

INVESTMENT OUTLOOK

September 2009

As investor sentiment remained positive and economic data releases continued to confirm an economic recovery, the market continued its uptrend in the third quarter. We are confident that the recent portfolio restructuring is not only serving us well but that this benefit will continue over the intermediate term. That the market has performed so well this year has been a surprise to many, perhaps due in part to the bearish proclivity of many talking heads, who have been very quiet of late. A year past the collapse of Lehman Brothers and the ensuing liquidity crisis that hit markets around the globe, it appears that the coordinated action of the Federal Reserve and Treasury to flood the market with liquidity was the right call. The positive reverberations of this liquidity are still exerting their impact upon asset prices and credit spreads.

Our portfolio construction earlier in the year was heavily skewed towards capital preservation in the face of a potential cataclysm in the financial markets. During the second quarter as we heard management teams discuss their first quarter earnings, their outlook for the remainder of the year, and the cost cutting measures they had taken to protect their earnings, we gained confidence that the doomsday scenario we envisioned was becoming less likely and gradually began shifting the portfolio towards companies more likely to benefit as the economy expanded. Second quarter earnings reports and commentaries provided evidence that revenue shortcomings would not necessarily be accompanied by earnings shortfalls, and this data combined with some indications of a better outlook began to appear. Consequently we made further shifts in the portfolio towards a more aggressive, pro-cyclical stance, and eliminated essentially all of our ETF hedges. Companies with little correlation to a recovery scenario were reduced or eliminated, and higher beta, early-cycle stocks were added. As a result, our underperformance early in the quarter was partially offset during September, and further signs of an economic recovery would put us in good stead as we close out the remainder of 2009.

We hear and read a lot of commentary on the sustainability of the current rally. While it is clear that the market has had a tremendous run from the March 9 lows, it must be emphasized that the relevant reference point is not necessarily where we came from at the bottom, but where we were before the credit crisis hit and how divergent actual values were from normalized intrinsic values in March. In our last letter we addressed many potential threats to the economy's continued recovery. Given the very pro-cyclical stance we have adopted in the portfolio as well as the elimination of nearly all ETF hedges, we are extremely vigilant for signs that could change our views on the economy.

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Aside from the usual chorus of threats to the market's bullish tenor, which include inflation, housing, and a de-leveraging, unemployed consumer, we are also actively evaluating possible exogenous risks to the recovery. These include geopolitical risks involving the Middle East, swine flu pandemic, the potential for increased labor union appeasement which is antithetical to free trade, the potential if not likelihood of higher tax rates on consumers and businesses, including a potentially destructive carbon tax, and the potential for policy errors by central banks around the globe. In recent weeks we have also heard from several Fed governors about the need for an 'exit strategy' to deal with all the liquidity sloshing around in the system, and also the possible need to hike interest rates even before it is obvious that a rate hike is needed to cool off the economy. We also evaluate the market's technicals and general economic indicators which are reported on a regular basis. Commentary by management teams on their third quarter conference calls regarding their outlook will be even more important than in a typical year with regard to the information content provided to investors.

To date we have not seen signals that represent major concerns to our positive outlook, but we are evaluating new data on a daily basis. Early October employment data was a disappointment and reinforces our view that it is highly unlikely employment will show a robust recovery for quite some time. The only positive aspect to this unemployment data is that for the time being, it is likely to restrain the Fed's desire to hike interest rates or embark upon other liquidity dampening measures. However, the broader availability of credit, demonstrated by narrower credit spreads, active issuance in the fixed income and equity markets as well as a resurgence of M&A activity, is a fundamentally bullish development that underpins the equity market rally.

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