



## 2010 Second Quarter Performance Report

The mild correction in the first quarter was obviously not enough to satisfy this difficult Market. In the second quarter we had a more severe correction (i.e. greater than 12 percent) which is continuing as I write this letter. Some of the negativity underlying this market is based on an over-reaction to the sovereign debt issues in Europe, the Gulf oil spill, and a monetary pullback in China. On the other hand, some of the negativity is based on the reality that economic growth in the developed world is slowing. Economic (GDP) growth in Japan, Europe, and the US has slowed to a point where it is not generating sufficient job growth. I agree with former Fed Chairman Alan Greenspan's statement that it is not unusual to have a slowdown in the early stage of an economic recovery. In my judgment, it is highly likely that the present slowdown will be short-lived and not the beginning of a "double dip recession". The end result, however, is that this continues to be a very difficult investment environment.

Portfolio actions taken during the second quarter were limited to balancing our holdings and replacing stocks that were sold due to options expirations. By the end of the second quarter, our average cash position was roughly 5 percent.

### TIMING MODEL

The Timing model continued to strengthen in the second quarter. It moved up by five points to a strong bullish reading of 70%. Thus, it predicts a 70% chance of market appreciation and a 30% chance of market decline, over the next 3-6 months.

### MARKET OUTLOOK

The most significant change to the market/economic outlook, compared to last quarter, is that the various government stimulus programs have worked their way through the economy and their effects are now fading. This would explain the slowdown we are now experiencing. It is time for the private economy to sustain future growth. The deficits that were generated around the world will probably reduce future growth a bit – but remember that without the financial bailout and large deficit spending of the recent past, we would probably now be in a depression (i.e. greater than 20% unemployment).

The monetary policy of the Federal Reserve is still very stimulative. Short – term interest rates are close to zero, and thirty year fixed rate mortgages are well below five percent. Given present Fed policy, our financial institutions are getting stronger with every passing quarter. As time goes on the toxic assets are being written off and they are able to increase their foundation capital. At some point, the banks will more aggressively seek to lend money to small businesses and others. At that point our economic growth rate should accelerate. Because of the depth of the recent recession, however, this may be a frustratingly slow process.

As you might conclude from the above discussion, my view on the market has not changed. I believe that the present market decline should be viewed as a correction within a potentially long-term Bull market. My confidence is primarily based on two things. First, the US (and most other countries) economy is now growing, and second; stock market valuations are cheap. Let's look at an example from our portfolio. Oracle Corporation is one of the premier software companies in the world. It is considered a growth company and a leader in data base software. Oracle announced second quarter earning two weeks ago. Earnings improved by thirty percent on a year over year basis. At its present price of 22.5, it has a trailing price/earnings ratio of 13. Oracle has historically traded at a price/earnings ratio closer to 20. Thus, it can easily appreciate by 50% in a more normal environment.

A second more conservative example from our portfolio is AT&T. At its present price its dividend yields 7 percent annually. This compares to the 1-3 percent yield that one can expect from a bank CD or Treasury bond. By the way, even in this difficult economic environment, AT&T's earnings are growing. I could go on – but you get the idea.

If one is a value investor, there is more opportunity than risk in this market.

Sincerely yours,

Ray Hofshi