CAUBLE & HARRE WEALTH MANAGEMENT

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It has been an interesting year in the markets, and I do not think the interesting events are over. I would describe us as still in the aftermath of the major market dislocations that occurred in 2008. I wanted to spend this letter commenting briefly on a number of issues, but I want to preface my comments by making a couple of observations.

While it always feels different as you are experiencing events in real time, the markets have found their way through turbulent and difficult times before in our history. Second, recognize that as we attempt to navigate our way through this period, the management teams of companies we invest in are also working to do the same. When we choose to invest in a company, we are not evaluating the price based on the assets of that company today but also the ability of management to work through the challenges of the current economy in order to continue generating earning per share growth and dividends to shareholders.

The equity markets are close to fair value at current levels. The market price depends on both the earnings of the market (or company) and the multiple of earnings that people are willing to pay. For example, if a company earned $2 per share and sold for $30 per share, the multiple would be 15 times. There are two ways the market can go up. The earnings of a company can rise and the multiple participants are willing to pay can rise. Earnings multiples are not constant. Sometimes they are higher than average, and sometimes they are lower than average. If we want to guess at the future price of a company or market, we can guess at the change in earnings and/or the change in the multiple (if any).

Changes in earnings are easier to get a handle on. They depend on top line or revenue growth, and how much of this revenue falls to the bottom line (earnings). Top line growth seems hard to come by lately, but some industries are stabilizing. Not every dollar of revenue finds its way to earnings. Overhead, such as costs of manufacturing or salaries comes out of revenue. One aspect of a market recovery is that it is typical to underestimate the positive impact of corporate restructuring on earnings. In other words, when companies reduce their overhead, more of their revenue can reach the earnings, and the market can be surprised at the level of earnings actually achieved. This happened in the second quarter and I would guess that it would continue during the third quarter.

The dramatic market moves occur during times when both the earnings and the multiple are increasing or decreasing. Consider the above company that earned $2 dollars. What if the company earned $2.25 the next period? At a 15x multiple the stock would rise from $30 to $33.75 or 12.5%. But if the multiple of the stock increased to 17x and the company earned $2.25, the price would increase to $38.25 or 27.5%. Conversely, if the earnings expectations fell to $1.75 and the multiple fell to 13x, the price would fall to $22.75 or a loss of 24%. Note in this example we changed earnings by 12.5% but the price action ranged from minus 24% to positive

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27.5% based on changes in the multiple. Remember the rise in internet stocks during the late 1990's when earnings were increasing and multiples were ballooning?

It is also possible for the change in earnings and the change in multiple to go in different directions. During 2002, earnings were beginning to increase, but the market could not seem to rise because the market multiple was continuing to fall from it's much higher than normal 2000 perch. Earnings continued to rise and eventually the multiple stabilized and even rose a bit. As a result, we experienced a nice market rise through 2007.

Now let's use this framework to describe 2008 and 2009. In 2008 some major things started to break. Without regurgitating all the details again, one result is that no one had confidence in earnings expectations. While there were numbers written on paper somewhere, investors really did not know what to expect, if anything, in terms of earnings. The fear was that earnings would collapse, and this brought down the multiple as well. I believe that the recovery we have seen since March of 2009 reflects a bit more confidence in the worse case for earnings levels. As confidence grew that earnings would not be zero, the market was willing to put on a more reasonable multiple on those earnings. Note that one reason investors became a bit more confident in the earnings expectations was the information conveyed during the first and second quarter earnings releases. As I stated earlier in this letter, companies were able to show how they had been navigating this market in a reasonable fashion.

Where do we go from here? Through the third quarter of this year, earnings do not concern me, in fact I think earnings expectations might have to rise for the full year. This should be a positive. I do have questions on the market multiple. I would guess that earnings expectations will increase a bit causing the market multiple to drop a bit. I do not think that the multiple can rise much due to factors increasing the concern of investors. Future gains in the market will likely be dependent on earnings growth which in general will be slow after this initial period of positive surprises based on restructuring.

What are the factors keeping investors (read me) nervous? The government would be one. Specifically, tax policy, spending and financing the growing deficit. How do we convince foreign investors to continue purchasing our debt, and do we have to increase interest rates at some point in order to accomplish this. Increasing taxes reduces the after tax return on investments and also reduces economic activity. I still have lingering concerns over the government's involvement in our economy and unilaterally changing the rules of the game. If investors have questions over the government's willingness to abide by property rights and the rule of law, they will lower the market multiple to reflect this higher risk.

Just this week Ken Lewis announced his resignation from Bank of America. He is tired of all the flack (from the government) stemming from the Merrill Lynch acquisition. I suppose when the United States Treasury Secretary and Federal Reserve Chairman tell you to do something in very

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strong terms (i.e. buy Merrill Lynch), you should recognize that they will not back you up after the fact, and tell them to take a hike. Not very inspiring.

High unemployment, a weaker dollar, continued stress in the credit system, the impact of declining stimulus spending; these also are reasons to be concerned. I do think that we are currently in a better position than 9 months ago, so it is not all doom and gloom. We continue to look for opportunities while trying to pay attention to what could go wrong.

Please call with any questions you might have about your portfolios.

Regards,

Peter. B. Harre, CFA

Enclosure