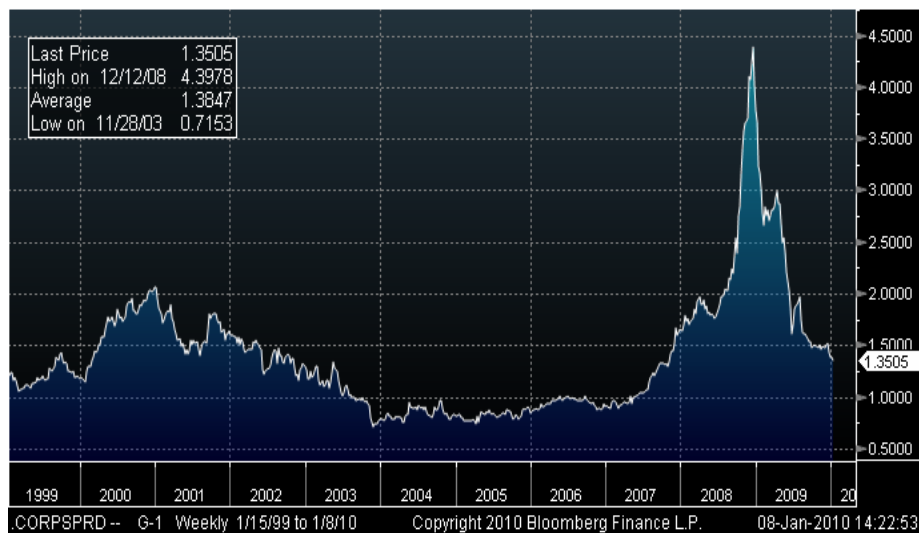


Ah, to be blessed with interesting times! A year ago we had just experienced a seizure in the credit markets and were on the verge of the third 50%+ bear market for equities in the post-World War II era; the second in a decade. Key for our success last year, I was optimistic that 2009 would be better, and signed off last year's January letter expecting better things to come. It would take months, until March in fact, for the markets to reach their ultimate bottom. In April, I wrote that I believed we had seen the worst. It's never easy going against the crowd (e.g., an email circulated in February apologized that the light at the end of the tunnel had been turned off!) but it seemed we had come full circle. A couple of years earlier investors demanded almost no premium return on risky assets; while early last year no return offered, however high, was enough. One of the things I appreciate most about our investment process is that we look at investing as, well, investing. It's not trading or momentum driven, or based on some esoteric quantitative black box. It's based on our attempt to figure out what an asset is really worth and not overpaying for it. Early last year almost everything was priced cheaply and, happily, we were opportunistic enough to take advantage.

Since March, we have seen an incredible advance in the stock and bond markets. The bond market's reaction is particularly significant for many of our investors.

Chart One shows the corporate yield spread for the past ten years. You can see that the spread ten years ago doubled from about one percent to two percent. As the recession of 2002 waned

Chart One. Corporate Yield Spread



the spread dropped back down to under one percent. What is important to note is that the yields being offered on those corporate bonds didn't change all that much even as the spreads did. This time around was completely different. When the spread rose to over four percent a year ago it came from both treasury yields dropping and corporate yields rising. In recent months

the contraction in the spread has been mainly from a reduction in the returns being offered by corporate bonds. Since treasury yields have remained pretty skimpy, this means the interest rates offered on corporates are pretty skimpy now too. This is making the job of generating current income very difficult.

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So, where do we go from here? This year will probably be better for the economy than it will be for the major stock market averages. Since the credit crisis caused a synchronous global recession, its not a stretch to think the world's economies would recover together as well.

We have seen the strongest data coming from Asia but we are seeing better things here as well.

Chart Two. US Initial Unemployment Claims 4 Wk Avg

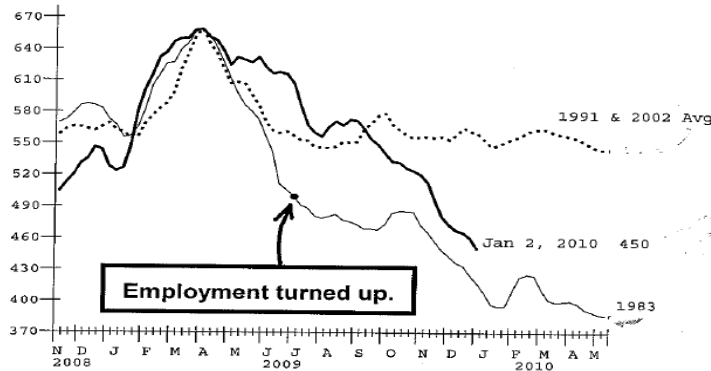
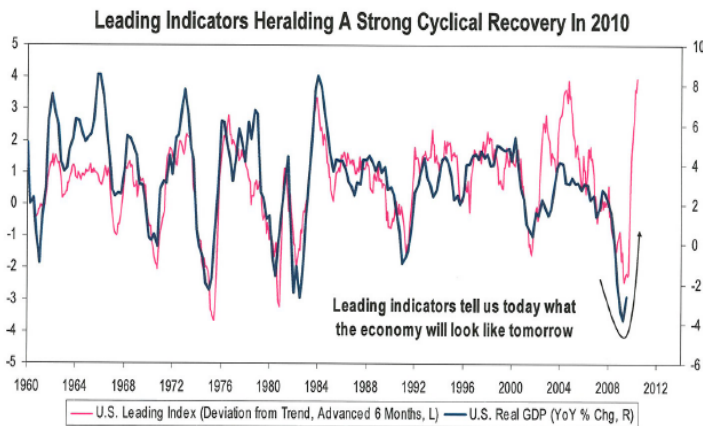


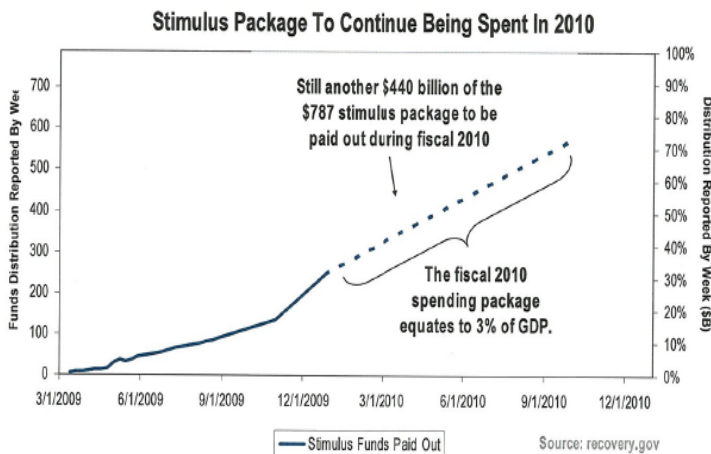
Chart Two shows initial unemployment claims for this cycle in relation to the past three recessions. After acting much more like the anemic recoveries of the 1991 and 2002 recessions, in recent months claims have fallen quickly and now look much closer to the strong cyclical rebound of the 1983 recovery. Chart Three shows the very strong relationship between the leading economic indicators and growth in our economy. Both indicators suggest a healthy recovery this year. We also have the majority of last year's stimulus package being spent this year as shown on Chart Four.

Chart Three. US Leading Index



There has been quite a bit of evidence that this type of government spending provides little addition to GDP other than the spending itself but the \$440 billion expected to be spent this year still amounts to 3% of GDP. Unfortunately, years after the initial market and economic recoveries took place the financial markets' returns were lackluster.

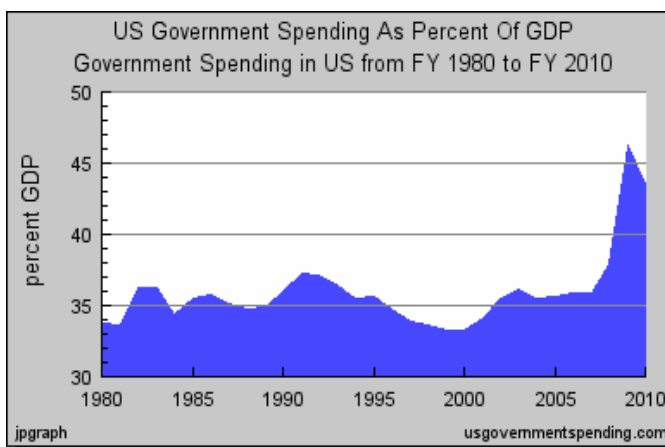
Chart Four. Stimulus Funds Paid



All the spending and creating of money by the government and central bank has generated a lot of concern for some. As well it should! I have been happy to benefit from the cyclical recovery that appears to be starting but there are potential clouds on the horizon I am concerned about.

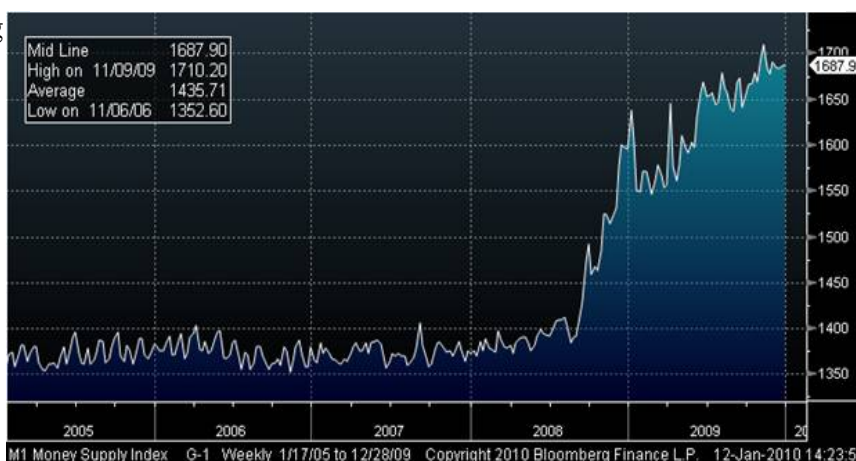
Spending by the federal government as a percentage of GDP, which has remained fairly constant at around 35% of GDP since the early 1980s, rocketed to more than 45% of GDP last year (Chart Five). Meantime, the Fed expanded the money supply. Chart Six shows the expansion of the narrowest of money definitions, M1.

Chart Five. US Government Spending as Percent of GDP



M1 has grown by more than 20% in under a year and a half. These are very “Keynesian”-type responses by our government. Keynesian economics had been largely discredited after the 1970’s malaise but has made a big comeback recently, and not just by the current administration. It’s important to consider what happened in the past after this kind of policy as the investment environment was very different from what we experienced in recent times.

Chart Six. M1 Money Supply Index



Keynes had some interesting theories that were mainly based on intuition rather than empirical evidence. He thought the government would do a better job investing than the free markets. In 1936 he wrote his ‘General Theory’ in which he favored “a somewhat comprehensive socialization of investment”. This investment would be done by intellectuals whom he thought would make smarter decisions than the masses. His is “demand-side” economics. Spend more, save less, and grow wealthy! (Believe it or not, true!) When times were tough and consumers weren’t spending enough then the government should become the spender of last resort. He saw no difference between a government creating money to spend and someone spending savings. He thought that government borrowing and spending during a slump would grow the economy enough that new tax revenues would be enough to cover the debt service.

Keynes predicted that economic growth and employment was a function of demand. Evidence from the 1970s don’t seem to support that claim. In the 1970s high government spending and increased money supply did not produce the anticipated Keynesian results. We suffered high inflation with high unemployment and low levels of economic growth. Stagflation was the term coined at the time. The high inflation rates and static tax tables led to bracket creep, where real incomes stagnated but taxes increased. Financial investment stagnated during the period as investors sought commodities to protect the buying power of their currency rather than fund

companies. The decade saw the worst growth in the economy since the Great Depression and led many economists to recommend getting used to “diminished expectations.” Profligate government spending and high taxes proved to have poor record creating an environment friendly to economic growth.

Chart Seven. US Payroll Unemployment

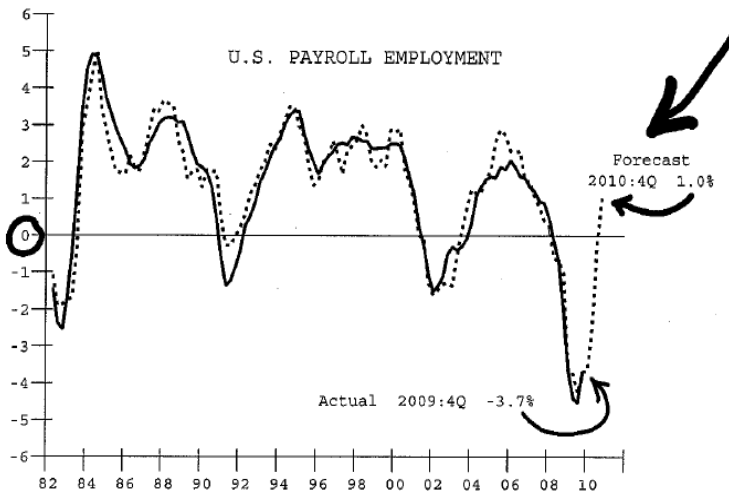
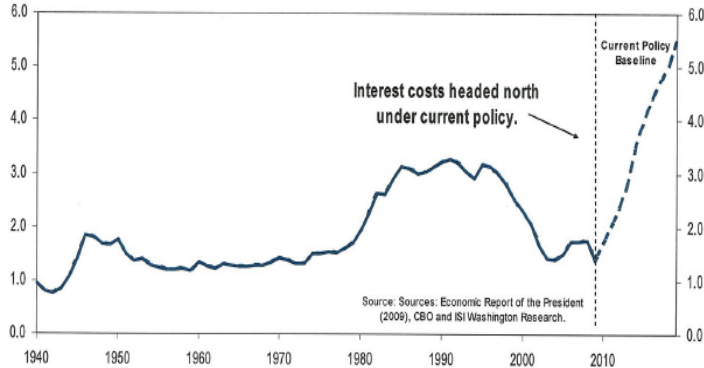


Chart seven shows a model that is about 90% accurate in forecasting employment growth. There are several variables that make up this model but two important ones are interest rates and corporate profits. We hope that future policy initiatives will consist of more proven ways to improve economic growth, and profits, while keeping inflation low. Left unchanged, as shown on Chart Eight, the course we are now on leads to a historic burden just to pay the debt service on the debt being created. It seems improbable that that kind of future would be good for the economy nor the financial markets.

Chart Eight. US Government Debt Service Is Likely To Increase Under Current Policy. Net Interest as Share of GDP



We continue to invest in a way to benefit from the cyclical economic recovery. This means we are looking to over-weight sectors with greater cyclical exposure for our equity portfolios. We are very defensive for fixed income investments. Current interest rates are so low that we feel the risk to capital just on a move to more normal yields is not worth the small return being offered. And, we are keeping a close eye on fiscal and monetary factors that should influence our markets.