Excerpt from Year-end 2010 letter to clients

To decide whether to invest in the stock market you need to make a guess of what the earnings of the companies are going to be, what you are willing to pay for those earnings and compare those returns to what your alternatives are. In March of 2009, our guess of future earnings for the stock market divided by the price that the stocks were trading at in March was just too cheap to stay there for long and prices have gone up. Today we think that there is still value in stocks and here is how we come up with that conclusion. It is estimated by a consensus of Wall Street gurus that the S+P 500 will earn around $90 a share this year which would be a new record for that index. If you take that $90 figure and divide it by today's price of the S+P 500 which is 1257 that gives you an earnings yield of 7.1%. You can then compare that yield to other alternative investments to see if you want to bet on stocks as a group. Ten year treasury bonds are yielding 3.4%, is that a better place to be than stocks? We don't think so. Junk bonds are trading at around a 7.5% yield which is not bad compared to the 7.1% stocks might yield but we don't get any growth from junk bonds if inflation comes back. Junk bonds trade a lot like stocks as well, so if the economy goes down so will they. Triple BBB rated corporate bonds are trading at 6% which isn't bad but that is below its historical yield of plus 7 percent. The only asset class that is trading below its historical average is stocks so we continue to favor them. The next question we get is how solid is that $90 Wall Street earnings estimate? In other words, if we go into a double dip recession isn't that number bogus? The answer would be yes, so we also monitor the health of the economy to help us with our stock market call. Right now our monetary indicators are all green and getting better, not worse. We think the odds of a

recession hitting in the next 12 months right now are pretty low. So to sum it up, the stock market is cheap because the public keeps selling stocks and buying bonds which tells us we need to buy stocks and sell bonds until the public gets happy again. We think the public will stick its collective toes back in the water again in 2011 but it will be awhile before they stick their whole leg in much less take a swim.