

The calendar year 2010 has unfolded largely in line with our expectations going into the year. As expected, the markets have been choppy with a multitude of starts upward and drops downward. With every stop and start, not surprisingly, investor anxiety increases and invokes fears of the marketplace in 2008 and 2009. But the truth is we have largely been in a +/- 10% trading range throughout the year. Historically speaking, this might be more of a rarity than most people would guess. In 25 of the past 84 calendar years, the S&P 500 Index has ended the year between +10% and -10%. That's less than 30% of the time! The other 70% were double-digit gains—or losses. In fact, the S&P 500 has passed through the 1060 level no less than 17 times in the past year. Despite the volatility in equities, other areas of the portfolios are holding up quite well. As a firm, our allocation to fixed income has returned +4 to +5% year to date. Across our allocation to alternatives, we are seeing flat results on the year. Said another way, diversification matters again. Given that (broadly) equities are down mid-single digits, fixed income strategies are up mid-single digits and our alternatives are flat – most of our portfolios are hovering around break even on the year.

But, there are always reasons for concern. At any point in time, we could conjure up a list a mile deep with reasons not to invest. Just a few on the list for 2010 include the "Flash Crash", Gulf Oil Spill, sovereign defaults in Europe and the massive U.S. deficit. One obvious reason for today's pessimism is the recency effect. Simply stated, it means people tend to recall items at the end of a list rather than in the middle. William J. Bernstein related the concept to the investment world when he said, "Two of the most virulent behavioral organisms are overconfidence and an overemphasis on recent history." This recency bias is certainly driving emotional decisions across capital markets and one reason why we see massive inflows into bond funds when yields sit at historic lows. In looking forward we see reason to be cautious, but we also see pockets of opportunity. Below we intend to highlight areas in portfolios where we are defensive and give you a few positive points to consider in these seemingly dark times.

How did we play defense?

During the fourth quarter of 2009 our Investment Policy Committee decided to reallocate our equity portfolios to reflect a more conservative view in the short-to-intermediate term. We targeted an increased allocation to high-quality stocks by ratcheting up our positions in managers like IVA Worldwide and Smith Group, and reduced our position in several managers that had huge rebounds in 2009. One manager we reduced was Third Avenue Value, which we felt was a little too concentrated in two Hong Kong real estate companies. Through July 31st, IVA Worldwide was up nearly 4% on the year and Smith Group was slightly negative. This compares to the S&P 500 Index, which was slightly negative and the MSCI EAFE Index, which was down -5%. Our inkling that Asian real estate and equity markets were a little too hot and that Third Avenue might suffer was correct. It was down about -3% through July. We still think highly of this group and will more than likely increase the position at some point in the future.

Action	Manager	YTD Return*	2009 Return
INCREASED	Smith Group	-0.3%	10.7%
INCREASED	IVA Worldwide	3.9%	23.3%
DECREASED	Third Avenue Value	-3.3%	44.5%
INDEX for Reference	S&P 500 Index	-0.1%	26.5%
INDEX for Reference	MSCI EAFE Index	-5.0%	31.8%
*As of 7/31/10			

Fixed Income is another area we've been managing with a defensive mindset. One way we've done this is to lower the average maturity of our portfolios over the past 2-3 years. Our portfolios today maintain an average maturity that is 50-75% shorter than standard industry benchmarks such as the Barclays Aggregate Index. Our portfolios maintain a large target weight to defensive fixed income, primarily via the FPA New Income Fund. This Fund hasn't experienced a down year in 28 years and has a stated goal of "never losing money". We're comfortable giving up a small amount of yield in the short-term in exchange for the protection that a defensive stance provides against a potentially larger move down in values should rates rise quickly. In addition to lowering the portfolios' average maturity, we have included a position that plays on the long-term strengths of Emerging Market economies versus that of the U.S. This position has worked well over time, but in markets dominated by elevated fear, it tends to bounce around more than your average fixed income position.

Our alternatives exposure via commodities has been roughly flat during the first half of the year. In an environment where liquidity remains at a premium and equities worldwide are off almost 10%, trading water is a reasonable result. We believe a commodity investment serves a variety of purposes today. One, it diversifies the portfolio and acts as a shock absorber. Two, while the U.S. may be in a prolonged slow growth period, many other countries continue to grow and are demanding more resources to do so. It is our opinion that even though the U.S. economy may not grow enough to trigger inflation in the short-to-intermediate term, countries like Brazil, China, and India certainly are and could be the main causes of inflationary pressure going forward. For instance, China's GDP is growing at 8-10% annually and has massive energy needs. Last year China knocked off the U.S. and became the largest auto market in the world. The International Energy Agency claimed China's total energy usage exceeded the U.S. last year. This isn't surprising as a large portion of the country's 1.3 billion people are in the midst of transitioning from an agrarian to an industrial society.

Are Bonds More Fun?

When measured by U.S. Large Cap stocks, we have just experienced one of the lowest returning 10 year periods in market history. Decades experiencing subpar market returns have historically been followed by long periods of adroit returns. The chart below illustrates this for each of the 9 previous decades since 1928 when the market produced returns of less than 5% for a 10 year period. The ensuing recovery periods, as indicated by the green bar, averaged 13% per annum.



Source: Thomson Financial, Lipper, Bloomberg and Davis Advisors. The graph represents the S&P 500® Index from 1958 through 2009. The period 1928 through 1958 is represented by the Dow Jones Industrial Average. Investments cannot be made directly in an index. Past performance is not a guarantee of future results.

The natural question would be, is similar performance possible in the coming decade? We think many of America's best corporations have navigated the crisis substantially better than most people realize. Corporate profits have quickly recovered to the levels of 2004-2006. This is due to companies acting quickly during the crisis to aggressively streamline operations and shore up their balance sheets by paying down debt, accruing cash, and refinancing debt at lower interest rates. The recovery in corporate profits has in fact widely outpaced the recovery in the economy due to productivity gains and flat or decreasing labor costs—a combination sure to boost the bottom line results. Based on these measures and the public's distaste for equities, the S&P 500 Index is now sporting a forward price-to-earnings ratio of about 12, a dividend yield of 2.4%, and the real possibility for growth going forward.

How does this compare to everyone's favorite asset class today? Bonds, as measured by the 10 year treasury, are offering a paltry yield hovering below 3%. Stepping out on the risk spectrum can generate a little bit higher income, but still nowhere near the inverse earnings yield of the S&P 500, which would be about 8.3%. (The earnings yield is earnings divided price.) A favorite manager of ours, Southeastern Asset Management, laid out a similar argument using the earnings yield of the Dow Jones Industrial Average versus yield on long-term corporate bonds. The crux of their stance is that during equity market lows the spread has averaged (2.8%) and in early July it stood at (4.3%), indicating a good entry point for owning stocks.

As Southeastern Asset Management stated, "We have rarely witnessed this much disparity between the benefits of being an owner of a growing* coupon (equity ownership) versus being a lender for a fixed* one (bond ownership)." (*Emphasis added is our own.)

Despite our cautious optimism for the capital markets, we recognize that current sentiment is decisively negative for risk assets like equities. The massive cash flows into fixed income funds illustrate investors' attitudes quite adequately. We are aware of the challenges our economy faces like the enormous debt burden that has shifted from the private to the public sector. We also believe that the vast majority of those reading this letter will not reach their financial goals by stuffing their savings under the mattress or moving entirely to money market funds. Therefore we are charged to take some degree of risk in order to earn attractive risk adjusted returns over time. This is a tall task but we believe that global diversification combined with a disciplined process and a bias toward value investment principles will achieve success over time.