MARKET COMMENTS

November 24, 2010

Through late November, 2010 has been a somewhat volatile year for stocks, albeit with a positive bias for most of the year.

The first quarter saw solid returns for equities as earnings momentum from 2009 carried into the first quarter. The S&P 500 peaked at 1,220 on April 26, up 9% from the end of 2009.

Growing concerns about the strength of the economic recovery, sovereign debt defaults in Europe, and increased legislative and regulatory uncertainty in the U.S. led to a mid year correction from April 26 through July 1 of 17%, as the SPX reached a 2010 low of 1,011. From there, the S&P 500 rallied 21% to post a new high for the year of 1,227 on November 9. As of the November 12 close at 1,199, the S&P 500 was up 7.5% year to date.

At the end of 2009, we posited fair value for the S&P 500 for 2010 in a range of 1,250-1,300 based on an expectation of earnings for the Index between $75-80. It appears that earnings for 2010 will exceed our estimate from one year ago and approximate $83-85, which leaves some upside for the market for the last six weeks of the year.

Corporate earnings have continued to surprise on the upside throughout 2010, and we believe it is likely that 2010's profit momentum will continue into 2011, and result in earnings for the S&P 500 of around $95. We believe a P/E for the market of 15x is reasonable assuming continued profit growth in 2011 and continued low interest rates (i.e. the yield on the 10 year Treasury remains below 4%), which would imply a fair value estimate for the S&P 500 of around 1,425 for 2011, approximately 17-20% above the current 1,200 level for the S&P 500.

Plenty of risks to our constructive outlook for stocks remain.

First, the pace of the current recovery is far below that of "normal" economic expansions. We believe the slow aggregate growth is due to the ongoing deleveraging process by consumers, companies, and countries in the wake of the massive debt build-up of 2003-2007. Savings rates have risen significantly despite record low yields for money market and short term debt instruments.

Second, unemployment in the U.S. has remained stubbornly high, and until it improves, aggregate consumer spending will remain under pressure, which has a dampening effect on U.S. GDP. We believe job growth will improve over time, but an after-effect of the massive fiscal stimulus of 2008-2009 is the increased role of the government in the economy which over time does slow GDP growth.

Third, while political uncertainty was reduced by the November elections, the risk of political gridlock in the U.S. for the next two years may result in investors' risk premiums remaining higher than normal. When investors are more risk averse than normal, capital markets' returns are muted.

However, the Fed's efforts to force investors into riskier assets appears to be having some positive effect, as asset values over the past several months have risen. The Fed appears to be willing to trade the risk of inflation longer term for the possible short term benefit gained by buying up U.S Treasury assets and driving investors into riskier assets. The Fed is clearly in uncharted waters with this approach, and this risk may be weighing on equity valuations, because "normally" the combination of the strong earnings growth achieved in 2010 and very low interest rates "should" result in a higher valuation level than is currently being accorded U.S. equities.

The fact that equity valuations are not higher may indicate that investors are also concerned about the sustainability of the earnings recovery going forward. We believe that 1) corporate balance sheets are in exceptionally good shape (cash balances for many companies are at all time highs) which provides companies with great flexibility to grow business value going forward, and 2) earnings are likely to continue to surprise on the upside in 2011 given the strong profit progress made since early 2009 despite very challenging economic conditions.

Despite the risks, we believe the prospects for continued earnings growth for U.S. companies remain reasonable, and in conjunction with low current valuations and strong balance sheets, we believe that U.S. equities have good upside potential on balance over the next several years, particularly those companies that have a material presence outside the U.S., because the weaker dollar engendered by the Fed's expansionary monetary policy should make U.S. goods and services very competitive in global markets.

Our companies have on average not had price appreciation in 2010 commensurate with their earnings growth. We believe that over the long run, stock price appreciation is fairly closely correlated with underlying earnings growth, and we expect some price catch-up is likely for our companies on balance going forward.

We believe that current valuations for our companies suggest that we will do well in two ways over the next several years. We expect a continuation of the strong financial performance we have seen since early 2009 as the economy continues to recover which will drive business value higher, and as it does, we would expect some improvement in the valuation accorded our companies.

We continue to favor two types of companies: 1) those with strong balance sheets, dominant franchises, and high returns on capital that consistently generate excess cash flow, and 2) companies that have similar characteristics to the first group but with greater exposure to an improving economy. Generally, companies in the second group do not have returns on capital or margins that are quite as high as those in the first group, and their earnings and cash flow characteristics tend to be more variable given their greater economic sensitivity, but they are more leveraged to incremental gains (or decreases) in economic activity.

Companies in the second group have on balance been better performers in the market in 2010, and include industrials, transports, materials, and some energy and technology companies. Companies in the first group on the whole have not performed quite as well in the market in 2010 (despite very solid underlying financial performance) as investors have gravitated toward companies with more leverage to an improving economy as the year has unfolded. Companies in the first group include consumer staples, health care, and business services.

Examples of companies within each theme include:

<u>Dominant Franchise. High Profitability, Consistent Earners</u>

Allergan
Apple
Berkshire Hathaway
Celgene
Google
MasterCard
McDonald's
Microsoft
Pepsico
Procter & Gamble
Qualcomm
Stryker
Visa

High Quality Beneficiaries of an Improving Economy

Apache
Best Buy
BHP Billiton
Capital One
Carnival
Caterpillar
Emerson Electric
Fedex
Fluor
Roper Industries
Target
Union Pacific
UPS

We recently looked at U.S. companies with market caps of $10 billion or more, and examined net profit margin, return on equity, and debt as a percentage of capitalization as indicators of "quality." We divided the companies into three groups by net profit margin: those with net margins of 20% or more (highest quality), those with net margins of 10-19% (average quality), and those with margins of 9% or less (lowest quality).

Clearly, the best performers in 2010 have been the lower quality companies. The group with net margins of 9% or less appreciated 15% year to date through the end of October, and traded at 15.2x estimated 2011 earnings, with an average net margin of 6%, a return on equity of 17%, and debt that totaled 36% of capitalization.

By contrast, the companies with net margins of 20% or more advanced 5%, and now trade at 14.4x estimated 2011 earnings with an average net margin of 27%, ROE of 23%, and debt to capitalization of 21%. We believe it is clear that large cap, higher quality companies are very undervalued both absolutely, and relative to companies with less desirable financial characteristics. While this sector may continue to lag the broad market during periods of sharp advances, we believe that high quality growth companies currently offer exceptional long term value given their current low absolute and relative valuations. In a sense, the "best companies" remain very much on sale at the present time.

Our challenge in 2011 will be to strike a balance and effectively allocate portfolio capital between those companies with the most attractive long term valuations and those companies with relatively better near term earnings leverage and growth prospects.

We are constructive entering 2011 because we believe equities in general remain undervalued despite the price advances to date in 2010, and because we believe the companies in our portfolio are significantly undervalued given their strong balance sheets, high levels of profitability, and solid prospects for growing shareholder value over the next several years.