



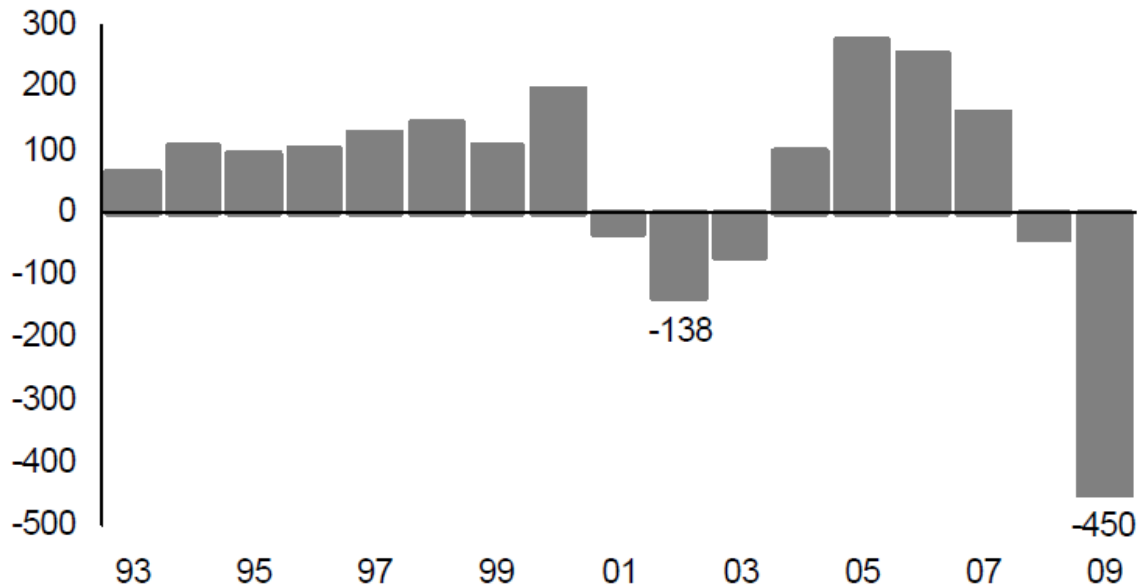
Outlook 2010 and Beyond, “In the Wake of the Great Recession”

Because the Great Recession will cast such a long shadow, our outlook this year will go well beyond 2010 and identify themes that will be with us over the long-term. This period will leave a lasting impression not dissimilar to those following the Great Depression, World War II and the end of the Cold War.

Uncle Sam has Become the Largest Interest Rate Speculator

In 2009, federal tax receipts fell by \$450 billion (shown below Exhibit 1) while government spending jumped by \$670 billion (shown below Exhibit 2) resulting in a skyrocketing deficit. As a comparison, in the last recession receipts fell by \$138 billion and spending increased by \$172 billion in 2002. The Office of Management and Budget (OMB) currently forecasts the debt to top 75% of GDP over the next 10 years. The OMB also forecasted that interest payments and entitlements will increase from 45% of total federal spending in 2009 to 62% by 2019. With 39% of the debt coming due within 1 year and 74% within 5, our view is that Uncle Sam has become a speculator, hoping rates won't rise. This is the same behavior as the sub-prime borrowers who financed their purchases through adjustable rate mortgages. We have experienced nearly three decades of declining interest rates; our view is that over the next few years they will transition to rising as our total debt becomes more troublesome.

Exhibit 1: Change in Federal Tax Receipts (US\$ in Billions)



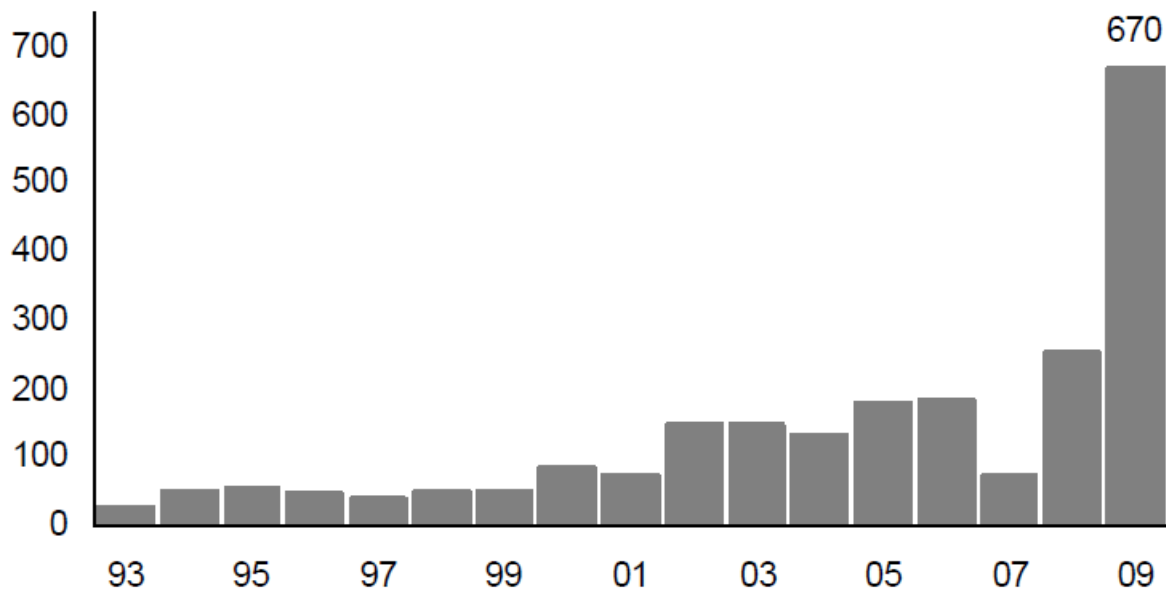
Source: Office of Management & Budget

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Exhibit 2: Change of Federal Spending (US\$ in Billions)



Source: Office of Management & Budget

Japan will serve as a litmus test as their total debt to GDP will exceed 200% by this June. I expect that their debt situation will become dire within the next four years and educate us on the perils of letting your debt run amuck. The net result will create the need for significantly higher taxes combined with lower government spending.

The Federal Reserve will look a lot more like the ECB going forward

Like in the Wizard of Oz, Fed Chairman Greenspan sat behind the curtain pulling levers and pushing buttons to help drive the economies success while maintaining price stability. Unfortunately, we all know how that story ended, with massive excess liquidity leading to irresponsible lending and irrational behavior, puff, up in smoke.

At a point in the not too distant future, we look for the Federal Reserve's responsibility to resemble the European Central Bank (ECB), focusing on price stability rather than economic growth and employment. With such, future economic upturns are more likely to be more subdued. With lower long-term economic growth, U.S. focused stock investing needs to screen for companies that have cash on hand, the ability to generate cash, the willingness to part with that cash through dividends and stock buybacks and the ability to grow earnings in an overall mundane economic environment. Good active management will outperform indexing for equities.

Savings Rate

In the near term, a risk to the economy is that consumers save too much, undermining an already fragile economic recovery. Over the long-term, the risk is exactly opposite, consumers do not save enough.

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On average, a person needs to save 8-10% of their income each year to maintain their current lifestyle in retirement. We expect the saving rate to renormalize in the 4-5% range. The future implications of this lack of savings are considerable as it becomes evident that many have not adequately prepared for retirement. Seniors, who vote in large numbers, could exert pressure on their elected officials for even greater redistribution of wealth further complicating the budgetary situation.

Financial Industry Regulation

Change should be focused on decreasing the likelihood of future financial crises and containing them once they occur. At the same time, re-regulating poses significant risks. Increasing capital requirements may have unintended consequences by increasing companies and the consumers cost of capital. This is already evident as government money has flowed into bank coffers to sit because of stricter lending standards and the increased capital requirements have excluded most borrowers.

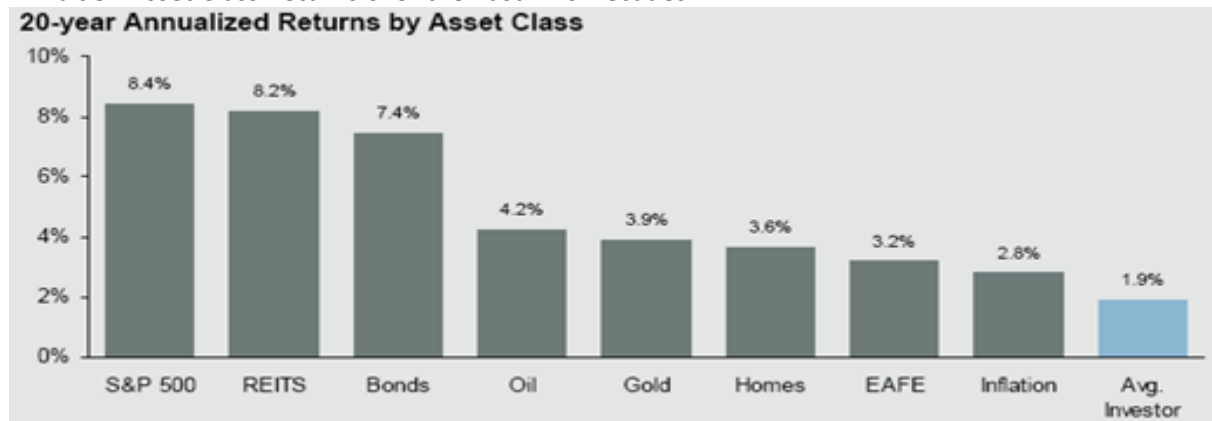
Developed Versus Developing

Though valuations are currently slightly stretched we foresee an extended period of Emerging Markets outperformance. The average debt to GDP in the Emerging Markets is just 36% and falling while in excess of 70% and growing in the developed world. This coupled with their superior growth outlook should drive their markets to higher returns versus the developed world over the next decade plus, but expect them to remain volatile.

Stocks, Bonds and Alternatives

As shown in Exhibit 3 below, over the past two decades all asset classes have outperformed the average investor as calculated by Dalbar, so we surely don't want to follow the crowd.

Exhibit 3: Asset Class Returns over the Past Two Decades



Source: Dalbar

Since the March 2009 stock market bottom, the crowd's been buying bonds at ten times the rate of stocks giving us confidence in our call for higher interest rates in the future. As we transition from 27 years of generally declining rates to rising rates, bond returns will struggle to match inflation.

Stocks have just finished their worst decade ever adjusted for inflation. Yes, even worse than the Depression years. We turn to our friend Jeremy Grantham from GMO, whose prescient historic predictions inspired us to

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write our article “Almost Nostradamus”. Jeremy agrees with our high quality call, he sees “U.S. High Quality” stocks returning 6.8% per year over inflation, but meager returns for the U.S. stock markets in general. He’s more constructive on foreign stocks looking for above inflation returns of 4.7% annually for International Large-Cap, 4.6% International Small-Cap and 3.9% for Emerging Markets stocks.

To us Alternatives include investments that don’t fall into the category of a stock, bond, or cash. The smartest minds have proven that incorporating “Alternatives” can significantly increase your risk adjusted returns. Below (Exhibit 4), we’ve included a chart of the indices’ that comprise the Alternative Investments we use in blue and the S&P 500 in green over the past 10 years ending November 30, 2009. The allocation includes a one-third weighting in Managed Futures, a third in the Credit Suisse Hedge Fund Index and a third in the Credit Suisse Hedge Global Macro Index. The tools we use to access these investments for our clients are liquid daily and fully transparent.

Exhibit 4: Our Allocation to Alternatives versus the S&P 500 for the Past Decade



The inclusion of Alternatives surely has proven its usefulness and we expect this to continue in the future by reducing volatility and enhancing overall returns. We see Alternatives continuing to enjoy the highest risk adjusted returns of the three asset classes over the next several years.

The Demise of “The U.S. Empire”

For those that are concerned about the demise of “The U.S. Empire”, even if fact, I’d like to remind you that during the decline of “The British Empire”, England was a perfectly wonderful place to live and thrive.

The world likes having a super power, it creates stability, but given the budgetary dilemma we’ve described, it would not be unreasonable to assume that the level of U.S. military spending could come under pressure. Some might argue that this would be a positive and shift the need for U.S. allies to increase their own defense spending. But, a cardinal rule of investing tells us the markets like stability and dislike uncertainty.

With our outlook of significantly higher growth rates in Emerging Economies the world’s wealth should follow that growth reducing the world’s dependence on the U.S. as the major growth engine.

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The U.S. Dollar

Over the long-term, countries that enjoy the highest growth with lower debt levels also enjoy the strongest currencies. The U.S. dollar has been declining for years, is probably overdue for a near to intermediate term bounce, but will continue to decline longer-term. A declining dollar has several benefits; it reduces the value of our debts against the rest of the world, it makes us more competitive globally and for investors that include foreign investments in their portfolios, a boost in return.

Change Brings Opportunity

We've been living through what will probably end up being the biggest economic event of our lifetime. We've come back from the brink of Armageddon with reports that our financial system was within a day of collapse. Some of the world's brightest financial minds have admitted trips to the ATM for emergency reserves of cash in case of the worst late last year. We don't see a repeat, but the world is changing, humans have thrived on their ability to adapt. We will keep you posted on changes as we see them and how to adapt.

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NOTES TO HYPOTHETICAL INFORMATION

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