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The following letter is a bit long, but it gives you an idea of what I am thinking and paying attention to as we begin a new year.

The passage of time can be interesting and surprising. If one opened the financial pages on January 1st of last year and again only on December 31st, they would have concluded that 2009 was a good year in the markets. One who paid attention each day during the year might draw the same conclusion, but would have a bit more gray hair while doing so.

The passage of time brings changes. Sometimes more than we remember. Christopher Caldwell in a recent Financial Times editorial notes that the Beatles' release of 'Love Me Do' is now closer to the First World War than it is to us. Also, the birth of Ronald Reagan is closer to Napoleon's Waterloo than it is to us. How did that much time pass without us noticing?

What about the decade just finished? Of the top 25 public companies in 1999, only 8 remain on this list as of 2009. Of these, only ExxonMobil and Proctor & Gamble have greater market value than they did 10 years ago. The total market cap (the market value or number of shares times the price per share) of the top 25 group shrank 20% in the decade. China went from having zero companies in the top 25 to having 4. These tidbits are from the Wall Street Journal.

The Wall Street Journal also reported on December 21, 2009 that the change in personal income during the decade was 5%. The decades prior produced increases of 18%, 23%, 17%, 36% and 28%. What about change in Net Worth? Down 13% versus increases in decades prior of 44%, 35%, 12%, 25%, and 26%. Employment increased 0.5% versus decades prior results of 20%, 20%, 27%, 31% and 24%. The 2000's were quite different.

Stocks had their worst decade ever. It seems that the decade of the 2000's was a lost decade. Some are asking whether we might suffer the same fate as Japan and suffer two lost decades. I don't think this is the case, but there are some similarities that one should understand. In 1989, I was in graduate school at Washington University. In one of my international classes, we were writing papers and presenting these to our fellow students. A group of Japanese students' paper strived to defend the valuation of the Japanese stock market at that time. In December of that year, the Nikkei 225 average reached a peak of 38,915.87 (versus about 10,600 today). Two decades later the market is 72% below the peak. We are about 10% below the peak in 2000 and 26% below the peak in 2007.

The argument made by the Japanese students in our class was that many Japanese companies held real estate on their books. If the value of this real estate was taken into consideration, the market prices of the stocks seemed reasonable. The real estate market in Japan at the time was in a bubble. In St. Louis right now, you can buy a good house for between $160 and $200 per square foot. At the peak of the real estate bubble, you could by a condo on the Florida beach for $700 per square foot. In 1989, some choice real estate in Tokyo's Ginza district was selling for $93,000 per square foot. It was these prices that were being used to defend the equity prices (Ginza real estate is about $9,000 per square foot now).

Our real estate market does not need to make this magnitude of an adjustment. Furthermore, the value of our stock market was not dependent on the value of the underlying real estate (you can find specific companies where this might be true, but not for the market as a whole). The market did need to recover from the ridiculous prices during the internet bubble and it has. While the Dow Jones index is 10% below the 1999 peak, some technology stocks are much further below their peaks. Intel and Cisco are down about 70% from their peak. Microsoft is down about 50% from its peak. The adjustment has been made.

How are we similar to the situation in Japan? Author Richard Koo wrote a book about it that I read earlier this year. He is the current Chief Economist at Nomura Research Institute. He defines the events in Japan as a 'Balance Sheet Recession'. I believe I have mentioned his work before. He states that when consumers and companies delever (reduce debt), government must borrow and spend to keep the economy from collapsing into a recession. Our consumers and companies have been reducing leverage and our government has been spending money. So far so good. The idea is that the government can reduce its borrowing and repair its balance sheet when consumers and businesses begin spending again.

While I have supported the increase in government spending, I do have some concerns. I believe that when the government spends money, it does so less efficiently that the private sector. The results therefore will be less than they could have been otherwise. The reason for this is that the allocation system for deciding what projects get funding is influenced by relationships and other forms of payola rather then economic returns. Perhaps this is better than no spending, but it needs to be a temporary event. If the government spends more by instituting more programs that cannot be ended, the result will be a lower standard of living than if the private sector invested these funds.

The concerns I have with the dollar and our debt is not the current borrowing, but whether the global markets and investors believe that we have a commitment to reduce these borrowings in the future. If they begin to believe that current spending is permanent, they will refuse to buy our bonds at current prices and will demand higher yields.

Furthermore, if the Government continues to spend at these levels when the consumer and businesses begin borrowing again, there will be competition for investors (lenders) and interest rates will be pushed up.

Another concern I have is how this country responds to the current crisis legislatively or on the regulatory front. In my opinion, the government never took responsibility for its direct role in making the financial crisis as bad as it was. Specifically for pressuring banks to make loans to people who could not afford them, and then sheltering Fannie Mae and Freddie Mac from pressure to reform requiring them to shrink their balance sheets. This prudent financial action was against their social goals.

With the statistics I mentioned before: 5% change in personal income over a decade, 0.5% change in employment, 13% decline in net worth, there is a fair amount of frustration out there. Politicians can stoke this frustration to accomplish their own political aspirations and end up making changes that will damage the country's future.

I believe that the above statistics reflect an adjustment from the tech bubble and the impact of globalization. We cannot stop globalization. Without capitalism, we would likely be worse off today than we are. In the October 19, 2009 issue of Forbes, Steve Forbes provided a good description of capitalism.

"This is how wealth is produced in society: Countless individuals seek to meet their own needs by meeting the needs and wants of others. That's indeed the moral basis of capitalism. It is the antithesis of greed. Forming networks of cooperation, individuals create businesses that produce innovations – not just pencils but inventions ranging from laptops to washing machines. In the process of providing for themselves, people generate the capital and innovations that yield economic growth, improving living standards and enabling society to advance."

Government does have a role to tax and spend on projects and services for the common good. It is important to remember however that Government cannot take and redistribute something that someone else didn't first make. Government needs to be cautious about how its actions impact the creation of wealth, and the machine that creates jobs.

In a Wall Street Journal editorial on November 6, 2009 by Carl Schramm, Robert Litan and Dane Strangler, they state that according to the Census Bureau, nearly all net job creation in the U.S. since 1980 occurred in firms less then five years old. They also cite a Kauffman Foundation report that shows that as recently as 2007, two-thirds of the jobs created were in such firms.

The government has a role to support an environment that is conducive to the creation and growth of these. Education also plays a role. Jobs and industries will change, and will require workers that want to thrive to change also. They need the skills and knowledge to do this. The commitment we make to our educational system and our attitude toward education is critical to this. Michael Milken in a Financial Times editorial on October 5, 2009 describes an interesting item.

'The return on investment in education is apparent in a comparison of Singapore and Jamaica, former British colonies that once shared many similarities. In the early 1960's, each had a population of 1.6 million and almost exactly the same gross domestic product per capita – about $2,200 current U.S. dollars. Then they diverged. Jamaica stuck to agriculture, mining and tourism while Singapore focused on educating its people, who expanded manufacturing capacity and developed advanced technology. Today, Singapore's GDP per capita is nearly $39,000 – more than seven times that of Jamaica.

Property rights, the rule of law and corruption also plays a role. For better or worse, we are in a global economy, and we cannot escape the effects of poor decisions. Change has always been inevitable. In the past, though, it seems to have occurred at a slower pace. One generation might have stayed on the farm their entire lives. Then the next generation migrated to cities and manufacturing. The next couple of generations might have stayed here, and then one generation decided to go to college. Over time, there was what we call creative destruction, but it occurred over generations, each generation was not called to make great changes during their own lifetimes and the standard of living continued to rise.

In today's world, there is not time to wait for the next generation. Change is occurring too fast. Those that do not continue to adapt and better themselves during their lifetimes will find that they continually fall behind. Personal income rose just 5% during the 2000's (adjusted for inflation). People have been working hard, and I would say that we have managed to survive the initial stages of significant globalization. So far it has been a source of negative wage pressure as high quality work can be done overseas (whether manufacturing or services). The payoff is that going forward, as the standard of living increases around the globe, globalization can represent new markets to sell into for those who are prepared.

I do believe that the markets can sustain the current equity valuations. Companies are doing their part to make themselves more efficient. The better positioned companies have opportunities to sell around the world. While the market indices have appreciated greatly from the March 2009 lows, they are still below the 2007 market peaks. This is appropriate since our economy is below this peak also. I do believe that earnings will continue to rise making current valuations sustainable.

I also believe that interest rates will rise this year, and that certain fixed income securities will struggle against this tide. Investors should pay attention to maturities and interest rate risk. The dollar will likely weaken a bit this year, thought I do not look for a collapse.

Normally, I would be more bullish coming out of a recession when I know that companies have increased their operating leverage. There are a few things that temper my enthusiasm and keep me closer to a market weighting for equities.

Government regulation and activity will be very important to determining where we end up. Spending is important, but so is an acknowledgement and actions supporting eventual cuts in spending. Securitization markets need to open up again. Securitization is when lenders package the loans they make and sell them to investors. This allows the lenders to make additional loans. If they cannot sell of the packages of loans and have to keep them on their balance sheet, fewer loans will be made and economic growth will be slower. Right now the Government is the primary purchaser of mortgage loans. Much good has been accomplished by homeowners who have refinanced at these low rates. Unless additional purchasers of mortgage loans come to the market, mortgage rates will have to rise and fewer loans will be made. The same goes for credit cards and auto loans. There are additional laws that are coming into effect for credit card companies that make them less profitable for issuers. This will act to reduce the amount of credit available. Credit card issuers also need to be able to sell off their loans to other investors.

We know that the amount of credit issued going forward has to decline, because we know that many people received credit in years past that were undeserving and could not pay. My concern is that these mechanisms and regulatory changes restrict the issuance of credit beyond what is required. I will be paying attention to this as it impacts growth.

The decline in commercial real estate could grab some headlines this year. Valuations have been falling and many loans that were made from 2005 on cannot be supported by current property prices. As these loans come due, losses will have to be recognized. I do not think this will be a repeat of the subprime crises for several reasons. First, the Fed has been orchestrating a massive transfer of wealth from savers to banks. The low short term interest rates targeted by the Federal Reserve have allowed banks to make large profits. These profits help them rebuild their capital base to make up for previous losses and to help absorb future losses. Also, the aggregate amount of securities made to commercial real estate is less than the aggregate amount of loans based on subprime residential real estate. Finally, the majority of lenders in this sector of the market have not funded themselves with short term commercial paper type money. There were a lot of investors of subprime mortgage securities that were investing with borrowed funds. These borrowed funds came due all at the same time and the investors could not sell their assets to pay off the loans (nobody wanted the assets).

We continue to monitor these events and the investment portfolios, looking for risks and opportunities. While there is a performance figure in the enclosed reports, I hope to have a more detailed discussion out by the end of January.

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

Regards,

Peter. B. Harre, CFA

Enclosure