Market Comments

December 19, 2008

The stock market has advanced approximately 17% since November 20th, which was the lowest point for equities since the bear market which began in October, 2007. The S&P 500 is up almost 20% since the intraday low of November 21 of 741, at which point the S&P 500 had equaled the low point of the 2000-2002 bear market.

In recent weeks, the economic news has worsened, but we have been impressed with the market's resilience in the face of the onslaught of extremely negative headlines regarding the fallout of the financial crisis and the worsening U.S and global economies.

While the future is always uncertain, investors are battling more uncertainty than usual as they consider the outlook for 2009 and beyond, given the extent of the economic disruptions caused by the financial difficulties created by the credit collapse of 2007-08.

The good news is that valuations for both bonds (outside of Treasuries, where yields are at historic lows as investors have bid up the price of "safety") and stocks are at or near historic lows.

Despite the terrible equity and fixed income (outside of Treasuries) market returns of 2008, we remain constructive on the outlook for 2009 and beyond, for a number of reasons:

1) valuations for stocks are very low by historical measures, even assuming a difficult earnings environment in 2009. Assuming $60-70 of operating earnings for the S&P 500 in 2009, valuations with the S&P 500 in the 800-900 range are roughly equivalent (if not somewhat lower) to the 2001-03 bear market lows, when the S&P 500 reached 750 on about $35-40 of operating earnings

2) credit spreads for investment grade corporate bonds remain very wide relative to historical norms (even though they have improved (narrowed) some since October-November) – A-rated corporate bonds are about 250-300 basis points above Treasury yields versus a long term historic average of 50-75 basis points

3) reversion to the mean is still the most powerful force at work over time in the capital markets – history strongly argues that over time, valuations tend to move from extreme levels (positive in 1999-early 2000, and negative in 2002-early 2003) toward "average" levels

4) the market is a discounting mechanism – in the aggregate, prices move before the reasons "why" are apparent in the headlines. In 2003, unemployment peaked at 8.7% in June; by then, the S&P 500 was up 25% from its last low in February. As the rate of negative news changes from "accelerating" to "stabilizing", securities prices will begin to rise as the market anticipates "improvement"

We expect continued higher than normal levels of price volatility in 2009 given the economic risks, negative headlines, and investor skittishness and aversion to "risk." However, over time, investors need to earn higher returns than those currently afforded by "safe" assets (cash, where yields are barely positive, and Treasuries, where the 10 year yield, at 2.2%, is priced to provide a negative real return if inflation averages 3% per year over the next decade). The need to earn

higher returns will result in capital returning to stocks and corporate bonds over time as the current recession plays out and investors focus on longer term investment objectives.

Money market mutual funds now have 37% of all mutual fund assets, the highest level since 1991. There is plenty of buying power, which we believe will migrate to higher return assets once the economy and the capital markets show signs of stabilizing.

Historically, the best returns for stocks have come after periods of extreme economic stress and extended periods of negative returns. The October 2007-December 2008 period certainly meets the "extreme" criteria, and we expect that stock market returns over the next three years will be significantly better than those of the past three years.

Since World War II, the average bear market has resulted in a decline of 33.8% in the S&P 500. At present, the S&P is down 45% from its all time high. We have attached a chart that shows the range of recoveries for the S&P from post-war bear markets over varying time frames. On average, the S&P 500 was 22.6% higher six months after bear market lows, 37.1% higher one year out, and 55.2% higher two years after reaching bottom. Currently, the S&P 500 is 17.5% above the low set on November 20. Even the most tepid recoveries argue for staying the course, as the market was 21% higher one year from the bottom in its "worst" recovery, and 41.7% higher two years into the "worst" recovery. The current environment, which is characterized by a worse than normal bear market decline, significant amounts of cash (which currently gets almost zero return), widespread investor pessimism, and large amounts of short interest, creates the potential for a significant move higher in stock prices in 2009 and beyond.

Our companies have strong balance sheets, and have shown an ability to generate increased shareholder value over time through a wide range of economic conditions. We believe higher-quality companies will perform relatively well in 2009 as investors concentrate capital on those companies with relatively less economic and balance sheet risk and strong business franchises that can grow and create solid returns for shareholders over the long run. While we expect the market environment will remain choppy in 2009, we believe that the combination of low stock market valuations, extreme investor pessimism, and high levels of liquidity will lead to improved stock market returns on balance over the next several years.