Commentary - 4th Quarter 2009

Happy New Year. The financial markets closed 2009 near their highs for the year, sustaining the recovery from the March lows. January is off to a good start and we cannot help but feel more optimistic than this time last year. There are many hurdles to overcome before the markets regain their previous highs, but the economic situation is improving and growth should become self-sustaining in 2010, eliminating the need for monetary and fiscal stimulus.

For the year, the Dow Jones Industrial Average rose 22.68% but the gain from the March 6 lows was an impressive 61.20%. (For those who are superstitious, please note that the March 6 low on the S&P 500 Index was 666.) Many investors are nervous that the market has risen too fast and is becoming overvalued. Our opinion is that the market is expecting a vigorous economic recovery and a strong rebound in corporate profits. We do not expect gains similar to the ascent from the March lows, but we could see an additional 10-20% rise in the broad market indices this year.

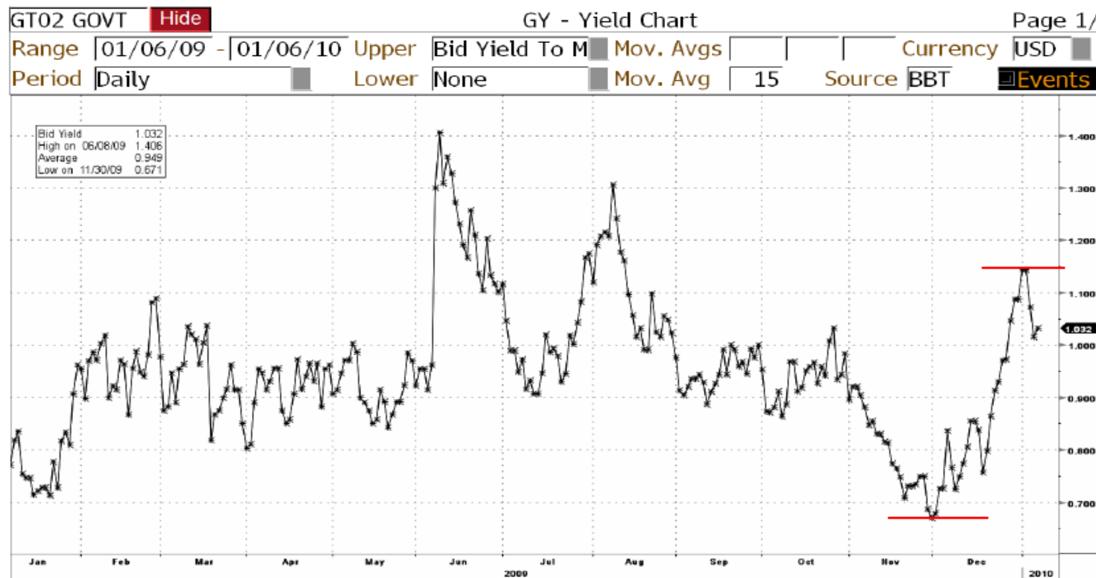
A few reasons to be optimistic this year include the wealth effect of the rising financial markets, the stabilization of the housing sector, an increase in merger and acquisitions activity, strength in foreign economies - especially Brazil, Russia, India and China, and the lower probability of big, new programs from Washington that will impact business costs. There is also an outside chance that the current Iranian administration will be forced out and moderates who favor democracy will take over, ending their nuclear arms ambitions and support of terrorist organizations. If that happened, the risk premium in energy prices would drop substantially. Lower energy prices would act as a global tax cut, increasing consumers' disposable income.

We continue to see money flowing out of money market funds into higher yielding assets. It is not difficult to find higher yielding assets since most money market funds have an effective yield of less than 0.10%. Money market fund balances fell another $150 billion during the fourth quarter and could decline by another $800 billion if they went back to their average balance over the last five years. This could be a strong source of demand for stocks and bonds this year.

Consumer confidence is rebounding and that is being reflected in spending. Retail sales have risen for the last three months and car sales ended the year strongly. The employment picture is beginning to improve, with unemployment insurance claims dropping to their lowest level in over a year and last month's drop in nonfarm payrolls coming in at a negligible 11,000. Some economists are predicting that GDP could expand by over 6% in the fourth quarter as businesses begin to add to inventories again. That would provide a big boost to confidence and corporate profits.

But if the economy is beginning to recover at a faster than anticipated pace, will that force the Fed to raise interest rates sooner? The Fed may already be behind the curve on raising rates. As shown in the graph below, the yield on the two year Treasury note rose by over 0.50% last month.

Graph 1.Two Year Treasury Note Yield, Trailing Twelve Months Source: Bloomberg



As demand for credit increases with economic activity, the Fed will have less control over market interest rates. Earlier in 2009, with weak credit demand, the Fed could dictate market interest rates with their purchases of Treasury and Federal Agency bonds. Now the Fed must begin to look for ways to reduce the monetary stimulus they have injected into the financial system since 2007. The Fed has already completed their purchases of Treasury Notes and Bonds and will end their program to support the mortgage market in March, 2010. As market interest rates rise without the Fed's dampening impact, we should see a recovery in the dollar and less dramatic increases in commodity prices. On the other hand, if the Fed neglects to raise interest rates in a timely manner, we could see a weaker dollar, higher rates of inflation, and more severe Fed rate increases as they try to catch up.

Many clients have expressed concern about the weak dollar and growing federal debt levels. We share some of the concerns, but we think the worries about the weak dollar are overblown. The dollar weakened in 2007-2008 as the Fed flooded the system with liquidity in response to the subprime mortgage problem. Unfortunately they prescribed the wrong medicine for the problem that was more balance sheet-oriented than monetary. As commodity prices exploded during 2008 in response to the Fed's liquidity injections, the economic situation became more precarious. After the Lehman bankruptcy, there was a global flight to quality that benefitted the dollar temporarily. Once China announced their stimulus package and developing economies that were not as leveraged as some developed Western nations began to recover, the dollar weakened again. The recent gains could prove illusory if the Fed waits too long to reduce their stimulus. We would rather see the Fed be more aggressive in raising rates since the federal government's budget is still in a strongly stimulative position. The Fed needs to raise rates so they will have some "dry powder" to fight any unforeseen events that could impact economic activity negatively. As you can see in the graph below, the dollar is now trading at levels slightly lower than it was during the early 1990s against a basket of foreign currencies. Considering we are fighting the worst financial and economic problems of a generation, it is not too surprising that the dollar

is weak. Once it becomes apparent that the economy's "animal spirits" have improved, the dollar should recover. Confidence will return.

Graph 2.US Dollar Index, 1980 to Present   Source: Bloomberg

The other concern expressed by many investors is that the federal government's deficit spending is hurting our long term economic potential. That is a valid concern if the high deficit spending is sustained because interest expense will become a larger portion of the federal budget and will restrict the government's flexibility to address other spending needs. Compounded interest expense could become a significant drag on the federal budget. It does not represent an efficient use of the country's public capital. Fortunately, the fears of runaway deficit spending are already being felt in Washington. Members of Congress are proposing a new commission to deal with structural deficits and the Obama administration is signaling its concern with the deficits. Again, as the populace regains confidence in the economy, they will be more demanding of their Washington representatives to limit government spending. They will be less likely to ask Washington for help and protection like last year during the depths of the recession.

Here is how our asset class strategies performed in 2009. Please do not expect a repeat this year.

Blue Chip Strategy: Our large cap stock strategy rose 7.92% in the fourth quarter, versus a gain of 6.01% for the S&P 500 Index. For the full year, the Blue Chips rose 20.93% while the S&P rose 26.50%. We are not surprised that the Blue Chips underperformed this year as the S&P 500 Index has more technology and growth-oriented companies in it. The Blue Chips held up better than the S&P during the 2008 decline. We have always held the Blue Chips out to be less volatile than the S&P Index with higher total returns over long time periods. Since we launched the strategy in January, 1996 the Blue Chips have returned 0.51% annualized more than the S&P 500 Index. Al-

coa was the strongest portfolio holding during the fourth quarter, gaining 23.1%. American Express rose 20.1% during the quarter and 124.5% for the full year as the best performing position for 2009. Bank of America was the weakest performer for the fourth quarter, falling 10.9%, while ExxonMobil was the poorest performing position for the full year, falling 12.6%. Citigroup and General Motors were dropped from the Dow Jones Industrials during 2009, replaced by Travelers Corp. and Cisco Systems. Your Blue Chips were changed accordingly. We expect the profits of the Blue Chip positions to benefit from stronger domestic growth and the impressive rebound in foreign sales.

Small Cap Value Strategy: Our small cap stock strategy rose a relatively subdued 2.28% in the final quarter of 2009 versus 3.87% for the Russell 2000 Index. But for the full year, the small cap composite surged 59.70% versus the Russell 2000 Index gain of 27.17%. The best performing positions during the fourth quarter included Imperial Sugar, up 37.7%, and MVC Capital, up 36.0%. Imperial Sugar benefitted from higher sugar prices and a better than anticipated settlement with their insurance companies for replacement of their Georgia processing plant that exploded in 2008. The value of MVC's private equity portfolio holdings improved as liquidity flowed back into the capital markets. The weakest performers during the quarter were Xerium Technologies, down 41.5%, and Winn Dixie Stores, down 23.4%. Xerium avoided bankruptcy by reaching agreement with their lenders to restructure their balance sheet. They had too much debt going into the recession and will need to exchange equity for some of the debt. Winn Dixie's earnings report was weaker than expected as weakness in food prices hurt the margins of most grocery chains. We still expect a strong recovery in Winn Dixie as they have no debt, plenty of cash, and are renovating their store base from current cash flow. Renovated stores continue to exhibit competitive gains for them. For the full year, by far our strongest performing position was Dollar Thrifty Automotive Group, rising over 2,000%, followed by Cooper Tire and Rubber who rose 236.0%. Dollar Thrifty successfully reduced their overhead expenses, fleet size, exposure to Chrysler, and their debt while maintaining profitability. They also benefitted from strength in used car prices when new car sales plummeted during the recession. Cooper Tire was helped by lower commodity prices, lower operating expenses from their move to manufacture in China, and an improved pricing environment for tires. Our weakest performing positions for the year were Jackson Hewitt Tax Services, falling 71.6%, and Winn Dixie, falling 37.6%. Jackson Hewitt was hurt by weak revenue during the 2009 tax season as taxpayers were reluctant to pay for preparation assistance during a recession and their lack of an online tax preparation package. Jackson Hewitt announced an agreement with WalMart to provide tax preparation services in approximately 2,000 WalMart locations which should help future earnings, but they also lost a source of earnings when their primary banking provider of income tax refund loans was forced by the banking regulators to decline that business for 2010. We added one new position during the quarter, Powell Industries, a manufacturer and provider of services and systems to manage the flow of electrical energy. The Intrinsic Value Research Summary for Powell is included for clients in the small cap strategy. In total, we added eight new positions to the portfolio this year and sold two. We are optimistic that our small cap portfolio will show additional gains in 2010.

High Yield Convertible Securities Strategy: The high yield convertibles portfolio rose 11.13% during the fourth quarter and a whopping 80.64% for the year versus 5.58% for the Merrill Convertible Index and 5.83% for the Merrill High Yield Index during the quarter; and 47.19% and 56.28% respectively for the full year. During the bleakest time of the credit crisis, no companies with much debt were expected to survive. Fortunately, all of our 2009 holdings except Thorn-

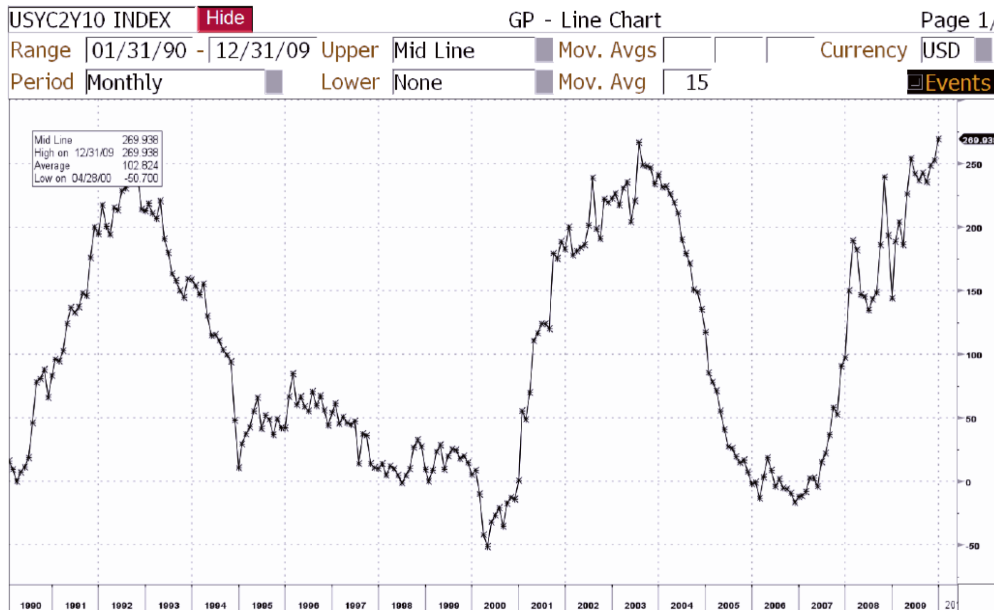
burg Mortgage were able to survive the crisis. Last year's impressive gain resulted in a slight positive return over the last two years for the strategy. Our strongest position in the strategy for 2009 was our convertible preferred issue of Ford Motors, rising 384%. Ford survived the credit crisis and the severe recession by maximizing its cash position in a timely manner in 2007. They avoided bankruptcy and appear to be the strongest domestic auto manufacturer, poised to gain market share during the economic recovery. The weakest position for the full year (excluding Thornburg) was Callon Petroleum. Callon suffered from the 2008 decision to abandon their biggest offshore drilling project. They acquired some on-shore reserves but must still attempt to restructure their debt. We sold the Callon position in December. During the fourth quarter, the Ford position was the best performer, rising 32.5%, followed by Teekay Offshore, rising 24.2%. Teekay Offshore is a shipping company that services offshore oil and gas drilling operations with storage and transportation services. They announced a sizeable acquisition that closed in the fourth quarter and are expected to increase their current dividend yield of 9.0% by at least 20% next year. Callon was the quarter's weakest performer. One special situation that we were watching closely in the fourth quarter was the proposed debt for equity swap by YRC Worldwide (Yellow Trucking). After the third try when the minimum percentage of bonds required for the deal was exceeded, the exchange was completed and we exchanged your convertible bonds for convertible preferred stock and some common stock. The deal closed on December 31st, so you may see some positions on your brokerage statement that do not reflect market values. That is because there is not a market price for the convertible preferred yet. We valued it at the $50 par value on our reports, even though the conversion value was over $150. The preferred cannot be converted until a shareholder vote to approve the additional issuance of shares. We expect that once the additional common shares are approved, the market value of the preferred will be somewhere between the $50 par value and $150. We are optimistic that the high yield convertibles can generate attractive returns in 2010. A stronger economy will boost revenues and if the equity markets strengthen, we should see some of our positions go "in the money" where we can enjoy the returns of rising stock prices. Credit spreads continue to decline, but they have room to fall more if the economic recovery gains strength.

Intermediate Taxable and Tax Exempt Bonds-J.P. Szafranski: Our Intermediate Taxable Bond Portfolio rose 0.73% for the quarter, versus a gain of 0.26% for the Citigroup 1-10 Year Government/Corporate Index. Our portfolio finished 2009 with a gain of 9.72%, beating the Citigroup Index which returned 5.23% for the year. Our tax-exempt strategy declined 0.60% in the fourth quarter, while the Merrill Lynch 3-7 Year Insured Bond Index gained 0.41%. Our tax-exempt portfolio returned 4.96% for the year, underperforming the Merrill Lynch Index which rose 7.01% in 2009.

The taxable bond portfolio outpaced the index largely as a result of our over-weighting to corporate bonds. Prices for these bonds benefited as the credit risk premium demanded by the bond market continued to diminish. Another reason we outperformed was our avoidance of U.S. Treasury bonds in favor of U.S. Treasury Inflation-Protected Securities (TIPS). The semiannual interest and principal for TIPS are indexed to changes in the Consumer Price Index. In 2009, nominal U.S. Treasuries, as measured by the Merrill Lynch Treasury Master Index, declined by 3.72%, (the first negative annual return since 1999), while TIPS gained 8.94% for the year, according to the Barclay's U.S. Treasury Inflation-Indexed Notes Index.

In our last letter we expressed our view that interest rates should move upward. One indicator of future interest rate expectations is the slope of the Treasury yield curve. A quick way to observe the yield curve is to look at the difference between the yield of the two year T-Note and that of the ten year T-Note.

Graph 3. Treasury Yield Curve Spread 2 Year Maturity vs. 10 Year Maturity
Source: Bloomberg



At December 31st, that difference had grown to 2.70%. As the chart above details, this is a remarkably "steep" yield curve. Over the past two decades, only 1992 and 2003 offered comparable steepness. We believe this is the bond market's way of telling us to expect higher yields in the future, along with a strong economic recovery. Broadly speaking, this is bullish for stocks and bearish for bonds. As the economy returns to growth, numerous forces, including the Federal Reserve, will push interest rates higher. Rising rates will hurt the market value of any bond portfolio. In order to mitigate this risk, we will maintain a shorter than average maturity which will be more insulated against any rise in market yields.