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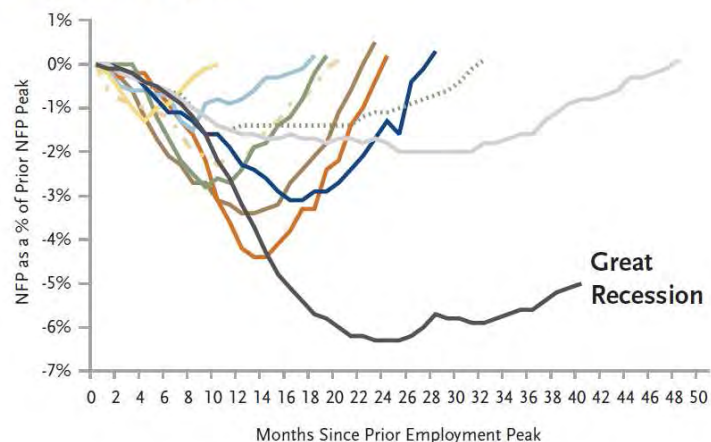
The economic recovery hit another “soft patch” in the second quarter, similar to last spring, causing the stock market (as measured by the S&P 500) to fall 3.6% from its early May peak through the end of June. Yet stocks were still up 0.1% for the quarter and 6.0% year-to-date. Reflecting both continued downward pressure on interest rates from a deleveraging environment and a flight-to-safety in the midst of ongoing global risks, the bond market (as measured by the Citigroup 1-10 year Treasury index) gained 2.2% in the quarter and is up 3.2% year-to-date.

The lack of strength in the economic recovery has been on par with our expectations. Some of the weakness in the second quarter can no doubt be attributed to transitory factors, chiefly pressure on consumers from rising gas and food prices and global supply disruptions from the tsunami in Japan. In a recent press conference, Federal Reserve Chairman Ben Bernanke noted that:

[S]ome moderation in gasoline prices is now in prospect, and the effects of the Japanese disaster on manufacturing output are likely to dissipate in coming months. Consequently...the [FOMC] Committee expects that the pace of economic recovery will pick up over coming quarters.

While we find plausible the argument that these transitory pressures will recede and economic growth will continue, there is no doubt that the recovery has been much weaker than prior recoveries. The following graph shows job trends from the recent recession relative to those seen in other recoveries post-1950 (NFP stands for nonfarm payrolls; source: BLS, TCW):

Figure 3: Comparative Job Creation With Other Cycles



This weakness reflects the “new normal” that we have discussed, brought about by a debt overhang that continues to pressure both consumers and the government. Yet while we have been restrained in our optimism for growth, we nonetheless believe that the country will overcome its challenges and continue to be a great place for investing capital. In a recent note, we explained that the recovery will improve once housing gets back on track, which will require time. Warren Buffett stated as much in a recent interview:

Well, what's happening in the whole economic picture, and it's been happening since the fall of 2009, is business has been getting better consistently in every area except construction...I think people vastly underestimate the amount of unemployment that is attached to these very subnormal home construction figures and I think when home construction moves up you will be amazed at how fast employment will improve and how fast the unemployment rate will drop.

We agree; while the recovery will probably continue to lack steam over the near term, things will most likely keep getting better gradually and an eventual improvement in housing, though hard to time, will help lift economic prospects further.

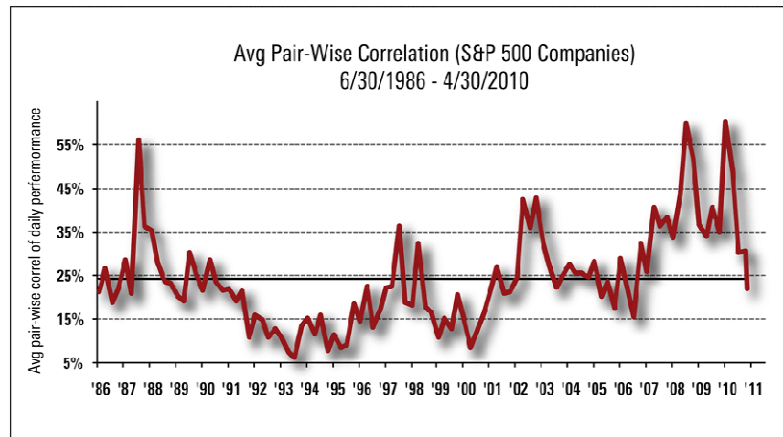
Of course there continue to be serious macroeconomic risks, as there always are. We will briefly discuss two – Greece and the U.S. debt ceiling. Greece, along with other peripheral European countries such as Ireland and Portugal, is facing serious financial difficulties. The probability of some form of default is likely high. We do not know what the fallout from a prospective default will be, but obviously it brings risk. However, we think comparisons of Greece to the subprime housing crisis in the U.S., the Lehman Brothers bankruptcy or another “black swan” event are misplaced – the potential for a Greek default has been both recognized and analyzed in the market for some time and exposure is likely not as material as some fear. While such an event would no doubt have an effect on economic growth and does risk contagion, we do not think that it will derail the domestic recovery.

Meanwhile, the U.S. is struggling with its own fiscal challenges. We believe that while daunting, the federal government’s problems are addressable. Unfortunately, political actions in Washington have not been cause for confidence. Using the debt ceiling as a bargaining chip strikes us

as dangerous policy, akin to playing with fire. No matter what political orientation one may have, not paying our bills is neither an acceptable nor intelligent decision. The focus of the government should be on long-term reforms – specifically streamlining the tax code and attacking entitlement programs (most importantly through reforms aimed at reducing medical care costs). It is possible that an inability to come to an agreement by the August 2nd deadline could have only a moderate impact on financial markets, but we see no reason to, in Buffett’s words, play “Russian roulette.” We trust that our policymakers will find a short-term compromise and not endanger the health of the financial system. Longer-term, we hope that, despite contrary indications thus far, Republicans and Democrats can work together to find innovative solutions to our fiscal challenges. (Winston Churchill once said “You can always count on Americans to do the right thing – after they’ve tried everything else.”)

Regarding the stock market, we continue to believe that companies, as a whole, are slightly under- to fairly-valued. We have, however, noticed more dispersion in potential returns for the businesses that we follow. The chart shown on this page depicts the average correlation of stocks in the S&P 500, or in other words, the extent to which they move together (from Bank of America Merrill Lynch U.S. Quantitative Strategy).

As can be seen in the figure, for the past few years stock correlations have been quite high relative to historic norms. This has made it somewhat difficult to pick stocks that would outperform the index – essentially, most everything went down together and then most everything came back up together. Recent correlations have decreased, though, giving rise to better opportunities for bottom-up stock-picking. For example, we recently authored a note that highlighted the potential to find above-average returns in certain banking and building stocks. The iShares Dow Jones US Financial Services ETF, a proxy for financial services companies, has trailed the broader stock market by ~10% so far this year. Accordingly, while we are still neutral (neither underweight nor overweight) the broader stock market, we are hopeful that our bottom-up research efforts will yield opportunities for attractive new investments. We had more activity – buying under-valued stocks and selling fairly- to over-valued stocks – in our portfolio in the second quarter than we have had in some time.



Our strategy for other parts of the investment portfolio remains the same. Our decision to not reduce interest rate risk abruptly, but instead let it fall off gradually, has been beneficial as interest rates have fallen and bond prices have risen. However, we do continue to believe that over time interest rates will rise and that bonds do not present attractive long-term investment potential from

current levels. So our cash balances have risen as we have underweighted our fixed income portfolios. In the short-term, higher cash balances have acted as a slight drag on investment performance as both bond and stock markets rose, but we believe that the decision to hold cash will prove valuable as volatility yields future opportunities for attractive investments. We are also continuing to focus our relationships with our highest-conviction absolute-return oriented investment managers working in fields outside our areas of competence (e.g. arbitrage and distressed debt).

As expected, the country will not be able to “snap-back” as in times past from such a deep and difficult recession. But we firmly believe that our investment principles, centered on diligent bottom-up research, will give us the opportunity to earn attractive returns over the long-term. As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
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