Douglass Winthrop

New York Washington, D.C. West Palm Beach

January 10, 2006

Dear Friends,

In 2005 the common stocks in our Composite[1] rose +4.1% before management fees, returning slightly more than the S&P 500 Index (+3.0%) and the Dow Jones Industrial Average (-0.6%). Our results were relatively strong in weak market conditions, as our equities declined less than the S&P 500 in five of the seven negative months for the index. Last year was the third consecutive year of positive returns for our clients, measured from the date we installed Advent software in 2002.

While our primary aim is to achieve superior long-term investment results for our clients, we are mindful of the importance of reinvesting in our firm's human capital so that Douglass Winthrop Advisors can continue to attract the very best people. Lea Highet joined our partnership in 2004 and has significantly enhanced our advisory service by working with many clients to optimize their estate plans. This year we are pleased to announce the promotion of our colleague, Stephanie Di Martino, to Client Service Officer.
Many of you already know Stephanie as a tireless and cheery member of our team who is always available to manage administrative issues that arise.
She has also developed expertise with our portfolio management software and will now be a more visible member of our team, focusing on client service. Beginning this year we hope you will meet Stephanie, either in person or by phone, and trust you will admire her talents as we do.

Our investment results last year were achieved in a market environment notable for its lack of excitement as the major U.S. stock market indexes ended the year about where they began. The S&P 500 Index rose +3.0% for the year, while the Dow Jones Industrial Average declined -0.6%. By contrast many international stock markets rose sharply, propelled by 1) growing confidence in emerging markets including India, Brazil and Mexico, 2) Japan's recovery from its decade-long bout of deflation, and 3) robust growth in European corporate earnings. Although stock prices in the U.S.

[1] Composite includes all fee-paying, discretionary accounts, with an equity weighting of 65% or greater and a total value of $100,000 or greater on the last day of the prior quarter. Composite results are calculated using a "Time Weighted Rate of Return" methodology. The composite excludes accounts that maintain legacy positions not initiated by Douglass Winthrop where these positions comprise more than 25% of account's value, and accounts open for less than one quarter. Results for benchmark indexes are index-only returns. Past performance is no guarantee future performance.
Results are unaudited.

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barely moved during the year, powerful economic undercurrents were afoot. Corporate earnings continued to rise as the economy grew for a fourth consecutive year, reducing the stock market's price-to-earnings multiple closer to its long-term average of roughly 16x. Despite two deadly hurricanes and a boom in commodity prices – including oil, which jumped over 40% to $60/barrel – industrial production and employment rose. The long-feared bursting of the housing bubble did not happen, although home prices in some markets were clearly cooling by year-end. A pick-up in mergers and acquisitions, including Procter & Gamble's $57 billion acquisition of Gillette and the contested battles to acquire Guidant and Unocal, signaled confidence by corporate managers in future growth prospects. Even an imminent changing of the guard at the Federal Reserve from Alan Greenspan to Ben Bernanke and no break in the Fed's campaign to raise interest rates failed to derail the economy. By year end, the stock market's dull performance seemed out of step with a healthy economy.

With benign economic conditions and low volatility in stock prices, we were pleased to have the opportunity to purchase five high quality businesses at attractive prices, including eBay, Kinder-Morgan Inc., St. Joe, John Wiley & Sons and Heineken. While each company has specific attributes we admire, all share exceptional governance, durable competitive advantages and financial strength. If you would like to learn more about these companies feel free to call any of us.

Looking ahead to 2006 we expect the effects of higher interest rates and rising commodity prices to take hold. As mentioned earlier, the Fed has raised its target rate for federal funds from 1.00% in June 2004 to 4.25% currently. Interestingly, longer-term bond yields have actually declined in this period from 4.65% to 4.40%, offering bond investors meager incentive to tie up their capital for ten years. Historically a flat or inverted yield curve signals an economic slowdown, and we would not be surprised to see such a slowdown within the next 12-18 months. Even so, our portfolio companies should do well in a tougher economic climate as most have the advantages of scale, low capital-intensity and pricing power.

In prior letters we have written about the relative attractiveness of quality companies, by which we mean companies with sustainable competitive advantages, high-quality earnings, high returns on invested capital, strong balance sheets and shareholder-oriented management teams. Many quality companies have delivered unexciting returns in recent years, even as their underlying financial results have improved. Consider Diageo, Wells Fargo and Pfizer--since 2001 each company has increased earnings, raised dividends and repurchased shares. All are available for less than 15x earnings with higher after-tax yields than 10-year Treasuries and greater potential for capital appreciation. We believe 2006 will be a year for quality companies to outshine their more speculative peers.

We start 2006 with passion for our work, confidence in our team and gratitude to our clients. In a challenging stock market environment our firmhas outgrown the start-up phase while remaining true to our founding principles of respect for clients, commitment to achieving superior investment results and charging a fair fee. Looking ahead, we rededicate ourselves to these principles, believing they are the difference between our service and that offered by our competitors in the investment profession. We welcome suggestions as to how we can do our job better. And if you know someone who might benefit from a relationship with Douglass Winthrop please let us know that too! In the meantime please accept our thanks and best wishes for a happy New Year.

Sincerely,

John Winthrop, Jr.
Robert R. Douglass, Jr.
Charles T. Howard
Lea Paine Highet
Arthur Yorke Allen