

Market Commentary

2Q10

Quite a quarter! We have seen a shift from markets in which complacency had set in, to wide scale pessimism in three months. We expressed doubts in our last commentary about the ability of the economy to sustain its growth pattern as government stimulus was withdrawn. The question then moves to what happens in the financial markets as a result.

Perhaps nowhere is it more apparent how the private sector has relied on government help than in housing. As the tax incentive for new buyers expires, sales have dropped precipitously, and home prices are under renewed pressure. Consumers continue to struggle, as high unemployment and accumulated debt weigh on their ability to aid in any economic upswing.

We believe we are in for a protracted period of slower-than-normal growth, as debt levels across individuals and government need to slowly unwind. The market has quickly adjusted to the idea of a renewed economic slowdown. When we look at our companies, we see many of them in the best financial shape in decades. Cash on corporate balance sheets is at levels rarely seen. Dividends have been raised, often sharply, for many. Coming out of the worst recession of our lives, we cannot help but believe that these high quality companies offer the best values in the financial spectrum. Equally important, overly rosy expectations for earnings have come down, muting the potential for disappointment down the road.

The markets always seem to find a way to surprise the most people. Almost every economist and portfolio manager (including us) was concerned about a potential rise in interest rates. Instead, with the Federal Reserve keeping short term rates at effectively zero, we also have seen a drop in 2, 5, and 10 year Treasury rates. Money from risk-averse investors and institutions has avoided stocks, and instead seems to be directed toward low-yielding government paper. The fear of inflation has given way to fears of deflation. Apparently, the Fed, by keeping short rates at zero, is also showing concern about a deflationary spiral.

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Just as the stock market seemed to be ignoring potential pitfalls in March, we believe that people are now too pessimistic on some segments of the market. Clearly, stocks have inherent risks and volatility, but sometimes, the risk-reward pendulum favors stocks. With interest rates low, it is fair to ask whether Treasuries are reflecting artificial depressants or because of weak economic demand and diminished inflationary expectations, they truly reflect a subdued economy. We think it is mostly the latter, and that is why stocks have perversely become more attractive. We can buy a variety of stocks with current dividend yields that

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we believe can grow over time, well above the risk-free rate of return. That is a rare occurrence, one we have not seen since the 1950s.

The past quarter was marred by two significant factors: the huge ongoing oil spill, and problems in Greece and Spain. The dislocations from both will be felt for quite awhile, but the markets have had time to factor them into prices.

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Financial “reform” is practically impossible to decipher, given the lengthy and complicated text. In our opinion, three important things NOT dealt with are leading to increased volatility and decreased individual participation in stocks. These are the 2007 abandonment of the uptick rule on short sales, computerized high frequency trading and trading in naked credit default swaps. Investor confidence continues to erode. The stock market has compelling values, but few willing participants.

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We prefer to do our investing when pessimism is high. We believe we are at a better juncture than a few months ago.

Past performance is no guarantee of future results.

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