

## **Fourth Quarter 2010 Commentary and Outlook**

For the first time in a decade U.S. stocks achieved double-digit returns two years in a row as the Chairman of the Federal Reserve Board told wary investors the central bank was prepared to employ unconventional means to forestall deflation and prevent a second dip into recession. With that reassurance, a 16% midyear correction in the S&P 500 Index ended in midsummer and equities resumed their cyclical bull market advance.

Entering 2011, investor optimism remains high and U.S. economic conditions are equity friendly. Growth is solid but not too strong. Inflation is low. Liquidity is plentiful and stock valuations, by most measures, are not extended. As long as corporate profits continue to rise, equities should deliver positive returns.

In this environment, sanguine views may be justified but complacency is not. A number of conditions hold potential to move investors away from riskier assets, such as equities. Four such issues worth highlighting include financial instability in the Eurozone, the potential for disappointing corporate earnings, rising government bond rates, and the uncertainty surrounding China's growth. If none of these seriously impair the outlook for risk assets, then the related downside volatility should present a particularly attractive opportunity to commit capital to equities.

### **Deepening of Eurozone sovereign debt crises**

European countries will need to refinance or repay record amounts of debt in 2011. At the same time, it appears many investors are pulling back from making financial commitments in the Eurozone periphery because of default risk. This situation is aggravated by uncertainties surrounding the establishment of an institutional architecture for funding a "lender of last resort" as the ongoing pull of national sovereignty conflicts with the necessary push for coordination.

With estimated foreign bank exposure to Portugal, Ireland, Greece and Spain totaling more than \$2 trillion, just a whiff of funding difficulty will likely produce another rush to safety that could prove destabilizing for global financial markets. Recent increases in borrowing costs and a surge in credit default swaps of the troubled countries suggest this next phase may not be far off.

## **Corporate sales insufficient to deliver on earnings expectations**

Favorable earnings surprises have factored importantly in higher share prices over the past two years. With sales, as a percentage of GDP, at a 50-year low, U.S. corporations have successfully relied on stringent cost-control measures to bolster margins and profits.

Looking ahead, it is unlikely the cost side of the equation will continue to support widening margins. Labor costs are near historical lows and unlikely to drop further. In addition, import and producer prices, which aided margins when they fell below consumer prices in 2009 and 2010, have recently risen and are now well above consumer prices. This unfavorable relationship presents a headwind for margins and profits.

With cost containment unlikely to drive earnings growth going forward, the burden of meeting earnings expectations will fall to revenue growth, which faces several challenges. Relatively low levels of capacity utilization will limit pricing power and with offshore sales responsible for 35% of total profits for U.S. corporations, slower economic growth in emerging markets and Europe further dampens the potential for revenue growth. Under these conditions, domestic employment will need to grow at a much more rapid rate to permit corporate sales to translate into robust profit growth.

## **Higher interest rates and a crowding out in credit markets**

A favorable supply-demand balance for credit supported bond prices in 2010 but the dynamics are shifting. Last year, a \$1.6 trillion increase in the supply of U.S. Treasury securities was accommodated due to an even larger \$1.8 trillion decline in private sector credit issuance.

While the U.S. Government's borrowing needs continue unabated, private sector demand for credit is on the rise. This growing demand for credit holds potential to stress the already weak consumer, mortgage, and housing markets. Adding to complications, one of the biggest buyers of U.S. Treasuries, the U.S. Government, may pull out of the market with the scheduled conclusion of QE2 at the end of June. Even if the pace of economic activity calls for extending QE2 beyond June, intensifying pressure from Congress and other quarters could make it more difficult.

## **China's balancing act**

In recent years China has emerged as a powerful economic engine, accounting directly for around 20% of global growth and even more indirectly. However, its ability to sustain this contribution to world growth is being challenged by inflationary pressures that are especially acute for the most politically sensitive of items – food and property. Achieving a policy balance that brings inflation to a level that removes the threat of destabilizing social unrest is complicated. Food-related inflation does not lend itself to mitigation through monetary policy. A meaningful appreciation of the currency would result in lower import prices, but it would also run the risk of undermining the competitiveness of the country's exports and of causing an increase in unemployment as a result.

While China's policy makers are capable they are also operating in uncharted waters. At present there is no evidence to suggest inflation is under control, but there are signs the economy may be slowing, perhaps substantially.

## **Corporate uses of cash hold potential for shareholder benefit**

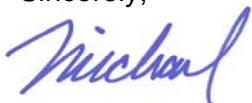
While all of these issues present risks, as long as corporate profits continue to forge ahead the outlook remains positive, even more so when one considers excess corporate cash balances. Companies' cash reserves stand at a 50-year high and look as though they are finally going to be spent. This shareholder-friendly event should be well received by the market and your portfolio. We are optimistic that dividends may rise at a rate well ahead of expectations; that share repurchase programs will accelerate and add to earnings per share; that companies will pay down debt more rapidly, enhancing their options for capital deployment; and that the pace of mergers and acquisitions will accelerate, underpinning values and translating into incremental returns.

Your portfolio is well positioned to benefit from these types of financial initiatives. It holds many investments characterized by strong financial postures. These businesses generate substantial free cash flow and own valuable strategic assets. As long as macro concerns remain in the background, correlations at the security-level should be relatively low, allowing company-specific events to aid your portfolio's returns. We are particularly excited about the long term potential of recent investments we have made for your portfolio as well as some new opportunities our team has identified. We look forward to discussing these with you during the course of the year.

## **Firm Update**

I am pleased to let you know that we have established a Partner Participation Plan (the "Plan") and have admitted Jason Kesselman, Megan Kulick and Justin Steinberg as Partners under the Plan. The Plan gives them defined shares in the profits of the firm on an annual basis. I continue to serve as Managing Partner. I am pleased to recognize the contributions of these senior investment professionals and congratulate them on this appointment.

Sincerely,



Michael A. Steinberg  
Managing Partner