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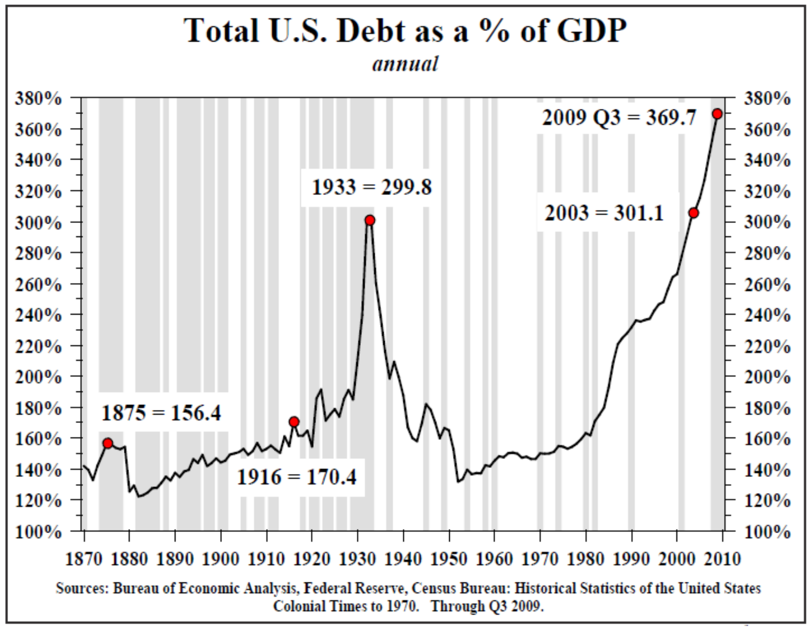
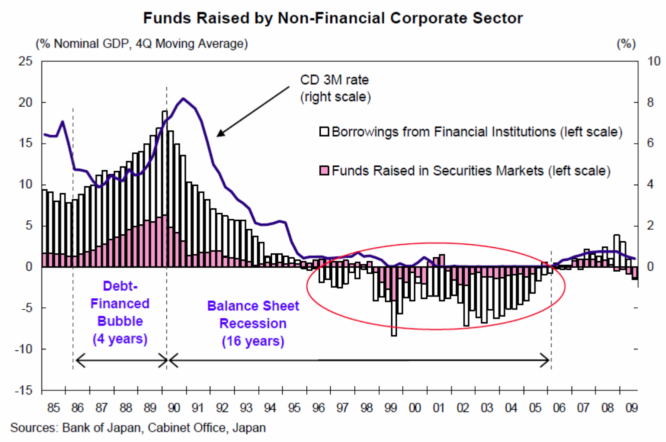
For the last year we have remained unconvinced that the economy was embarking on a V-shaped recovery. Short-term economic growth was drastically impacted by inventory restocking and short-term government stimulus. Over the last three months economic data has grown increasingly dour, suggesting that indeed the recovery has lost steam. While many still regard the probabilities of a double-dip recession as low, we nonetheless remain cautious. While our views are influenced by a host of different research inputs, the following figure embodies our most significant concern:



Hoisington Investment Management Company

The debt figure portrayed represents both public and private debt. Put simply, our country (as well as other developing nations) has amassed a debt burden that will require significant work to reverse. The explanation is not overly complex – for years, Americans supported their consumption not only with the full use of their current income but also with promises to pay out of future income. Unfortunately, the increased leverage was used to fund the purchase of goods that, for the most part, did not add to the future productive capacity of the nation and therefore did not materially increase the projected growth rates of future income available to service the increased debt levels. We spent money on televisions, second homes, automobiles, etc. Eventually, such a cycle must end when it reaches critical mass and reverses trend – your banker won't let you continue to pile up loans. But our economy's bankers – the Federal Reserve, Congress, foreign creditors and the shadow banking system (i.e. non-bank banks) – were all too willing to keep the music playing. Accordingly, the economy progressed passed the point where the unwinding of our debt burden could occur with only manageable interruptions to economic activity.

Now, the process of deleveraging that we have discussed so often in the past begins to occur. Consumers, who for years built up promises against future income, must come clean. As a result, they reduce current consumption in an effort to pay down debt. Even with interest rates at rock-bottom levels, lending activity slows and savings rates increase. This weighs on aggregate demand in the economy and increases excess industrial capacity. As the following graph illustrates, Japanese corporations faced a similar condition during their country's "Lost Decade," as borrowing rates contracted for an extended period despite low interest rates (the bars are proxies for borrowing activity, the line for interest rates):



Richard Koo

There are no easy solutions to this conundrum. Low interest rates lose effectiveness during balance-sheet recessions, failing to spur debt-financed expansion. In the past, countries could count on population growth to increase the amount of productive capacity in the economy to help meet debt payments, but unfortunately developed countries now face challenging demographic trends. Forecasted economic growth doesn't appear likely to reach the "escape velocity" necessary to grow the country out of its challenges. Obviously defaults are an option, though they require severe short-term sacrifices. Actions by the federal government over the last year have shifted debts from private to public balance sheets, though, making default an untenable choice. Over time the government could turn to the printing press to inflate the country's debt away, bringing with it a host of other problems.

For the time being, however, markets have allowed our government to continue to borrow at historically low rates. Ten-year Treasury bonds fetch less than 3%. While the public debt challenge is a real and present one, we don't think that inflation is on the near-term horizon. Inflation occurs when too much money chases too few goods. The opposite is occurring in our economy now – consumers are forgoing goods and demanding money (in the form of cash, bank deposits and reduced debt levels). Short-term fiscal support, though rarely optimally structured, remains the key policy tool. Deficit hawks calling for an immediate return to fiscal austerity should recognize that such measures entail meaningful downside risks to the economy. While their recommendations may be prudent, we think that the most obvious policy choice is to reform long-term entitlement programs, though doing so requires a notable feat of political accomplishment.

We don't venture to predict the trajectory of economic growth from here. We instead opt for our margin of safety approach, applied not only to stocks but indeed to all of our endeavors. The margin of safety approach takes a conservative, baseline estimate and then evaluates decisions in an even worse potential environment. If courses of action appear favorable even in the worse-than-expected scenario, then future risk-adjusted rewards should be attractive. Accordingly, we are evaluating investments through a lens that assumes sub-par economic growth with downside shocks, short-term deflationary pressures and long-term inflationary challenges.

As always, grim economic expectations do not preclude our participation in the stock market; indeed, they may spur our investment activity if they result in the market pricing stocks at attractive levels. The second quarter fall in the S&P 500 of -11.5% brought certain stocks back to levels that appear attractive even in an absolute sense. Potential returns aren't stellar, but they aren't terrible either. It should also be noted that the non-financial corporate sector was, for the most part, not a participant in the great debt expansion of the last few years. Culprits include financial institutions, consumers and governments, but public corporations maintained manageable debt levels and now have one of the highest levels of cash relative to total assets in the past century.

We expect heightened market volatility (big moves in prices in either direction) to continue. If you only have 5% equity in your home, changes in home prices will have a much greater effect on your wealth than if you had 30% equity. Leverage magnifies returns in either direction. Likewise, the large amount of total public and private debt outstanding relative to our national income will likely lead to continued volatility in the markets. This can be a risk or an opportunity, depending on your perspective. Market salesmen will use developments to scare market participants and introduce new, expensive products and strategies that "control volatility" and "ride the trends." Typically, these developments have good economics for the proprietors but poor economics for the investors.

We believe that if investors have a disciplined approach to valuation and a focus on long-term returns, the volatile environment will offer opportunities to purchase great companies at wonderful prices. This is a clear benefit to the patient, long-term investor. Warren Buffett writes:

> [T]he true investor welcomes volatility…That's true because a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly.

While short-term results may be bumpy, long-term results should be fair or attractive. However, this state of mind requires a sufficiently long time horizon and the ability to withstand speed bumps. The investor must be prepared for bouts of investor fear and not sell into down markets. If your time horizon or your ability and/or willingness to accept risk do not afford you the opportunity to withstand large moves in the prices of investment securities, it makes sense to revisit your current asset allocation. For the time being, we continue to be relatively conservative in our allocations, retaining some dry powder for potentially better investment opportunities in the future.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict
David J. Manger