October 1, 2009

Client
Address
City

Dear Client:

Last quarter I observed that markets were in a stalemate, with a lousy economic environment on one side and non-existent returns on safe investments and significant levels of liquidity on the other. This stalemate resolved itself to the upside in a major way for all markets, as zero percent returns on safe, short-term investments motivated investors to ignore economic concerns and buy with abandon, driving up asset prices.

While there was some stability, and even glimmers of hope, regarding the economy during the quarter, in my opinion, much of this was government manufactured or seasonal in nature, and hence somewhat artificial. Therefore I am cautious in regards to portfolio positioning. I stopped investing new funds in municipal and corporate bonds at the beginning of the quarter as I saw little remaining opportunity there. I have only been buying short-term U.S. Government bonds at this point as an alternative to money market funds, which provide literally no return.

I was less invested in the various stock markets than I would have liked given the magnitude of the advances seen worldwide, but I am having trouble getting over the economic risk factors. However, I am adding to equity investments as I find attractive opportunities. My concerns about the economy are as follows.

Housing prices turned upward in many markets from previous months during the summer. This was heralded as great news even though housing prices normally increase from one summer month to the next and are still down year over year by double digits. Home sales, and price stability, were assisted by a first time home buyer tax credit (which expires in November of 2009), fire sale prices due to distressed sellers and massive government intervention to keep mortgage rates low and mortgage loans available.

The U.S. government backed guarantees on 85% of new mortgages, up from the 30% range a few years ago, and purchased 80% of those mortgages (this program is scheduled to end by the 2nd quarter of 2010). Mortgage rates would easily be a full percentage point higher and not as available if not for government support, which would hinder the housing market.

While many thought that no money down mortgages were a thing of the past, the FHA (Federal Housing Authority) underwrote 24% of mortgage loans recently, up from 2% in 2006, and required less than a 5% down payment. Combined with the first time home buyer tax credit of 10% of the purchase price, up to $8,000, FHA has replaced sub-prime lenders in financing 100% of the purchase price of a home. While homes have declined in price enough to be fairly valued at this point, the expected seven million foreclosed home wave that has yet to hit could well drive prices lower over the next year. Clearly prices may not have stopped declining were it not for government involvement.

Retail sales to the consumer continue to be weak, even with the “Cash for Clunkers” program boosting activity, as a new found frugality grips the nation due to concerns for saving more, the fashion of thrift, involuntary unemployment or the lack of access to credit. As the consumer segment represent 70% of the economic activity of this country, it is hard to imagine a robust recovery until individuals save enough to repair their balance sheets or feel comfortable that they have an adequate cushion against economic uncertainty. The markets are behaving as if this will be a normal economic recovery, which I highly doubt.

Finally, the zero percent interest rate policy adopted by the Federal Reserve Board earlier this year has severely distorted asset prices, as was their intention. While this is fine as an emergency measure, the longer it lasts, the harder it becomes to feel comfortable with asset prices based on a normalized economic situation. As many of these Government supports are removed over the next months and years, we could well find that asset prices got ahead of economic reality.

Attached please find your portfolio report for the periods including the third quarter of 2009. And rejoice a little as we have had nice account appreciation in the quarter. I have also included a couple of articles in support of my concern for your review. Please feel free to call if you have questions or concerns that we need to address before I contact you.

Best regards,

Peter V. Hedberg