



October 12, 2009

Quarterly Commentary

3rd Quarter 2009

In the last year, the worldwide investment community has experienced extraordinary volatility in the securities' markets. There is a tendency for investors to forget recent history, and we do not want you to do that; for it is the recollection of our experiences that makes us better future investors. Unless one can vividly recall living during the Great Depression, few of us have lived through much of what we experienced in the last four months of 2008 and the first three months of 2009. It was highly emotional, volatile, and even chaotic. Entire markets ceased functioning for days on end. We have discussed with our newer associates what a great time this was for them to be cutting their teeth at our firm. They have been told to never forget these extraordinary experiences. They will be able to draw from them throughout their careers.

Investment lessons can be learned from first-hand experiences at all ages, not just from textbooks or from professional experiences. One of our investment team members recently recalled a learning experience he had during his sophomore year of college that had a profound impact on him as a professional investor. Just as the swine flu is spreading unabated through certain college campuses today, back in the late 1970's there was an epidemic of similar but less life-threatening proportions – the infamous financial chain letter. It became the “buzz” of the campus. A participant/victim would “buy” the opportunity to have his name and address added to the chain letter list by sending \$10 to five people at the top of the list. There were daily campus-wide announcements about different people that had received dozens, if not hundreds, of \$10 bills in the mail. The excitement was palpable. As enthusiasm grew, the more people participated; that is until the chain was broken and panic ensued. Market strategist, Ray DeVoe, effectively coined the term “Crack of Doom” to describe that instant an investor feels that all is lost. While that foolish experience cost that student \$30 (he did actually receive \$20 in the mail), the lesson learned for that future investment professional was invaluable. It was probably this very experience that protected this investor from the internet boom and bust of the late 1990's.

When the markets were in panic mode last October, we did something that we have never done before with our clients. We asked them to consider sending us excess cash that they might have to invest in under-valued bargain stocks that we were identifying with increasing frequency. We expressed to our clients that, while just a few months prior we were having difficulty identifying bargains, the number of stock bargains on our buy list had doubled in short order. We were not attempting to call a bottom in the stock market, because we will

never make that kind of prediction. What we were saying was that many stocks of great companies were on sale for the first time in a long while.

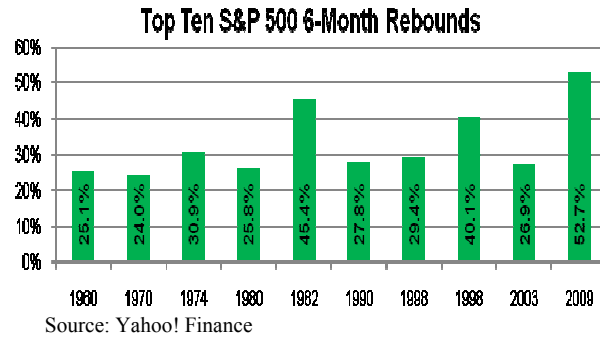
Controlling one's emotions is critical to the long-term success of investors. Realize that we did not say eliminating the emotion. As hard as we try, even we, who hang our hats on the rack of stoic long-term value investing, experience these emotions alongside our clients. All humans possess these feelings. How one harnesses these emotions greatly determines his potential investment success. Fortunately, we are trained to override these raw emotions with fundamental research and rational thinking. It is not we, but you, our clients, that deserve the credit. When we are asked, "To what do you attribute your investment success?" our immediate response is, "We work with great long-term clients who understand that patience and perseverance are critical to investment success." We can not thank you enough for entrusting your long-term assets with us. We know there have been and will be times when our investment discipline falters or looks to be off target. However, we believe strongly that this value discipline works over the long term, and it is this patience and perseverance that make up the critical ingredients for that investment success. Without our clients possessing those attributes, investment success would not likely occur.

For institutional investors, another event occurred during this period to cause intense pressure on individual securities within portfolios – the recent adoption of FASB 157 that dictated new standards on how to account for "other than temporary impairments" (OTTI). We have not seen much written about the psychological impact on portfolio managers of institutional portfolios with regard to these newly adopted accounting standards. From our experience, however, we believe that FASB 157 has created very short-term (one year or less) scrutiny on long-term assets. You have heard many times from us that we do all that we can to maintain a long-term focus on the management of clients' assets. FASB 157 dictates, in layman's terms, that an institutional investor is generally required to write-down a long-term investment when it has traded significantly (generally 10-20%) below its original cost for a period of time (generally twelve months). There is no allowance for writing up a security on a mark-to-market basis until the security is actually sold. This accounting procedure forced institutional investors to write-down sizable amounts on their equity portfolios in 2008 and early 2009. To this point, we have only discussed the accounting practices implemented. That is not our primary concern. Our experience is that these accounting practices cause proportionately high levels of scrutiny on the worst performing securities of a portfolio. While some scrutiny is deserved, we know that portfolio managers feel pressure to sell an under-performing security from a portfolio so as not to have to defend further ownership of that security. We can not quantify the impact of this pressure, but we became convinced that these actions caused excessive downward force on the stock prices of many under-performing stocks in the fourth quarter of 2008 and the first quarter of 2009. We believe the level of stress on institutional investors and their portfolio managers increased significantly. Our personal experience has generally been that it is common for the security that must be defended the most, quite often can add the most to future portfolio returns.

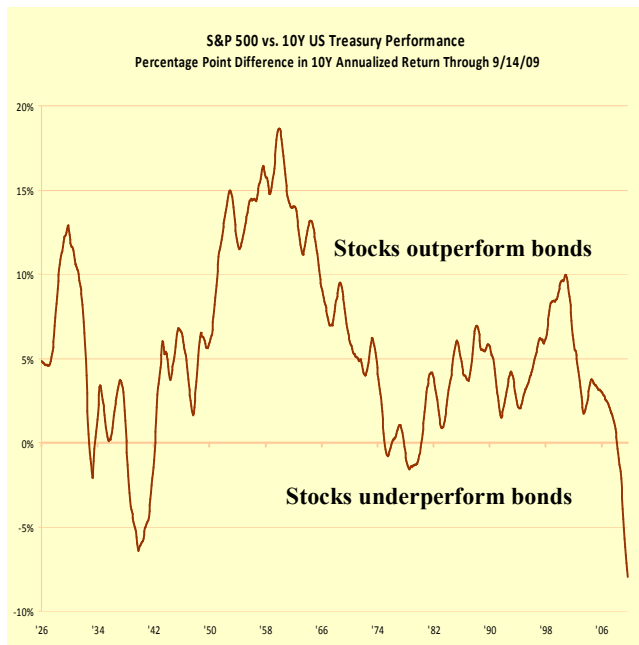
So where do we stand today? First of all, the volatility continues, but now on the upside. As you can see from the chart on the following page, stock appreciation over the last six months

is extraordinary. Our chart shows that the current six-month stock market upswing is the greatest since 1950.

It would not be unusual for stocks to pull back in price because stock prices rarely move in one direction for very long. You might not be surprised to hear that our buy list has shrunk somewhat, since bargains have become less numerous as many stocks have moved up closer to their intrinsic values. We remain patient and price-sensitive. A pullback would actually be favored, since it would allow us to capitalize on new investment opportunities.



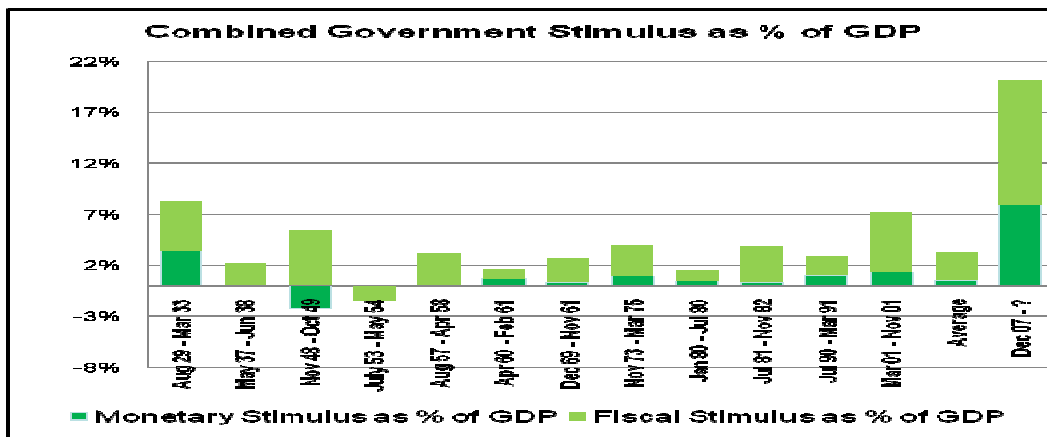
Two quarters ago, we showed a chart we created reflecting the rolling ten-year returns for stocks going back to 1935. We reflected that the last ten year period ending 12/31/08 was the worst of its kind for stock returns going back to the Great Depression. We decided this quarter to compare those same rolling stock returns with rolling ten-year Treasury bond



Source: "Irrational Exuberance" by Robert J. Shiller

returns (see below). This chart shows the wide disparity between stock and bond returns over the last ten years. Because stocks generally are more volatile investments than bonds, their ten-year return has exceeded that of Treasury bonds in approximately 85% of these periods. That is definitely not the case today. This chart speaks volumes about why we feel strongly that stocks should generate far superior returns to bonds in the future. Historically, stock outperformance has occurred after this chart has bottomed, as in 1932, 1941, and 1975. It is possible that this reversal of returns could already be occurring given the strong outperformance of stocks over bonds for the last six months.

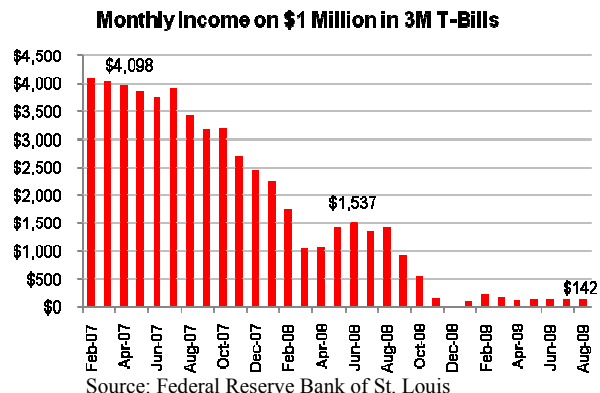
Our biggest question regarding this relationship is whether stocks will perform well on an absolute basis or whether bonds will perform poorly on an absolute basis. We believe that interest rates should begin to rise up from generational lows, because inflation will begin to be recognized in the bond market. The chart we created on the next page helps put the combined government monetary and fiscal stimulus for this cycle in perspective. The current combined government stimulus is 6.1 times the average relative historic response going back to 1929. After viewing this chart, how could inflation not be with us today and in the near future?



Source: Federal Reserve Bank of St. Louis, Federal Reserve Board of Governors, Congressional Budget Office (latest GDP as of 1Q09; **latest Fed assets as of 2Q09; ***latest deficit as of Aug 2009)

Savers Being Sacrificed

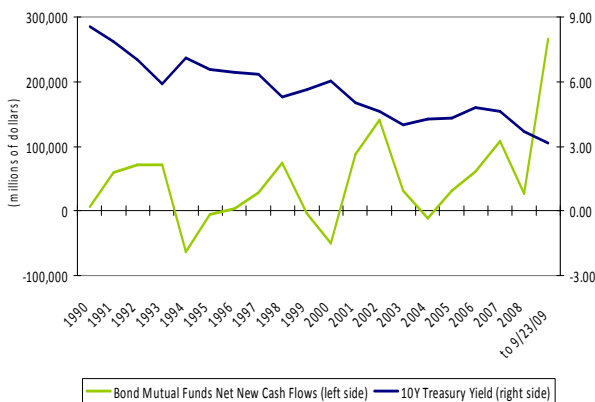
This leads us to focus on a related topic that is of concern to us. We believe that the Federal Reserve’s present policies are unabashedly favoring borrowers over savers. There will be repercussions that will emanate from the fact that yield-starved savers are being exploited by the current government policies of ultra-low interest rates. We know that the Fed is attempting to stimulate the economy using very aggressive monetary and fiscal stimulus techniques. However, we believe there are huge unnecessary costs to savers that are beginning to affect investor behavior. Our chart at right shows the monthly income for an investor fortunate enough to have accumulated \$1 million and invested it in three-month Treasury bills. Two and a half years ago, the monthly income for that investor was over \$4,000, and today that number is down to just \$142. Since \$142 per month is not sufficient for someone to live on, that investor has likely changed course.



Source: Federal Reserve Bank of St. Louis

As you can see from the below chart, the amount of money flowing into bond mutual funds is setting new records. Just as in the past, conservative, income-oriented investors have

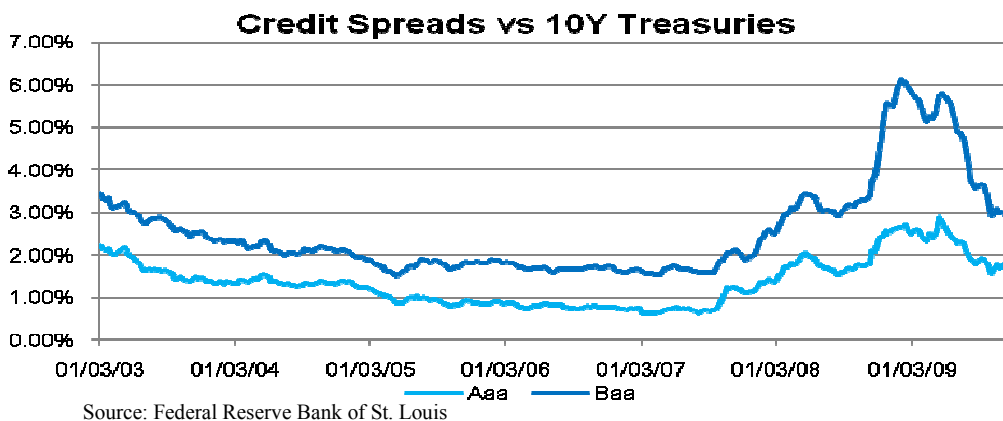
New Cash Flows into Bond Mutual Funds vs. 10Y Treasury Yield



Source: Investment Company Institute, Federal Reserve Bank of St. Louis

begun to abandon money market funds, T-Bills, CD’s, and other low-risk income producers for higher-risk, longer-maturity, lower-quality fixed income instruments. This behavior almost always ends painfully for those desperate investors stretching for yield. We are concerned that these income-oriented savers are being sacrificed for the benefit of borrowers. Our third chart on the following page reflects shrinking yield spreads for corporate bonds, as investors begin to have a higher tolerance for credit risk in

order to maintain their income. As money pours into bond funds, the portfolio managers of those funds must invest that cash which temporarily drives bond prices up and yields down. Just in the first nine months of this year, \$60 billion of new funds has been invested in municipal bond funds, far above the prior annual record of \$30.6 billion in 1993. You might have guessed that the next year, 1994, was one of the worst years for bond returns in history.



Great News!

We have exciting news! On October 12th, **Tom Hill** joined Foundation Resource Management as a senior portfolio manager. Tom is a *magna cum laude* graduate of Vanderbilt University, received his M.B.A. from the Wharton School of the University of Pennsylvania, and earned his Chartered Financial Analyst designation in 1991. Tom was one of the founding members and a past president of his local Chartered Financial Analyst Chapter. He has worked with Merrill Lynch for the last 28 years, serving both institutional and individual clients. Most importantly, Tom is a dedicated value investor. Our principals have known Tom for more than 20 years and have tremendous respect for him as a



professional, as a colleague, and as a person. He is a man of the utmost integrity and character. We have commented that nowhere could we find a better fit for our firm than with Tom. And how far have we had to travel to find him? About 5 miles. Tom recently retired from Merrill Lynch, but has many more good years of investment work left in the tank. We are thrilled that he has decided to move from the sell-side to the buy-side of the investment world. You will be getting to know Tom soon as he transitions into our firm. He brings to us an energy and a forward-thinking vision that will prove valuable. Tom has been married to Debbie for 23 years and they have four daughters, Sarah – 18, twins Anna and Elizabeth – 17, and Mary Claire – 15. Please welcome Tom when you get a chance.