April 9, 2009

Client
Address
City

Dear Client:

I started this year with some optimism towards all types of investments except government bonds. My research led me to believe the root for our economic problems — the severe decline in residential real-estate values — had nearly run its course. The measures of home prices compared with rents and median incomes, adjusted for mortgage rates, had reversed all of the recent excesses and were at reasonable levels established over the last 50 years.

The same held true for equity investments when total market value was compared to economic output and total cash and equivalents, again adjusted for interest rates. Also supportive of equity prices was the current versus historic valuations based on normalized earnings. In addition, three factors pointed to considerable thawing in the once-frozen corporate credit markets: the lowering of interest rates on investment-grade bonds, a narrowing of the interest-rate spread compared to government bonds, and $100 billion in new corporate bond issuances in the month of January.

However the February stock market plunge reminded me that asset pricing is a function of the following elements: government and market systems, investor confidence in these systems, the economic environment, the amount of available liquidity, the emotional state of investors, industry conditions, investment expectations, entity specifics and, lastly, asset type and detail. As such, with the change of administrations and the accompanying intense populist rhetoric, uncertainty expanded beyond the credit market crisis and plunging economic activity, leading investors to question the very basis of this country's capitalistic foundation. Hence, lower asset prices.

It's important to remember that our country, government and market systems have been tested in the past with a Great Depression, two world wars and many smaller conflicts, numerous market panics, severe inflation and deflation, the impeachment and resignation of presidents, recessions too numerous to count and a couple of oil embargos. If you believe this too shall pass, it is wise to hold onto your investments — or add to them, as the best prices are obtained during times like these. However, these uncertain times call for an increased level of stable investments so funds are available for spending needs while we wait for asset price recovery. This explains the higher cash levels in the accounts I manage. I will deploy this cash, hopefully at these or lower price levels, once I become more comfortable with the resolution of the issues of the highest level.

On another topic, the recent enormous increase in U.S. Government debt, spending and Federal Reserve liquidity injections has given rise to concerns about future rampant inflation. There are two relevant, though maybe extreme, comparisons in recent history, Germany after World War I and Japan since 1990. Germany owed an enormous amount to foreign creditors as a result of war reparations while facing incredible domestic demand for goods and services at a time when productive capacity was severely reduced. The German government printed money to pay off foreign interests. This increased the country's money supply very rapidly, leading to hyperinflation. Japan expanded its money supply by a large amount, taking interest rates to almost zero, to belatedly address a lack of domestic demand after an investment bubble burst in 1990. But after 19 years Japan is still battling deflation because the country lacks domestic demand for goods and services due to an aging, saving-oriented population that is actually shrinking in size.

The current U.S. situation has similarities to each period. We owe foreign investors large sums, but not nearly to the degree that Germany did when compared to our economic output. Globally, demand is weak

while there is plenty of excess productive capacity in terms of labor, plants and equipment. So I would not expect the hyperinflation that Germany experienced in the near term. While our domestic savings rate has taken quite a jump recently, I don't expect it to match Japan's in the near term for both cultural reasons and because our population is growing by a couple of percent a year. Therefore an extended period of deflation is unlikely as well.

As I write this letter the recent surge in government-provided liquidity to the economy has helped stabilize and support asset price increases. Given the current economic climate, here is what I consider to be the proper investment approach:

- Keep some funds liquid to provide for current cash needs and to take advantage of the higher interest rates expected in the future. Invest in corporate bonds of up the seven years in maturity to boost current income and avoid any government bond investments due in over two years.

- Maintain a position in real assets such as real estate and commodities, but not to an extreme extent.

- Invest in companies that have the ability to increase prices while keeping their costs in check.

- Increase investments overseas, without hedging the currency risk, to benefit from more robust growth and to profit from a declining dollar once the global economy begins to recover.

- If necessary, borrow funds only at a low, long-term fixed rate.

During this period when an increased amount of our country's capital is allocated at the government level, as opposed to at the private level, expect slower economic and standard-of-living growth. Also plan for tax increases as the economy stabilizes.

Again this quarter, the value I have added was measured by losing less of your hard-earned money than other managers might have, having cash available for your current needs, staying focused on managing a balanced, long-term investment portfolio and being available to address your concerns. I appreciate your continued confidence in my handling of your investment portfolio and please call if I may be of service. Attached please find your portfolio review for the just completed first quarter of 2009.

Best regards,

Peter V. Hedberg