

January 3, 2008

To the friends and clients of Harvey Investment Company,

In the middle of June 2007, the press began coverage of the travails of a hedge fund sponsored by the Bear Stearns Cos., one of Wall Street's largest and most respected broker/investment banks. It was the introduction to the public of what was to become **the** story for 2007 investors – the subprime mortgage catastrophe. The very name of the fund says a lot. It was called High Grade Structured Credit Strategies Enhanced Leverage Fund. If you have a hard time visualizing what that means; well, that was the only way the whole darn mess could get off the ground. Wall Street financial engineers, laboring like mad scientists in the last few years, created financial structures so layered with complexity and conditional promises that it is now clear that investors were buying no more than a pig in a poke. From that June coverage of the Bear Stearns difficulties to this day, the subprime fiasco and the accompanying chill in the world's money markets have hogged the front page of the financial press. The great irony of the situation is that the concoctions Wall Street brewed to facilitate the sale of such massive amounts of bad debt, in the end, found their way right back to them since they were the only ones with sufficient capital to absorb so much paper. It would be a good joke if the pain had not spread so widely to innocent bystanders or if the tens of millions of dollars in bonuses collected by the individual perpetrators of this fiasco had to be returned to their now ailing corporate employers.

The credit crisis is symptomatic of a deeper secular issue challenging our country. As the United States has grown and prospered, there has been an inexorable rise in the average American's expectation for a continuously rising standard of living. Furthermore, the general sense of economic security has increased with our wealth. Over the past several decades, consumers, most of whom now have no memory of the hardships of war or economic depression, have gradually become comfortable carrying large amounts of personal debt. With each year the nation's economic priorities have tilted more toward consumption and less to saving and capital formation. Banks and other lenders have been happy to encourage this trend as it represented an excellent outlet for their burgeoning capital. Killjoys, including us, have always fretted that we would reach a point at which the growing leverage would become a danger to our financial system. The current crisis is, perhaps, an indication that that condition is at hand.

Although the story has been moved off the front page, \$100 per barrel oil and \$3 per gallon gas are further evidence of the imbalance between consumption and saving. This is because oil is a global commodity that trades in dollars. As the dollar declines in relation to other currencies, it exacerbates the pain of rising oil prices for us. The dollar is falling because we consume more in imports than we export. These twin difficulties, homeowners struggling with their mortgage payments and rising oil prices, are the ugly result of the same problem – hyper-consumption. Sluggish seasonal Christmas sales and slowing trends across a wide swath of other consumer-driven industries indicate a new cautiousness that may last well into the New Year. We are also likely to enter an extended period when shoring up of finances by consumers and financial institutions takes precedence over more immediate gratification. We expect a slowdown in the economy and accompanying disappointment in corporate profits, but, on the plus side, we are likely to be on sounder financial footing a year from today.

The stock market gave a relatively good account of itself considering the gloomy developments. The S&P 500 advanced by 5.49% for the year, and many other indexes did as well or better. The performance of individual portfolios depended on how far removed from ground zero of the mortgage meltdown their holdings were. One might visualize concentric rings with companies directly involved in the mortgage industry at the center. These would include financial companies heavily involved in subprime lending, homebuilders, and others similarly close to the residential housing industry. The first circle out from the center would be direct feeders off of home building and real estate business: Home Depot and Lowe's, rug and furniture manufacturers, suppliers to the building contractors of material like lumber, hardware, shingles, etc. Next out would be businesses that depend on an optimistic consumer to fuel growth in their business. This group would include most retailers, manufacturers of discretionary consumer goods, transportation companies that deliver such products, landscapers, pool builders, etc. Beyond this second ring, company profits and stock performance generally ran true to governing industry conditions and individual company positioning. Energy related enterprises did very well. Also, domestic industrial companies with a high percentage of business tied to infrastructure development in rapidly growing countries such as China, India, Russia, and in the Middle East were strong performers. Laggards included insurance and finance in general, while health care company performance was determined by individual circumstances.

Our core portfolio holdings performed in line with the S&P 500. We had some notable winners, but we were held back by investments in companies found in the first two rings out from ground zero described above. We are still enthusiastic about these laggards despite our expectation that their fortunes will not improve soon. The pent-up demand for their products and services should eventually lead to strong gains. We largely avoided the direct bombs decimating many housing related stocks, but not in every case. Though our portfolios have many identical holdings, there are distinct differences in individual taxable accounts that have legacy holdings with very low cost basis securities. In a few instances, such holdings related directly to the mortgage crises and were dealt with severely by the market as the scope of their problems emerged. We expect them to gradually work through the difficulties, but it will take time. One disturbing aspect of 2007 was the astonishingly rapid disintegration of a number of well regarded businesses as well as the downgrading of thousands of highly rated debt instruments. The stunning speed of the deterioration and particularly its pervasiveness led us to consider carefully, with some urgency, the level and nature of risks in our investment strategy.

We have reported extensively in our quarterly reports and personal communications the discipline with which we make our individual stock selection. We focus on top quality securities with powerful structural advantages in their industries. We work hard to find management whose personal values will be a plus for the shareholder. We are, also, patient about waiting for a good time to buy a stock to avoid losses from simply overpaying. These practices are at the heart of our risk management to protect your assets. We take much comfort in them. Our review did turn up one risk that we think is worth articulating. Our portfolios reflect an underlying optimism that the American economy will grow and thrive despite inevitable bumps in the road. It is an important time to highlight this working assumption if one believes, as we do, that the problems mentioned earlier in the report have the potential to create a recession and a lower level of stock

prices. We believe strongly that the companies we hold will succeed and produce substantial profits for their shareholders in the long run, and, thus, we are likely to hold them through thick and thin. The serious financial challenges that surfaced in the economy in 2007 caused us to reflect especially carefully on this aspect of our portfolio management procedures. There are several reasons justifying continued adherence to this practice. We have never believed that one could invest in a business (which is what common stock investing is) and simply get the good times without the bad. How silly an expectation is that? So, we won't be jumping in and out of stocks we like. Our experience has been that the optimists end up with the money. A simple comparison of the cost versus current market value of long-held securities in older portfolios is a compelling advertisement for a buy and hold approach. Why is this so? We believe the American economy possesses a special resilience that relates to the nature of our democracy. One of the many freedoms we have in this country is the freedom to get rich. If one is smart, hard working, brash, or sometimes just lucky, it is possible to build substantial wealth. The ability to make this particular dream come true establishes a powerful adaptability and forward momentum in the U.S. business environment. Our financial history is replete with instances of destructive private folly or unwise government policies throwing road blocks in the way of progress, but we have always found a way around them in time. The optimism implicit in this observation explains our strong bias toward owning domestic common stocks. Your asset allocation will reflect this attitude balanced, of course, with your unique personal circumstances. We think it is important that you be aware of this point of view.

As always, we appreciate your faith in us and will work hard to produce investment results that are more than satisfactory. Best wishes for a great new year!!

Sincerely,

Samuel C. Harvey

In compliance with Rule 204-3 of the Securities and Exchange Commission, we are pleased to offer you upon request and without charge a copy of Part II of our Form ADV. This disclosure document contains information about the business practices and procedures of Harvey Investment Company, LLC. Please call us at (502) 339-8270, if you would like a copy.