NOVEMBER 2009 — MARKET REPORT

WHAT WE LEARNED FROM 3RD QUARTER RESULTS.

As we stated last month, the third quarter earnings season would be a good barometer to measure the current health of our stocks and the stock market as a whole.

First and most importantly, our stocks performed exceptionally well. Most of the stocks in our portfolios received 3% to 5% surges after the results were announced. While short term stock moves are seldom to be taken seriously, the reaction to this earnings season presented a rare opportunity for a simple test of the strength of the market and our stocks. After the huge rally from the lows in March, the market must be watched closely for "investor fatigue". Sometimes the equity market can move up quickly and get to the point where investors feel forced to take some profits by selling. We anticipate that following the earnings season, the market will experience some "fatigue" and the resulting increase in volatility. Market volatility has certainly risen in recent weeks, specifically on the last three trading days of October, which had the market down 2%, then up 2.25%, and then down nearly 3%!

In anticipation of the increase in volatility and the recent 50% rise in the portfolios, we made the decision to raise about 15% in cash in all portfolios. This is NOT an endorsement to the idea that we are going to experience a massive retreat in stock prices. It is simply a way to temper the short term risks, while continuing to participate in the long-term upward trend of a market and world economy coming out of a deep recession.

CONTINUE TO EYE INFLATION.

Inflation is the key trigger to changes in the economy. Federal Reserve officials are thinking mostly these days about how to unwind the unprecedented stimulus they've pumped into the economy. Eventually that will mean raising interest rates. What will a Fed tightening cycle look like? When will it begin? Fed officials don't have answers to either question yet, and investors would be wrong to think they do. But the contours of what a rate-boost cycle could look like are beginning to come into focus as future Fed's policy meetings approach.

Three points are emerging: First, an internal debate on tightening policy and how to communicate that to the market is only just beginning, and most officials don't believe the economy is near healthy enough yet to move toward tightening. Second, don't count on a tightening cycle to look like the last one. And third, the behavior of financial markets could take on added importance this time.

One obvious indicator on the economy is the unemployment rate, at 9.8% in September. Because it is so high -- which implies that inflation is going to stay very low -- officials aren't inclined to be in a big rush with this process. Another indicator is inflation expectations, which remain contained and give the Fed room to stay easy. A third is core inflation, which has slowed since last year but might need to slow further to justify such low interest rates.

Long before the Fed moves, it will need to communicate its intent to investors. The first step will be tiptoeing away from saying rates will stay low for an extended period. The communication strategy is likely to come up at future Fed meetings, though it remains unclear when a change in the wording will happen.

Officials haven't decided how fast they'll raise rates once they do move. They can't, because they don't know yet what the recovery will look like. If it is exceptionally slow, rates could go up slowly, too.

But there's a good chance it won't look like the last Fed tightening cycle from 2004 to 2006. Back then, the Fed raised interest rates in a slow, methodical way, ratcheting the federal-funds rate up in quarter-percentage-point increments 17 consecutive times. This time they might want to move faster, in part because rates are so far from normal now. Policy makers also could decide to pause along the way, if the economy remains soft or the unemployment rate is slow to come down.

The uncertainty this creates for financial markets might not be such a bad thing from the perspective of some Fed officials. The slow, predictable path to interest-rate increases that they took in 2004 to 2006 gave investors an all-clear sign to borrow cheap money and turn it into speculative investments like housing. Policy makers don't want uncertainty for uncertainty's sake, but they're also wary of giving investors license to speculate with low rates again.

Asset prices could matter more in this cycle than they have in the past. Fed officials have believed for a long time that they can't stop asset-price bubbles from happening without doing a lot of damage to the economy. But the housing bubble has shaken their views on this issue. They are increasingly focused on movements in financial markets, in the U.S. and abroad.

Though markets are soaring in some parts of the world, and in the U.S. credit costs have come down surprisingly sharply, officials don't think there's a bubble now. But if markets do start looking frothy, or if the dollar become so weak it spurs import inflation, it could weigh on Fed decisions about when to start tightening or how aggressively.

As always, thank you for your trust.