



Fourth Quarter 2009 Commentary and Outlook

Only a year ago our economy had almost shut down. We faced a near collapse of the banking system. Credit markets were frozen and consumer confidence was plummeting. Confronted with huge uncertainties, investors sent stocks into a free-fall. The crisis was halted by governments' unprecedented massive monetary and fiscal policy responses.

With the economy and financial system stabilized, investor attention for 2010 will be focused on the strength and durability of the current recovery.

The hope is that the incipient recovery will move to more solid footing and become self-sustaining. If the typical cyclical process unfolds, and is not interrupted by any serious unexpected developments, then the restocking of depleted inventories will lead to an increase in hiring, which will produce income essential to growth of consumer spending. As capacity utilization rises, higher levels of investment in plants and equipment should develop. In addition, exports should bolster growth.

Obstacles on the Path to Recovery

Despite headwinds from the lingering after effects of the credit crisis, the economy appears to be broadly following a typical recovery pattern. However, because the stresses from the crisis have only been reduced, not eliminated, the recovery is unusually fragile and vulnerable to being derailed by unanticipated shocks. Areas worth monitoring for their potential to undermine the recovery include, but are not limited to the following:

- Premature Tightening: Policy makers are under pressure to address concerns about the size of the Federal deficit and excess liquidity in the system. A premature withdrawal of stimulus could undermine the recovery.
- Relapse in Residential Home Prices: The perception that the residential real estate market has turned up has helped buoy consumer sentiment and has aided economic recovery. However, the fundamental supply-demand balance for housing could turn unfavorable. On the supply side of the equation, foreclosures are likely to accelerate and government policies to forestall them have not been, to date, adequate. At the same time, the effective pool of home buyers may be constricted by several factors: rising mortgage rates, the scheduled expiration of government programs designed to encourage home purchases (tax credits for first-time home buyers and government purchases of mortgage-backed securities), and the implementation of tighter credit requirements for home loans by the Federal Housing Administration (FHA) and other lenders.

If the supply-demand balance for home purchases takes an unfavorable turn in 2010, the resulting decline in home prices could swiftly undermine already fragile consumer confidence.

- Higher Real Long-Term Interest Rates: In the month of December the yield on the government's 10-year note rose to 3.78% from 3.20%. This substantial rise in real, not nominal, interest rates for this benchmark security may signal that investors, particularly foreigners, are growing weary of extending long-term credit to the U.S. government at around historically low interest rates. With a record supply of government paper to be issued in 2010, a less favorable supply-demand balance may translate into undesirably high real interest rates that weigh heavily on the economy.
- Credit Contraction: Credit has been contracting at a steep rate in recent months. No matter the reason, whether the result of reluctance of lenders to extend credit or borrowers to take on debt, if bank loans continue to fall and the broadest measures of the money supply (M2 and reconstructed M3) are not more robust, it will be damaging to the economy.
- Other Factors: In the year ahead, developments surrounding sovereign debt risk, protectionist moves by Congress, commercial real estate losses, as well as financial problems at the state and local level could all produce impediments to the economic recovery.

Investor expectations for a classic cyclical recovery reflect a defensible base-case thesis, albeit one that will likely be challenged due to the fragile condition of the economy and financial system as well as the unexpected effects from the credit crisis. The fragile nature of the recovery holds the potential for a higher level of market volatility than occurred for much of 2009.

Investment Strategy

Our investment process and strategy is built on rigorous in-house fundamental research to identify businesses with exceptional risk-reward profiles. We believe our expertise and approach are well suited to the current environment, and we are confident that our investment process will continue to produce strong long-term investment returns.

Currently one area of focus is identifying businesses that offer remedies to the problems created by the credit crisis. For example, in order to limit further economic and financial dislocations due to the failures of regional banks, the Federal Deposit Insurance Corporation (FDIC) has instituted a program that offers sound institutions opportunities to acquire failed entities at very attractive terms. We have identified several companies which appear particularly well positioned to capitalize on this FDIC program and to achieve outstanding returns on invested capital as a result. We plan to continue to build positions in these selected equities for your portfolio opportunistically.

Sincerely,



Michael A. Steinberg
Managing Partner