Investment Update
Year-End 2009

A very long year is finally over. Like many other investors, we were holding our breath a bit going into year end, optimistic that things will continue to improve but also very aware of all the things that could still go wrong. However, there is no question that we prefer this kind of stress, created by the constant balancing of possible risks and rewards that is a normal part of investing, to the stomach-churning fear that was so widespread this time last year.

As we expected, the global economy is recovering from a long, deep recession and is now growing again. In the U.S., economic activity that fell off a cliff at the end of 2008 and continued to fall through the first half of 2009 finally bottomed out during the summer. Real growth in the third quarter of 2.2% was not particularly strong, especially when compared to most other recovery periods, but any growth is welcome.

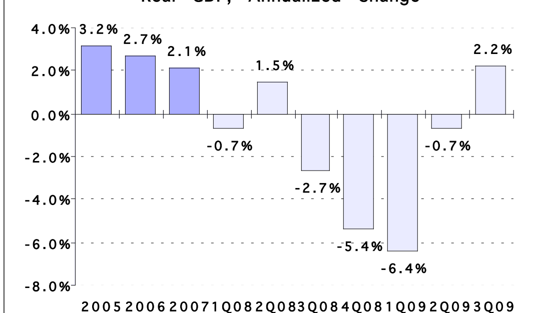


Chart 1: US Economic Growth
Real GDP, Annualized Change

Globally, the emerging economies continue to drive much of the rebound in growth. These less-developed economies never slowed to the extent that the older, more advanced economies of Japan, Western Europe and North America did, and they are in a good position to continue to grow faster. Whether the U.S. continues to benefit from this faster foreign growth depends on the maintenance of relatively free trade arrangements. The piecemeal adoption of protectionist legislation, tariffs and quotas is a serious, potentially harmful trend that we are monitoring carefully.

The positive trends in most economic data during the fourth quarter argue for stronger growth in the last quarter of the year versus the third quarter. Christmas retail sales improved from last year, auto sales are rebounding (even after the expiration of Cash-for-Clunkers), home sales activity is picking up, international trade volumes are growing, both the manufacturing and service sectors have been expanding for several months now, and corporate profits are consistently exceeding expectations.

Even the employment situation seems to be slowly improving. Although the unemployment rate is still high at 10%, the rate at which jobs are being lost is steadily coming down, initial claims for unemployment assistance have dropped 25% over the last six months, and there has been a recent pickup in hiring for temporary positions.

For 2010 much depends on whether the employment situation continues to improve, as job security greatly affects consumer behavior. The recent pickup in hiring for temporary positions is one indication that right now employers have more work than their permanent employees can handle. All else being equal, it is likely that today's better business conditions and improving corporate profitability would already be leading to more job creation, but several large uncertainties currently facing employers are probably making them more cautious than they would otherwise be. Future costs of doing business could be changed significantly by legislation currently being considered, in particular cap and trade for regulating carbon emissions, health care reform, and changes in the tax code. Resolution of these unknowns would surely help job creation.

The consensus expects 2010 to bring a "New Normal" of weak consumer spending, slow economic growth and stubbornly high unemployment in the U.S., but no double-dip recession. We agree that the headwinds facing the economy make slow growth a distinct possibility. But the rate at which things have been improving lately also raises the odds that growth in the last quarter of 2009 and in 2010 will be better than the consensus expects. Keep in mind that the consensus has been behind the curve in forecasting most of the improvements that have already happened (to be fair, this is almost always the case whenever the economy changes direction). If pressed to guess whether 2010's economy will be better or worse than the consensus, we say better.

Powerful rallies in world stock markets from the March low points survived several tests in June, September and October to finish the year with large gains. Although most markets are still well below their 2007 highs, in general they are very close to where they were just prior to Lehman Brothers' bankruptcy filing in September 2008.

A large part of the worldwide post-March rally is attributable to the simple fact that the worst fears of a complete collapse of the financial system did not come to pass. The world did not end, and life goes on. Since then, economies have improved enough to justify additional gains. Corporate profits have held up surprisingly well during the recession, as corporations were very quick to cut costs, particularly payrolls, and to adjust production plans and inventory levels as the recession deepened. We do not agree that the rally lacks fundamental underpinnings.

Table 1: Equity Markets, Price Change

	Since 3/6/09	4th Qtr 2009	Full Year 2009
S&P 500	63%	6%	24%
NASDAQ	75%	7%	44%
MSCI EAFE	71%	2%	28%
MSCI Emerging Mkts	97%	7%	66%

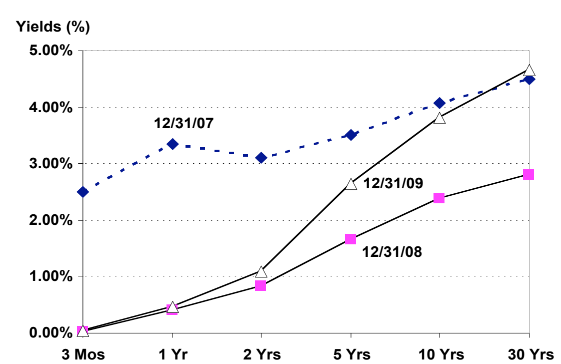
The S&P 500 index is trading at 15.5 times estimates of earnings for 2010 of about $74. Given the current environment of relatively low interest rates, this price/earnings multiple is inexpensive – the average forward p/e for the market when rates are this low has historically been about 18 times. However, given the uncertainty about how much interest rates might rise over the next few years, a somewhat lower forward multiple seems reasonable to us.

If the US equity market is reasonably valued today based on current consensus estimates for earnings, then there is potential upside if the economy is stronger in 2010 than the current consensus and as a result earnings are higher. It is also possible that the Fed is able to manage the difficult feat of effectively removing excess liquidity without large interest rate increases, and that might also be a source of upside for the equity markets. Negative surprises in each case would of course be a source of downside risk for equities.

For some time we have thought that the extremely low levels of interest rates that prevailed for much of 2009 would not last. During 2009, Federal Reserve monetary policy kept very short-term interest rates close to zero, which has anchored the short end of the yield curve, but longer-term rates have now moved up to roughly where they were two years ago, before the financial crisis.

There is now additional yield to be had from buying longer-maturity bonds, but that additional yield must be measured against the potential losses to principal as interest rates continue to rise. The Fed has clearly signaled its intentions to begin undoing some of the crisis-related liquidity injections, which it can do without necessarily raising short-term rates. But eventually, if economic growth continues, a 0% fed funds rate will no longer be acceptable to the Fed in its role as inflation fighter.

Chart 2: US Treasury Yield Curves



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