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Greetings,

Enclosed is your investment report through June 30, 2010. Your return is ____. The return of the S&P 500 is -7.6%. This past quarter has been the first down quarter for the market since the bull market began a year ago last March. It was the worst second quarter for the S&P 500 since the second quarter of 2002 which was not long after 9/11. It was also the worst two weeks prior to July 4th in just over 100 years. The financial markets were bad for the last month and a half. Over the last week and a half, it went from bad to brutal. As brutal as things are now, we have seen much worse, as recently as a year ago last winter. I do think the worst is over and the market will stabilize soon.

As stated in the recent issue of Barron's by Michael Santoli (a columnist that I like to read), the stock market right now is trading as one real-time gauge of economic anxiety. Ultimately, corporate earnings move stock prices. That is in the long run. At this point in time, the term "long run" is not the focus of the majority of people in the market. The majority of people are focused on hour by hour data checks of economic activity. Whether it is the latest employment report, housing starts, consumer confidence, inflation or manufacturing activity, that is where the focus is. Any kind of focus of company fundamentals (which is the most important thing that I focus on) at this point in time is a thing of the past. Company valuations are cheap by almost any measure. Just try bringing up the term valuation to someone you know who is in the stock market and see what the reaction is.

Other than attempting to time the market (usually an exercise in futility), I am doing what I can to maximize our returns. I did take some money off the table in the spring and held some cash. I did put it back to work a little too early. Several weeks ago, it appeared that things had calmed down. Things had calmed down but not for long. Today, we are at a point of extreme pessimism. Expectations are really down for both the economy and the stock market. Historically, when people are this down on the market, most of the people who want to sell have already sold so there are few sellers left. I don't see a lot of people selling with the market at these levels but there isn't much buying interest. I do think that things will turn around soon, most likely when corporate earnings start to be released. When things do turn around, we are well positioned to do well, just like we did last year.

The stock market absolutely detests uncertainty. What we have now is uncertainty on a myriad of things. Just a sample of what the market is uncertain about are; the domestic economy, the European economy, the political situation, the Gulf Oil spill and the fragile investor psychology.

There appears to be a tug of war now between the pessimists and the extreme pessimists as to the direction of the domestic economy. First quarter GDP was just revised down to a growth rate of 2.7%. The consensus for the second quarter is supposed to be in the 3% range

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although many economists are beginning to see growth in the 2.5% range. I am in that camp. The economy is not in a recession. Many people don't realize this for one reason or another. The financial markets are forward looking. I understand that. The extreme pessimists are now forecasting the possibility of anywhere between a 35-50% chance of a double dip recession. While I would not rule that possibility out entirely, my view is that it is closer to a 5-10% chance. While a 10% chance of another recession in the near future is higher than zero, I would say that the chances are slim.

The problem (among other things) is that historically, when the economy comes out of a recession, the economy has robust growth. This time around, the growth is tepid, at best. I saw Alan Greenspan this morning on CNBC. He is a man that I respect. Mr. Greenspan called what is happening in this economy a normal pause in an economic recovery. The labor market continues to be a disaster. New jobs are being created but barely enough to keep up with the new people who are coming into the work force. That is why the unemployment rate is just under 10%. What the financial media (both print and over the air) refuses to point out is that the people who have jobs are not in bad shape. The reason that they aren't in bad shape is because interest rates are so low and inflation is practically non existent. If either a consumer or a business needs to borrow money, the borrowing cost is cheap since the prime rate is 3.25%. With inflation at 2%, real wages for the first time in years are rising so the consumer has more purchasing power.

A co-worker of my wife's (people she knows have been providing me with some interesting things to write about lately) recently asked her to ask me "when is the economy going to get better". That is one heck of a question! The answer is that the economy has gotten better. Other than the unemployment rate, the economy by just about every measure is better than it was last year and two years ago. Without speaking to her, my belief is that what she meant was when will the economy be as good as it was before the recession, say 3 or 4 years ago? I think that I am less negative in respect to the economy and the stock market than most people are now. Given that, it will take a long time for the economy to get back to where it was before the recession. Forecasting a time period is a challenge. With all the uncertainties around now and the foreseeable future, I would be pleasantly surprised if people felt good about the economy again within the next two years, possibly longer. You see, most people didn't realize back then but are beginning to understand now, that the economy back then really wasn't as good as it appeared to be on the surface. Similar to when we had a technology bubble brewing in the late 1990's (also during a supposedly strong economy), we had a housing bubble 4-6 years ago. Consumer spending makes up nearly 70% of Gross Domestic Product. Consumers back then were living beyond their means, spending more than they had and accumulating massive amounts of debt. Many people were using their home equity as an ATM machine. Now, with home values down anywhere between 20-40% (depending

on which part of the country you live), a significant amount of home owners owe more than the value of what their homes are worth. This is frequently termed as being underwater.
We are now in a period of deleveraging. Both consumers and businesses are paying down debt. IMO, this is a good thing. After years of having a negative savings rate, consumers over the past year are finally saving money. While this is a good thing in the long run, in the short run it will keep a cap on consumer spending which will then result in a slow growth economy.

What is lost in all of this noise is that historically, the stock market has done well in a slow growth economy (some people call this a goldilocks, not too hot, not too cold) with low interest rates and low inflation. If the economy were to grow significantly faster than it is now, I can assure you that interest rates (both long and short term) would be going up quickly as a result of inflation fears. I remember not that long ago, there was some concern about impending inflation later on in this year and for next year. Those fears have dissipated. Any fear of inflation would have an adverse affect on the stock market. Yes, it would be ideal for the stock market for the GDP to be growing in the 3-3.5% range with lower unemployment, say in the 5-6% range. Over the last 30 years, we have rarely had this scenario. Also over the last 30 years, the stock market has had more years in which it was up than it was down so the market has done well in less than ideal scenarios.

I recently listened to Abby Joseph Cohen, the lead strategist of Goldman Sachs on CNBC. I have listened to her many times over the last 15 years and she is frequently the voice of reason. While she is not expecting much improvement in the economy over the next 6-9 months, she does expect a significant improvement in the stock market over that time period. She stated that the market has overreacted to the recent bad macroeconomic news and that all the bad news in the economy is already factored in. I couldn't agree with her more. She also touched on valuation and how cheap stocks are now. I will expand on that. Historically, the price to earnings multiple of the S&P 500 is 18. Currently the S&P 500 is trading at a forward multiple of 12. This means that the market is trading at a 33% discount to its historical valuation. With the stock market's valuation so low and with so much liquidity (cash) out there, it won't take much to move the market higher. I am confident that once things do get moving upward, it will move quickly since the institutional investors will be fearful about underperforming against the indices and missing out on the rally.

The domestic economy is not the only uncertainty as far as the market is concerned. The European economy is a concern and was the catalyst in sending the market down last month. The main reason why Europe is such a concern is that those countries purchase many of our exports. If exports decrease to Europe, then corporate earnings going forward will be disappointing.

A big concern to me and others is the political situation in this country. This along with the Gulf Oil spill has had a big negative effect on consumer confidence and subsequently, stock market psychology. When you see and hear each day on the news about the worst oil spill ever and that it won't be contained for at least a month, possibly two months, it is going to put people in a sour mood and rightfully so. The Congress currently has (depending on which poll you read) anywhere between a 15-17% approval rating. When you have less than one out of five people in this country approve of the job that our elected officials (who make our laws) are doing, it is not a good thing. In addition, the President has a 45% approval rating and it is most likely going lower. The problem as it affects the stock market is the administrations hostile attitude towards business. I don't think that anyone expected an administration that would be friendly to business. I did not expect hostility. I was mistaken in that respect. Whether you like Corporate America or not, small businesses create 70% of jobs. That is a fact, not my opinion. The administration does do a good job of talking about helping small business but its policies don't reflect its words. Today, corporate balance sheets could not be any better. Large corporations are sitting with $ 1 trillion in cash. Normally, these companies would be pumping the cash back into the economy with either capital expenditures, increasing dividends or stock buy backs. All of these are positives for the stock market. The problem is that when you have an administration that is hostile to business the people who create jobs simply don't feel confident enough to expand their business and spend the cash, which of course would lead to job creation. The thing about political uncertainty is that it could be a temporary problem. On the recent front page story in Barron's, they wrote how they expect the Democrats to lose many seats in both the House and the Senate. I believe that the probability of gridlock in Washington will be a positive for the stock market in the second half of the year.

After what the financial companies did to wreck the economy and the stock market, I am not a fan of the financial services industry, at least as far as public companies are concerned. There is a huge (2100 pages or so) financial services bill that is close to being passed. I am relieved that this regulation isn't worse than it is. There are some good things in it. Feel free to email me or call me if you are interested in some of the details. My biggest complaint with this new regulation is what is not included. It does nothing to address the problems with Fannie Mae and Freddie Mac. There is also very little if anything to prevent another financial collapse and future bail outs.

Our mutual funds certainly could be doing better. The market is doing poorly. When things pick up, I expect that our funds will also improve their performance. As a result of what is going on in Europe, our International and Global funds hurt us. I did sell some of our position in our International and Global funds a couple of months ago.

Longleaf Partners has been far and away our best performer, with a return or -1.6%. This fund has a concentrated portfolio. They do this to focus on their best ideas. Longleaf Partners purchases companies based on their appraisals of what the company is worth based on a discounted value of its free cash flow.

Its appraisals are done conservatively incorporating a poor macro economic environment. Once the appraisal is arrived at, they will not pay more than 60% of this number so there is a large margin for safety. Unlike most mutual funds, this fund is not afraid to hold a substantial cash position if they can't find 20 stocks that meet their strict criteria. The fund held a 15% cash position going into the second quarter of this year. DirecTV and Disney are two of the funds largest positions and both companies are doing very well.

The Janus International Forty fund has been a disappointment with a return of -9.4%. I met the fund manager in NYC in early December. I was surprised to find out that the manager who I recently met left the fund last month. I was considering selling some of our position from the fund anyway in addition to what I sold a couple of weeks before he left. I was told in person by my Janus rep. that the new manager also runs the Janus Overseas fund. That fund has an outstanding (it is in the top 3% of its category for the last 5 and 10 years) long term record so we are staying put for now.

Please call or email me if you have any questions or if there is anything that you want to discuss. This is a very trying time now. I greatly appreciate both your confidence and patience during this difficult time.