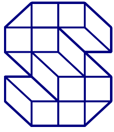
Steinberg Asset Management, LLC

Third Quarter 2009 Commentary and Outlook

The equity market recovery continued through the third quarter with the S&P 500 Index notching a second consecutive increase of nearly 16%, fueled by a powerful cocktail of liquidity and the prospects of favorable earnings results for corporations. The monetary infusion came at unprecedented levels, courtesy of the Federal Reserve, while the earnings optimism emanated from the easy comparisons companies will face in measuring results in the next several quarters against those from near-meltdown conditions of the second half of 2008 and early 2009.

The robust nature of the stock market recovery – nearly a 50% advance since the market troughed in March – raises legitimate and timely questions about the sustainability of the advance. We believe two principal factors – government policy and consumer behavior – will determine the answers.

Government policy will shape economic activity

Perhaps more than at any time since the Great Depression, federal government initiatives will define the direction and force of the economy. Our government's recent intervention, through unparalleled monetary and fiscal stimulus, staved off financial and economic collapse. While a stabilization of the system has been accomplished, the actions that brought it about have imposed new challenges that must be addressed if our economy is to continue to recover.

Monetary Policy – Having injected massive liquidity into the system, monetary authorities now must calculate an exit strategy that neither undermines growth through premature withdrawal of liquidity nor unleashes inflationary pressures due to delays in restoring the monetary base to an appropriate and disciplined level.

Fiscal Policy – While the $787 billion fiscal stimulus program has helped stabilize the economy, it has added to budget deficits that are now projected to reach almost $1 trillion in each of the next ten years. Even with reasonable economic growth in the years ahead, deficits at this level are inconsistent with a sound economy, particularly for a country whose position of leadership is tied to its standing as the world's reserve currency. To meet our social, financial, and geopolitical commitments and obligations in the years ahead, we will need to reduce our federal budget deficit to a sustainable level. The necessary reduction of the deficit – perhaps by half – will be difficult to accomplish, particularly while the economy remains fragile. The primary fiscal tools, taxing and spending, carry significant political as well as policy complications.

Tax increases hold limited potential to close the projected deficits because of the contractionary force they would exert on economic growth. While raising taxes on the wealthy holds political appeal (households with annual income over $200,000 represent only 4.5% of U.S. households), the economic effects would likely be counterproductive. These taxpayers account for more than 30% of disposable consumer income, and increasing their tax burden may reasonably be expected to slow consumer spending.

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A tightening of federal spending also has drawbacks as it would risk hastening the end of recovery and moving a still-tentative economy back into recession. From a political perspective, meaningful spending reductions are difficult even in times of economic strength as individual programs tend to foster powerful constituencies, reinforced by interwoven coalitions.

In the absence of easy and painless solutions to deficit reduction, policy makers would be well advised to identify opportunities for tradeoffs that would prove, on a net basis, to be stimulative of both economic growth and tax receipts. For example, if the government adopts a cap-and-trade system for energy-related pollutants it could be matched with a program to reduce payroll taxes in order to encourage economic growth. The higher tax receipts generated by the energy policy could offset the initially lower revenues resulting from the payroll tax reduction. There is no evidence to suggest that policy is moving in this direction, but an administration seeking to implement its policy initiatives will increasingly find itself constrained by the need to control deficits and foster growth.

Consumer recovery remains critical

For the equity markets' advance to continue, investors will likely require evidence of sustainable corporate profit growth – both through and beyond the current period of easy quarter-to-quarter comparisons. So far, earnings improvements have largely reflected the benefits of corporate cost-cutting initiatives and the restocking of inventories.

Durable top line growth throughout the economy ultimately depends on the availability and use of private credit to finance increased consumer spending. To date, this has not occurred. Consumer confidence, while having rebounded from extremely depressed levels, remains low due to meaningful deterioration of net worth, high debt relative to disposable personal incomes, the threat of higher taxes, stringent lending terms from financial intermediaries, continued high unemployment and still-falling home prices. Surveys show that only a small proportion of consumers are prepared to increase spending meaningfully. This situation needs to change for corporate profits to demonstrate vitality beyond the first quarter of 2010.

Portfolio Performance and Exposures

Liquidity driven markets, such as those we have experienced this year, generally are characterized by lower-quality securities outperforming higher-grade investments. In this environment we might expect our performance to be challenged and to some degree this was the case in the most recent quarter. As we discussed in prior letters, we expected a fundamentals-based recovery for quality investments once the forced deleveraging had run its course and a fair measure of this has occurred.

We remain extremely positive on the long-term prospects for value creation at the companies in your portfolio. Recent developments have, in our judgment, strengthened the longer-term fundamental position of several businesses in your portfolio and we have, or plan to, add to these investments.

Firm Update – Enhancements to the Investment Team
In the last quarterly letter, we discussed the progress of our strategic plan to augment our investment team with outstanding investment professionals. This rigorous and deliberate process spanned the better part of the past year and has now been concluded. We are pleased and excited to have our team of ten investment professionals in place to take the firm forward. The new members of our team are:

Jason Kesselman
Jason, who has 12 years of investment experience, joins us from Karsch Capital Management, a fundamental-value focused multi-billion dollar hedge fund where he was a managing director. He started his business career in the mergers and acquisitions group of Lehman Brothers. Jason holds a BA in History from the University of Michigan and earned his MBA and JD, with honors, from Columbia University where he was an editor of the Columbia Business Law Review.

Grant Toch
Grant, who has eight years of investment experience, joins us from Decade Capital, a fundamentally-value oriented hedge fund, where he was a senior analyst. Grant holds a BA in Political Science from the University of Michigan. He earned his JD, from the George Washington University Law School, with honors, and his MBA from Columbia University Business School.

Brett Boshco
Brett joins us from Morgan Stanley's investment banking division where he was an analyst in the media and communications group. Brett has BS degrees in Management Science and Economics from the Massachusetts Institute of Technology.

We believe these exceptional individuals fit extraordinarily well with our investment style and will add further depth to our investment team. Our objective remains to create meaningful value for clients by identifying superior long-term investments through rigorous fundamental research, and we are pleased that we have been able to use this period of dislocation in our industry affirmatively to further that objective.

Sincerely,

Michael A. Steinberg
Managing Partner