January 5, 2010

2009 Year End Review

I have to admit to being more than a little daunted by the task of attempting to summarize the past year's events in a two-page letter. It is mind-boggling how much has transpired since our last year-end review. Instead of boring you with details of the historic nature of recent events, I will err on the side of oversimplification in order to hit a few high points.

We had a terrible crash. Then we had a terrific recovery. That just about says it all. It was a wild ride and we are thankful to have survived and profited. Many investors didn't. In March of 2009, the equity markets completed a historic over 50% slide from highs reached in October of 2007. In round numbers, the Dow Jones Industrial Average dropped from 14,000 to below 7,000, while the S&P 500 Index fell from 1,550 to below 700. After unprecedented government intervention, the equity markets bounced back up to a level that recovered 50% of that loss. As you will recall from your math class, a loss of 50% followed by a gain of 50% leaves you with only 75% or your original investment, or a loss of 25%. Fortunately, we have benefited by reacting to the crisis before and as it developed, then becoming less defensive and participating to some extent in the recovery when it occurred.

For the full year the Dow Jones Industrial Average gained 18.8% after losing 35% the previous year, and losing an additional 26% into the first quarter of 2009. The S&P 500 gained 23% in 2009 after losing almost 40% in 2008, and declining an additional 27% until the bottom was reached in March. Corporate bonds generally went up nicely, while the Barclay's Long Term U.S. Government Bond index fell by 15%. To say that the experience of investors was traumatic is an understatement. To those who were overly committed and who reacted too late, it was potentially devastating. Fortunately, we accomplished our goal of weathering the storm and emerging with our cargo of capital largely intact to keep on sailing.

The government has released a tidal wave of cash into the economy in order to avoid a banking crisis and the depression that had been feared. It appears as though that possibility has been successfully avoided. We now appear to be slowly emerging from the first global recession since World War II. However, the government actions themselves may prove sticky to unwind. Some have called the moves by the Fed and the Treasury "The Infinite Intervention." Unintended consequences from such massive injections of money are probably unavoidable. In addition, the government's policy of charging almost nothing for short term money has become the government's method of choice to shovel cash back into the banks. In the meantime, you and I get almost nothing for our savings. I am surprised so few people have recognized and complained about the decision to re-inflate the banks in this way at the expense of retirees and savers.

We continued the course that we set last quarter where "our strategy has been to sidestep the crash as much as possible, then begin rebuilding our portfolios with the investments we'd like to own for the next several years." We continue to move incrementally. These new investments would include stocks in recession resistant companies with potential growth and good dividends, inflation hedges, "too cheap not to own" (deep value) special situations, income producing investments, energy companies, and, in order to be prepared, a few leveraged to a rebounding economy. We have added positions in large multinational corporations with good dividend yields and cash flow such as Proctor & Gamble, Pepsi, Bristol Meyers, Johnson & Johnson, AT&T, Verizon, and Microsoft, to name a few. We are also adding investments in smaller companies

that are more sensitive to economic recovery that we hope will give us more dramatic returns when economic activity picks back up. By combining the characteristics of large, stable, dividend-yielding stocks with those of smaller, more dynamic companies, we intend to lay a foundation of quality to carry the portfolios higher over the next several years, even if recovery is slow.

The next several years may be the kind of environment where investment selection will be much more important than it has been in the past. In the 1980's and 1990's bull market, it was very profitable to "index" your portfolio and ride with the general market. That strategy has not worked well for 10 years now. There may be a greater divergence between winners and losers as the aftermath of this recession unfolds. Consequently, our investment selection will probably be more important than the direction of the overall market.

It should not be surprising if we experience at least a small intervention-fueled "boomlet" in the economy in the near future. Most companies have cut costs dramatically and a small increase in revenues can mean large increases in profits. So we may have more to go in this rally. The more important question involves whether the nascent economic recovery can sustain itself once the massive intervention is withdrawn. The markets have benefited from billions of dollars of government checks written in the last year. Debt as a percentage of GDP will have grown from 40% to 80% by the end of this economic intervention. That injection of government largesse will likely be absent and may be partially withdrawn beginning in March. Another question is when and how quickly interest rates will rise from their current historic lows and if inflation will return. A dangerous mood of complacency may have settled in as confidence grows that government policy responses fixed this crisis, and by extension can fix the next one as well. However, the tools used in this crisis may not be available or adequate if there is a round "2" downturn.

The most reasonable path that I see is to pick our investments carefully with a "margin of safety" and monitor the situation as it develops. A reasonable reaction to reality can be more profitable than a faulty forecast of the financial future.

Enclosed you will find your year-end reports and statements. To save you time and money in your tax preparation, we will also gladly provide capital gains reports and copies of other tax reports to your tax preparer if you will just let us know your wish to do that.

I count it as a privilege to have worked with you on your investments this year past, and I look forward to doing so again in the New Year.

Sincerely,

Claude Carmichael CFA