



2010 Fourth Quarter

January 2011

In our 2009 year end letter, we wrote that we believed that the economy would continue to recover, inflation would remain low, S&P earnings would be surprisingly strong, and that the valuation of the market would remain in the 16-18x range. We were correct on the first three items, but too optimistic on the fourth as the multitude of continuing worries kept the market's valuation in the 13-15x range for the latter part of 2010. Nevertheless, the market did generate a 15% return for the year, all of which occurred in the last four months. The drivers of performance were somewhat similar to those of 2009 in that smaller companies did better than larger ones and lower quality outperformed high quality. Active managers, and particularly fundamentally driven stock selection strategies, underperformed in 2010 as the riskiest stocks contributed the largest proportion of returns. Merrill Lynch research stated that 2010 was the worst year in the history of their data for large cap managers, with only 1 in 5 outperforming the market. They also state that stock pickers will make a comeback in 2011 since historically, fundamental strategies and actively managed funds have had strong outperformance following years of high correlations and low performance spreads like 2010. We expect that they are right.

Our outlook for 2011 is one of optimism - for the economy and especially for the US equity market. We have been cautiously optimistic for the past 12 months, but are now dropping "cautiously" from our official forecast. This adjustment is less about seeing fewer problems or worries, and more about our belief that the problems are now well recognized and that most everyone from politicians to the man-on-the-street is willing to confront them realistically. The US economy must continue to strengthen for our outlook to be fully realized, but since the "equity market" is heavily influenced by international economies and by companies' own abilities to manage their destinies, stocks should perform even better than the economy. Pundits will continue to report on all the problems that we face and people will listen. But, John Stuart Mill's 1828 quote is still very relevant: *"I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage."*

Our economic outlook includes: real GDP growth of at least 3.5% for the full year with growth accelerating in the second half; the Fed maintaining its low interest rate policy but signaling rising short term rates by the fourth quarter; unemployment declining modestly but still remaining stubbornly high; and housing stabilizing as the mortgage mess moves towards resolution. Business confidence has increased, especially in the last two months, as President Obama and Congress have begun to move toward more business friendly policies and economies around the world have stabilized. Increased confidence will eventually lead to more investment, lending, risk taking, and hiring. Capital spending surveys have been on the rise and the backdrop for banks has improved to the point that both loan demand and credit availability are increasing. With their operations normalizing, banks should begin to reinstate dividends within the next few months. Inflation in the US should be higher than it has been recently, but not to the levels experienced by some of the emerging market countries such as China, India or Brazil. Our view of accelerating second half growth stems from our belief that as this recovery's base becomes more solid, consumer and business confidence will increase markedly.

Consumers in general are in better shape financially than they have been for some time. The savings rate has settled in the 5.5% area, installment debt looks to be increasing again, and the credit card delinquency rate is below normal, all suggesting that consumers have adjusted to the new normal. However, most consumers will remain very leery of overspending and it is unlikely that the US consumer will return to the spending

patterns of the last 25 years. This recovery will most likely be driven by corporate and infrastructure spending rather than the consumer. Housing prices have stabilized in most areas except possibly for locales such as California, Florida, Arizona and Nevada. Many headwinds still abound with the most severe being housing, debt and the rising cost of living. While housing prices seem to have stabilized, the mortgage problems have not. However, we believe that within the next six months, a more workable plan to deal with foreclosures will surface. Once the mortgage debt problem is settled, the remaining problem debt is mostly federal, state and local. One only need read the papers to see that the once untouchable causes of government deficits are now front and center. Solutions can be found, but pain will need to be endured. We do not see massive defaults in tax exempt bonds, but we do believe that there will be enough defaults to get the parties to the table. Erosion of purchasing power will become a primary problem as inflation creeps up. Rising commodity costs such as gasoline, metals and food have been felt for many months, but that is only one aspect of inflation. The cost of importing goods will rise if the dollar weakens. We have already begun to experience cost increases from increased regulation, and when taxes rise, it too will impact purchasing power.

Our outlook for US large cap stocks is very favorable, with returns possibly exceeding 2010's performance. This group has been a laggard for such a long time (10 years) that 2011 should be an inflection point for their outperformance relative to other asset classes. These stocks are very well capitalized, trade at historically low relative valuation levels, and have the financial flexibility to take advantage of opportunities both at home and overseas. While rising interest rates are typically a headwind for stocks as investors lower their valuation hurdle, we believe that large companies will be less affected than small and mid-cap stocks which are already trading at large premiums to large caps. Huge fund flows out of large cap for the past decade has drained this category of sellers. The decade of the 2000's favored fixed income and international stocks, especially emerging markets, and large cap US stocks were the source of funds. The rebalancing has probably been completed and we believe may finally be set to reverse. The reasons for this belief are that they are very out-of-favor, are now fundamentally very attractive investments, and most pay a decent and growing dividend. This last point dovetails well with our thesis on protection of purchasing power and our observation that the baby-boomers are now retiring and increasingly need a growing stream of income. Finally, historically the third year of a Presidential cycle has been very strong, with an average 12.3% return.

The structure of our portfolio changed fairly dramatically during the year as opportunities arose and as we became more convinced of the direction and durability of the economy. The Consumer Staples, Healthcare and Utility sectors, typically viewed as defensive, were materially reduced with proceeds moving into Energy, Financials and Technology. We also reduced cash to a minimum believing that equities would not remain in a directionless range. Our investment process dictated that positions such as Nestle, Teradata and Questar be sold as they neared their sell targets. Others such as Medtronic and Roche were sold when our confidence in our investment case fell below an acceptable level. We opportunistically bought Anadarko Petroleum, a 25% owner of BP's Macondo well, after it fell sharply on fears that they might be liable as part of any settlement. Our analysis showed that even if they were, the stock price more than fully reflected potential damages. Since our purchase, they announced several new discoveries and the Macondo well was capped. Anadarko was our best performing stock for 2010. We diversified somewhat away from pure bank exposure in the Financial sector by purchasing State Street and Aflac. In adhering to our investment process, our purchases trade at significant discounts to their calculated sell targets, but we are also cognizant of concentration and diversification risks in managing portfolios. Aflac gives us insurance exposure, while State Street adds exposure to the asset management area. The Schwab position was also increased as our analysis on it and State Street suggested that both should add significant value over the next few quarters. Our Industrial holdings were maintained at a heavily overweight position as we continue to see value in the individual names and believe that the sector itself will respond well to a strengthening economy. UnitedHealth Group, also one of our top performers, is a good example of how our long term focused, sell target driven approach works. With the passage of the healthcare bill earlier in the year, conventional wisdom might suggest that UnitedHealth would be a poor performer. However, we concluded that ultimate growth in participants would offset any potential squeeze on profit margins allowing earnings to normalize and its valuation to rise modestly from its very depressed level.

Time has a way of healing fears and ills. As we move through 2011, the devastation of 2008 and early 2009 will further recede from our memory. That will be replaced by a resignation that we are undergoing our own trials as have generations before us. Just as those of the 1930's and the 1970-80's endured very hard times but survived and prospered, so shall we. Our future will not be of ever rising spending using borrowed money, but a more realistic sense of what can go wrong. Promises that cannot be kept will be less likely to be made and those that have already been made will need to be reconciled to today's realities. Since 1980, the US has experienced three decades of declining inflation and interest rates, rising home prices, and rising debt levels. We expect that the US is now faced with probably at least a decade of necessary deleveraging, stable home prices and rising inflation. Our belief in investing in stocks has never been stronger, for to us, the best way to protect against a loss of purchasing power caused by inflation is to be an owner. An owner does accept the risk of loss if their company does not do well, but they also participate in its increased value if it does. An owner also does not worry about what they can sell their company for today; they only want to be assured that it can grow and can pay them an increasing dividend. Companies are dynamic. They are able to adjust to changing conditions and challenges. The lost decade of the 2000's is now over and we are looking forward with great anticipation to this new decade with its challenges and rewards.