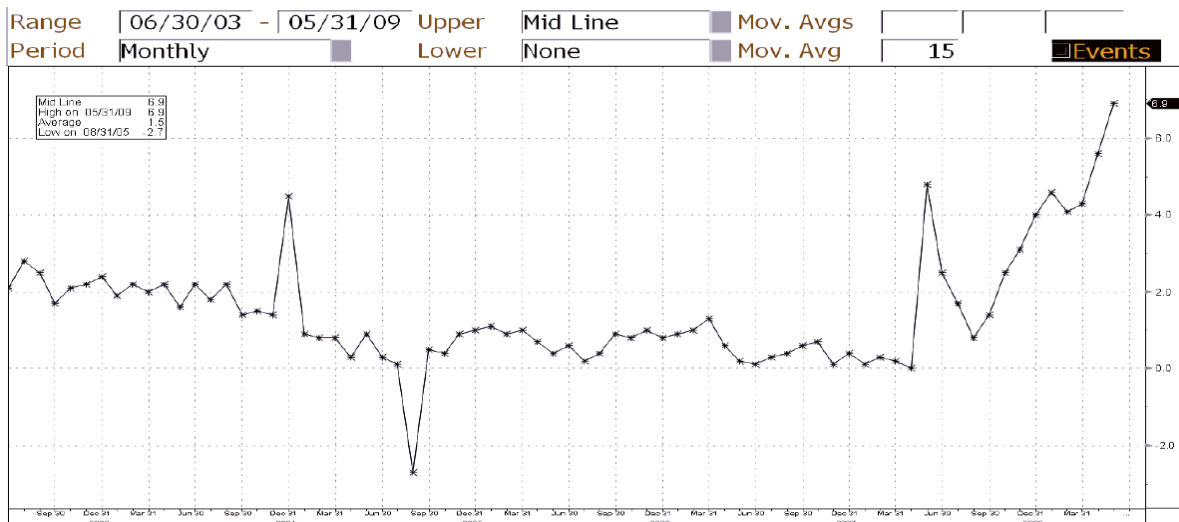


Commentary - 2nd Quarter 2009

We hope you are enjoying this summer and the recovery in the financial markets. The second quarter of 2009 was one of the best on record for us and it could not have come at a better time. We know that it is still going to be a difficult task to recoup the declines that were inflicted on our portfolios by the financial crisis, but we are optimistic that we are on the right track.

Most investors are breathing easier now, but are still concerned that the market rebound is just another bear market rally and we may still see new lows. We pointed out many of the risks to the market in our first quarter letter but we still believe that the worst of the stock market's problems are behind us and we can expect stronger earnings to support higher prices. In our view, the sell-off last fall and early this year was due to the credit crisis. There was so much leverage in the financial system that its survival was in question when Lehman Brothers failed and a domino effect ensued. The rapid deleveraging of balance sheets, both personal and corporate, put tremendous pressure on asset prices as buyers were reluctant to step in front of the selling tsunami. Now that credit is available again, the deleveraging can be completed in an orderly process. The selling pressure has been relieved by the renewed functioning of the credit markets. High yield bond issuance in the second quarter was triple the amounts of the first quarter. May was the most active month for high yield bond issuance since November, 2006. Investment grade bond issuance was equally impressive. But what encouraged us the most was the ability of banks to raise equity capital once the Feds indicated that the stress tests were not going to cause many of the big money center banks to fail. Banks raised over \$80 billion in new equity capital during the second quarter and many of the big banks stopped using the FDIC guarantee to sell new bonds. Now that liquidity concerns have been addressed for the banking system, we do not have to deal with a financial system collapse, just a longer and more severe economic recession than usual.

Graph 1. Personal Savings Rate as a Percentage of Disposable Income Source: Bloomberg



We are not as optimistic about the economic recovery. We think this recovery will be slower than normal. The federal government stimulus spending will help support economic activity, but consumers look to be saving more of their income since they cannot rely on rising home equity as a savings cushion. The graph above shows the personal savings rate over the last six years. While home values were rising, many consumers saved less of their income. Starting in the fourth quarter of last year, the savings rate has climbed dramatically. In May, it reached 6.9%, higher than any time over the last six years. As consumers are successful in repairing their balance sheets, similar to the big banks, they will be more likely to spend again. But given the experience of the last year, they may not spend as freely as before the crisis. Lower levels of consumer spending will result in slower growth in the economy. Higher savings will make the country less dependent on foreign sources of capital and encourage developing countries to become more self sufficient.

Another big concern that we have heard raised was the potential for higher inflation. We are as concerned as everyone else about the Federal Reserve's balance sheet expansion and the federal government's high level of spending as a percentage of the economy. Right now we think inflation is not likely in the near term. There is too much slack in the economy. Utilization of manufacturing capacity is down to 65%. (Much of the decline is due to auto manufacturing running at only 35% of available capacity.) It would take much higher levels of capacity utilization for price increases to stick. As the economic recovery gains momentum, there is a possibility that the Fed may not pull back some of the liquidity they are providing in time to head off price gains. We have confidence that the bond market will take care of that scenario. Ed Yardeni was the Chief Economist at Prudential Securities in the 1980s and 1990s. He came up with the term "bond vigilantes".

In the early 1990s, whenever it looked like the economy was strengthening, the bond market would sell off, sending interest rates higher, and slowing the economy. President Clinton was not able to pursue some of his big plans because the then-current Treasury Secretary Robert Rubin told him that the increase in government spending to achieve Clinton's plans would lead to more government borrowing and higher interest rates. If the high interest rates slowed the economy too much, then re-election was out of the picture.

We have already seen this dynamic repeated this spring. When the bond market perceived that the economy was bottoming out, and government spending was still increasing, we saw a dramatic rise in the yields on Treasury securities. The interest rate on the ten year Treasury note increased from 2.50% in March to 4.0% in June. That pushed up mortgage rates and other consumer loan rates. So there is a self correcting mechanism in place to regulate the economy - the bond market. The only way to short-circuit this mechanism is for the Fed to purchase Treasury and federal agency securities through the creation of credit on the Fed's balance sheet. The Fed has already announced that they will pursue this "quantitative easing" policy by purchasing \$300 billion of Treasuries, \$200 billion of federal agency securities as well as \$1.25 trillion worth of mortgage backed securities. Much of this liquidity provi-

sion offsets the loss on subprime mortgage backed securities suffered by financial institutions since mid-2007. However, if the Fed was to announce they were increasing the amount of bond purchases while the economy is improving, that would be a clear sign that they are going to monetize the government spending. The dollar would fall in value and inflation would be likely. The Fed understands this risk; therefore we do not think this is a likely outcome.

The economy is showing some signs of life. Reports from the housing sector indicate that it is stabilizing. Car sales are starting to improve and the new "cash for clunkers" program should provide a temporary boost to sales. Commodity prices suggest that demand is picking up. Business inventories are low, so any increase in sales will lead to restocking of inventories. Durable goods orders increased for two months in a row. The weekly unemployment insurance claims are falling, though they are still high. Consumer confidence has rebounded from the doom and gloom of last year. All of this evidence leads us to think the economy will begin to grow again in the second half of the year. We may not experience a strong recovery, and it may be in fits and starts, but many companies cut back sharply on their expenses last year so any increase in sales should result in strong profit growth. The market is already expecting some improvement in earnings. Let's hope expectations are exceeded. Here is a look at how our asset class strategies performed in the first half of the year.

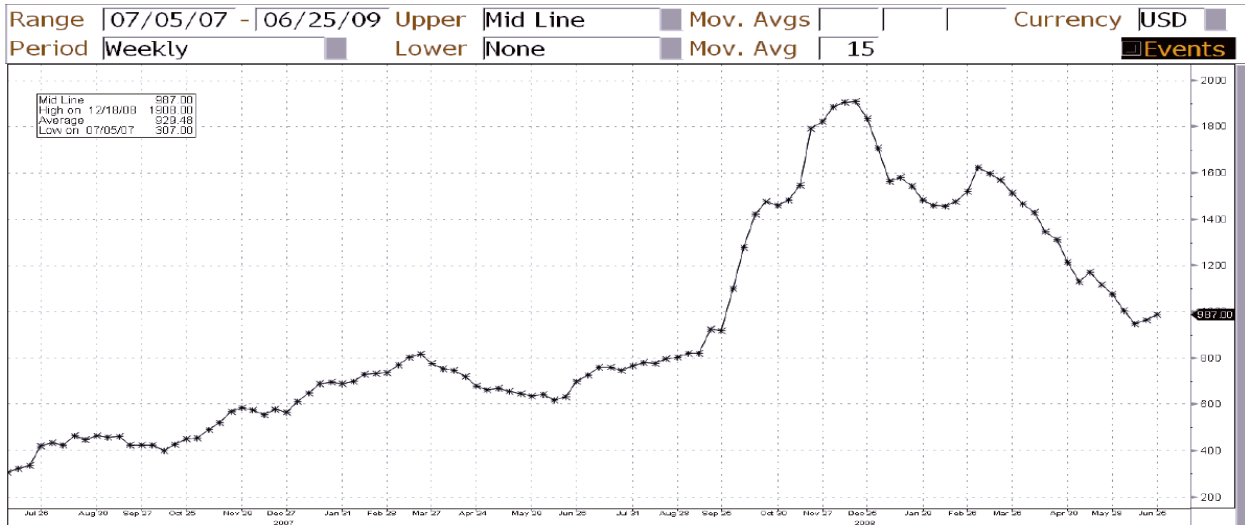
Blue Chip Strategy: Our large cap stock strategy gained 11.54% in the second quarter versus 15.94% for the S&P 500 Index. The strategy is still down 3.00% for the first half while the S&P 500 is up 3.26%. The Blue Chips have lagged due to the weak performance of some of the industrial stocks and the weakness in two companies that were removed from the Dow in June. General Motors declared bankruptcy while Citigroup exchanged a substantial portion of their preferred stock for common stock, resulting in the U.S. Government owning more than 33% of the company. They were replaced by Cisco Systems and Travelers. We thought Ford might replace GM but the committee that selects the members of the Dow Jones Industrials must have worried that Ford will still have a difficult turnaround job to survive. Cisco is a solid company with as much cash and marketable securities as long term debt. They will be a major player as wireless internet use grows. Travelers is a property and casualty insurance company trading at low valuations of earnings and book value. Boeing is another company in the strategy that has been a drag on performance this year. Boeing has had to delay the initial flight of their 787 Dreamliner yet again. Surprisingly, Wal-Mart was the weakest performer in the Dow (ex-GM and Citigroup) during the second quarter. Wal-Mart held up very well during the economic crisis as consumers were attracted to their low priced goods. Now that investors are expecting an economic recovery, they are moving out of safer names like Wal-Mart into companies that will benefit more from increasing sales. The companies in the Blue Chip Strategy have substantial exposure to overseas economic activity. Since we expect the domestic recovery to be lackluster, these companies should benefit from stronger overseas growth.

Small Cap Value Strategy: Our small cap portfolio turned in one of the best performances we can remember, gaining 72.77% during the second quarter versus a 20.69% gain for the Russell 2000 Index. For the first half of the year, the small caps rose 24.59% versus 2.64% for the Russell 2000 Index. As we have stated many times during the past, we expect our small cap strategy to be volatile. Sometimes it falls more than the market (like in the first quarter) and sometimes it gains more than the market (like this quarter). Over long time periods it has outperformed the Russell 2000 Index by about 3% per year. The biggest gainer for the quarter was Dollar Thrifty Group, the car rental company we purchased in the first quarter. (Some investors in the small cap strategy did not purchase Dollar Thrifty due to asset allocation overweighting in small caps or the lack of available cash.) Dollar Thrifty reported better than expected financial results, improved operating margins, minimal exposure to Chrysler's bankruptcy, and the paydown of debt. They were able to raise rental rates during the quarter since all the rental companies reduced their fleet size to closely match lower demand. Dollar Thrifty gained over 1,000% during the quarter. Air Transport Group turned in a strong performance in the quarter, rising over 200%. They restructured their agreement with DHL to lower their debt and lease more of their cargo planes to third parties. PRG-Schultz was our weakest performer during the second quarter. They reported weaker sales and earnings and we are not seeing any financial benefit from their agreement to provide services to one of their competitors for the regional Medicare audit recovery program. They have new management and it remains to be seen if the new team will be effective. We recently added one new position to the portfolio, Olin Corp. Olin is a chemicals company that produces chlorine, caustic soda, and bleach products among other chemicals. They also own an ammunition manufacturing business, Winchester. The ammunition business has been very strong recently, with over a one year order backlog. A research summary for Olin is included for clients in our Small Cap Value Strategy.

Convertible Securities/High Yield Strategy: Our high yield convertible strategy continued its strong recovery, gaining 29.70% in the second quarter versus a 22.55% rise for the Merrill Lynch High Yield Index and 17.27% for the Merrill Lynch Convertible Index. For the first six months of the year, the convertible strategy is up 34.73% while the Merrill High Yield Index is up 28.99% and the Merrill Convertible Index is up 20.29%. As the graph below shows, the yield spread on below investment grade bonds fell from approximately 1,500 basis points over Treasuries late last year to approximately 1,000 basis points recently. As the economy recovers and investors have more confidence that companies can repay their debt, the spread should trade closer to the long term average of 500 basis points. The strongest performing bond in our portfolio was the Beazer Homes convertible, rising 140%. The stabilization in the housing sector makes it more likely that Beazer will be a survivor. Ford Motor Convertible Preferred rose 150% as the auto manufacturer avoided bankruptcy and should gain market share from its fallen rivals. Markwest Energy was the strongest of our MLPs during the quarter, rising 60%. The MLPs that process natural gas are seeing improving margins and have regained access to the capital markets. We expect more improvement in our high yielding positions as the economy improves and investors' risk tolerance recovers. Many

investors will lose patience earning less than 1% on their money market investments, so we should see cash inflows into the high yield sector.

Graph 2. CS High Yield Index - Spread to Worst Source: Bloomberg



Intermediate Bonds: Our Intermediate Bond Portfolio rose 4.09% in the second quarter versus a gain of 1.58% for the Citigroup 1-10 Year Government Corporate Index. For the first half of the year, the Intermediate Bonds are up 4.04% while the Citigroup Index is up 1.61%. The Intermediate Tax Exempt Bond Portfolio gained 0.62% in the second quarter versus a 0.85% gain for the Merrill Lynch 3-7 Year Insured Bond Index. The tax exempt strategy is up 2.23% for the first half of the year versus the Merrill index gain of 2.84%. Our exposure to credit risk in the taxable bond strategy paid off this quarter as credit spreads tightened. We purchased Treasury Inflation Protected securities for our taxable strategy in early May to provide insurance against a possible rise in inflation. We believe that attractive value remains in high quality corporate bonds and the taxable bond strategy will continue to outperform its index as the economy improves. We have also picked up additional yield by swapping out of bonds we owned from companies like General Electric and Southwest Airlines and into very similar bonds issued by the same companies. In the each instance, we have generated approximately 0.50% in additional annual return and taken no additional credit or interest rate risk. The mispricing that was apparent in municipal bonds late last year and early this year has improved as hedge fund liquidations ended and the economic outlook improves. Municipalities are heavily dependent on economic growth for tax revenues, so an improving economy will alleviate investor fears of a high rate of municipal defaults. We are more cautious on the municipal bond sector now that yields have come down. The yield curve is very steep from an historical perspective. It suggests the economic recovery will gain strength. We plan to opportunistically invest in short and intermediate maturity bonds when the bond market sells off periodically as stronger economic data is reported.

