



January 25, 2010

During the quarter, the Dow Jones Industrials, the S&P 500 and NASDAQ were up 8.6%, 6.0% and 7.8%, respectively (the S&P figure includes dividends).

If your portfolio is modestly lagging the S&P 500, our benchmark, we would remind you that this is a long distance race, not a 100 yard dash. Absolute performance in the few months of 2009 we were managing the account was somewhat influenced by and dependant on when the account was opened. It is still early days. If your portfolio had gotten off to a great start and, say, was to be up 40% in the first year, it would not prove much; we would still have to manage the monies to perform in coming years, and one year would not mean much with that kind of perspective. It is nice to get off to a good start but what is most important is the performance over several years. This may sound like a fancy way to rationalize underperformance, but we hope to be measured over a 3-5 year period, which is more or less a minimum for judging investment results for serious money. Actually, it is after no shorter a period that investors can properly judge the various managements of one's portfolio companies. The measurement of our job is whether your capital has been preserved and has grown. That will depend on how good our company selection has been, and if we did not overpay.

The U.S. economy continues to show broad evidence of improvement, with initial unemployment claims continuing to decline each month, and employment about to turn positive for the first time in over a year. Corporations, generally, are lean and in good financial shape, i.e., with healthy balance sheets. That we are still early in the upswing is seen by the fact that inventories still shrank in the quarter, so there is plenty of upside for the economy. National productivity, another way of saying output per employee, remains exceptional, but we believe it is near a peak which means hiring will rise as demand for goods and services rises. December retailer numbers were impressive as are recent semiconductor equipment orders and the oil and gas rig count.

Internationally, many countries are recovering from the worldwide recession faster than we are; there are actual gains in employment in a broadening array of countries, together with increasing industrial production, consumer and business confidence and stable unit labor costs. Global steel production is back to 2007 levels. Greater economic strength in quite a few countries overseas is helping our exports. However, as we go to press it should be noted that Chinese and Indian central banks appear to have switched to a tightening policy. Twenty-five years ago, such news would not have seemed very important to U.S. investors, but those two countries have seen their economies grow materially larger in recent years.

The continuing worldwide economic recovery is clearly beneficial for the more GDP oriented parts of your portfolio, i.e. the industrials, materials, technology and transportation sectors. The

defensive segments include insurance, consumer staples and health care, and you will note that they comprise a sizeable portion of the portfolio and provide some balance with the more GDP heavy portion.

We are asked about inflation, and we must say that despite the rising price of gold, other precious metals and copper as well as the rising CPIs of Korea and India, we are not worried near-term about inflation. You cannot have inflation without wage inflation, and you cannot have wage inflation with high unemployment. Thus, despite Federal deficits of 13% of GDP (which makes GWB's 6% number look fiscally conservative, which it was not), the bill, in terms of inflation, should not come due in 2010 or even perhaps in 2011, especially if President Obama's highly advertised tax increases become a reality; that would depress the economy, thus interrupting recovery and delaying inflationary pressures.

With respect to investment, bonds remain unattractive for new purchases. This is not to say that it is time to sell bonds. Corporate bond yields, though on the sparse side, remain in excess of inflation.

Stocks are, on balance, moderately undervalued with the number of bargains having declined in the past six months. The conundrum for the coming year is: if the economy continues to build, as we think it should—that GDP grows 4%, then 4.5%, and if employment builds on the positive side of zero (it is already positive in 11 states) as 2010 ploughs onward, and unemployment comes down to 8% or 9%, and then as a result, interest rates are seen to be rising, can it be long before price-earnings ratios (PERs) fall? Stocks sell on earnings eventually. Will the market rise on the higher earnings or fall as the inverse relationship to interest rates kicks in?

Looking at the numbers a little, if the above scenario unfolds, then the S&P 500 should earn \$75-80 (versus about \$56 in 2009) which puts the S&P 500, now at 1090, at 14 times earnings. The ten year bond, at 3.60% now, is generally expected to rise to 4.5% later this year, but even if it rose to 5% or 5.5%, the current 14 PER would not be high. Historically, when interest rates have been around 5%, stocks have had no trouble selling at multiples between 15 and 20 or even a little higher. That makes us fairly sanguine toward equities. However, 5% - 5.5% rates are not the consensus, and those kind of rates might spook a nervous stock market for a while. Certainly, at current valuations, we do not see much downside risk to the market, barring, of course, some nuclear or terrorist scenario. The market can always correct 5-10% (meaning the S&P 500 could go to 13 PER), but that would be called a correction, not a new bear market. As for the upside, the S&P 500 could readily go to 1300-1400.

One development that gives us pause in all this analysis is the big change in sentiment in the past year. A year ago, sentiment was overwhelmingly bearish; now it is overwhelmingly bullish. Another question is the conflict of various government policies. Thoughtful and savvy investors that we know are concerned about policies that our government seems to be pursuing that are at cross-purposes. Here we are selling Treasury bonds to a big existing creditor, China, and using the money to finance our deficits, which hurts the dollar and angers the Chinese; meanwhile, at the same time we are trying to get the Chinese to raise the value of their currency, we are angering China further by raising tariffs by 15% on steel pipe we import from China. Another example of conflicting policies: at the same time we want to encourage more bank lending, we are raising taxes on banks and vilifying them publicly. Even Warren Buffett claims taxing banks to help pay for bailouts doesn't make sense. The crisis de jour that seems to be bothering stocks

here in late January is the uncertainty about Ben Bernake's confirmation hearing by the senate that has been delayed. As we all know, markets dislike uncertainty, especially when it comes to Fed policy.

It is a natural psychological reaction by investors, after we have been conditioned to the type of broad market decline we had in 2007-2009 to worry about an erosion of the appreciation we have seen in our stocks and the general market as they have rebounded off their winter 2008-2009 lows. We would point out that it is precisely to feel secure and to secure the integrity of our assets that we buy securities in high quality companies with proven records in bad times and good, and run by savvy, experienced managements who we believe know how to steer these particular companies through present (and future bad times). The shares' quoted prices may fluctuate but we are relying on the underlying business and the intrinsic values represented to eventually carry the day.

We have been in touch with our portfolio companies and are quite comfortable with the fundamentals of those companies for the coming year, as well as further out. 2010 will see profits gains that should be modest to substantial. We are quite comfortable with the business models and the managements of those companies, and we are quite convinced that your list is comprised of strong companies that are above average growth vehicles and good stores of value for the world we foresee.

Thank you for your continued confidence and trust in our management of your assets; we consider our clients sacred, as is the charge and trust we receive from you. Happy New Year, and as we always say, we are accessible to your needs, and we welcome your calls.

Most cordially,

Roland D. Underhill
Managing Director