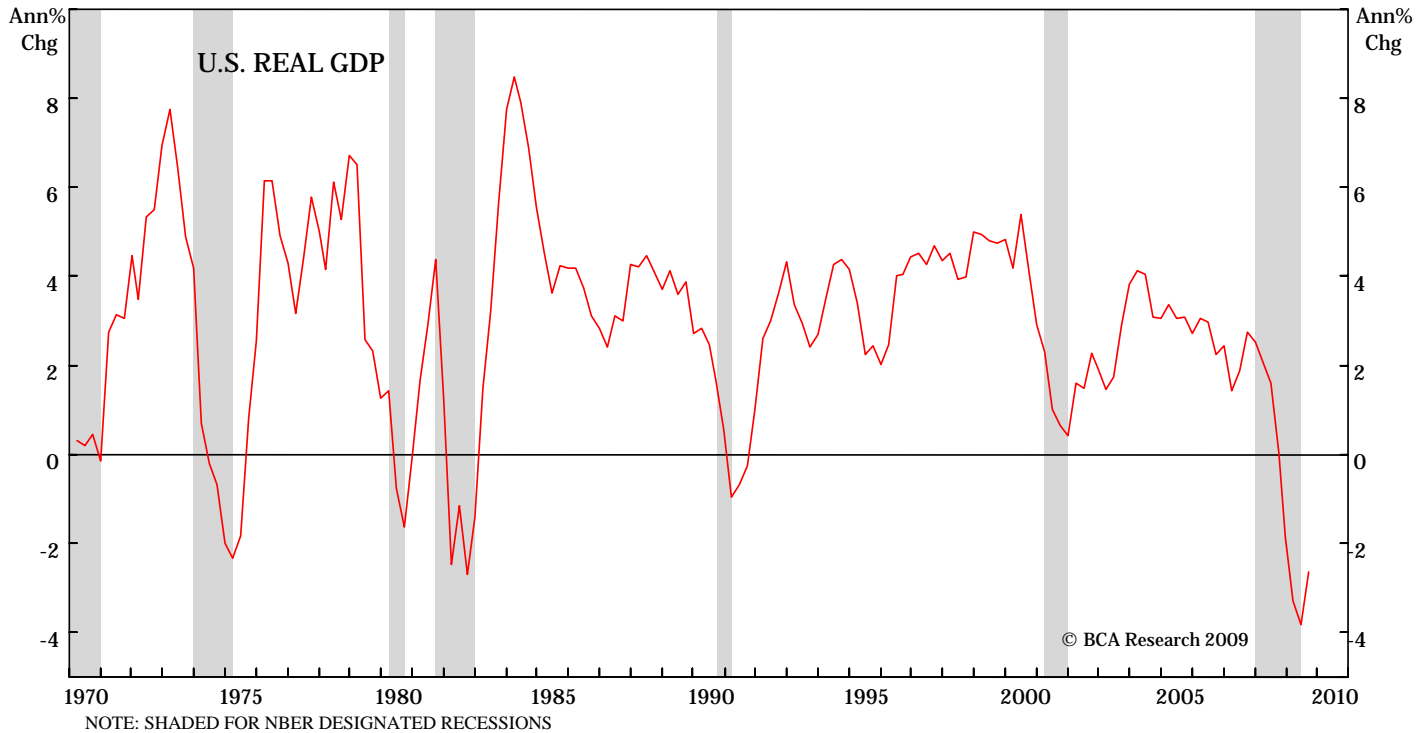




Economic & Market Commentary

The first quarter of 2009 opened with U.S. GDP (Gross Domestic Product) declining sharply and stocks falling 26% to the March 6 lows. The U.S. recession continued through the second quarter but appears to have come to an end during the third quarter. The recession has already been the worst since the 1930s as measured by GDP.

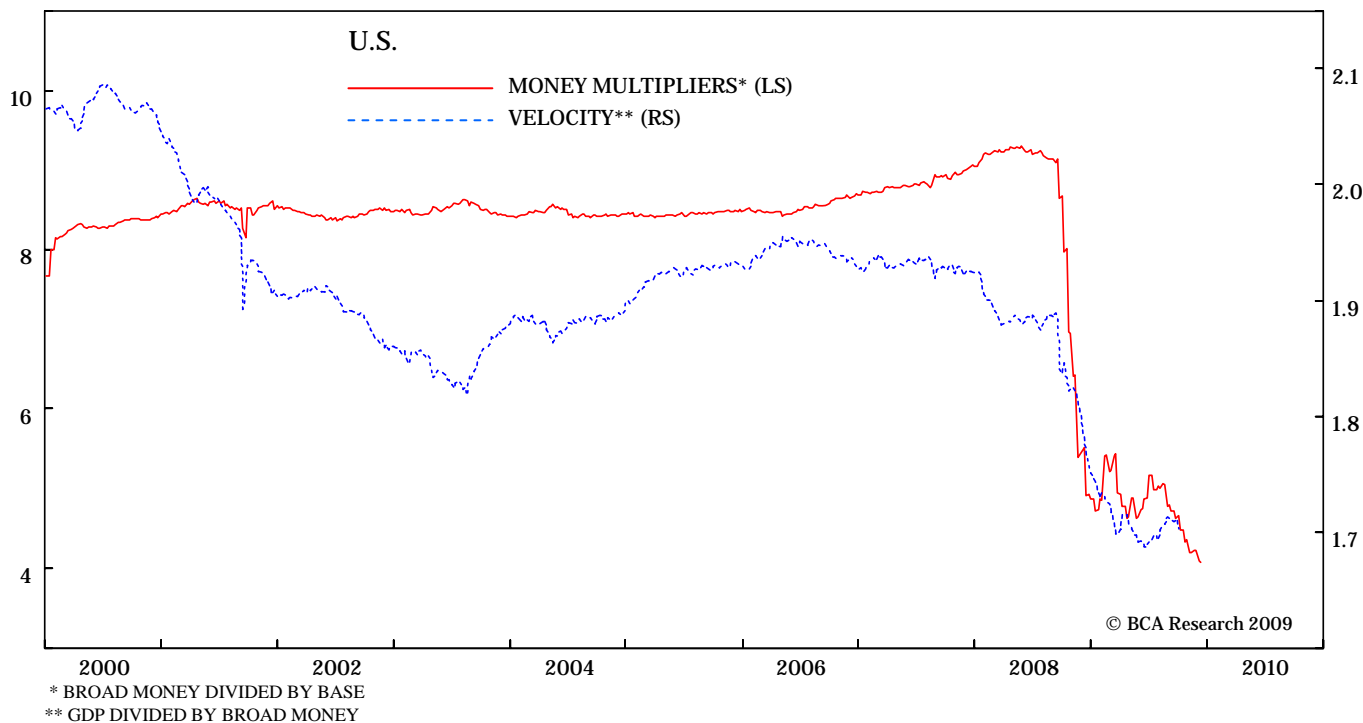


The Federal Reserve responded somewhat belatedly, but aggressively, to the seizing up of the credit markets after the Lehman Brothers' bankruptcy and the deep recession with a massive expansion of its balance sheet from \$800 billion to \$2.2 trillion. This increase of \$1.4 trillion or a near tripling is without historical precedent.



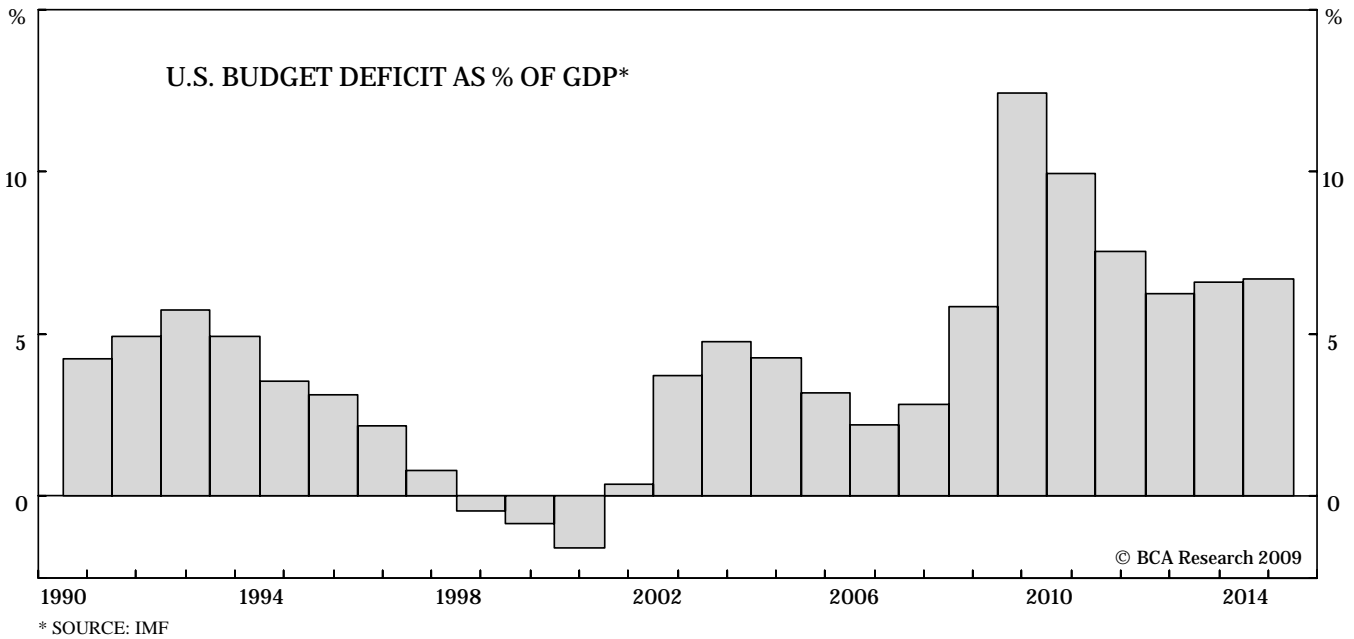
NOTE: DASHED LINES DENOTE PROJECTIONS BASED ON EXPECTED RUNOFF IN LIQUIDITY FACILITIES AND MATURITY OF EXISTING SOMA ASSETS

Unfortunately, the resultant increase in the money supply failed to spur GDP expansion as private sector demand remained weak and the money multiplier and velocity of money collapsed as shown in the chart below.

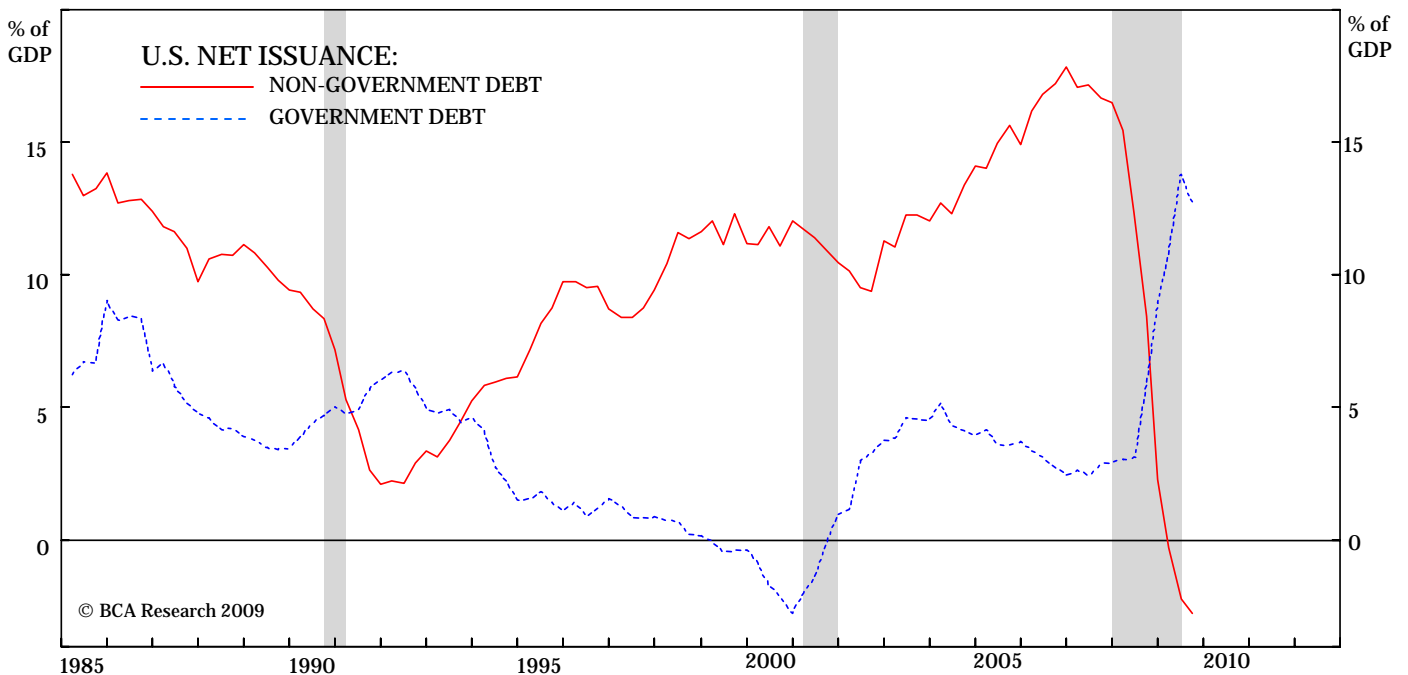


In other words, the money supply growth did not result in sharply increased economic activity or increased private sector lending. The money went towards improving bank balance sheets and, ultimately, some of these excess reserves were used by investors to buy various risk assets. Stock prices moved back towards late 1998-2001 price/earnings multiples (historical all time highs) on both a prospective and trailing basis. Junk bonds rallied even as default rates surged towards 12%. Industrial commodities, such as crude oil, copper and aluminum, sharply recovered in price even though above ground inventories of these materials are near all time highs; under normal circumstances surplus above ground inventories are a precursor to lower not higher prices. In addition, gold reached an all time high in December, even in the face of benign inflationary data, as the excess liquidity poured into risk assets. In our opinion, the liquidity created by the Federal Reserve moved into most risk assets pushing them up in price as this liquidity failed to spur private sector loan growth, jobs or economic activity. We did not anticipate that the combination of an expansionary Federal Reserve policy and limited loan growth would create an environment where stocks would have a sustained rally, even as earnings estimates for most companies headed down through July and trough operating earnings for the S&P 500 moved towards our below consensus \$50 estimate.

The U.S Government also aggressively moved to stimulate the economy. While the \$787 billion dollar stimulus bill was the centerpiece of this fiscal stimulus, automatic stabilizers like lower tax receipts and higher unemployment benefits also contributed to the fiscal party. The fiscal deficit on a calendar year basis surged from 2.5% in 2007, to 5% in 2008 to an unimaginable 12% in 2009 as a percentage of GDP. Fiscal thrust, or the increase in fiscal deficit as a percent of GDP, was 2.5% in 2008 and 7% in 2009. The government had joined the Federal Reserve and gone “all in” to save the economy.

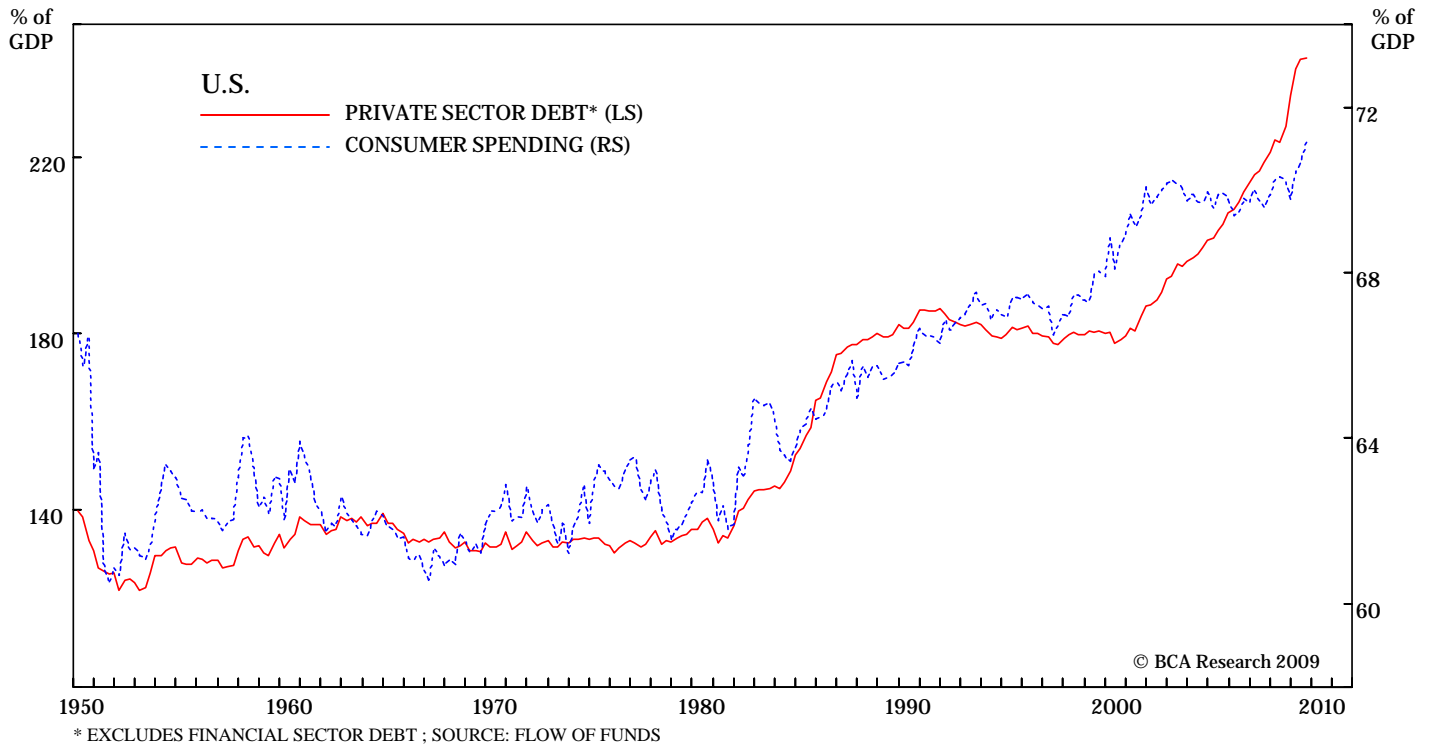


This fiscal thrust, combined with the Federal Reserve’s move to increase asset prices, produced modest GDP growth of 2.2% annualized (or 0.55% quarter over quarter) for the third quarter of 2009. We expect fourth quarter economic growth to be similar or higher as the fiscal stimulus continues to have a positive impact. Most observers believe that without the fiscal stimulus third quarter GDP would have been near 0%, indicating that all of the growth was from the government and private sector self sustaining growth has yet to materialize. This lack of private sector growth and surge in government spending is readily apparent in the chart below that shows the borrowings of these two sectors as a percent of GDP.



SOURCE: FLOW OF FUNDS DATA
NOTE: SHADING DENOTES NBER-DESIGNATED RECESSIONS

The contraction in the private sector's debt is in our opinion a multiyear process as this debt has surged relative to the economy since 1981. All indications are this debt growth has now gone into reverse.



We expect this contraction of private sector debt to lessen the economy's dependence on consumer spending over time. As you can see in the chart above, private sector debt and consumer spending as a percentage of GDP are highly correlated. As the growth of consumer spending slows, we would expect to see an improvement in the net export position of the United States and improvement in the investment picture. We expect the net result to allow for modest economic growth over the next few years including 2010.

While our base case is for modest growth in 2010, we recognize that economic contraction could resume in 2010 as the economy weans itself off the unprecedented fiscal and monetary stimulus. While the authorities will attempt to remove stimulus carefully without creating a double dip, it is not a certainty that they will accomplish this goal as an experiment of this magnitude has never been attempted. The other aspect of this high wire act (which we discussed in detail last quarter) is the U.S. dollar, and the willingness and ability of foreign central banks, mainly China and Japan, to support the dollar and buy U.S. assets. Both of these countries have indicated dissatisfaction with the current U.S. fiscal and monetary policy and are clearly attempting to influence U.S. policy with the clout of their huge (approximately \$800 billion each) U.S. Treasury holdings. It may not be possible for either the Federal Reserve or the U.S. government to further expand its stimulus programs in the face of a potential dollar crisis. We expect the threat of a dollar crisis to limit large new monetary and fiscal stimulus programs. Although a double dip recession is not the most likely outcome, its negative impact on stock prices must be considered when evaluating stock market opportunities. If this double dip or extended recession were to occur, stocks would react negatively given their extended valuation parameters and investors' expectations of a record setting earnings recovery in 2010.

Another big unknown for 2010 is the banking sector. After taking some huge write-offs in the fourth quarter of 2008, they have been relatively slow to recognize their losses or set aside loan loss provisions so far this year.



SOURCE: FDIC
* LOAN-LOSS RESERVES DIVIDED BY NON-PERFORMING LOANS

The coverage ratio is loan loss reserves divided by non-performing loans. The banks have woefully under-reserved for losses and will have to catch up at some point. This could start as early as the fourth quarter earnings reports in January but the timing is very uncertain. Regulators and accounting changes are encouraging banks to wait as long as possible to make write-offs as this impairs their capital and their ability to lend. The banks' nonperforming loan problem is yet to be resolved and creates an additional uncertainty for 2010.

The FDIC closed or merged 140 banks in 2009. The number is expected to increase in 2010 as the number of banks on the FDIC problem watch list has surged to 416. Given the high level of closures, the FDIC has run through its reserves and now has a deficit that will only grow. We expect the FDIC will need to draw on its U.S. Treasury credit line at some point in 2010. To forestall this event, the FDIC has required banks to pay their insurance premiums for the next three years in advance. With bank write downs expected to accelerate across numerous assets (commercial real estate, home mortgages and credit cards) in 2010, the FDIC will be busy. This bank closure activity could constrain the supply of credit in 2010 and presents an additional wild card to a year that has far more uncertainty than normal.

With the benefit of hindsight, we were too conservative in 2009 as we were influenced by our evaluation of the difficult economic situation and the expected drop in individual company profits while not giving enough weight to the potential positive impact on risk assets of the Federal Reserve's near tripling of its balance sheet. In most instances, price/ earning ratios and stock prices go down as earnings are revised sharply downward. Third quarter economic activity as measured by revenues, earnings, employment, unemployment rate, workforce participation, federal tax receipts, state sales tax receipts or private sector

activity were in line with our expectations and well below consensus expectations that were held in the March quarter of 2009. The Federal Reserve's monetary stimulus trumped economic health in this particular case and stocks recovered sharply after their collapse during the first quarter.

Going into 2010, we expect the most likely scenario is a modest U.S. economic recovery as the private sector finally starts to improve. Revenue and earnings should show improvement in this environment, but may fall short of consensus expectations that call for a historic recovery in earnings. We are especially worried about the banking and consumer cyclical sectors as they appear to be discounting overly optimistic profit assumptions in the face of a secular decline in private credit and discretionary consumption. On the other hand, we are finding great values in stable, growing businesses in the healthcare and consumer staples area. Our client portfolios are overweighted in these two sectors as we are finding numerous companies selling at significant margins of safety as compared to our estimates of their underlying business value. In addition, many of the companies that we own have a large exposure to international economies which we expect to grow at a faster rate than the domestic U.S. economy on a secular basis.

With regards to long-term interest rates, U.S. Treasury rates rose during 2009 as the yield curve steepened to over 285 basis points between 2 year and 10 year interest rates before flattening slightly toward the end of the year. We expect Treasury rates to increase again during 2010, as Federal Reserve purchases of Treasury and agency securities come to an end and the U.S. Treasury issues larger amounts of debt to finance the fiscal deficits. While most economists expect the Fed to keep short term rates at very low levels throughout the year, the combination of lower demand as the Fed ends its securities purchases coupled with more supply as the government issues bonds at all maturities should push long rates higher. We expect slightly higher rates by year end 2010 at all points along the Treasury curve except at the very short end where the Fed normally operates. In our view, the modest rise in long-term Treasury rates this year will be driven by increased supplies coupled with more limited demand from three major buyers of 2009: the Federal Reserve, Japan and China.

We expect that modestly higher interest rates will have little impact on the economy and on stock prices with the exception of higher home mortgage rates in an already fragile housing market. Long rates have already climbed close to 200 basis points from their January 2009 lows with no negative influence on stock prices to date. We expect further increases in both the long and short end of the yield curve to be small during 2010. If this expected muted rise in interest rates becomes more pronounced, it could create problems for stocks. However, our potential concerns about stock prices focus on other themes, such as sluggish economic growth, reduced consumer spending, and a highly levered U.S. housing market that will be attempting to bottom in 2010.