



First Quarter 2010 Performance Report

A year ago the stock market began its recovery. We brought the world financial system to the brink of a cliff, looked over and decided not to jump. A dramatic relief rally ensued. Then we saved the banks, reopened the credit markets, saw huge productivity gains, applied fiscal and monetary stimulus, began inventory rebuilding and now we have a quarter with 5% GDP growth and a record number of companies beating their profit estimates.

Add it all up and you get a stock market that is up 70% from its March lows, but despite all this progress, the headlines only feature bad news. The prevailing opinion is that this crisis will never end, and every piece of evidence to the contrary is met with disbelief. What a great time to be a contrarian! All the evidence is in your favor, but the crowd doesn't believe it.

It's been called the melt-up rally because it's been slow and steady. Not a lot of volume, but broadly based. No two hundred point up days on the Dow, but day after day of less than 100 point gains. What could be better than that?

It might be better for the market if we had one of those perfectly normal ten or twenty percent corrections that the market forecasters have been predicting for the last 3000 points on the Dow. At some point we will have a correction, but not until the market has inflicted the maximum amount of pain to the market timers.

We have no interest in trying to time the next market correction. When it happens, it happens, but it's not worth missing the long term recovery to try to catch a short term dip. We have been pairing down some of our more risky positions as we always do when the market becomes richer. We've seen some great moves in small caps stocks that will no doubt continue to be great companies, but aren't the screaming bargains they were a few months ago. Fortunately, there are plenty of big cap stocks that have trailed the market, but offer a much better safety profile. We've been putting our cash into these; both because they offer better relative valuation and because they should be safer when the correction comes.

We think big cap names like P&G, J&J, Wal-Mart, JP Morgan and IBM are attractive for their rock solid balance sheets, rising dividends, attractive valuations and international exposure. After several years of outperformance, small and mid cap stocks look

relatively expensive compared to the big guys in the Dow. We like laggards. We love the blue chips.

We have been buying bonds to keep our balanced portfolios in line with their investment objectives, but it is hard to get enthusiastic about bonds. Interest rates are going up and the only question is how fast and how high they will get. Eventually, that will mean we will get high yields in bond portfolios but in the mean time, the value of our bonds will be going down. The expectation of high rates in the future and relative safety of short maturities keeps us out of long dated paper.

Last year any bond from a financial services company or issuer that didn't have a squeaky clean balance sheet was trading like junk. Those bonds have appreciated almost as much as stocks as fear is leaving the bond market and yield hungry investors have driven up prices. We still think there are a few bargains out there, but they are only bargains relative to very low treasury yields and narrow spreads between treasuries and corporate bonds.

That said, we have no alternative but to buy bonds even though yields will probably be higher in the future and there may be some short term price depreciation. The cost of holding cash in a zero interest rate environment is just too painful to wait for higher interest rates. So, we are doing the best we can get some yield and protect our clients.

We look forward to the remainder of the year. At some point in the not too distant future, the market will transition from anticipating the recovery to anticipating a more normal economy. After the last couple of years, any form of "normal" would be something to celebrate.

PARADOXES, CONUNDRUMS AND ZEN

Life is full of paradoxes. Fat people are always on diets. Rich people are always worried about money. And, my favorite, we fear most what is least likely to happen to us. The chances of being a victim of a terrorist attack, airplane crash or shark attack are much less than being struck by lightning on your front lawn, but which one gets your heart pounding?

Paradoxes, unlike conundrums, are explainable. We fear sharks more than our front lawns because we fear most what is unfamiliar to us. Familiarity breeds complacency, so a walk to the curb just doesn't get the neurons sparking like the thought of an irrational thousand pound sea creature. Everyday paradoxes are pretty harmless, but failure to understand investment paradoxes can cost you a lot of money.

POPULAR INVESTMENTS ARE GENERALLY THE MOST DANGEROUS

I read about this great company. They are revolutionizing their industry. All the research was very positive. The stock is supposed to double! Some very smart people have already made a killing in it and nobody has a bad word to say about it. I'm getting in now before the stock goes up any further.

Six months later the stock is down 50% because only one of twelve analysts dropped his buy rating and the company reported good, but not great earnings. What the inexperienced investor failed to understand was that stocks move on changes in future perceptions, not on what has already happened. Nothing is harder to improve than the expectation of perfection. Yes, everyone loved the stock and thought it could do no wrong. Could it get any better than that? No, it could only get worse, and the stock could only go down at some point.

Engineers have a hard time with paradoxes. Build with concrete and steel and it will be stronger than cheap lumber. The difference in strength can be calculated and you can even predict how much wind it would take to blow the walls down. Investments have far less predictability, and attempts to impose an order on them are usually both futile and harmful to your financial health.

Surely an investor who follows a rigorous program of principal protection using sophisticated stop loss strategies and options programs can outsmart the market. There must be a way for really smart investors to have both good rates of return and safety. It's a lovely thought, **except that:**

MOST STRATEGIES THAT ATTEMPT TO LIMIT RISK IN THE SHORT RUN... INCREASE RISK IN THE LONG RUN.

Less you think we have gone on paradox too far, consider: Hedge Funds, Long term Capital, and Bernie Madoff. Hedge funds were created to let the smartest guys on the planet use every strategy under the sun to control risk (hedge), while giving investors a reasonable rate of return, yet almost all fail to do that on a consistent basis. Indeed, every study ever done on hedge funds has found that they gain their advantage, if any, by using leverage (increasing risk) and are fairly inept at controlling risk.

Long Term Capital was the most famous hedge fund of all time. It was staffed to the gills with PhDs and even Nobel laureates, who promised, and for several years delivered, low risk and great returns. They were the biggest, best, brightest and the most powerful hedge fund on earth. What could go wrong?

The PhDs at Long Term Capital said nothing could go wrong. They hedged their positions with assets that had a 99% certainty of moving in the opposite direction of their longs and had plenty of AAA rated paper that was perfectly liquid. But, if you weren't a PhD, you had to ask yourself if it was REALLY possible to get double digit returns without a single quarter in the red? It turns out it was only possible if you were willing to occasionally risk losing everything, which of course is what happened. It was a

classic case of short run predictable gains versus the likelihood of a disaster in the long run.

Long Term Capital proved this to be true in the bond market, but the paradox is equally true for the stock market. Trading and derivative strategies that attempt to provide steady, low risk returns in the short run, invariably are risky in the long term.

On the most elemental basis, since stocks are the best performing asset over the long run, all money moved to cash and hedges will reduce your long term return. Add in the cost of hedging, taxes plus trading risk and it's easy to see why what feels good in the short run is bad for you in the long run.

The best example of such a strategy is selling out of the money put or call options. I won't bore you with the details, but basically you can sell the right to buy or sell a stock for a limited period of time at a price the stock is unlikely ever to hit. It is so unlikely that maybe 95% of the time you will pocket the money at absolutely no cost to you. The only catch is, the 5% of the time you lose, you will lose 20 to 30 or more times what you got paid. It may take years for it to happen, but when it does, welcome to your personal Long Term Capital.

Bernie Madoff was smarter than the PhDs at Long Term Capital. Bernie knew that there was no way to get even 10% on a consistent basis without taking a lot of risk and having inconsistent returns. He said he could beat the market on a regular basis because that is what investors wanted to hear, but to his credit, he never even tried. He just cooked the books from day one. Bernie might have been a crook, but he was no fool.

Before Bernie Madoff became an infamous Ponzi artist, he practically invented computerized trading off the exchange floors, where the vast majority of securities are traded today. He understood more about stock trading than just about anybody on Wall Street. He'd seen thousands of geniuses try to time the market with short term trading strategies. Bernie knew the most important market paradox of all:

ANY MARKET WHERE THE MAJORITY OF PARTICIPANTS ATTEMPT TO PREDICT ITS DIRECTION, IS UNPREDICTABLE IN THE SHORT RUN.

If Bernie didn't know that, he would have just gone out and hired some really smart guys to time the market and wouldn't have had to go to jail. Most people on Wall Street know you can't successfully trade the market, but then they act like they can. You hear: "I'm not a market timer but I need to protect my client's money." How? By jumping in and out of the market on little more than herd instinct and a reliance on pseudo-science? If you really believe the market is unpredictable in the short run, then you either live with its volatility or you become a crook.

Now there are two kinds of crooks on Wall Street. One just steals your money the way Bernie did. That's the kind that eventually goes to jail. The crooks that get away with it are the ones who run a more sophisticated Ponzi scheme. They use smoke and mirrors to

produce relatively good short run returns, while all the time knowing (or they should know) that they are risking a future disaster for short term returns. They give the illusion that they can predict the short term direction of the market, while exposing their clients to tremendous risk.

What's so risky about a strategy that goes to cash on the first sign of trouble? Being wrong, that's what. If you miss just one major move in the market it can wipe out decades of returns. Going to cash exposes clients to that risk. Cash is the riskiest of all assets because it has the worst long term return of any asset class. There is one thing more certain to get a worse return than being in cash and that is active trading. Yes, in every market there are traders who make money, but CNBC only interviews the winners. The market is unpredictable because the very people who are trying to predict its direction ARE the market. No individual market participant can get an edge for long because the market is nothing more than the collective judgment of all the participants and much too complex and changeable to be reduced to a predictive formula

MOST MARKET PARTICIPANTS KNOW THEY CAN'T PREDICT ITS SHORT TERM DIRECTION, BUT ACT LIKE THEY CAN

That is the ultimate conundrum. It's just unexplainable. We know the human brain is wired to see patterns, even in random numbers where there are none, but we overcome a lot of instinctual behavior every day to do what is logical. Why can't the rational side of our brains control our investment behavior? Could it be because clients want to believe that market timing is possible and Wall Street is in the business of selling clients what they want, even if it's a hoax?

An economist would just say that attempts at market timing, while non-productive to the participants, is productive for the market as a whole via "the invisible hand". It is because all those people are doing something stupid, trying to time the market, that the market is efficient. An efficient market represents the consensus view of its most powerful constituents based on the best available information. It's not always right. It's just right enough times to make anyone who bets against it wrong in the long run. This brings us to Zen, or at least my interpretation of it, when it comes to investing.

ACCEPT THE UNKNOWABLE, KEEP YOUR MIND ON THE PROCESS, NOT THE GOAL.

Don't believe in Zen? Go to a good golf pro and ask him how to hit the ball further. What's the first thing he'll tell you after watching you labor through a swing about a fluid as brick? ***"STOP TRYING TO HIT THE BALL SO HARD."***

Want to make more money on your investments? ***"STOP TRYING SO HARD TO MAKE MONEY."*** There are very few things that we know will increase the odds of making money and reducing risk. Most of what investors do has little to do with what we know works, but they flounder about anyway wasting time, money and energy that

should be used on what we know works. Why? Because we just can't accept our limitations and be content with what we can do. It is better to find peace by accepting the market for what it is, not what we want it to be.

Early in my career I would start each morning by calling up my client's assets to see if they were up or down. I even had a program that calculated the percentage change and tracked it graphically. Long ago I recognized that it was a waste of time and energy to do this. Information (which was what these numbers were) is not knowledge.

Information is only useful if it leads to knowledge and knowledge is only useful if there is something productive you can do with it. The fact that my accounts go up and down with the market is not knowledge that leads me to a productive result for my clients.

A recent study by the American Investment Institute confirmed what every previous study of "active investors" has found. There is an inverse relationship between account activity and annual returns. Active traders had about half the gains and twice the losses of buy and hold investors and almost never beat the indexes on a long term basis. It might feel good to take profits, try to limit losses and move from one hot sector to the next, **but it is destructive to your financial health.**

Warren Buffet may be the ultimate Zen master. He may eat junk food and be totally incapable of getting into a lotus position, but here is guy whose wealth can go up and down by a billion dollars in a single trading session and he doesn't even have stock monitor in his office. He doesn't need the noise of stock trading interfering with the real task of making money. Here is a guy who understands the difference between keeping score and scoring points; between information and knowledge.

I've got a lot stock monitors in my office but I can't say they ever made me any money. They tell me when a stock goes down, but they can't tell me if it's a bargain. I can see what all my clients accounts are worth to the last penny every minute, but they can't tell me if they'll have enough money for comfortable retirement or what they'll be able to pass on to their kids.

I believe I provide a superior return for my clients and limit risk by concentrating on what I can control.

HAVE FAITH IN THE MARKET. As I said, markets aren't always right, just right enough to make betting against them wrong in the long term. Stocks have been the best performing asset class for over a century. Someday I may come to the conclusion that the world is too dangerous a place to be a capitalist, but until then, I'll assume stocks will continue to outperform all other investments.

DIVERSIFY WITHIN THE MARKET. If you believe in the market, you have a portfolio that represents the market. That means owning a portfolio diversified by market capitalizations and industries so it can follow the broad market. **Active trading doesn't reduce risk, diversification does.**

AVOID MANIAS. Just because the market is generally efficient doesn't mean that it isn't subject to going to extremes. I can't tell you when a bubble will burst, but I've got a pretty good chance at spotting the bubble. The hard part is avoiding them when the market is going straight up and everybody else is making money hand over fist. Part one of being a contrarian; avoid crowds, even ones that are having a party. Occasionally overall markets have manias, but there is almost always a portion of the stock or bond market experiencing hyperactivity. Some people try to play a hot trend and hope they can get out before the bubble busts. I prefer to avoid manias by getting out way too early.

BUY PANICS. Market extremes on the down side can be at least as extreme as manias. The market panic we have just gone through was as bad as anything anyone has ever seen. In retrospect, March of last year was tremendous buying opportunity for stocks and corporate bonds. It was a classic case of a market overreaction to bad news, but it was only clear in retrospect. The panic of October 2008 was just as bad, but the lows weren't reached until five months later. Buying panics is not a guarantee of instant success, it's just better than selling, and usually fantastically rewarding in the long run. There are mini-panics in individual sectors of the market and individual companies due to the same mob psychology that causes manias. In theory, as long as there are market participants whose investment strategy is to follow the market instead of making their own decisions, the market will overreact to good and bad news. That overreaction causes buying opportunities for contrarian investors.

True contrarians love panics, but they just don't happen enough to rest your investment strategy on just buying when the market is flat on its back. Most of the time we have to be content with markets that are neither outright panics nor manias, but the next best thing is when:

THE MARKET CLIMBS A WALL OF WORRY

If anything describes the market for the past year, it is this paradox. Investor sentiment has been terrible. Most of the money that went into mutual funds this year went into bond funds instead of stocks. The political situation looks like the Hatfields and McCoys. Federal, state and local governments are broke. Scandals have brought down some of our most respected leaders. The official unemployment is stuck near 10%, and the real rate may be twice that. ***IT'S A WALL OF WORRY!***

With that, the stock market is up 70% from its March lows. If that surprises you, you don't understand paradoxes. Sure things are bad, but the market thought a year ago that it would be worse. When I hear market pundits say that they are cautious because; "*This is going to be a slow recovery*" or "*There's no confidence out there,*" its music to my ears. Nothing is better for stocks than a slowly improving economy with plenty of skeptics. **Skeptics are sources of cash that fuel markets advances.**

According to the numbers, there are plenty of skeptics left. Last year stock funds saw 32 billion dollars in redemptions in the face of one of the strongest stock markets in our life times and 438 billion poured into bonds funds, despite some of the lowest yields we have ever seen and the near certainty of higher interest rates (lower bond prices) to come. The suicidal behavior of individual investors is truly the greatest conundrum of all. How many crashes do you have to be in before you stop driving looking at just the rear view mirror! True, the individual investor is encouraged to act irrationally by the talking heads and Wall Street “pros” who pass themselves off as analysts, but whose only real job is to sell product. They figured out a long time ago that it’s a lot easier to sell people what they want, instead of what they need; so when people are scared, they sell false safety, when people are greedy, they sell inflated dreams.

If you have followed this letter and the way we have managed accounts, you have seen that we have consistently had one message in good and bad markets. We have tried to temper the enthusiasm investors naturally have in the later stages of bull markets (avoid manias) and take full advantage of bear market recoveries (buy panics). Hopefully, we have set realistic expectations for our performance and given a full explanation of market risks.

If we have done that, we feel we have put our clients in an elite group of investors who approach the market armed with knowledge, instead of transitory information and herd instinct.

BILL MATTHES