



A good investor isn't someone that throws caution in the winds and gets on for the ride. A good investor is somebody that identifies all of the possible risks and finds ways to hedge or avoid as many of them as possible. Seth Klarman

February 1, 2010

Dear Valued Client:

We chose to highlight the quote above because it accurately conveys our belief that the foundation of investment success begins with a healthy aversion for risk. Years of observation have led us to believe that the most talented investors are not those who have some uncanny forecasting ability, or others who create elaborate spreadsheets, but instead, it's the investor who has a fundamental understanding of the economics that drive the business, a fundamental understanding of the possible risks, and a patience to purchase a business when those risks are more than accounted for in the stock price. Although there are some who say our caution sacrifices our potential for investment return, we would argue that it actually amplifies our potential for investment return when measured over the long term. Our value-driven investment approach will continue to be a competitive advantage that distinguishes our firm from other wealth management firms in the Knoxville and Oak Ridge communities we serve.

Markets had a rude awakening for the first month of 2010, ending down -3.32%, -3.6%, & -5.37% for the Dow, S&P, & NASDAQ, respectively. On the political front, there were two major developments affecting the market during January. The first dealt with the special election held in Massachusetts, where the Republican Scott Brown won over Martha Coakley, which eliminates the super majority held by Democrats in the Senate and could have an impact on the shape and size of the health insurance reform bill currently being debated in Congress. The second major political development deals directly with Wall Street, as President Obama announced a proposal to limit the size of the nation's largest commercial banks and reduce the risks they take in complex and exotic investments. Specifically, the plan would prohibit banks from owning or sponsoring hedge funds and private equity investments, as well as engaging in proprietary trading. In the wake of the Great Depression, similar reforms were made in 1933 through the Glass-Steagall Act, which attempted to curb speculation and conflicts of interests by separating commercial banking from investment banking activities. In November of 1999, through the Gramm-Leach-Bliley Act, those provisions that prohibit a bank holding company from owning other financial companies were removed.

Ironically, the timing of the Gramm-Leach-Bliley Act coincided closely with the bursting of the technology bubble, which caused interest rates to move lower, and in turn, planted the seeds for the next bubble, which was in credit via real-estate. The combination of low interest rates with the hungry risk appetites of bankers fueled an explosion in the securitization market, where loans were originated and sold with little regard to the borrower's capacity to repay. The environment post Gramm-Leach-Bliley also fostered an explosion in the scope and size of securities trading



within investment banks, now fortified with greater leverage capabilities from which they could speculate and produce profits for the bank. As all we know now, many of these trading operations destabilized our financial system and were one of the primary reasons Bear Stearns and Lehman Brothers are no longer in existence today. Although we are typically against the hand of government interfering in the private sector and initiating reform, we believe some level of reform is prudent and necessary so that securities activities are never in the same position again to threaten the integrity of deposits in our banks or the stability of our financial system.

Aside from the previously mentioned political developments, there are two unknowns occupying the minds of most market participants. The first unknown is to what extent, if any, long-term interest rates will move higher when the Federal Reserve stops its purchases of mortgage backed securities in the 1st quarter of 2010. Upon completion, the Federal Reserve will have purchased 1.25 trillion of agency mortgage-backed securities and 175 billion of agency debt. Further supplies of agency-backed mortgage debt will now have to be absorbed by private investors, who may or may not be able to absorb supply without corresponding price weakness. Banking institutions will continue needing favorable spreads between short term and long term interest rates, along with favorable affordability for new and existing loans, which will give banks the earnings power they need to work through their ongoing loan problems.

The second unknown that market participants are worried about are inventories. Specifically, many wonder what the self-sustaining pace of economic growth will look like after we've passed through this initial phase of reinvestment in inventories. Fourth Quarter Gross Domestic Product (GDP) increased by 5.7%, but if you take out the change in inventories, fourth quarter growth would have only been 2.4% (Source: Bureau of Economic Analysis). There may be another quarter or two where growth is inflated due to inventory replenishment, but ultimately, it's the pace of self-sustaining demand that really matters to investors.

For clients needing retirement income, today's low interest rate environment has produced somewhat of a dilemma, as cash earns nothing and bonds do not earn a sufficient yield to compensate for downside price risk that would happen when interest rates start to move higher. As a result, the lack of competition from other assets coupled with investor demand for return has pushed some investors back into equities. Despite their low yields, we continue to believe that cash and fixed income serve important roles in client portfolios, principally in the following three ways: 1) Through diversification, they reduce overall portfolio volatility; 2) They provide a modest yield and a stable principal base from which withdrawals can be taken; & 3) Cash holdings allow for increased purchasing power that is available for use when equities move lower and become attractively priced.

We'll end our letter with a recent quote we liked from Howard Marks, Chairman of Oaktree Capital. In his latest memo to clients, he said: "With most assets valued about fairly today, caution, discernment and discipline—not much needed in 2009—have replaced guts as the essential elements in profitable investing."



The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

The opinions and forecasts expressed may not actually come to pass. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security or investment plan. The representative does not guarantee the accuracy and completeness, nor assume liability for loss that may result from the reliance by any person upon such information or opinions. Past performance does not guarantee future results.

Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.