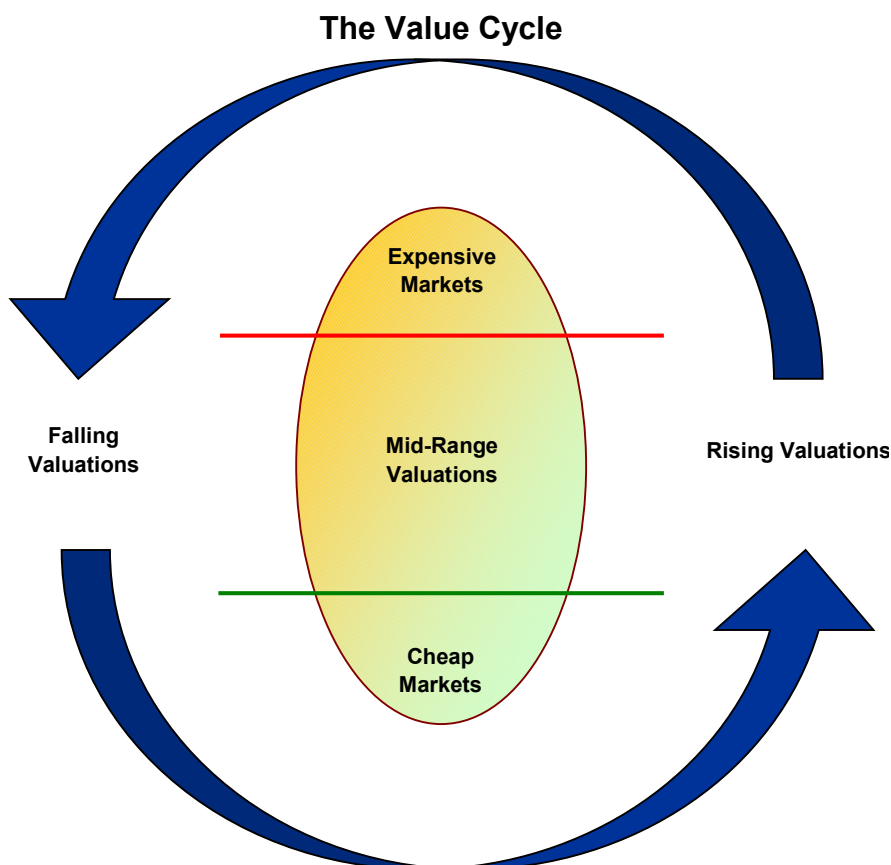


Client Letter, July 2009

A large part of our mission is not only to deliver excellent results to our clients, but also to take away some of the mystery and misinformation about investing.

Recently, a client asked us what we thought about the idea that the market can't be beaten, so that the best approach is to own "a little of everything" through an index mutual fund. This concept stems from the belief that stocks are unpredictable and because index fund investors do beat the vast majority of their non-indexed counterparts. Well, having carefully considered the evidence for and against indexing for years now, we find overwhelming support for the non-indexing method. As we will show, the stock market actually *is* predictable over meaningful timeframes and the *same* approach for making those predictions can also be used to surpass index funds. This letter will address how to predict expected returns for the stock market while our next quarterly letter will explore and dispel the notion that index fund are the best way to go.

We begin by introducing a concept we call the Value Cycle, derived from the Graham Price-to-Earnings (Graham P/E) analysis we have previously discussed, demonstrating how the stock market goes through extended periods of valuation expansion and contraction. The Value Cycle graphic shows the cyclical nature of the market. Remember not to confuse *value* with *valuation*. Value is a reasonable estimate of what something is worth based on an asset sale or on future expected earnings; valuation is the price-multiple investors are willing to pay for that value.



The numbers behind the Value Cycle provide a powerful way to project how good or bad returns will be in future time periods from one's starting point (figures are adjusted for inflation; market valuation and index pricing data is from Yale University's Robert Shiller: <http://www.econ.yale.edu/~shiller/data.htm>). Two factors stand out as predictive variables: 1) whether we are in a bear market (contracting valuations, depicted in gold) or bull market (expanding valuations, in green) and 2) the initial valuation. Our present position is highlighted yellow. The good news for today's index investors is that returns are expected to be positive. The bad news is that those returns may provide little comfort relative to the emotional distress imparted by the volatility often seen during bear markets.

| Bear Markets / Falling Valuations ::: Expected TOTAL Returns | | | |
|--|------------------------------------|-------------------------------------|-------------------------------------|
| Graham P/E Range | Total Return over the next 5 Years | Total Return over the next 10 Years | Total Return over the next 20 Years |
| Above 20 - Expensive | 37% | 45% | 56% |
| 15 to 20 - Mid-Range | 39% | 97% | 138% |
| 10 to 15 - Mid-Range | 35% | 129% | 214% |
| Below 10 - Cheap | 45% | 158% | 290% |

| Bull Markets / Rising Valuations ::: Expected TOTAL Returns | | | |
|---|------------------------------------|-------------------------------------|-------------------------------------|
| Graham P/E Range | Total Return over the next 5 Years | Total Return over the next 10 Years | Total Return over the next 20 Years |
| Above 20 - Expensive | 39% | 48% | 56% |
| 15 to 20 - Mid-Range | 34% | 120% | 200% |
| 10 to 15 - Mid-Range | 66% | 201% | 485% |
| Below 10 - Cheap | 121% | 186% | 460% |

| Bear Markets / Falling Valuations ::: Expected ANNUAL Returns | | | |
|---|-------------------------------------|--------------------------------------|--------------------------------------|
| Graham P/E Range | Annual Return over the next 5 Years | Annual Return over the next 10 Years | Annual Return over the next 20 Years |
| Above 20 - Expensive | 4.9% | 3.1% | 1.9% |
| 15 to 20 - Mid-Range | 7.5% | 6.7% | 3.9% |
| 10 to 15 - Mid-Range | 7.3% | 8.2% | 5.5% |
| Below 10 - Cheap | 8.1% | 9.4% | 6.7% |

| Bull Markets / Rising Valuations ::: Expected ANNUAL Returns | | | |
|--|-------------------------------------|--------------------------------------|--------------------------------------|
| Graham P/E Range | Annual Return over the next 5 Years | Annual Return over the next 10 Years | Annual Return over the next 20 Years |
| Above 20 - Expensive | 5.3% | 3.3% | 1.9% |
| 15 to 20 - Mid-Range | 7.0% | 7.7% | 5.2% |
| 10 to 15 - Mid-Range | 11.2% | 11.1% | 8.7% |
| Below 10 - Cheap | 19.0% | 10.3% | 8.6% |

| Bear Markets / Falling Valuations ::: Change in Wealth | | | |
|--|--------------------------------|---------------------------------|---------------------------------|
| Graham P/E Range | \$10,000 over the next 5 Years | \$10,000 over the next 10 Years | \$10,000 over the next 20 Years |
| Above 20 - Expensive | \$13,659 | \$14,450 | \$15,590 |
| 15 to 20 - Mid-Range | \$13,921 | \$19,713 | \$23,831 |
| 10 to 15 - Mid-Range | \$13,475 | \$22,889 | \$31,361 |
| Below 10 - Cheap | \$14,504 | \$25,778 | \$38,988 |

| Bull Markets / Rising Valuations ::: Change in Wealth | | | |
|---|--------------------------------|---------------------------------|---------------------------------|
| Graham P/E Range | \$10,000 over the next 5 Years | \$10,000 over the next 10 Years | \$10,000 over the next 20 Years |
| Above 20 - Expensive | \$13,941 | \$14,777 | \$15,617 |
| 15 to 20 - Mid-Range | \$13,442 | \$21,952 | \$30,042 |
| 10 to 15 - Mid-Range | \$16,562 | \$30,109 | \$58,493 |
| Below 10 - Cheap | \$22,077 | \$28,634 | \$56,014 |

Fortunately, we can use the Value Cycle concept to our advantage even when the market on the whole is facing a headwind. This we will explore in our next letter, due out in early October. In the meantime, rest assured that our research efforts continue and that our portfolio management process reflects our best and latest thinking.

As always, we welcome your questions and comments. Feel free to pass this letter on to anyone you believe would appreciate our investment insights and approach.

Warmest Regards,

Chris Mendoza & Ian Lucas