Letter to Shareholders

July 14, 2008

Dear Fellow Shareholders,

The Torray Fund depreciated 14.9% during the first half of 2008, compared to a loss of 11.9% for the Standard & Poor's 500 Index. We are disappointed with this result and know you are too. The optimism we expressed in last year's annual report was based on what seemed at the time to be a sound economy with low unemployment and interest rates as well as historically moderate stock valuations. Normally one would expect a favorable return in this setting.

Regrettably, the situation has turned out to be anything but normal. A combination of sharply rising gasoline and food prices, the sub-prime mortgage meltdown and collapse in housing has seriously clouded the economic outlook, discouraging investors and undermining consumer confidence. Bank balance sheets have been impaired by write-downs and losses on a range of loans and investments that we discussed in our last two shareholder letters. In response, banks have been forced to beef up capital ratios, selling billions of dollars in equity and preferred stock to domestic and foreign investors. Fortunately, despite the enormous sums involved, the recapitalization efforts so far have been successful. Bank stocks, nevertheless, remain very weak and lending has turned negative, putting pressure on the economy and a wide range of corporate and individual borrowers.

All in all, with the exception of a few sectors – especially commodities – stocks have dropped sharply over the last nine months. The good news is that the bad news seems priced into a wide range of stocks that should make them attractive to investors with a long-term perspective; in saying this, we underscore *long-term*.

Stocks have gone nowhere for nearly 10 years. This has not happened since the 1965-74 period which was even worse. On top of that, markets are now dominated by hedge funds and other speculators, increasing volatility and adding to investors' frustration and fears. It's gotten to a point where many people are probably questioning whether they want to own stocks at all. On the other hand, bond yields are low, which creates a conundrum. Quality five-year corporate bonds and U.S. Treasuries yield only 4.3% and 3.1%, respectively, and tax-free municipals, 3%. These poor alternatives leave today's bond buyer with a negative return after taxes and inflation - the latter now running at about 4%. Some, understandably, will say that a small loss on bonds is better than a big one on stocks. This is true only in the short run. Over the 70 years since 1938, bonds, net of inflation, returned only 1.6%, while stocks made 7%. At those rates it would take 45 years to double money in bonds, but only 10 years in stocks.

Among other things, this certainly shows how far off base people were in the '90s thinking they could make 15% or 20% a year trading stocks and buying companies with no earnings and, in some cases, no sales, at astronomical valuations. When that bubble burst, the S&P Index dropped 50%, the NASDAQ, 80%. Even today the latter is still 60% below its March 2000 level. As we've written before, stocks measured over time cannot outrun economic fundamentals, but they certainly do outrun bonds.

Many investors are at an age where a decades-long outlook is not important, a point politely made to us by a number of our shareholder friends. We are sympathetic. What's to be done? Unfortunately, there is no easy answer. For those waking up every night worrying, the best course may be to cut back on stocks and put the money in a bank, despite low interest rates. Having said that, our confidence in the future of the American economy and the historic record of stocks relative to the alternatives has not diminished. Although many stocks in The Torray Fund continue under pressure, they have reached levels that we believe are extraordinarily low. We have witnessed this situation many times over more than four-and-a-half decades, and in each case when the dust settled, stocks that had underperformed the most did the best.

On a different subject, it seems clear to us that financial markets have been turned into a virtual gambling emporium. The current focus is on what stocks will do today, tomorrow or next quarter, instead of long-term business prospects. We have always seen things the other way around. The surge of speculation has made share prices highly volatile, sometimes rising or falling 10% to 20% in a day on trivial news or suspect rumors. The SEC has just announced a broad-scale investigation into the latter. Many of these swings are in response to earnings releases that miss Wall Street estimates by pennies per share. For example, General Electric, one of our largest holdings, had originally forecast earnings of $2.42 per share for 2008. On April 11, the company reduced that estimate to $2.20-$2.30. The stock, which sold for $38 a week or so earlier, dropped to $32 after the announcement, for a loss of $60 billion in market value. Though the company had nothing further to say on the subject, the stock continued to decline, hitting a low of $26.15 on June 27. By then, GE's 10 billion shares had lost a staggering $120 billion – 60 to 100 times the reduction in estimated earnings.

These meaningless ups and downs combined with generally falling prices and gloomy media coverage have heightened the public's fear that something worse is in store. Meanwhile, the New York Stock Exchange is hostage to complex and opaque strategies that, in just minutes, cause wild swings in the market based on nothing substantive. On a recent day, our Fund's price was up two cents at seven minutes to four, but closed down 21 cents, or seven-tenths of one percent. We are aware of no changes whatsoever in the business fundamentals of any of our companies during those seven minutes. This level of volatility distorts the system and scares investors.

Short sellers (speculators that borrow shares to sell, hoping to buy them back later at cheaper prices, pocketing the difference) are another destabilizing factor in the market. The same thing happened in the 1930s when bands of Wall Street veterans combined to pull "bear raids" on crippled stocks, piling on those already in a downturn, driving them lower. The practice caused such a howl from bruised shareholders that in 1938 the SEC promulgated what became known as the "uptick rule." Designed to restrain short selling in a falling market, it required that a stock could only be shorted at a price higher than its last sale. This effectively stopped the "bear raids." A year ago, short selling proponents guilefully persuaded the SEC to lift the rule claiming that investors would somehow be better off. They aren't. The short interest has nearly tripled this year to a record 18.7 billion shares, with a heavy concentration in the market's weakest sectors.

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According to a July 2 article by Deborah Brewster of the *Financial Times* reporting from New York, Wachtell, Lipton, Rosen and Katz, a prominent New York law firm and big advisor on mergers and acquisitions, recently sent a memo to clients saying that the SEC had filed the uptick rule based on a pilot program conducted during a period of rising stock prices and low volatility (a hostile environment for short selling). The limitations of that pilot had become "painfully clear," the firm said. "Today, many of the same conditions that led to the adoption of the rule in 1938 are reappearing." Wachtell went on to say that rumor mongering and "bear raids" by traders may have played a role in the demise of Bear Stearns. On July 8, Jamie Dimon, Chairman of JPMorgan Chase, echoed the point at the FDIC conference in Arlington, Virginia. He suggested the SEC subpoena telephone records, emails and correspondence of traders in Bear Stearns stock prior to its collapse to determine whether those heavily involved had engaged in illegal activity. Today, as we write, the SEC has done just that.

Now that the market has fallen more than 20% from its peak last October, Wall Street and the media have declared a bear market. The truth is, we've been in a bad (if not bear) market since the spring of 2000. At the highs back then, the S&P Index reached 1527, while last Friday, July 11, it closed at 1242 for a loss of 18.7%. Needless to say, this is a terrible outcome. The result is traceable to twin speculative bubbles: the first one in stocks, the second in houses. As far as we know, this has never happened in America before. Right at the top, in early 2000, the public couldn't get enough stocks, and then, five years later, after prices had doubled, they were scrambling for houses. Now investors want neither. This highlights a defect in human wiring that invariably leads to disappointment: investors buy more when prices are inflated and sell when they fall – the opposite approach they take to everything else.

While these are uncertain times, and no one can know the future, stocks, from a historical perspective, are certainly a far better value now than they were eight years ago. Earnings on the S&P Index have risen from about $57 in 2000 to an expected $88 this year, and, as noted, the market has declined. Although the timing is unpredictable, we are confident that today's fundamentals will ultimately be reflected in share prices, rewarding investors for their patience. Despite the many challenges our country has faced, things have always worked out in the end, and we believe this case will prove no different.

Sincerely,

Robert E. Torray
President