NAVIGATING THE RECOVERY

The stock market could not ignore the massive amounts of stimulus thrown at it by the world's governments and central banks in the second quarter with the S&P 500 advancing by 15.9%. Risky assets did even better with small caps up 20.7%, the NASDAQ higher by 20% and emerging markets rising by 29.9%. We are very pleased with our results for the quarter. Our portfolios were aggressively structured at the beginning of the quarter to take advantage of the panic lows. Since that time we have significantly reduced our risk by selling stocks and buying high-quality corporate credit to reflect our near term concerns after a huge trough to peak move in the broad stock market.

The stellar performance of the stock market is a reflection that we've sidestepped a collapse of the financial system. The past few months have seen impressive progress on the credit front. Plus, there is a lot of cash in the system: private-sector cash holdings recently reached 70% of U.S. gross domestic product, a postwar high, according to Wells Capital Management. Improving conditions even allowed the major financial institutions to raise more than $85 billion in capital, including over $65 billion in equity offerings, which is very positive.

However, although government support might be enough to stave off collapse, it does not guarantee the economic rebound will be vigorous. A weak recovery is almost guaranteed due to the interconnected forces of deleveraging, high and rising unemployment, and a still fragile housing market. As of March 2009, households owed roughly 127% of disposable income. With the era of easy credit over, household debt could fall closer to a 100% of disposable income sapping at least $3 trillion in household borrowing from the economy. Unemployment is heading to double-digit levels, the highest in a generation. In addition, aggregate private wages and salaries have now fallen for six months in a row, an unknown occurrence in the 50 years the data have been measured. And with unemployment comes more foreclosures and lower property prices. The latest US mortgage delinquency figures are horrendous, with about 12% of all mortgages delinquent or in foreclosure, including more than 6% of prime mortgages in arrears, which is more than double the long-term norm. The bottom line is that robust consumer demand will only return once the balance sheets of over-indebted households are repaired or when countries with high savings rates consume or invest more. Given the extraordinary debt accumulations of the past decade these adjustments will likely take years.

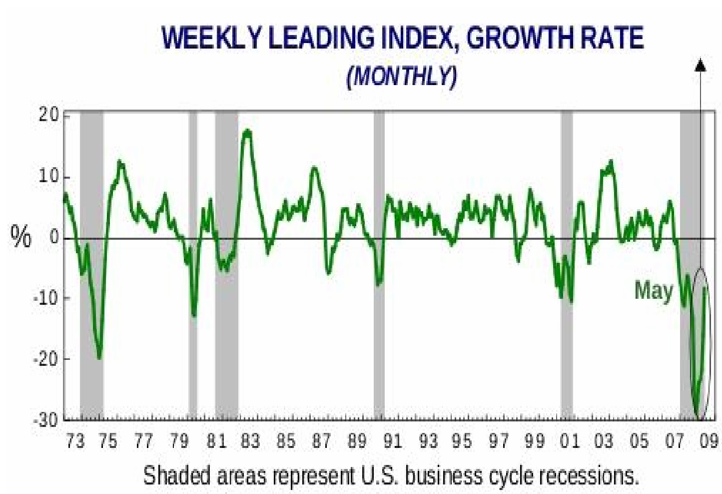
Investors will also have to grapple with deteriorating fiscal conditions of the public sector. The International Monetary Fund predicts that the public debt of the ten leading rich countries will rise from 78% of GDP in 2007 to 114% by 2014. Worse, today's borrowing binge is taking place just before the pension and healthcare costs of a graying population start to escalate. By 2050 a third of the rich world's population will be over 60. The demographic bill is likely to be ten times bigger than the fiscal cost of the financial crisis. In the U.S., state and local governments are in a world of hurt. States face aggregate budget shortfalls of at least $230 billion from fiscal 2009 through fiscal 2011. The bulk of funds from the federal government's stimulus package will be allocated by 2011, but tax collections aren't likely to be enough to take their place even if the economy is recovering.

We have emphasized our theme of "navigation" since before the financial crisis, as a strategy to achieve the highest risk-adjusted returns and are more committed to this approach than ever. With all the obstacles reviewed above we strongly believe a reduction in risk is justified after a 35% rally, even if the markets move higher from these levels. This is especially true since we can park the money in high-quality corporate debt that pays a nice yield. In the summer of 1999, we argued that the NASDAQ was wildly overvalued and had a similar conservative approach. While we were ultimately proven right (ten years later the index is about 25% lower), the NASDAQ doubled over the next six months. This experience speaks to the importance of having a long-term strategy and sticking with it when it goes against you in the short-term.

On the buy side we continue to favor stocks with strong balance sheets, secure dividends, minimal exposure to the U.S. consumer, and growth opportunities in the large emerging economies. If we do encounter some near-term turbulence we expect stocks with these characteristics to hold up well. Overall, investors have gotten more complacent recently driving volatility down. We suspect that will change sometime before the end of the year and plan to use it to our advantage.

Thank you for your confidence in us and trusting our firm with your and your clients investments.

THE ECONOMY STILL LAGS THE MARKETS' RECOVERY



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