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Client Letter - March 31, 2009

The first quarter was again challenging for equity markets, with the S&P 500 down 11 percent. During the quarter, the S&P 500 reached a 12-year low at a price of \$666 on the 6th of March. The market dropped approximately 56 percent from the peak of October 2007 to the low of March 2009. Fortunately, your portfolios have performed significantly better. Even still, we reiterate our mantra that over the past several quarters, the businesses you own have not been impaired as much as portfolio performance would suggest. In large part, what we are seeing is simply deferral of performance, not a permanent loss of capital. On a positive note, the quarter finished with a strong rally through the end of March, at one point increasing 25% from its low (to \$833). Investor confidence seems to have turned from extremely gloomy to seeing a glimmer at the end of the tunnel. However, in the face of worsening economic indicators, this rally seems to be fueled by an optimism that things seem to be less bad than expected.

Are we finally out of this mess?

Unfortunately, we believe this hope for recovery is premature. This is not to say we will not see a further advance in stock market prices. Prices are simply a function of supply and demand, and in the short run, all sorts of factors can come into play affecting emotions. We may see little blips of economic indicators showing improvements now and again, but then other data may surface that would reverse the sentiment. In other words, we do not believe this will be a sharp "V" recession where the markets bounce right back – and if they do, we certainly do not believe it is sustainable. It will likely be several years before the macro scene truly stabilizes and improves substantially. That does not mean that quality businesses will share the same fate. On the contrary, we are witnessing the growth of these companies' intrinsic value of which many are acquiring other companies, raising their dividend, and or repurchasing their own stock.

The Need for Debt Restructuring

The reason we believe this rebound is a false start is because, as we have outlined in our past few letters, there is still a lot of deleveraging needing to take place. Much of the economic growth we have experienced for decades has been fueled by debt, and more recently, through non-bank credit, i.e., homes. Americans have been living beyond their means for years and thus the consumer is simply overspent (most recently spending 130% of disposable income!). The deleveraging we are experiencing from the burst of the housing bubble and the debt restructuring that is necessary is a negative reinforcing cycle that will likely take years to correct. As assets are sold to reduce debt, there is downward pressure on prices. Ironically, this actually increases leverage ratios, creating more pressure to reduce debt burdens. Additionally, home prices are dropping, stock portfolios are shrinking, and thus consumers are reigning in their spending. Businesses suffer or go bankrupt and so unemployment

increases, creating a further incentive for consumers to reduce spending. Not only are they unable to spend, but their *willingness* to spend drops as they brace themselves for possible unemployment. Accordingly, consumers are actually beginning to save again (for a time the savings rate was negative!). In short, the overspent consumer, which has made up more than two thirds of GDP, will not be pulling us out of a recession anytime soon. This is an opportunity for Americans to make a long lasting change in the way we live and manage our own balance sheets.

Ray Dalio, Chief Investment Officer of Bridgewater Associates explained it nicely when he said, “Basically what happens is that after a period of time, economies go through a long-term debt cycle – a dynamic that is self-reinforcing, in which people finance their spending by borrowing and debts rise relative to incomes...At cycle peaks, assets are bought on leverage at high-enough prices that the cash flows they produce aren't adequate to service the debt. The incomes aren't adequate to service the debt. Then begins the reversal process, and that becomes self-reinforcing, too. In the simplest sense, ***the country reaches the point when it needs a debt restructuring. General Motors is a metaphor for the United States***...If you think that restructuring the banks is going to get lending going again and you don't restructure the other pieces -- the mortgage piece, the corporate piece, the real-estate piece -- you are wrong, because they need financially sound entities to lend to, and that won't happen until there are restructurings.” (*Barron's*, February 9th issue)

This country will go through some form of debt restructuring and the process will be difficult and economic growth slim. Thus, we believe that over the ensuing years we will continue to see wide volatility to the up and the downside, but overall, not much progress. We would not be surprised to find the S&P 500 trading near these price levels five years from now.

Government Response

Just as our investment approach includes researching management, we believe it is helpful to study government responses. Another cause for the March rally seems to be a hope that efforts by governments around the world will help contain this financial crisis. As a whole, there seems to be a basic belief that we are entitled to economic prosperity and that the government has the responsibility to clean up this mess and not allow the normal business cycles to pan out. As such, we get the feeling the government is currently more concerned about getting us out of this crisis quickly without consideration for the long-term effects, thus only prolonging the inevitable painful correction process. Excessive debt got us into this mess, and the government seems to think repeating this process by being the consumer of last resort through trillion dollar stimulus band-aids will get us out. We were glad to see the government took steps last year to prevent a complete collapse of the financial system, but we fear they are now stepping beyond their bounds and meddling too much into the self-correcting free market system. By delaying the healing process, we are only deepening the wound.

How effective all these aggressive government programs will be is unclear. In general, large government intervention and stimulus programs (such as the New Deal during the Great Depression) have proven unsuccessful because the government is a lousy capital allocator. Milton Friedman said it best – “The market isn't perfect, but the government is a lot worse...[because] nobody spends other people's money as carefully as he spends his own.” He also said, “The burden of government is not measured by how

much it taxes, but by how much it spends.” We agree with Mitt Romney’s recent slogan “Stimulate the economy, not the government.”

A *Barron’s* editorial piece from February 9th noted that, “Socializing failed businesses – whether in housing, health care, or in Detroit – is not a long-term solution. Expanding government’s intrusion into the private sector doesn’t come without great risk. The renewing and self-correcting nature of the private sector is largely lost in the public sector, where accountability is impaired by obfuscation of responsibility, and where special interests benefit even when the public good is ill-served...Government regulations should be limited to those that increase and protect transparency and competition, protect public and private property, promote individual responsibility and enforce equal opportunity under the law. Even if the right laws and regulations could be found, they would prove insufficient to protect freedom and prosperity.”

Concluding Remarks

Once again, our brief macroeconomic discussion has trumped discussion on fundamental analysis about the individual companies we own. We acknowledge the strong interest you have in understanding the state of the global economy during these extraordinary times. And while understanding the generalities of the macro economy has some merit, in the end, what matters most are the individual businesses you own. Consequently, our stripes have not changed. Our focus remains on individual security analysis rather than forecasting inflation, currencies, commodity prices, interest rates, the direction of the market, or weather for that matter! Thus, the positive news: should these troubles persist for quite some time as we expect, there are certainly many quality businesses that will not only survive this downturn, but will reward us handsomely because their stock prices are selling *far below* their intrinsic business value. It would be a mistake to assume these dreary conditions will last forever. A common saying on Wall Street will prove yet again to be true, “You make your money during the bear market, you just don’t realize it during that time.” We remain optimistic about the future returns in the companies we own from these attractive price levels. The investor, as in times past, will be rewarded for patience.

Sincerely,

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