

## **Point of View**

The threat of imminent failure of the financial system has retreated as a result of massive government intervention. Nevertheless, substantial economic, investment and systemic risks remain. While we cannot foresee the future and acknowledge that markets sometimes trade independently (or ahead) of fundamentals, we believe these risks call for continued caution notwithstanding the exuberant rebound of equity and debt markets as they responded to virtually unprecedented government actions and assertions that it would do “what it takes” to turn the economic tide. Herein we address the state of the economy and the financial markets.

### *The Economy*

Unemployment (now at 9.8%) and underemployment present a significant impediment to sustained growth in a consumer-dependent economy and result in a self-reinforcing negative feedback loop. At the same time, consumers who have previously incurred substantial residential and credit card debt are now faced with the need to deleverage. While such deleveraging is fiscally responsible, it nevertheless slows new consumer spending and, in turn, pressures corporate revenues. Although we believe that deleveraging and capital restructuring are the dominant fundamentals for the foreseeable future, we recognize that cost cutting, cyclical rebuilding of inventories, productivity gains and the required spending by business have positively contributed to corporate earnings and improvements in the economy.

The reinvigoration of a willingness of banks to lend and the demand for credit has not yet occurred and will likely take much time to resume given the deleveraging mode of consumers and businesses. Notwithstanding access by the largest banks to large pools of new private capital, as well as a yield curve offering substantial operating profit opportunities, bank failures continue to climb and the coffers of the FDIC have been drained. Losses continue for residential real estate loans. Bank balance sheets are still problematic with the IMF projecting an additional \$1.5 trillion of losses to be recognized in bank securities portfolios worldwide through 2010.

Finally, we are sorry to report that bad behaviors continue at many financial institutions. Insufficient loss provisions (for securities and loans reflected on bank financial statements) remain while certain institutions create or structure transactions that leave them with all of the economic risk though meeting technical accounting requirements to treat these assets as being sold, thus avoiding future (or presently required) write-downs. How can this still be going on?

### *The Government*

The Administration and Congress have voiced their determination to enact regulations that will protect the financial system, consumers, and investors. Nevertheless, the rhetoric has been focused on populist issues such as compensation caps, incentives and board composition rather than the substance of capital requirements, leverage restrictions, substantial corporate guarantees for securitized loans sold to investors, derivative securities regulation, accounting for derivative securities, and restricting banks from operating as private high-risk trading enterprises subsidized by the taxpayers. We also question whether disclosure of investment risk in structured securities is sufficient or is it time to better regulate product given the apparent imbalances in sophistication between the “buy” and “sell” sides of a transaction. We can only hope that serious minds will be marshaled to address these issues and will not succumb to the overwhelming assault that will be launched by the financial services industry. But can we realistically be hopeful when the FDIC is focusing on proposals for the banks to “kick the can down the road” by making loans (or prepaying assessments) to the FDIC rather than the FDIC just assessing as required and forcing banks to charge earnings presently for the costs of mismanagement?

At the same time the Federal Reserve Bank’s excessively low interest rate policy is fueling speculation by pushing yield-starved investors into riskier assets—corporate debt and equities. We question whether investors truly appreciate the level of risk they are accepting as share price climbs and credit spreads collapse.

Finally, the Administration is pushing forward on its healthcare agenda, income tax increases, and energy policy. The increased costs related to these programs (and the consequent increase in an already enormous federal deficit) have the potential to slow or retard economic recovery and present great risk to the capital markets.

### *The Equity Markets*

Share prices should reflect equity valuations based upon a multiple of current earnings and prospective earnings. Many investors believe past earnings are not relevant (i.e., driving while looking through the rearview mirror) while others, like us, believe that disregarding important past mistakes of management is dangerous and leads to overly optimistic forecasts of future earnings.

As for the earnings outlook, it depends on what one means by “earnings.” Standard & Poors provides the following data for the S&P 500 for 2010. We have selected various multiples to illustrate disparate valuation possibilities.

<u>Top Down*</u>	<u>Bottom Up</u>	<u>GAAP*</u>	<u>Multiple</u>
\$ <u>52.63</u>	\$ <u>72.80</u>	\$ <u>45.84</u>	--
631.56	873.60	550.08	12
789.45	1092.00	687.60	15
1052.60	1456.00	916.80	20

The S&P 500 Index at September 30<sup>th</sup> was approximately 1057.

Top-down earnings estimates represent operating earnings for the S&P 500 taken as a whole considering economic policy and financial models. Bottom-up operating earnings are an aggregation of earnings estimates constructed for each company in the index by securities analysts following each company. In both cases, operating earnings exclude the effects of certain items thought to be non-recurring or non-predictive of future earnings. The impact of economic policy and non-recurring matters, however, is apparently weighted differently in each methodology.

GAAP earnings (income from continuing operations determined under generally accepted accounting principles) includes the effects of non-recurring or other items thought not to be predictive and, unlike operating earnings, is the only standardized measure of financial performance. Without a standardized measure, valuation comparison and earnings trends are not reliably measurable. Given the disparity among earnings models, price earnings ratios are uncertain at best.

GAAP (actual) earnings based on a ten-year average ending December 31, 2008 were approximately 20% lower than bottom-up operating earnings estimated for the same period. It is difficult, therefore, to subscribe to the comfort that some take in equity valuations based on operating earnings. The volatility and exuberance reflected in the equity markets, notwithstanding the continuing opacity in these markets, cause us to characterize recent trading activity as more akin to commodities futures trading where share price is a proxy for a call on near-term government action rather than long-term corporate fundamentals.

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\* We note that just prior to finalizing this letter S&P announced its initial outlook for 2011 top-down and GAAP earnings at approximately \$62 per share for the S&P 500. This represents a 17% increase over their top-down estimate for 2010 but nonetheless would still imply that the market is currently trading at a 17 multiple of projected 2011 earnings. Given the economic concerns outlined above, this seems aggressive to us.

### *Interest Rates, Currency, and National Debt*

A protracted period of low interest rates, increased budget deficits, and record levels of national debt have pressured U.S. currency. This has potential to be inflationary as costs of outsourced production and services rise. This increase in cost would act like a tax on the consumer, slowing economic recovery. Similarly, an increase in interest rates (or taxes to service government debt) would be an additional drag on economic activity. We are hopeful that the Federal Reserve will find the right balance in reversing its interest rate and open market policies but will remain cautious as this unfolds. The contentious political environment only complicates what, for the Fed, is an already very difficult mission.

### *Portfolio Construction*

Portfolio construction has been the only reliable method of managing the ever-changing risk/reward balance of the investment climate. We are mindful of low interest rates available in quality fixed income investments. We are also mindful of the balance sheet risks that remain for financial institutions, and the economic and equity valuation risks discussed above.

In our view, these risks presently outweigh our dissatisfaction with fixed income returns. For most of our clients, we continue, therefore, to remain underweight equities and overweight cash. In our equity portfolios, we generally remain overweight mid-cap stocks. Most of our clients have participated in the increase in the equity markets this year, albeit at reduced levels, in recognition of the substantial risks explored above. Until these risks subside, we do not anticipate a near-term revision to portfolio construction that would more than equal weight equities (with fixed income), and while they remain heightened, we will remain underweight.

As you are aware, each KLS account is managed separately. Please discuss your individual account performance with your KLS Managing Director.

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