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Investment Outlook & Commentary
First Quarter, 2009

From what we can tell, most investors' experience in 2008 has been something like getting tangled in a fatal multiple car crash. In our case, we feel like we walked away from it not knowing whether to lament the car's damage or cheer because we had escaped something horrific. We are trying—with little success so far—to do the latter considering there were many others in the accident who weren't so lucky.

Despite our very defensive positioning, we could not fully escape the effects of a historic market crash and economic downturn. As with you, we focus on *absolute performance*, and so experiencing even a mild total return loss is gut-wrenching.

In contrast, most of the investment world uses *relative performance* measures, such as the S&P 500 or some blend of different indexes, to judge investment results. The problem is you can't eat relative performance, especially when the S&P is down nearly 40 percent and other indexes post large losses as well. We don't apologize when we under perform indexes, and we won't gloat when we beat them, either.

Despite the continued challenges facing the markets ahead, the opportunities to invest for solid gains in the future have grown substantially, in our view. We are feeling increasingly better about our positioning going forward.

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Whether it was the worldwide financial implosion, market crash, or the election of Barack Obama, 2008 will be remembered as the year things…*changed*. It was the year all sorts of proverbial pendulums peaked and swung the other way; the year reckless banks and Wall Street firms finally got their comeuppance; the year the laissez-faire economics of Reagan and Thatcher gave way to a renewed interest in the government-based Keynesian model of FDR's time; the year that ended—if only temporarily—ultra-leverage, risk-taking and conspicuous consumption.

The so-called "crisis of confidence" in America has been well documented: consumers are shopping less and are saving more, credit is harder to get, and layoffs are now commonplace and everywhere. All assets except Treasuries have experienced large price declines.

Restoring confidence has become priority number one in Washington; it is the one thing that can stem a vicious cycle of lower asset prices and unemployment. Rather than let levered excesses fully unwind naturally, Congress, Treasury, and the Federal Reserve have resorted to the printing press, and enormous sums of money have been thrown into financial bailouts. Abandoning any pretense of fiscal discipline, the White House and Capital Hill have committed to spend virtually any amount of money necessary to prevent a prolonged slump.

If you believe, as the saying goes, "You can't fight City Hall," then you surely don't bet against a determined federal government. The odds are Washington will eventually throw enough money to stabilize an over-extended financial sector and prevent a deflationary re-run of the 1930s in America or the 1990s in Japan.

With this in mind, we feel better about buying certain equities in the short term, especially with prices cheaper than they've been in decades. In fact, the market has been so punishing to even solid companies that the dividend yields on many far exceed that of government bonds. In other words, investors are getting a good deal from companies with solid balance sheets while being paid handsomely to wait until fear and recession dissipate.

Volatility and depressed prices and sentiment can be the best thing for the longer-term investor. We are looking toward re-deploying clients' ample cash and Treasury holdings and being opportunistic, even greedy, as others (most of whom are in a big financial hole) grow more emotional and fearful.

Any bullish feelings we have are tempered, even exceeded, by the longer-term implications of a win-at-all-costs bailout strategy. Currently, with the world concerned about falling asset prices and the deflationary affects of unwinding debt, government borrowing or printing too much money is of little worry to most. U.S. Treasury yields at all-time lows support a sanguine view.

But at what point does all the borrowing and printing reach a tipping point among investors, especially foreign ones that have bought, time and again, most of the U.S.'s dollars and debt? We don't know, but the probability of a collapse in the U.S. dollar has increased as its debt inches higher with every new bailout, stimulus, and spending plan.

That's the end game when a system continues to re-finance its excesses with more cheap credit—only to create more excesses in the future. Eventually, the jig has to be up. Exactly when is a subject for another time.

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Yes, change has come. And in this new era lie new challenges, risks, as well as new opportunities. While our core investment beliefs remain—that is, creating sound and forward-looking asset allocation strategies, owning high quality securities, and buying ownership of great businesses at reasonable prices—we also realize that a new paradigm in politics, economics, and capital markets will also require new and fresh thinking in keeping with our goals of achieving returns and mitigating risk.

We are looking forward to the work ahead. More importantly, we appreciate your trust and confidence, which we will work hard to earn and re-earn in the future.

Neil Rose, CFA
Chief Investment Officer