



Great Companies, Inc.

Quarterly Review 3rd Quarter 2007

Buying Future Earnings

The third quarter of 2007 could best be described as turbulent. Regarding stock prices, there was a lot of volatility; first down then back up. Traders were kept busy digesting a litany of provocative headlines regarding falling real estate values, the subprime mortgage meltdown, hedge fund collapses, interest rate concerns, high energy prices, currency fluctuations and Federal Reserve actions. All of this culminating in a classic scenario of “Wall Street Climbing a Wall of Worry.” When it was all said and done, both the quarter and the year posted respectable gains. Since, historically, stocks most often post their best gains in the fourth quarter, perhaps we have something nice to look forward to through year-end.

At Great Companies, Inc., we view ourselves as investors rather than traders. Therefore, our perspective of the third quarter and calendar year-to-date 2007 was much more sanguine than what active traders experienced. At Great Companies, Inc. we saw and expected a very consistent and reliable continuation of above-average operating performance from our portfolio of great companies. With a few exceptions, our great companies are having a great year. In some cases the market is rewarding us and in some cases it is not. However, our research clearly indicates that short-term stock price movements are not nearly as important as long-term operating results.

Utilizing our Great Companies, Inc. Fundamental Analyzer™ software, we offer the following graphs of Best Buy Co., Inc. for the period 1999 to current to illuminate this important concept. We chose this example because it's neutral. We don't own Best Buy Co., Inc., we own Kohl's instead; however, Best Buy Co., Inc. meets our criteria for a great company. The first picture of Best Buy is from the perspective of a terrific business, which is the focus we have at Great Companies, Inc. This is clearly a picture of a

successful business with strong and consistent earnings growth of over 23% since 1999, precisely the kind of business results we seek and covet, and a very comforting and confidence-generating picture. Doesn't it make you want to own Best Buy Co., Inc.?



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Picture No. 2 is from the perspective of stock price only for the exact same company (Best Buy Co., Inc.) over the exact same time frame, 1999 to current. Unfortunately, this is the only perspective most people have. Obviously, when all you see is stock price volatility, it can be quite unnerving to down-right scary. Imagine how you as a shareholder felt as you saw the price fall from \$38.22 on March 31, 2000, to \$11.44 by November 30, 2000. In eight short months, your investment value shrunk by over 70%. However, as you will see, in Picture 3, because of its powerful earnings advance, the price of Best Buy Co., Inc. subsequently rallied to \$59.50



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by 2006, a gain of over 420%. However, not before it rose and fell several more times along the way. This clearly illustrates the impact irrational emotions can have on price in the short run.

Picture No. 3 provides yet a different perspective by overlaying the first two as one. It is our contention that the green line (earnings X growth rate) represents the True Worth™ of Best Buy Co., Inc. Therefore, when the black stock price line is above the True Worth™ line, it signifies an overvaluation and risky situation. When the stock price line touches the green earnings line it's at fair value (True Worth™) and when the stock price line is below the green earnings line, it's on sale (cheap). An analysis of this picture shows that Best Buy Co., Inc. started out with the price slightly above the green earnings line, i.e., overpriced in the beginning of 1999, and ended with the price currently below the green earnings line. However, what's most important is that the price continuously, and we would argue, inevitably, follows the earnings and moves back to True Worth™ when it temporarily strays.



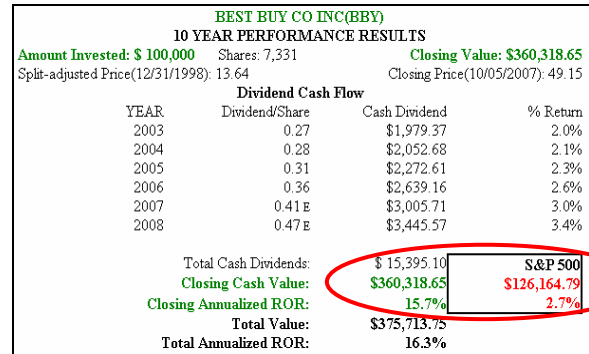
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The final picture, No. 4, shows the performance shareholders earned over the 1999 to current time frame. As you can see from Picture No. 3, (above) Best Buy's earnings grew at the rate of 23.1% for this period. However, since Best Buy started the period high and ended low, shareholders earned 15.7% capital appreciation, which is less than growth rate, because it started out overvalued. Then dividends added an additional 0.6% annually, for a total compounded return of 16.3%. This is more

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than 6 times the return investors in an S&P 500 Index Fund would have earned over the same time period. This clearly validates three critical principles that we at Great Companies, Inc. are continuously stressing.

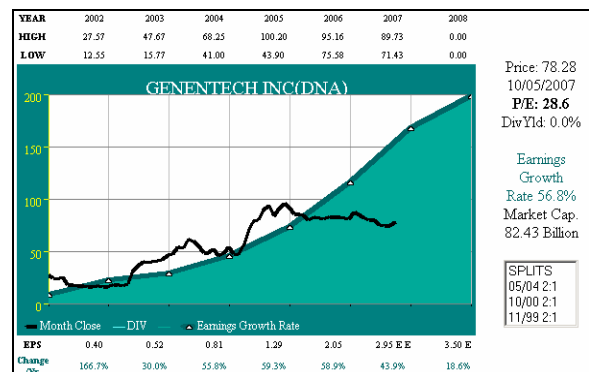


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First, earnings determine market price in the long run. Second, valuation coupled with earnings growth determines your ultimate return. Third, the stock market has little or nothing to do with it in the long run.

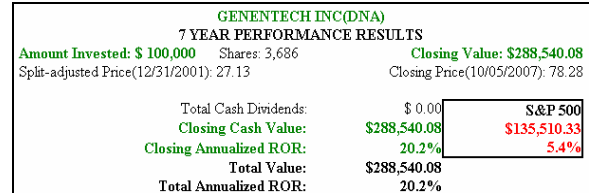
This quarter's feature company is Genentech, Inc., the world's 2nd largest biotechnology company. Once again, exceptional historical operating results generate exceptional index-beating returns.



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The following "Thesis for Growth" and "Outlook: Growth by the Numbers" on Genentech illustrates our reasons for investing in it.

THESIS FOR GROWTH

Outstanding Businesses

Genentech was founded in 1975 and engages in the discovery, development, manufacture and commercialization of biopharmaceuticals in the United States. With total product sales expected to nearly double by 2011, the company has leading commercial franchises with its novel agents Avastin (colon cancer), Rituxan (non-Hodgkin's lymphoma), Lucentis (age related macular degeneration), Herceptin (breast cancer) and Tarceva (non-small cell lung cancer).

Genentech has had a long-standing collaborative arrangement with Swiss drug maker Roche Holding A.G. In 1999 Roche purchased Genentech and then brought the company public again in 2002 to take advantage of favorable market conditions. Roche licenses and markets Genentech's products outside the United States.

With its dominant market share, innovative products, strong financials, and highly regarded management, Genentech is an extremely well-positioned biotechnology company. In addition to continued strong growth of the existing product portfolio, we are optimistic about the company's development programs with follow-on indica-

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tions for currently marketed therapies. The most significant opportunity is the potential use of Avastin for adjuvant colon cancer (to prevent recurrence) as well as non-small cell lung cancer.

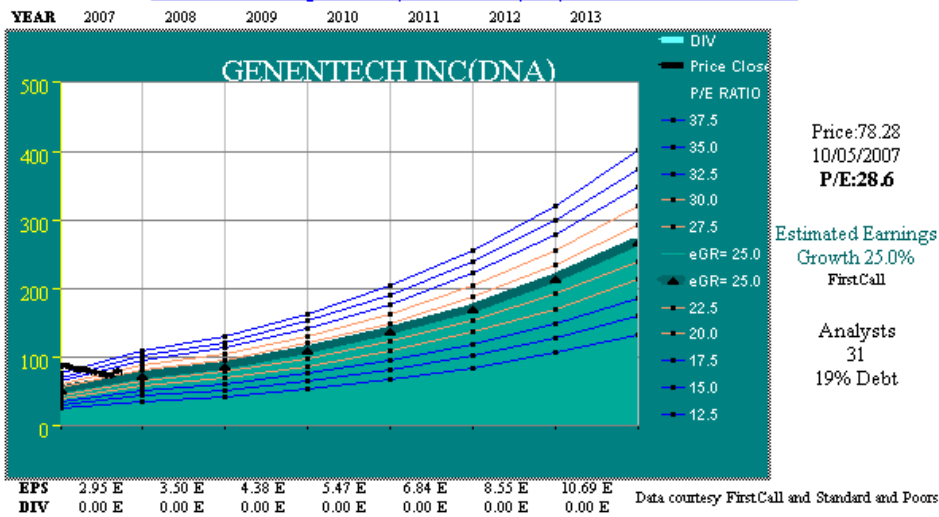
Rituxan could also be approved for multiple sclerosis. Lucentis may be further approved for retinal vein blockage and diabetic macular swelling. It is estimated that these add-on approvals could increase revenues by several billion dollars. In addition to new approvals for its currently marketed agents, Genentech has a broad clinical development pipeline consisting of over 20 novel products, either discovered in-house or acquired through collaborative agreements.

Genentech's very strong financial condition is a major advantage as it enables the company to continue its heavy spending on research and development (19% of sales). With a gross margin in excess of 80%, net profit margin near 25%,

return on invested capital over 20%, and solid cash flows, we believe the company can continue on its above-average earnings growth path as existing products increase penetration and new ones are brought to market. The outstanding management team, led by the chief executive who has been with the company since 1980, adds to our overall positive view as to the company's growth prospects.

OUTLOOK: GROWTH BY THE NUMBERS

10 Year Earnings Yield (Ratio 2.6:1) 5yr.Est.Tot.Ret.: 21.1%



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

ESTIMATED FUTURE FUNDAMENTAL VALUATIONS

The consensus of the 31 leading industry analysts reporting to FirstCall estimate Genentech's 5 year growth rate at 25%. Genentech has low long-term debt at 19% of capital. Genentech is currently trading at a P/E of 28.6, which is inside the value corridor (defined by brown lines) of a maximum P/E of 30. If the earnings materialize as forecast,

Genentech's True Worth™ valuation would be \$267.25 in fiscal 2013, which would indicate the potential for a 21.1% annualized rate of return.



There is a very compelling consensus for a slowdown of the future growth of earnings of the S&P 500, a proxy for the stock market. This gives us high optimism regarding the future prospects of your portfolio of great companies. The S&P 500 Index enjoyed an above-normal growth rate of earnings of 14.5% for the period 2002 through 2006. This is in stark contrast to its normal 7-9% growth rate. Consequently, since as we continuously point out, earnings determine market price in the long run, the S&P 500 generated a 12.5% return over the past 4 ¾ years. Once again, a return significantly greater than its historically normal 20-year, 9.2% return.

Most analysts and prognosticators are forecasting a 6-8% earnings growth rate going forward. To put this into perspective, if you buy one dollar's worth of S&P 500 earnings today at a 7% average growth rate, it will take 10 ¼ years before you see that dollar's worth of earnings grow to two dollars. This translates into a 6-8% (7% average) expected return from growth going forward.

In contrast, our portfolio companies are forecast to grow faster than average. The first and perhaps foremost trait that a company must have to be included in our Great Companies, Inc. universe is a 15-20% above-average growth rate both historically and forecast. Therefore, if our companies grow to forecast, it will only take 3.6 to 4.8 years for a dollar's worth of our portfolio holdings earnings to grow to two dollars. In other words, approximately a third to half the amount of time it will take the earnings of S&P 500 to double. It is through this higher growth that our companies are expected to separate themselves from average. In the short run, they will rise and fall as the market does. However, over time, it is the success of the individual business that matters most.

We are very bullish on the business prospects of the extraordinary companies purchased on your behalf. Close examination will reveal that each possesses the eight traits that great companies have. Even more importantly they were all purchased at attractive valuations based on consensus as well as our view of their future growth potential. It is critical to remember that in order for a great company to also be a great investment, it must be sensibly priced. Pay too much and your risk goes up, while your future return goes

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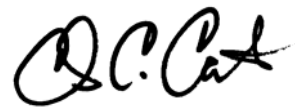
down. It requires patience to get this essential step correct, because exceptional businesses are rarely kept a secret.

Thanks to the inherent skittish nature of short-term markets ruled by emotion, volatility will always occur. Unfortunately, due to this emotional behavior, short-term movements in price are virtually impossible to accurately and consistently predict. On the other hand, the future business prospects of well-run exceptional businesses are much more clearly visible. So, if short-term price movements are unknowable, then how can you successfully invest and simultaneously control risk? The answer is very straightforward.

Even though you cannot know the exact movements of a stock's price in the short run, you can precisely know if it's overvalued, undervalued, or fairly valued. Furthermore, you can also know that inevitably it will move to fair value over time. Therefore, even though you cannot perfectly know price movement, you can make sound and rational decisions based on valuation which is a function of current price in relation to earnings power. Consequently, you can intelligently invest your money upon a solid foundation of earnings and cash flows that should lead to above-average returns at appropriately controlled levels of risk. This is the essence of true investing and the formula that Great Companies, Inc. invests with: $GC + GI = GR$ (Great Companies + Great Investments (in value) = Great Returns).

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

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