October 4, 2011

Name
Address
City

Dear Client,

Third quarter market performance was reminiscent of a childhood trip to Coney Island to ride the Cyclone. There were historic moves up and down in stock and bond prices. And like that old wooden rollercoaster, part of the anxiety of the experience was a result of wondering whether the European Monetary Union was going to fall apart. I would say disintegration of the Euro is not likely, but it is possible, and the ride is not over.

Let me start with the conclusion that my accounts were mostly well positioned to weather the turmoil, having exposure almost exclusively to U.S. Treasury securities and large capitalization, non-economically sensitive U.S. stocks. But I missed an enormous advance in the 30 year U.S. Treasury bond that resulted from a big decline in long-term interest rates, part of which was market based but much of which was Federal Reserve policy induced.

I have railed against bonds of all flavors for quite some time because the interest rates offered barely, if at all, covered the inflation rate, leaving no possibility for a real return on one's investment. Furthermore, locking in low, long-term rates would decimate the liquidation value of the bond in the event of an interest rate increase. College economic courses refer to U.S. Treasuries as providing a "risk-free return." I like James Grant's, writing in *Grant's Interest Observer*, description better, "return-free risk." Having re-examined my decisions regarding bonds, my opinion remains the same, with no regrets. There are just a lot of buyers in that market that have no concern for the economic outcomes of investments (envision the Federal Reserve and foreign governments like China and Japan).

All of my accounts, with most showing declines in value, performed better than all of the stock indices. In general, large stocks outperformed mid-caps, which beat small stocks, with international markets doing the worst. The biggest factor in the better relative results was my sale in the end of the second quarter and the beginning of the third quarter of a number of companies that I had little affection for. The impetus for that action was my growing concern about possible European bank defaults, which I addressed in my last quarterly letter. As I repositioned cash assets into U.S. Treasury securities and U.S. Treasury money market funds, I realized stocks had big downside risk if the fear of European bank defaults increased, which in fact did occur.

Going forward, there are two issues, not unrelated: the slowing, or possibly declining, global economic growth and concern over the future of the Euro and the European Monetary Union. Making matters worse is the perceived ineptitude of governing bodies in the U.S. and Europe and the lack of tools for policy makers to utilize to mitigate the downturn.

Looking at the Euro first, the current problems were anticipated when the Monetary Union was formed back in 1999. However, the vehicle to address these issues, promises by member countries not to exceed certain government spending deficit and debt levels in relation to the country's economic output, have not been honored. In the past when each country had its own currency, excessive spending and debt levels would lead to currency devaluation, an automatic adjustment process the Euro lacks. Unfortunately, the Euro lacks any adjustment process for the differing economic situations of its member countries, and so a solution will have to be created, but what?

That uncertainty is wrecking havoc amongst the less economically healthy of the European Community. Also negatively effected, as noted in my last quarterly letter, are the banks that hold debt previously issued by these countries. So to sum things up, the adoption of the Euro has been a success in lowering the costs of doing business within the trading bloc, has lowered the Government borrowing rates in most member countries, protected member countries from predatory currency devaluations and generally increased the standard of living in much of the region. But all that is imperiled unless a solution to the current imbalances can be found.

This drama with the Euro would be less significant if it weren't being played out during a global economic slowdown. The U.S. economy is slowing as the economic stimulus provided by government deficit spending and low interest rate levels dissipates, consumers continue to struggle with stagnant wages, declining asset values and high debt levels and businesses remain reluctant to invest in plant, equipment and new personnel. China's central bank is purposely slowing the economy there in order to mitigate the inflationary pressures created by prior economic policy. Japan continues in the slow to no growth pattern of the last two decades, and the European Community, which is a bit larger than the U.S. economy, is suffering from the issues mentioned above. Those countries not addressed above are smaller export driven economies that rely on trade with the large areas just listed, and so are bound to suffer.

Historically, one would expect the stock market to decline 15-20% over concern about a possible recession and drop another 10-15% if a recession in fact occurs. The wild card in this case is Europe, as severe banking problems could lead to a credit crisis like the one that hit U.S. markets for 50% from late 2007 through early 2009. I have mostly sold what I plan to sell as far as stocks go and am looking to add quality companies at inexpensive prices if the opportunities develop.

A final note, I have been out of the office more often recently for a variety of reasons and I expect that to be the case, or more so, going forward. These are mostly not vacation days, of which I take very few, but are times I am working at another location or meeting with clients. Years ago I set up redundant computer systems to protect against data loss, system failures and other operating risks. As such I have an office setup, one at home and a laptop that I take with me on the road so I can work anywhere. You can always drop me an email or call the number I leave on my office phone message if you want or need to reach me sooner than my expected time of return. Please keep in mind that due to spotty reception my cell phone is worthless in Westcliffe and messages left there may not be received for a long time. Enclosed please find your most recent quarterly performance report. Please contact me if you have questions, comments, concerns or just want to talk.

Best regards,

Peter V. Hedberg