February 2010

Dear Client,

Enclosed are the 2009 returns for your account(s). Where applicable, three, five and ten year returns are included as well.

The S&P 500 index returned +26.49% in 2009 including dividends. Our composite account returned +26.54% for the year (individual results may vary). Results for our composite, since inception on 01/01/2000 and through 12/31/2009, were +79.43% vs. -9.16% for the S&P 500 with dividends. Annually, that works out to +6.02% for the composite and -.37% for the S&P 500. In the process of calculating the returns for the composite and individual accounts, I took the time to review and examine our year-end client letters over the previous decade to see what factors may have been responsible for the overall favorable results. While this examination was by no means an exhaustive analysis of all of the securities purchased over the period, certain comments and actions did stand out and were readily identifiable in terms of their impact on the overall returns.

Upon review, what stands out as the single most important factor contributing to the out-performance over the decade was our strict adherence to fundamental value investing. The definition of what constitutes value investing has become somewhat muddled recently, but to us, it has always meant paying careful attention to the cash-generating characteristics of an individual business and the price being sought for a piece of that business. There can be no better example of the complete disconnect of this concept than the enormous bubble in technology stocks in the early part of the decade. We avoided investing in these stocks because we viewed them as speculative and risky and we said so in detail in our 1999 client letter. The fact that this bubble has now become obvious to everyone in retrospect, does not mean that it shouldn't have been obvious at the time and thus avoidable in terms of investment errors. Most professional investors and mutual fund managers chased these stocks not because they represented value (most of them knew better) but because they were going up in price and they feared under-performing their peers. This ultimately represented career risk to them. The public chased these stocks for a different reason; everyone appeared to be doing it and it looked like easy money. A dangerous harbinger of the yet-to-be housing bubble.

We referred to the housing bubble in our 2004 client letter, noting how the then extraordinarily low level of interest rates was inflating the value of many assets. While we were unaware of how shoddy underwriting standards in the housing industry had become, we were concerned enough to have sold two former favored stocks and long-term holdings, Freddie Mac & Fannie Mae (sold in 2003 & 2004) at substantial profits. The following year we noted that while generally speaking, the market looked fairly valued to us, several high-quality blue-chips appeared to be favorably priced. Specifically, we singled out Anheuser Busch (acquired, + 70%), Coca-Cola (+42%) and Johnson & Johnson (+5%). The characteristics these stocks all had in common were reasonable stock prices, very good business franchises and dividend yields approaching or in excess of three percent that were likely to continue growing into the future. Also highlighted that same year was the recent run-up in short-term interest rates and the recommendation to purchase short-dated (2-3 year) treasuries then yielding near five percent.

Almost as important as having the correct “toolbox” with which to analyze securities is having the proper temperament. We wrote about this subject at length in our 2006 client letter. We pointed out that the corrosive impact of emotions on the investment decision making process could not be overstated. That fear and greed and Wall Street’s willingness to eagerly cater to both had a lot to do with the poor performance investors often experienced in their own portfolios. As we were to find out, emotions would play an important role in subsequent years.

Our two most recent pieces of correspondence were written in the middle of the recent financial panic, in October 2008, and last year’s client letter written in February 2009 while stock prices were still declining. While the magnitude of the meltdown surprised almost everyone, we were fortunate enough to have entered the crises with large cash positions in our managed accounts and thus were able to take advantage of the severely depressed prices in the securities markets. Although our account values were obviously impacted by the large declines in prices, we were fairly certain that the entire system wouldn’t collapse and that we were buying securities at levels that would prove to be very rewarding. Many high quality businesses were priced at levels not seen in years. Similarly, high quality bonds, issued by conservatively operated and financed businesses, and in some cases municipalities, were available at double-digit yields. This was not the time to be a seller.

As of this writing, a large rally has indeed occurred. With respect to stocks, the market has rallied sharply off its March 2009 lows. In the fixed-income arena, the rally in the bond markets began several months earlier with large price gains and declining yields taking place in December 2008 and continuing to this day. It’s worth noting that at these inflection points (before large declines or big rallies), no one ever rings a bell telling you to buy or sell because securities are over or under-priced. These decisions are made using judgments. Often, those judgments may differ markedly from the then prevailing conventional wisdom.

By and large we are proud of the judgments we have made over the past decade and the outcome achieved as a result of them. Among his many brilliant observations, the economist John Maynard Keynes once commented “It is better to be approximately correct than precisely wrong”. We feel the same way when it comes to managing money.

While we aren’t sure what the future will look like, or what the stock market will do in the next week, month, or year, we are confident that by employing sound judgment and careful analysis, we will be able to add value and provide our clients with satisfactory returns over the long haul.

Please feel free to contact us with any questions or comments. As always, we thank you for your trust and patience.

Very truly yours,

Eckart A. Weeck
Senior Managing Director