

First Quarter 2010 Commentary and Outlook

U.S. equity markets recorded a rebound of historic proportions over the past year. On the heels of a punishing 18-month bear market, the S&P 500 Index gained 50.9% for the 12 months ended March 31, 2010 as unprecedented government-infused liquidity and fiscal stimulus, combined with an emboldened consumer and higher business spending pushed the economy into recovery. As we move through 2010 and into 2011, equity markets are likely to become more discriminating as a variety of factors at the government, corporate and consumer levels are all positioned to temper the pace of advance for the economy, corporate profits and, in turn, the broad equity markets. We believe such a move away from a liquidity-driven, cyclical market would likely be a positive development for your portfolio, which is built on stock selections of companies exhibiting specific and fundamental strengths.

Government – At the federal level, fiscal and monetary stimulus initiatives are starting to wane. With a reduced government role in financial and housing markets new sources of demand will need to materialize to avoid price declines of assets, across a broad spectrum, maintain and grow the flow of credit, and spur economic growth. On the fiscal side, the beneficial effects of the government's massive crisis-spending program are scheduled to fade just as growing financial problems of state and local governments begin to create fiscal drag. On the monetary front, the Federal Reserve begins winding down its special liquidity facilities with interest rates at levels considered to be at or around historical lows. This development is particularly striking since the phased withdrawal is occurring as bank lending continues to contract.

Corporate – Higher spending levels on inventories and on plant and equipment purchases are unlikely to be sustained. The restocking of inventories exerted an unusually favorable influence on economic activity following the crisis-induced liquidation. However, this boost to economic growth comes as a one-time surge that will dissipate as inventories are restored to normal levels. Likewise, the increase in business spending on plant and equipment largely reflects pent-up demand for maintenance-related spending. With factory utilization at relatively low levels, business spending to increase production capacity is unlikely. The upward trend in U.S. exports may also moderate from decreased demand as a result of fiscal pressures in Europe and tighter monetary policies in the developing world instituted to control overheating.

None of this bodes well for job creation, which needs to register a substantial pickup if the economic recovery is to be sustained. While the labor market shows some signs of stabilizing, owners and managers of small businesses, which account for the bulk of job creation, continue to express concerns about the economic outlook and future government policy. These concerns need to be assuaged if economic growth is to be kept on track.

Consumer – A combination of government income assistance, strategic mortgage defaults, tax reductions and a decline in savings rates combined to boost consumer cash flow by around \$450 billion over the past year. This boost, an amount equal to roughly 4.5% of total consumer spending, occurred at a time when more than two million jobs (more than 1.5% of the workforce) were lost and household credit contracted by \$235 billion, an amount equal to more than 2% of consumer spending. Looking ahead, while job losses are likely to slow, government is not in the position to provide a meaningful counterbalance should the positive economic trajectory of recent months moderate. At the same time, consumer spending will be constrained by weak labor market conditions, modest income growth, high debt, tight credit, rising gasoline prices, declining levels of personal wealth in housing and possibly higher taxes.

Financial Markets – Credit market conditions remain supportive of growth. Credit spreads across the maturity spectrum are back to pre-crisis or normal levels and in the equity markets, measures of implied volatility (i.e. VIX) have also fallen to pre-crisis levels. This placid state of our financial markets begs the question: Is risk being properly priced? We suspect it is not. In the face of large and growing federal deficits and significant unfunded liabilities these historically low interest rates are unlikely to be sustained over the long term.

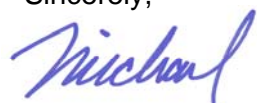
Movement toward More Discriminating Markets

The combination of factors we have discussed suggests the period of rapid economic recovery that has translated into leveraged earnings gains may soon be coming to an end. If we are entering a period of tepid economic growth, where gains in corporate profits are modest, then further equity market advances are likely to be neither dynamic nor broadly distributed.

This type of market is thought to be well-suited for investors who focus on individual stock selection. We believe your portfolio is particularly well positioned to benefit from this next phase of the market, which will likely be driven more by stock fundamentals and less by liquidity and cyclicity than those of recent quarters. This environment should favor companies that are well-financed and well-managed, companies that have secular pricing power, companies that can leverage their infrastructure through acquisitions or that are approaching a period of leveraged earnings gains due to shifts in the supply-demand balance for their product.

Many of the companies in your portfolio have these attributes, including several new positions we have recently initiated. For example, we have recently begun to build a position for your portfolio in a company whose high quality and strategically well-located assets give it an important structural-cost advantage, and in many markets a monopoly-like position. This company has strong potential to expand its productive capacity meaningfully over the next several years, at a time when competitors' abilities to expand are structurally constrained. The company's financial posture is solid. The balance sheet will be underleveraged, all earnings will convert to free cash flow and returns on capital are high. These shares, currently trading at about six times our projection of 2012 earnings, represent an attractive long term investment. Independent of market conditions, we believe investments like this should allow your portfolio to exhibit attractive returns over the next several years.

Sincerely,



Michael A. Steinberg
Managing Partner