Commentary and Outlook October 2009

Global financial markets registered strong gains in the year's third quarter, again lead by equities in emerging markets as the MSCI Emerging Market Index gained 21.0%. The S&P 500 gained 15.6% and international developed market equities gained 19.5% as measured by the MSCI EAFE Index. Year-to-date through September 30, the S&P 500 is up 19.3%, MSCI EAFE, 29.6%, and the MSCI Emerging Market Index is up 64.9%. Bond markets produced positive total returns as well, with the Barclays Capital US Aggregate Index up 3.74% in the recent quarter and 5.72% for the first nine months of the year. During the past ten years the annualized rate of return for the Barclays Capital US Aggregate Index was 6.3%, in contrast to the S&P 500 annualized loss of -0.2%. The MSCI Emerging Market Index was up 11.7% a year for same decade. The US dollar is down approximately 15% in the past ten years against a basket of currencies, which has added to the advantage of investing abroad. Of course, the domestic equity market sold at an extremely high price-to-earnings ratio ten years ago and now is close to historically average levels.

Given the unprecedented velocity of the equity market strength since early March there is natural concern that investors are too enthusiastic about the profile of an economic recovery and that equity markets have outpaced the likely fundamental progress and must decline to adjust to more realistic expectations. After all, unemployment continues at a historically high and probably increasing level and there is too much housing inventory to expect a rapid turnaround in residential real estate, to cite two major problems with any expectation of a rapid economic recovery. This view has prevailed since at least mid-year despite the fact that second quarter earnings reports generally exceeded expectations, although corporations benefited significantly from aggressive cost-cutting in the risk averse corporate environment that has prevailed since the Lehman Holdings failure in September 2008, and not to an increase in revenues. This has produced record high corporate profit margins well into an economic recession. We note that the corporate bond market is pricing debt at levels above yields of US Treasury securities close to the ten year average difference or spread, which suggests that fixed income investors are not uncomfortable with the financial condition of bond issuers. To us, this is an important observation because in the past debt markets have tended to lead equity markets. Please recall that our letters over the past year have mentioned that we monitor the condition of the credit markets as perhaps the most important economic variable and indication that restoration of equilibrium would give us more confidence about the economy and equity markets. Of course, the government and Federal Reserve programs continue to be important contributors to the improvement in credit markets. With the exception of the late September unemployment report and consumer confidence reading, economic news has been generally better than expected since mid-year.

Notwithstanding the recent quarter of 3.4% annualized GDP growth, there is much uncertainty about of the pace of an economic recovery, particularly with the deep structural employment problem domestically, with its attendant potential to derail the equity market recovery, which remains 32% below its high S&P 500 level of 1549.38 on October 31, 2007. We are regaled with daily prognostications of "V," "W," "U," and "L-shaped" recoveries based seemingly on the direction of the most recent economic statistic. Add to this chorus, talk of a permanently lower economic growth rate, mentioned in our last letter as "the new normal," and it is not surprising that mutual funds have had more inflow to bond funds than to equity funds this year as investors avoid the riskier, and higher potential equity category. We should note that although there have been many prognosticators forecasting a decline in stock prices since at least May, none has forecast a significant increase, such as that seen in the recent quarter or what might develop in the next year. It could be argued that the market recovery since early March was nothing more than a recognition that the financial system is far more likely to survive than it was in early March when the market hit its low point. History suggests that mean reversion and the enormous amount of liquidity injected into our financial system in the past year by the Federal Reserve and government stimulus programs will produce economic recovery, even if it is modest. Financial markets seemed to have discounted at least a modest recovery and/or have acknowledged that it is difficult to "fight the Fed," which is a market axiom that we mentioned in our first letter this year and one that was largely ignored by all commentators we have followed. While it was easy to imagine a year ago and earlier this year how things might be different this time in the markets

or our economy, we suggest that history will show that things (the economy and financial markets), while at extremes of historical experience, will not have been all that different in terms of broad patterns and mean reversion.

In terms of valuations, even if there is a generally modest earnings recovery expected, and there is room for upside surprise, the domestic equity market is near its long-term average multiple of earnings. Emerging markets, which we believe offer the best growth prospects, nevertheless sell at lower price-to-earnings multiples and have a much lower long term debt-to-capital ratio.[1] We believe that it is reasonable to expect that emerging markets will eventually be accorded a premium multiple of earnings given their superior growth prospects and strong financial condition. If prior sharp equity market recoveries during similar periods of economic distress are any indication, it is reasonable to expect major equity indices to stay near current levels for a year or so.[2] Of course, there will be sectors of financial markets that may diverge from a consolidating trend, both positively and negatively. Several sectors of the equity markets that continue to interest us are emerging markets, natural resource companies and small capitalized stocks both domestically and internationally. As we have often reiterated, the probability of consistently timing equity market movement is low, thus we advocate relatively fully invested portfolios that are allocated to those sectors that possess the best combination of improving fundamentals and attractive relative valuation.

As we have noted in this year's quarterly letters, the shift in borrowing from consumers and corporations to governments coupled with accommodative global monetary policy suggests that price inflation, while a more distant risk, is not an insignificant one, especially in the physical commodity sectors of energy, agriculture and metals, where capacity expansion is unlikely to keep up with demand when it returns to prior peak levels. Demand from developing countries, however, is having a more immediate, positive impact on prices of energy and metals and may continue to set such prices at the margin, although given the high unemployment rate in developed countries, the record low industrial capacity utilizations rates, the significant deleveraging under way and the large inventory of homes, to us there is more risk of deflation than inflation of prices in general. Therefore, it appears premature to allocate overweight positions to direct inflation hedges such as Treasury Inflation Indexed Securities, commonly known as "TIPS."[i] Please see the enclosed, updated paper on inflation hedges. We first sent this paper in several years ago and the Investment Committee decided to inaugurate a significant allocation to natural resources. We note that over long intervals, equities have been a good inflation hedge, although when general price inflation has been rapid, equity markets have tended to respond negatively due primarily to the increase in interest rates and therefore the discount rate applied to expected corporate earnings. When interest rates have stabilized or declined, equity markets have produced returns in excess of price inflation such that the long-term record shows an after-inflation annualized rate of return of about 6%. This is due to many factors, but importantly to the ability of corporations to eventually pass on prices increases to their customers.

An observation that we made in our last letter was that the current environment favors equity managers who do primary, in-depth research. While all equity managers should conduct this type of research and the vast majority do, many keep portfolio allocations very close to those of an index or benchmark that their investors deem appropriate in contrast to portfolio managers who select stocks based upon their idiosyncratic attributes with little or no consideration of how such a portfolio would compare to an arbitrary index benchmark. The former type of manager views risk in terms of deviation from the characteristics and performance of an index benchmark, while the later type is focused on risks of each portfolio constituent. We prefer to select funds managed by those who conduct

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[1] Based on 8/31/09 FactSet data, the S&P 500 P/E on last fiscal year earnings was 15.90, the P/E on next fiscal year estimated earnings was 15.48 and the next fiscal year earnings P/E is 13.39, while the respective MSCI Emerging Market Index P/E's are: 13.53, 14.41 and 11.76. The long-term debt to capital ratio of the S&P 500 was 34.40% and for the MSCI Emerging Market Index was 24.94%.

[2] The domestic equity market recovered over 50% from March 31, 1938 to October 31, 1938 and from September 30, 1974 to June 30, 1975, after which they were little changed for a year in the case of the 1938 episode and for four years in the 1974/75 recovery.

independent, in-depth research and who construct their portfolios one stock at a time without particular regard for how it may differ from an index or sub-index.

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[3]The US Treasury Department changed its reference to Treasury Inflation Indexed Securities from Treasury Inflation Protected Securities ("TIPS") several years ago after objections from its Securities and Exchange Commission that the word "protected" was inappropriate. Of course the original acronym persists, as it not only sounds better than "TIIS's," but also because it is assumed that the US Treasury will not default on its promises.