBERS

10 Year Earnings Yield (Ratio 2.7:1) 5yr.Est.Tot.Ret.: 20.8%



Forecasting Chart for BRCM

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ESTIMATED FUTURE FUNDAMENTAL VALUATIONS

The consensus of the 22 leading industry analysts reporting to FirstCall estimate Broadcom's 5 year earnings growth rate at 25.0%. Broadcom has no long-term debt. Broadcom is currently trading at a P/E of 37.9, which is outside the value corridor (defined by brown lines) of a maximum P/E of 30. Even at its current high P/E on temporarily depressed earnings, if the earnings materialize as forecast, Broadcom's True Worth™ valuation would be $95.75 at the end of 2012, which, assuming the company is trading at a 25 P/E at that time, would be a 20.8% annualized rate of return.

Great Companies, Inc.

our avoidance of the internet mania of the last decade.

To put these words into practice, you will begin to see either reductions to or complete elimination of certain of your portfolio holdings in the second quarter. Some of your holdings have done extremely well. Unfortunately, some of their stock prices have done even better and their valuations are becoming stretched versus what we believe are their future earnings growth prospects. As long-term investors, we loathe selling great companies, but as fiduciaries of your hard earned money, our job is to protect your money as much as it is to grow it. Our portfolio team is currently examining several great companies which our initial screens have determined have strong earnings prospects, but are more reasonably valued.

When opportunity does knock, it is incumbent on us to open the door. Investors often succumb to inaction when a stock price is declining, generally fearing that there is further downside to come. This may be true, but once you have done your homework, as we here at Great Companies do, then you can establish parameters to determine a reasonable price at which you can take a position. If the price declines further and you continue to believe the long-term fundamentals are intact, then adding to the position often makes sense to take advantage of the volatility. Large price declines are difficult to come by for consistent great companies, and we are constantly seeking such opportunities because the opportunity usually does not last long.

We believe we had another opportunity in the first quarter of 2007 when the shares of Google declined to a reasonable valuation during the market volatility at the end of February. The price/earnings ratio, as well as other measures we look at, such as price/sales finally became attractive whereby we believe we can generate strong long-term price appreciation with reduced downside risk. We anticipate the company's market dominance will continue to generate at least 30% earnings growth for the next several years and are pleased to have been able to purchase its shares at a reasonable price.

In conclusion, we are excited about our portfolios and some of the new prospects that we will be adding to them. We will continue to monitor both the business fundamentals and the stock valuations of the companies you own. Equally important, we will keep our focus on long-term opportunities and ignore short-term volatility or world events. If you too do this, we believe you will also be able to experience a greater level of tranquility regarding your investments, and avoid what often turns out to be needless worry.

And, as we hope you all agree: in the long run **Earnings Determine Market Price.** Always have, and always will.

Sincerely,

Charles C. Carnevale
Chief Investment Officer

The opinions in this newsletter are for informational purposes only and should not be construed as a recommendation to buy or sell the stocks mentioned or to solicit transactions or clients. The information in this newsletter is believed to be accurate, but under no circumstances should a person act upon the information contained within. We do not recommend that anyone act upon any investment information without first consulting an investment advisor as to the suitability of such investments for his specific situation.

Certain Statements that we make in this newsletter are forward-looking statements. These forward-looking statements are based upon management's current assumptions and beliefs in light of the information currently available to it, but involve known and unknown risks and uncertainties.