APRIL 2009 — MARKET REPORT

THE MARKET SPEAKS

Investor sentiment received a boost late in March from positive surprises on both the economic and policy fronts. The better-than-expected reports on housing, retail sales and capital goods orders continued a string of positive economic surprises. Markets also reacted positively to the details of the Private-Public Investment Program (PPIP), which aims to relieve banks of their legacy assets. The decisive break in the S&P 500 above its 65-day moving average, the weakening of the dollar and the rise in the price of oil above $50/bbl were all consistent with a moderation in risk aversion. The U.S. equity market is loudly voicing an opinion signaling that bringing a settling to the financial institutions will result in a robust appetite for cheap stocks.

We are cautiously optimistic that the cumulative impact of policy support could soon reach a critical mass. Nonetheless, the success of the PPIP is far from certain and we do not yet have confirmation that the recent equity rally will be anything more than a bear-mark rebound.

The success of the Private-Public Investment Program (PPIP) is critical to a recovery of the U.S. economy. The important result of this program is an increase in the transparency and recognition of losses on bank balance sheets. Investors cannot properly value banks because a large portion of assets at some financial institutions have no identifiable market value. The PPIP is designed to remove these assets, and thereby allow investors to better evaluate bank capital cushions. Some private investors have already expressed interest in the program, but pricing the legacy assets could be a major stumbling block.

The attraction for the private partners is that investors receive a stake in a beaten-up pool of assets with only a relatively small amount of capital at risk. High leverage and cheap financing create the possibility of very attractive investment returns. Moreover, the amount of capital at risk is relatively small, capping the loss in the event that financial markets continue to deteriorate. The attraction for the government is that the risky legacy assets are transferred to investors in a better position to bear the risk, while allowing taxpayers to share in some of the upside potential in the recovery scenario.

The major question is whether banks will be willing to sell their legacy assets at all. It is still uncertain whether the prices discovered under the PPIP will be above or below the value at which the banks currently carry these assets on their books. Healthy banks may be unwilling to sell assets, preferring instead to try to regain some of the losses. Weaker banks may be reluctant to sell assets if it means taking further write downs. There is also the risk that banks may try to have it both ways and use the proceeds of the sale of some assets to take on exposure to other risky assets, but with the benefit of generous government funding.

Treasury officials have reportedly been making efforts behind the scenes to discourage this outcome, but it may not really matter. The point of the PPIP is to use the strength of the government's balance sheet to diminish the punitive liquidity premium that plagues the valuation of legacy assets. If the PPIP is successful, then this will occur whether banks are buyers or sellers, or both. Asset prices will be marked up accordingly and overall bank earnings should end up better than they otherwise would have been due to smaller net asset write downs.

We continue to be patient with our cash levels and are methodically looking for buying opportunities. As the market ebbs and flows over the upcoming weeks, we will be looking to purchase stocks at these levels.