



Second Quarter 2009 Commentary and Outlook

Equity markets staged an impressive recovery during the second quarter with the S&P 500 rising 16% and entering positive territory for the year. The increase was especially notable, coinciding as it did with events that would normally present headwinds for equities – bankruptcies at General Motors and Chrysler, a sharp increase in the price of oil, and a 90 basis point hike in the 10-year U.S. Treasury yield. Investors shrugged off the bad news, focusing instead on early signs of economic improvement or at least stabilization. The resulting confidence brought welcome relief from the state of panic that prevailed late last year and earlier this year.

While it is not unusual for markets to discount an economic rebound, in order for stocks to continue an upward trajectory, compelling signs of an emerging and durable economic recovery are essential. Indications of falling unemployment and a recovery in consumer spending along with benign inflation, moderate interest rates and a functioning financial system will all need to be in place and prove to be sustaining for this rally to continue.

Bull Market Prerequisites: Sustainable Growth and a Stable Financial System

In the near term, U.S. GDP will likely begin to show substantial year-over-year growth starting in the third quarter. This upbeat outlook comes courtesy of unprecedented government stimulus, massive monetary expansion and easy comparisons to results from the financial reporting periods of late 2008 and early 2009. The current combined level of fiscal and monetary stimulus equates to about 30% of GDP. On a percentage of GDP basis, that is almost as much resuscitative power as was applied in total over the last 13 recessions, including the Great Depression. The questions of when this stimulus will kick in and if more stimulus is required dominate current political debate, but a larger, more important issue for investors is the long-term one: once the government's stimulus tapers off, will economic growth be self-sustaining?

The weakening of the U.S. consumer, whose spending represents about 70% of U.S. GDP, remains a primary challenge. Unemployment is at its highest level in 25 years and rising. Households, struggling to delever, have sent the consumer savings rate swiftly higher, from less than 2% in 2008 to nearly 7% as of May. In this case, the virtue of thrift is not without its drawbacks. Each 1% increase in savings reduces GDP by approximately 70 basis points. For there to be a sustained bull market, the savings trend will need to stabilize and employment levels will need to increase.

As discussed in recent letters, a healthy financial system, one capable of operating independent of government assistance, is also critical to market confidence and long-term prosperity. While no longer on acute life-support, there is scant evidence the financial system can operate without government intervention. The level of commercial paper outstanding (a key source of short-term liquidity for companies) is half of what it was before the credit crisis, and the Federal Reserve is now the single largest buyer. The securitization market operates at about one-tenth of pre-crisis levels and that's only with substantial government inducements. Nearly half of the approximately \$1.2 trillion in global bank recapitalizations has come from governments. In short, private sources of capital remain scarce and governments have assumed the role of supplying inexpensive credit. While this support provides a critical stopgap, it will not stand as a viable long-term solution.

Stimulus Effects: Interest Rates Up, Multiples Down

Numerous conditions and considerations factor into the price investors are willing to pay for shares of a company based on its current earnings. Among other factors, the price-to-earnings (P/E) multiple reflects interest rates, risk assessments and expectations for future earnings growth and inflation. Government efforts to stimulate the economy may reasonably be expected to eventually lead to upward pressure on interest rates, which in turn may dampen P/E-multiples.

Federal spending for the current fiscal year is projected to be about \$4 trillion. Tax receipts for this period are estimated to be in the area of only \$2 trillion. Therefore, borrowing of around \$2 trillion will be required to fill this gap. To put this in historical context, consider that as a percentage of GDP a deficit of this magnitude has only been exceeded during World War II, and there have been only three other times since the Civil War when tax receipts have covered a smaller portion of government spending.

Central banks have been willing creditors in recent years, buying nearly 100% of the U.S. Treasury securities necessary to fill our deficit gap since 2005. However, beginning in Q4 2008 foreign purchases of Treasury securities dropped to 42% of the required amount and fell to 24% in Q1 2009. In particular, China has put the U.S. on notice that it is unlikely to be increasing the proportion of its reserves committed to U.S. Treasury securities, and has signaled long-term plans to move away from U.S. Treasury holdings. So, while the deficit has increased dramatically over the last year, sources of financing it may be in danger of drying up. That means interest rates may eventually need to rise in order to attract creditors, which would in turn put pressure on multiples and likely earnings as well.

Investment Opportunity in a Range Bound Market

The long bull market that began in 1982, and that some say ended in 2007, developed on the back of growing corporate profits and a secular decline in long-term interest rates, which supported the expansion of P/E multiples. Today, that set of conditions seems absent. The economy faces a series of challenges including higher unemployment, constrained capital availability, the threat of rising interest rates and concerns that the government may pursue tax and regulatory policies that would inhibit growth. These conditions appear likely to produce a trading range for the market as opposed to the returns investors enjoyed in the secular bull market.

While the challenges facing the economy and financial markets may be large, we believe the opportunities to benefit are great. Investors who can effectively utilize in-depth fundamental research to identify investments that are well positioned to provide superior long-term returns should enjoy a preferred position. For example, recently, our research has identified investment opportunities that we believe are particularly well aligned to meet the challenges presented by the need to reduce the cost of health care and the increase in regulation of financial services. We are in the process of building positions in these companies for your portfolio with the belief they will produce exceptional long-term investment returns consistent with your mandate.

Firm Update

As we have discussed with a number of you, Bill Auslander has decided to leave the firm. We wish him the very best and thank him for his contributions. This change occurs as we are in the midst of implementing our strategic plan to add exceptional investment professionals to our team; given the current unsettled state of the financial industry, we believe that there is now a unique opportunity to attract talent. Over the past eight months we have engaged in a rigorous process to identify candidates to join our investment team. We are being deliberative so that

new additions are the best possible, and fit with our team, our investment style and our culture. We look forward to sharing the outcome of this process with you in the near future.

As many of you know, one addition we have already made is my son Justin Steinberg who joined us at the beginning of 2008 from Morgan Stanley's investment banking division, after graduating from Harvard Business School. I am gratified, both professionally and personally, that he is already making important contributions as a member of our investment team and on the operations side. In recognition of his operating role, we are formally designating him Chief Operating Officer.

We are fortunate to have the resources and patience to use this period of uncertainty in our industry to build our business for the benefit of clients long-term. We are confident that the course we are on will place us in the strongest position to continue to serve you with an investment firm of the highest quality.

Sincerely,



Michael A. Steinberg
Managing Partner