



QUARTERLY INVESTMENT REPORT June 30, 2010

Dear Investor:

A Dramatic Quarter with Unclear Economic Direction

Technically the great recession ended a year ago and real economic growth, as measured by the gross domestic product (GDP), has recovered strongly from its mid 2009 trough. And yet the economy feels so fragile again and at risk of a U-turn into double-dip territory. In response the stock market has been on a roller coaster ride all quarter.

Early in the quarter Greece's debt and solvency problems spread fear across the globe. Before investors could conclude that they were overreacting to Greece's real affect on global credit markets, the Deepwater Horizon oil rig exploded, killing 11 workers, and dumping millions of gallons of oil into the Gulf of Mexico. On May 6th stocks experienced and then rebounded from the largest ever intra-day decline. Finally, by the end of June, Congressional negotiators agreed on terms for a notable, yet controversial, financial reform bill. The bill will likely get passed in the middle of July.

Save for the momentary gasp as stock trading went awry in May for a day, the drying up of new home sales after the end of the government tax incentive for first time home buyers, and the very slow recovery in job growth, the catastrophe in the Gulf may be the biggest psychological reason investors feel uncertain and vulnerable.

It is premature to put numbers to the spill's impact on the economy but the costs will surely exceed the \$80 billion threshold set by hurricane Katrina. The impact on the Gulf's tourism, real estate, seafood, and oil & gas industries is wrenching and the ecological impact is tragic. We should expect to see higher seafood prices and possibly higher gasoline prices. The higher seafood prices may be mitigated by a shifting of resources from other domestic regions and offshore; we import about 80% of our seafood and the Gulf supplies only about 2% of our seafood consumption. As far as gasoline prices are concerned, we import more than 65% of our oil (have we forgotten that the whole point of our push into deep water

exploration has been to alleviate our dependency on foreign nations?) and our stronger dollar may keep oil prices in check for now.

Though the domestic economy will likely not feel a large ripple effect, the thousands of jobs lost in the Gulf region, while balanced somewhat by new oil clean-up jobs, may impact consumption behavior and ultimately a full recovery.

The many potholes this quarter have been jolting and recent unemployment and housing reports were disappointing, which reinforces the fact that we are experiencing a jobless and fragile recovery. It leaves many to wonder if our nascent recovery is in trouble.

There are several positives and negatives at work in the world economy right now.

2010 Economic Recovery?

Positives:

- Short-term interest rates are still at zero (mortgage rates will stay low)
- The yield curve is positive (banks can profit from borrowing short and lending long)
- Corporate profits have increased 30% year over year
- Corporate balance sheets are strong
- Household employment has increased by 1.3 million over the past five months (excluding census workers); that is an increase of 2.4% on an annualized basis
- Inventories are very lean
- The uncertainty of financial regulation is over and the impact to banks is less severe than feared

Negatives:

- The Eurozone could fall into recession later this year
- China's real GDP is falling and could hit 7.5% by year end
- Higher federal and state taxes will likely be necessary to cover budget deficits
- The impact of the oil spill on the Gulf coast region could be longer and broader than expected
- Uncertainty about the unemployment rate
- Sales of new homes slumped after the government tax credit was removed
- A strengthening dollar could hurt exports

It is impossible to know whether positive or negative forces will prevail. But the great debate is on amongst economists and financial reporters. For a double-dip to technically occur, GDP would have to turn negative again. Overall, economists are predicting that the economy for all of 2010 will slow to 3% growth. That is a significant decline from the 5.6% growth we had in the 4th quarter of 2009, but growth is growth.

Financial Reform Bill

If the economy is indeed slowing down, at least the new financial reform bill can't be accused of being a contributing cause. It may not go far enough to prevent future problems but it doesn't tamper too much with bank and financial service operations. Though we sit firmly in the camp of "less is more" when it comes to government regulation, preferring to let the marketplace reward or punish corporate behavior, we believe that governments need to step in and affect reasonable changes when the system is obviously outdated.

On the next page we highlight several of the major provisions of the bill. It is not a perfect bill but no one could expect a bill that would make everyone happy. **Big banks will see modest disruption to their normal operations. The three major changes for banks are that they will have to raise their equity capital over time, move some of their riskiest derivatives to separate entities, and pay for a portion of the costs of the reform package (which is estimated at \$19 billion over the next ten years).** The details of how the banks will pay are still being worked out, but it may be a combination of increased FDIC insurance premiums and a new tax payable to regulators over ten years. The latest deal has TARP ending three months early to save money and limit this bank tax. The tax may ultimately saddle borrowers with higher interest costs, but talk of it hindering economic recovery is exaggerated. To those who are angry at the notion of taxing banks at all, we say that the banks should consider it a fair trade for being able to keep their business models pretty much intact.

We can't imagine there are too many investors out there who actually believe that this bill will prevent future financial crises, but it's a start. For instance, it attempts to bring our financial system up to date with derivative securities by forcing standard contracts onto exchanges and customized contracts into reporting repositories. The bill creates an oversight council, led by the Federal Reserve, to work to proactively prevent another industry meltdown. That sounds good in theory but forcing banks to become smaller would have been a better solution.

The best part of the bill is that it provides for a consumer protection agency focused on ending predatory lending and making sure borrowers can afford their loans. If it accomplishes just this it will be a success.

Financial Reform Bill's Major Provisions

<u>The Problem</u>	<u>The Bill's Fix</u>	<u>Our Thoughts</u>
Consumers need protection from predatory salespeople: <i>greedy mortgage companies & irresponsible and/or ignorant consumers fueled an untenable real estate system.</i>	Creates a new agency housed at the Federal Reserve to tighten rules for mortgage & credit card lending.	It's another bureaucracy but at least it has a singular focus. Though the rules will still apply to them, it won't regulate small (< \$10 bil of assets) lending entities where problems could surface. Large lenders will find ways to make up lost revenues. The fix won't be a cure-all but is an improvement.
Banks' capital reserves are too low: <i>too much debt and risky assets on their balance sheets jeopardizes bank solvency.</i>	Changes rules for one type of asset, a trust-preferred security (these were bundled into complex CDOs). Within 5 years banks can no longer count these assets as Tier 1 capital (equity & cash reserves).	Over time banks will have to replace these assets and increase their equity capital. Small banks will be exempt. In the short term this change will be mildly disruptive. It is a good long-term change, though banks will likely figure out ways to replace this low-cost financing.
Banks invest in risky assets: <i>too many alternative and derivative assets on their balance sheets jeopardizes bank solvency.</i>	Banks must limit investments in hedge or private equity funds to 3% of Tier 1 capital. Standard derivatives will be traded on exchanges & customized ones will be reported. Banks must use subsidiaries for some of the riskiest derivative trading.	Banks got off pretty easy with these changes. In fact, most banks will be able to invest MORE money in hedge & private equity than they do now. Some banks will have to house certain derivatives in different corporate structures to fulfill new requirements, but essentially it is business as usual. Derivative assets play a necessary function for routine bank business and thankfully were not banned, but only forcing them onto exchanges without stricter rules does not go far enough.
Financial firms may be too big to fail: <i>there are no rules in place for fairly dismantling sick firms (eg., Bear got bought, Lehman went bankrupt, AIG and Fannie & Freddie were bailed out).</i>	Gives the FDIC authority to liquidate troubled financial firms before they go bankrupt. Final details aren't out yet but the plan is to charge the largest financial firms higher FDIC insurance premiums and annual taxes for 10 years to cover the costs of reform and for past and potential bailouts.	The bank tax will cut into bank profits and may force them to raise interest rates on loans to borrowers. Higher taxes are never desirable but with all the bellyaching about our government deficits and debt levels, it is not surprising that we should have the banks pony up some of the costs. We don't feel too sorry for them, and perhaps they can consider it a fair payment for being able to keep their business models basically intact.
The financial system is intertwined & susceptible to systemic risk: <i>the system is global; firms hold each other's debt and securities.</i>	Large financial firms will be supervised by a council led by the Federal Reserve. The council will audit and monitor large firms to proactively avoid another crises.	This sounds good in theory. Forcing banks to become smaller would have been a better solution.
Credit rating agencies failed at their job: <i>their ratings were too rosy; they are funded by the firms issuing the securities (eg., the foxes guard the henhouses).</i>	The agencies will have to register with the SEC. Investors will be able to sue them for reckless ratings.	This is an improvement but it doesn't go far enough because there is no change to how the agencies are funded.

Have a happy July 4th everyone!

Sincerely,



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