

MARKET REPORT FOURTH QUARTER 2009

In our annual review of market performance and economic happenings, we typically look back with a certain degree of sameness – one year oftentimes looks like another. The year 2009 will not be that way. In fact, it provided economic, banking, equity market and fixed-income market extremes that we hadn't seen since the Great Depression—more than 80 years ago.

During this period of extremes, we behaved as you would expect us to: We remained committed to our tried and true, value-oriented, bottom-up investment process which focuses on price-to valuations (i.e., earnings, cash flow, book value), return on capital, and business franchises with durable economic qualities. We take great pride in making the aforementioned statement, for not all investment managers can do the same. Adherence to our emotionless and valuation-driven process, which discounted many errant forecasts of doom and gloom, seemingly served all of us well. We appreciate your confidence and trust in us.

A Review of 2009

It is hard to believe that we started the year at 903 on the S&P 500. In the next 10 weeks it gave back 25% or 227 points, bottoming at 676 on March 9th. From its peak of 1,565 on October 9, 2007, to its trough, nearly 57% was lost in value. Almost as interesting was where it ended the year—1,115, a remarkable gain of 65% from its March bottom. We had not seen this level of volatility since the 1930s.

Growth stocks had one of their best years ever relative to value stocks. The Russell 3000 Growth Index posted a 37% increase for the year while the Russell 3000 Value gained 20%. In spite of the recent strength in growth stocks, for the decade ending at year's end, the Russell 3000 Growth index lost over 30% while the Russell 3000 Value gained over 30%. Small cap value stocks, represented by the Russell 2000 Value Index, rose more than 120% during the same period. Value stocks have beaten their growth counterparts in six of the last seven decades with the 1990s being the exception.

Technology and Materials, as defined for the Russell Indexes, were the top performing sectors for the year, up 67% and 55%, respectively. Consumer Discretionary, our largest sector allocation at year's end, also rebounded strongly rising 49% for the year. The Financial Services sector made a remarkable recovery from its March low as well. Many debt-laden companies saw their share prices skyrocket as the gridlock in credit markets and the banking system began to wane in late spring and fear turned to greed.

On a global basis, the MSCI EAFE index (which represents the developed markets of 21 European, Australian, Asian and Far East countries) advanced 28% for the year after retreating 45% in 2008. The MSCI BRIC index (Brazil, Russia, India and China) rose 89% after falling 60% in 2008. A dozen plus countries experienced gains of more than 50% for the year. Recoveries came swiftly as economic conditions showed the first signs of bottoming and sentiment quickly turned positive. Many emerging markets' economic growth outpaced that of their more developed brethren. Those countries with fewer banking/credit issues found their economic bottoms quickest and experienced a more rapid economic recovery.

The U.S. Treasury market was perceived to be the only safe financial-haven in 2008 (which led to a bubble in Treasuries). What a difference a year makes. It was virtually the only market, in general, to lose money in 2009 as investors who shunned risk early in the year quickly abandoned Treasuries when worldwide markets and their risk appetite improved. As the fear of a worldwide meltdown abated, corporate and convertible bonds were among the biggest beneficiaries.

Total Return as of December 31, 2009						
	Annualized					
	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
S & P 500	6.0%	26.5%	26.5%	-5.6%	0.4%	-0.9%
NASDAQ	7.2%	45.4%	45.4%	-1.2%	1.7%	-5.1%
Russell 3000						
Index	5.9%	28.3%	28.3%	-5.4%	0.8%	-0.2%
Value	4.2%	19.8%	19.8%	-8.9%	-0.2%	2.9%
Growth	7.7%	37.0%	37.0%	-2.1%	1.6%	-3.8%
Russell Mid Cap						
Index	5.9%	40.5%	40.5%	-4.6%	2.4%	5.0%
Value	5.2%	34.2%	34.2%	-6.6%	2.0%	7.6%
Growth	6.7%	46.3%	46.3%	-3.2%	2.4%	-0.5%
Russell 2000 (Small Cap)						
Index	3.9%	27.2%	27.2%	-6.1%	0.5%	3.5%
Value	3.6%	20.6%	20.6%	-8.2%	-0.0%	8.3%
Growth	4.1%	34.5%	34.5%	-4.0%	0.9%	-1.4%

High-yield corporates saw gains of more than 50% for 2009. You may recall that fear was so widespread and extreme that even money markets were called into question. The turmoil in credit markets and the banking system coupled with the perceived threat of widespread bankruptcies and government policy changes made bonds as volatile as stocks in many cases. Equity-like returns were not uncommon in certain bonds.

Commodities such as oil and base metals experienced significant gains for the year, but gold stole the headlines when it breached \$1,200 a Troy ounce. Oil continued in its volatile ways, nearly doubling from \$47 per barrel (yet it's still well below its July 2008 peak of \$147 per barrel). Agricultural commodities such as corn and soybeans had a wild ride but ended the year with modest increases. The U.S. Dollar was the mirror opposite of the U.S. stock market, rising early and falling the last 10 months. Low interest rates and fear of rising government deficits have weakened our dollar. While this garners a lot of negative media, in moderation, a weak dollar can be a plus for those companies who export or do business abroad.

While it's easy to point out the many economic woes that befell us in 2009, here are some headliners: lower home prices, higher unemployment, and smaller paychecks to name a few. The depth of despair was reached in early March as the Dow Jones Industrial Average plummeted to nearly 6,500. The worst seems to be behind us, but for many there is still great trepidation about what lies ahead. The economy appears to be recovering on the heels of massive government intervention through lending, guarantees and stimulus spending. Each of these efforts experienced or are experiencing moderate degrees of success, and we believe have helped the U.S. avoid another 1930s-like event, but at what cost remains unknown.

We said in our 4th quarter 2008 letter that economic times would get worse before they got better. Unfortunately, we were correct in our assessment. The economic recovery will likely be slower and weaker than most would like, but better than many believe is currently possible. Local, state and federal tax revenues are shrinking at the same time that needs are growing, causing large budget deficits at all levels. Full employment seems to be years away, yet unemployment appears to have peaked. Modest inflation (but not 1970-80s type inflation, given the acknowledged harm that it could bring) seems almost a certainty, which actually should help our housing industry. As banks' capital bases and the value of their collateral (think property values) stabilize and ultimately increase, the Fed can begin to exhale. Many banks' ability to raise capital (without government assistance) and repay TARP money is a testament to the progress that has been made in the last nine months.

We also stated in that same letter that the stock market was a leading indicator of the economy and that it would bottom before the economy, typically by a margin of several months. In other words, don't confuse the direction of the economy with the direction of the stock market. This clearly was the case during the last half of 2009. Economic news continued down a dark and seemingly endless path while the stock market roared ahead. The lesson to be learned is that while most people will think back to 2009 and relive the economic misery, investors who stayed the course were generally better off. The best buying opportunities obviously came at the lowest point in the market, which was also marked by the greatest degree of pessimism. We don't expect the rapid equity market appreciation of the past nine months to be repeated, nor do we expect the nadir to be revisited.

Looking Ahead

There are a number of positives that shouldn't be overlooked. With higher unemployment, businesses are leaner. Profitability should strongly rebound in 2010 as companies' right sizing efforts in 2008-09 begin to pay off. Low interest rates make homes very affordable for qualified buyers, especially given the more than 25% decline in property values in certain geographic areas. The cheap U.S. Dollar (relative to many foreign currencies), as previously mentioned, makes our goods and services very competitive internationally. Importantly, our financial institutions are making better underwriting and capital market decisions today versus three years ago. Our economic foundation is being rebuilt with less leverage, a long-term plus.

Currently, we believe that equity market valuations are fair, on average. However, certain sectors and individual stocks are trading at good discounts (think fur coat sale in July) when valued on their normalized or average earnings. As such, we firmly believe the next few years will be a stock picker's market. With bond yields continuing to normalize relative to Treasuries, stocks should be a competitive alternative even for the more conservative investor. In closing, we feel pretty good about stock valuations today and therefore the prospects for acceptable equity returns over the 2010-11 stretch and the decade.

Past performance is not indicative of future results. Market and economic data has been provided by third party services. This data, while believed to be reliable, has not been independently verified by EBS.