

## MARKET OVERVIEW AND COMMENTARY

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It is quite clear from the market debacle of 2008 that many factors behind economic growth this decade proved unsustainable. In particular, the dependence upon leverage (i.e., borrowed capital) reached its breaking point. Numerous analyses suggest that much of the economic growth of the past decade would not have occurred absent huge sums of debt. This is not unusual. Economic growth in prior cycles has also depended upon borrowed money, and consequently, most economic crises develop when leverage becomes excessive. The unusual nature of this crisis is its magnitude and the means by which capital was distributed globally. In several ways, the markets are undergoing a transition – a “normalization” – toward an environment with considerably less leverage. For those dependent upon leverage, this transition will require significant adjustments, many of which will be involuntary. For all, the financial markets could be returning to a simpler structure which should facilitate sustainable long term growth. It is likely that this period, as is the case with any transition, will prove volatile and, for some who remain unprepared or in denial, quite painful.

Eventually, credit markets will function properly, and capital will be allocated more efficiently. We believe that Fed actions directed toward “unclogging” the credit markets are beginning to gain traction. Investors will need to be patient. It is also likely, however, that tighter regulations will restrict the amount of leverage in the system once we emerge from the crisis. That implies a slower rate of economic and earnings growth. For a while, governments will serve as the engines of economic growth. To some, that will prove frustrating. Longer term, investors should greet this “*new normal*” with enthusiasm as it implies a more stable system which, in turn, should facilitate sustainable growth.

In the meantime, the ongoing de-leveraging in the markets has resulted in massive asset deflation. As a general rule of thumb, it is preferable to be a creditor/lender during periods of deflation. It is better to be a borrower during periods of inflation. This relates to the future purchasing power of one’s currency. In deflationary times, the purchasing power of cash rises. This present condition favors a strategy which emphasizes credit instruments (e.g., certain bonds). For example, while the cost of capital for many corporations remains relatively high because of yield spreads, this represents opportunity for investors to boost income as the markets traverse this period of transition.

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## WHAT SHOULD INVESTORS DO DURING THESE UNCERTAIN TIMES?

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We favor business models and asset classes that do not depend on leverage. Until we emerge from this recession, we also favor business models that depend on non-discretionary income as opposed to discretionary income. We currently prefer credit over equities:

1. **Risk spreads provide good income and long term rewards:** the yield spreads currently available in **high grade corporate bonds** are compellingly attractive.
2. **Protect against rising taxes:** likewise, the nominal yields available in **high grade, tax free municipals** are attractive. If tax rates rise as expected, municipals will only increase in their appeal as an asset class.
3. We favor **gold** as a hedge against devalued currencies.
4. As a hedge against inflation, we recommend instruments like **TIPS (Treasury Inflation Protected Securities)**. We have confidence that recent policy measures will prove successful in reinvigorating our economy. In that event, we believe investors will need to hedge themselves against latent inflationary pressures.
5. Equities: Remain **defensive**, but think long term and be **opportunistic**: the panic has rendered attractive many high quality companies with stable cash flows, solid balance sheets, and good business models. We prefer stocks with attractive dividend yields. Position accounts with an emphasis on capital preservation. However, do not abandon the markets and also remain positioned for “the turn.” Market uncertainty is generally ripe with opportunities for long term investors. Patience will be rewarded, as will discipline. **There is a tremendous amount of cash “sitting on the sidelines.”** Eventually, these funds will be re-allocated to other asset classes. Cash will re-enter the capital markets once confidence is restored.
6. **Commodities** sectors: the collapse in various commodities sectors, as well as the prices for actual commodities, presents long term opportunity. Price collapses below the marginal cost of production discourage development, which threatens the long term supply balance especially for crude oil. We feel commodities will be one of the first sectors to respond positively to a rebound in global economic activity.

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## LONG TERM INVESTMENT THEMES

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**Financials:** selective inclusion of certain franchises with solid balance sheets and sustainable business models. We feel it is important to maintain limited exposure to this sector, but we do not advocate complete avoidance. Mohammed El-Erian of PIMCO believes that bank business models, in a world with substantially less leverage, will resemble those of utilities – i.e., negligible growth potential; low valuation; restrictive capital structures; attractive dividend yields. Fundamentally, the sector is unlikely to experience demonstrable improvement absent massive consolidation.

**Energy:** the collapse in crude prices could discourage exploration and production, as it did in 1998. Long term, this dynamic renders the sector attractive as supply shortages will facilitate prices to rise over time.

**Agriculture:** We favor investment opportunities along the entire “food chain”: hybrid seeds; fertilizer; equipment; processing; storage. Driven by commodities prices, this sector is also prone to occasional price spikes that render valuations unjustified.

**Water:** perhaps the most important environmental and economic issue facing the world. We believe investment in all aspects of water development -- irrigation; sanitation; delivery; purification – are vital.

**Alternative Energy:** until a particular type of energy source becomes prevalent, we favor a “basket” approach using diversified ETFs. However, we feel that this sector, too, represents an important long term investment allocation.

**Global Infrastructure:** much hinges on the continued rapid expansion and build out of emerging Asia, particularly China and India. We believe many US companies are well positioned to provide the resources necessary for the Eastern hemisphere to improve its standard of living.

**Tax-Free Municipals:** given US fiscal pressures, we anticipate higher tax rates in the future. High quality tax-free municipal bonds could provide a stable source of income with attractive nominal, as well as taxable equivalent, yields.

**International:** no economy will be immune from a global slowdown, but we feel certain countries are better positioned long-term than others. Brazil, in particular, has the potential to become both an agricultural and an energy superpower.

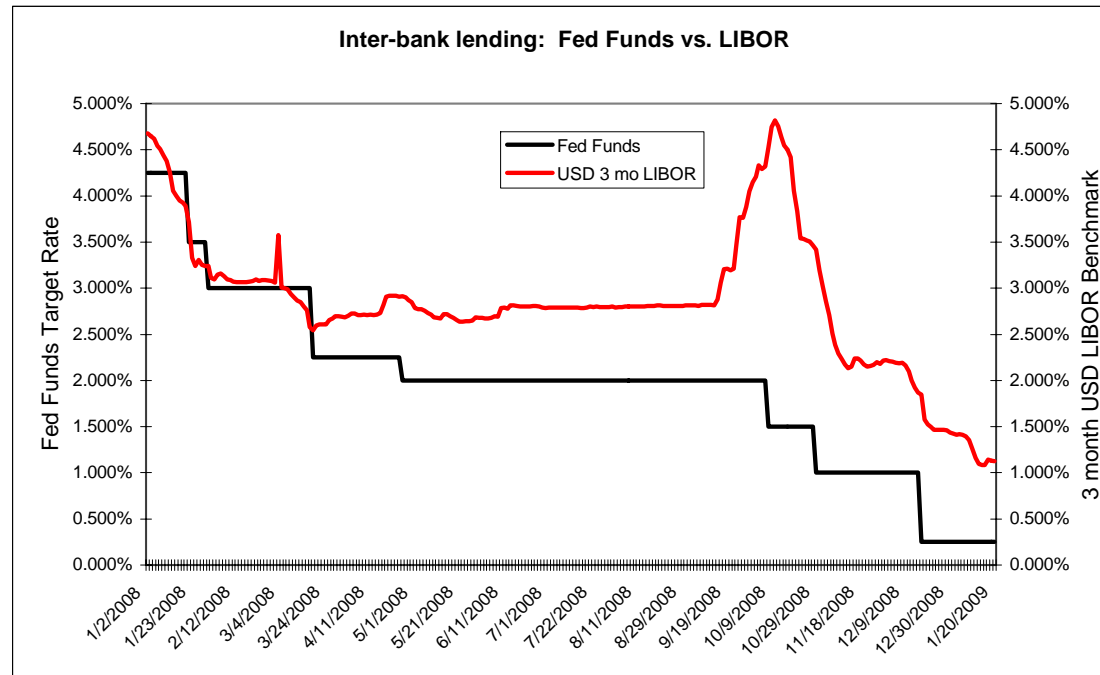
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FED ACTION HAS UNCLOGGED THE SHORT TERM CREDIT MARKETS

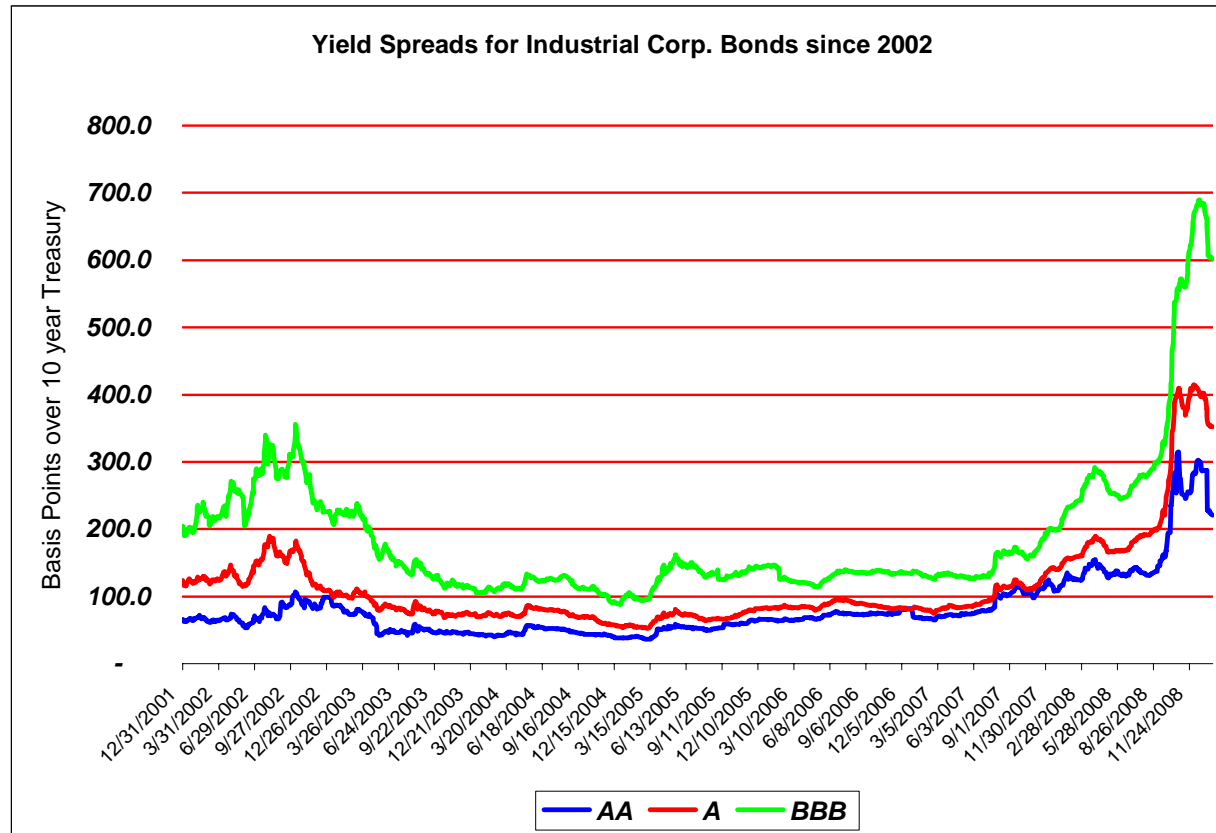


The various emergency programs implemented by the Fed have succeeded in thawing the credit freeze in the interbank lending markets. Now that banks are comfortable again lending to each other, they need to grow comfortable lending to everybody else.

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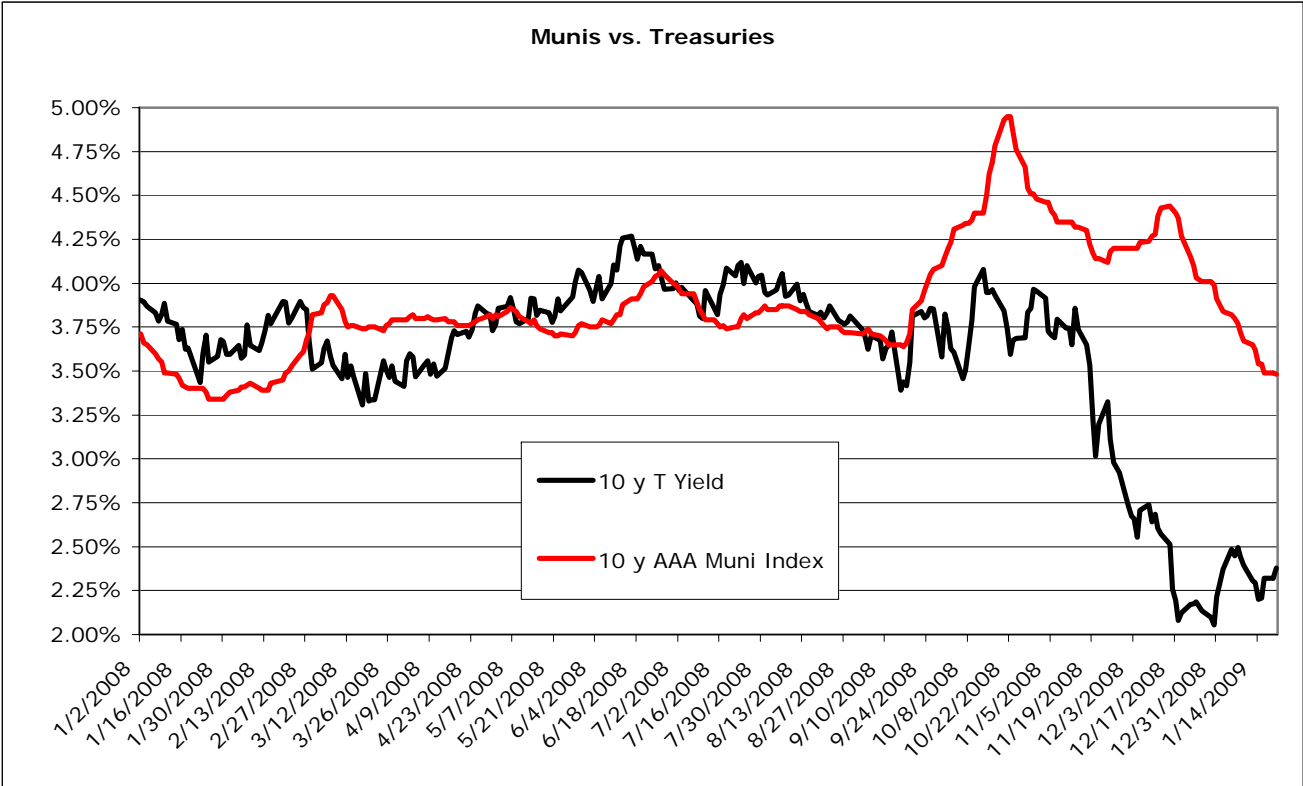
**OPPORTUNITIES REMAIN IN HIGH GRADE CORPORATE BONDS**



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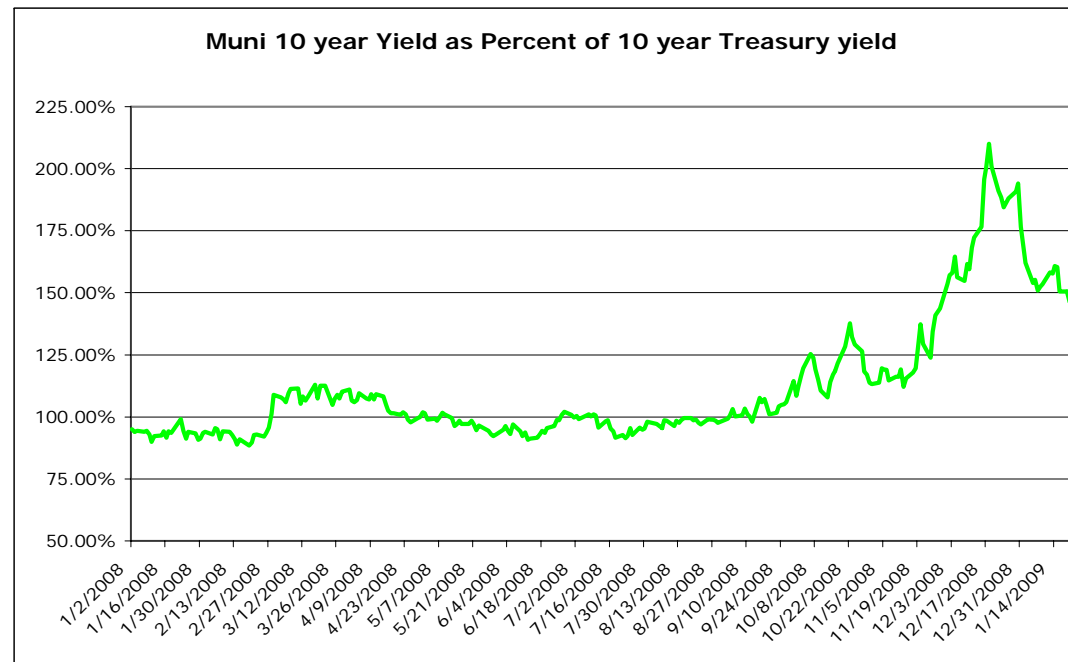
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OPPORTUNITIES ALSO EXIST IN TAX-FREE MUNICIPALS



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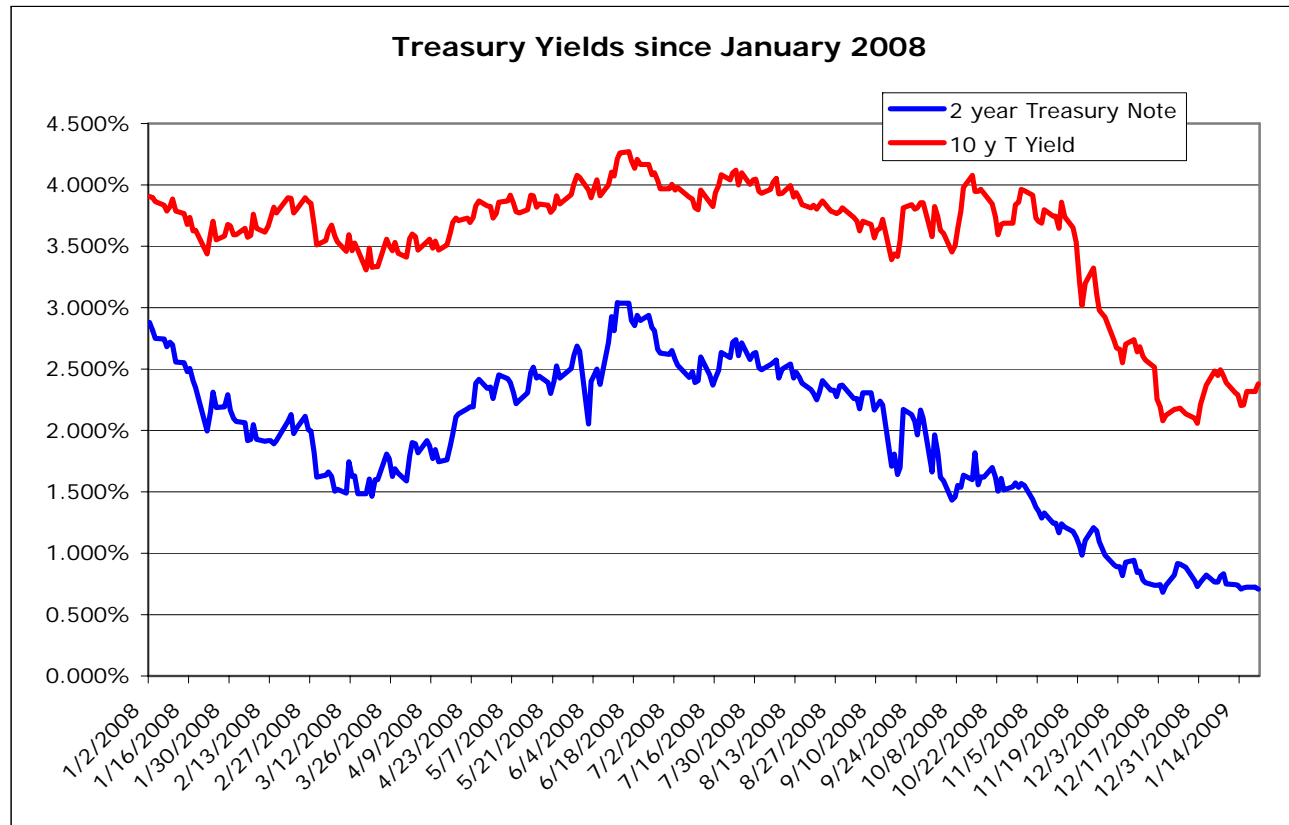


Tax-free municipals have historically offered yields 80 – 85% of comparable taxable bonds. When higher nominal yields are available in tax-exempt instruments, investors have the opportunity to capitalize on such dislocations as they likely will prove temporary. We believe tax-exempt yields will “normalize”, eventually, to their traditional relationship to taxable bonds.

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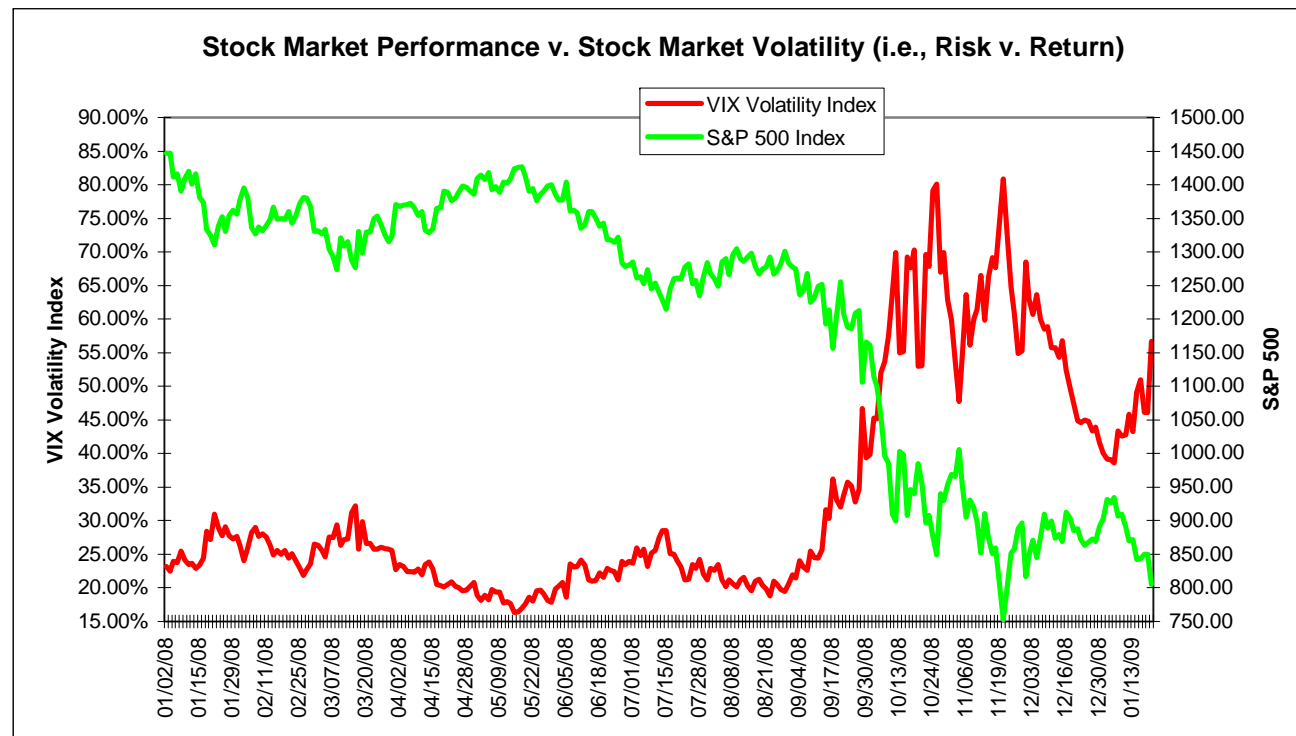
**BY DRIVING RATES TO "ZERO", THE FED WILL "ENCOURAGE" INVESTORS OUT OF CASH**



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FOR THE STOCK MARKET TO STABILIZE AND RECOVER, VOLATILITY NEEDS TO “NORMALIZE”



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