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THE TEXAS HEDGE REPORT

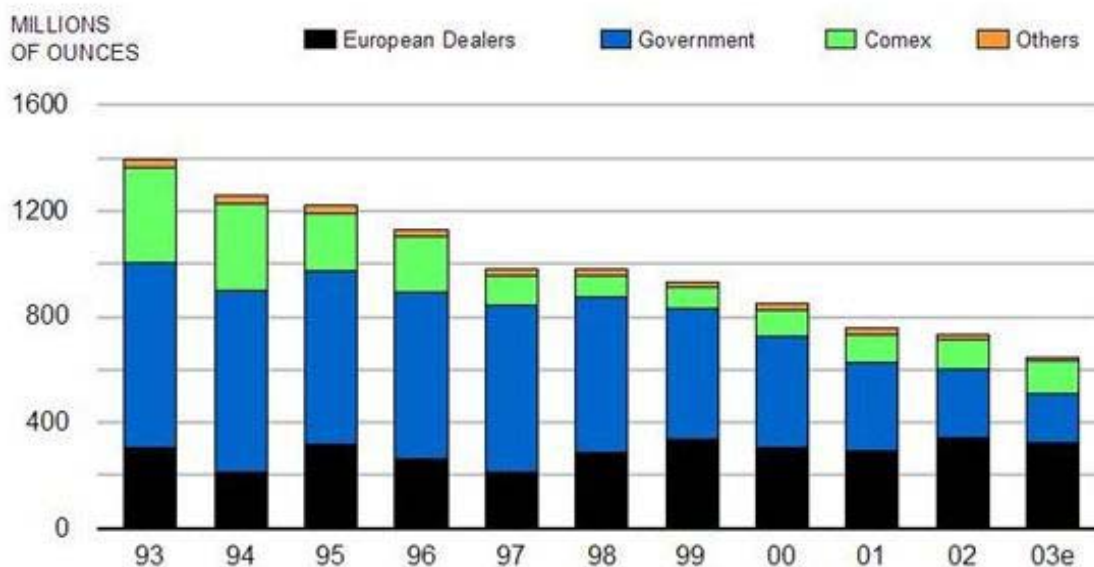
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SILVER

Though we generally prefer to own branded businesses with high barriers to entry, we think that silver in 2004 is a once in a life-time opportunity to participate in the meteoric rise of a dramatically undervalued commodity. Silver peaked at nearly \$54 an ounce in the early 80s as it benefited from the run-up in gold, strong fundamentals, and the Hunt Brothers' attempt to corner the market. Since then, silver has made a beeline south, mired in a 20-year bear market. Silver has had fits and starts upward in that time, but basically it has been a straight line down to the average price of \$4.60 in 2002. Silver bounced ever so slightly in 2003 averaging \$4.89 an ounce.

The real story on silver is the massive inventory depletion that has taken place over the last decade as depicted in the graph below. Since 1991, the above ground silver supply has declined from about 1.4 billion ounces to an estimated 600 million ounces (130 million of which legendary investor Warren Buffett may still own from his 1998 purchase). Silver deficits now run between 50-100 million ounces per annum. One hundred and thirty million ounces and possibly much more of the roughly 500-600 million above ground ounces are owned by investors like Buffett, who have no intention to sell anytime soon. In all likelihood, less than 350 million ounces are available to fill supply deficits at anywhere near current prices. We are running at critically low silver reserves and it is entirely possible that some time in the next few years that silver shortages may occur.



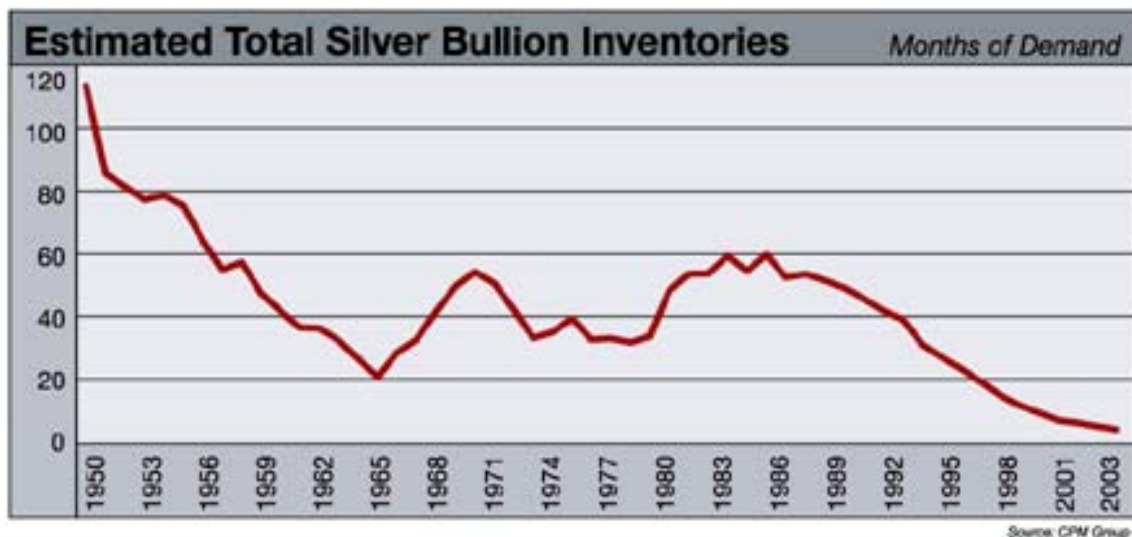
Source: Silver Institute



The only way to bring the supply/demand in balance for silver is higher prices. This is where the dynamics of the silver market become very exciting for silver bulls. Silver has a dual role as both an industrial metal and a precious metal. The majority of silver's current demand (560 million of 840 million ounces) comes from industrial and photographic uses due, in part, to its high conductivity. The rest of the silver demand is filled in by jewelry, silverware, and coinage. Investment demand in the last few years has been minimal but is picking up as concerns about the U.S. dollar abound. Silver supply is perhaps an even more intriguing situation. 65% of silver mine production is the by-product from copper, zinc, and lead mines. Only 35% of silver demand comes from pure silver mines and from gold primary mines where silver is a by-product. This interesting dynamic sets the stage for a potentially explosive move higher in the silver market.

We believe silver will do well, even if we are wrong about the economy's weakness to come. In a strong economic scenario, a resurgent industrial and electronic demand should propel silver demand higher, creating 50-100+ million ounce annual deficits, which should force prices significantly higher as inventories are depleted. Even better for silver would be the weak economy scenario, which we believe is destined to occur. In that scenario, silver's unique supply characteristics could cause a very large price increase. As strange as it may sound, zinc, copper, and lead prices are the primary driver of silver production in the form of by-products. Zinc, copper, and lead are base metals used in broad ranges of industrial production applications. These base metal mines (65% of silver mine supply) will produce more silver when the economy is doing well and less when the economy is struggling and base metal prices are depressed.

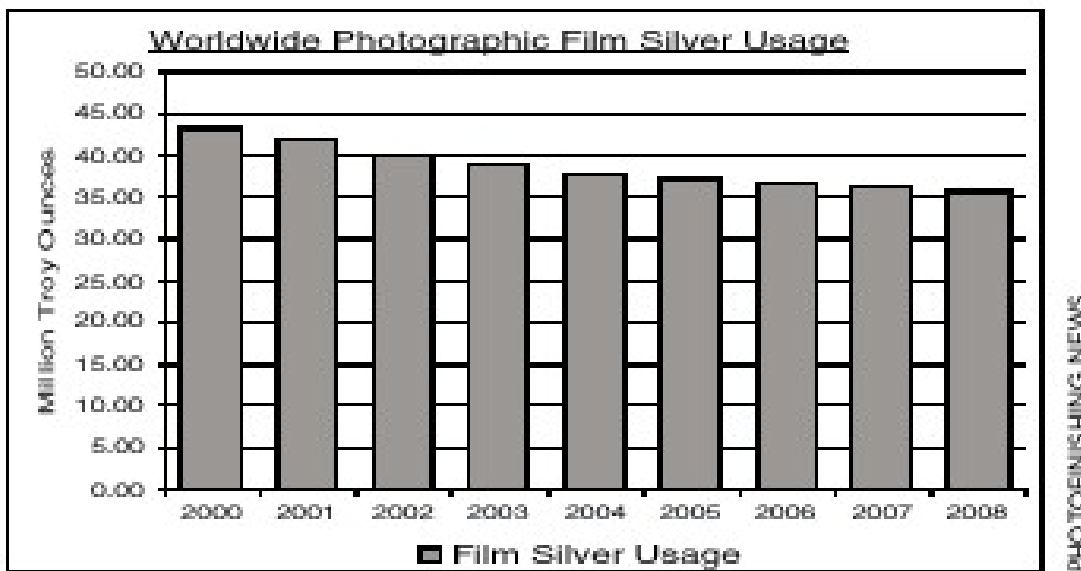
In a weak economic scenario, you could see many base metal producers shutter production and as a consequence, the world silver supply would decrease. At the same time, a weak U.S. economy may lead to a weak dollar, which spurs investment demand for both gold and silver due to the monetary nature of the two precious metals. In such a scenario of declining silver production and rising demand, the price increase required to bring on material amounts of silver supply could be quite large. To quote Warren Buffett, "and because...demand is...relatively inelastic, we don't think [that the] price change required to reestablish an equilibrium between supply and demand would necessarily be minor."



Both gold and silver have long been neglected commodities, but we believe they are still in the early stages of a secular bull market for precious metals. We think that gold could again challenge its early 80s highs of 800 bucks an ounce. But, as bullish as we are on gold because of its constrained mine production and the continued debasing of all fiat currencies (particularly the dollar), we believe the move up in silver could be several times higher than gold. And in what we believe is a very unlikely scenario of the economy and the dollar doing well in the next few years, silver will hold up much better than gold because of the tightness in supply/demand and its industrial nature.

A special note should also be made about the digital photography red herring that many silver bears throw out against the bulls. Digital photography is growing in industrialized nations which dampens silver demand somewhat, but the effect is not nearly as catastrophic as some have made it out to be because of 1) the use of silver coated paper for digital photography; 2) the second and third world countries simply cannot afford digital cameras and that situation is not likely to change anytime soon; and 3) most importantly, the true photographic silver demand is overstated because of the high amount of annual reusable silver scrap created by photography means that net photographic demand accounts for less than 10% of annual demand.

The graph below shows that worldwide photographic film silver usage is expected to hover between 35-40 million ounces per annum for at least the next 5 years. A rounding error in terms of demand if you believe silver investment demand will materialize in a significant way in the next few years.



We appear to have another catalyst coming in 2004 to drive the silver price higher. A silver ETF (Exchange Traded Fund) is in the works of being introduced. A gold ETF is slated for early 2004, and once it is done the Silver Institute intends to follow suit. These ETFs will enable many mutual funds and individuals to buy the precious metals much more easily than in the past pushing up silver prices. These ETFs will trade on the major stock exchanges just like the QQQs or Spiders and will enable



investors to electronically buy physical ownership of gold and silver. Those of us who have ever tried to buy gold and silver bullion know the difficulties of first locating, then transporting, then storing, and finally all the mark-ups that exist within the precious metals chain. Precious metal ETFs will likely add liquidity to buying and selling gold and silver bullion the likes of which have never been seen. It is our belief that traditional mutual funds continue to be vastly under-invested in precious metals and that their sheer size could provide a constant buying support in the next couple of years for gold and especially silver if the ETFs draw just a fraction of their assets.

Lastly, your authors want to point out that they are long silver and silver related equities. We will also point out that we are long-term investors with the ability to withstand the stomach-churning volatility that comes with investing in the silver sector. As always we urge investors to do their own homework and decide themselves whether they can withstand silver's volatility before investing.

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