

## Prepared Comments from 10/15/2010 Conference Call

My last conference call was on July 15<sup>th</sup>. US stocks have since recovered 7.2% (thanks to an amazing 11% gain in September alone). The 3<sup>rd</sup> quarter brought a recovery as investors saw their fears not fulfilled—there was no bankruptcy of Greece, and the US did not, at least at that point, enter a double-dip recession.

The country's unemployment rate is still terribly high, and while we are no longer losing a great number of jobs every month, the gains and jobs we are experiencing are woefully low. This prevents the US consumer and US companies from seeing light at the end of the tunnel.

There are some signs for hope on the job front. We are creating jobs, and workers are being asked to work more and more hours— and this last factor is usually preceding boosted hiring by companies. Generally companies try to squeeze more out of their existing work force before they hire more.

The brightest sign for our economy are our companies. They have very strong balance sheets, and strong profits. This is the direct result of draconian expense slashing for the past two years by US companies. This intense slashing enabled them to maintain necessary financial reserves, reserves necessary to make it through this recession.

Importantly, U.S. companies are in the process of reaping a new benefit and a substantial one. You have undoubtedly heard that interest rates are at all time lows, and there may be a bond bubble forming. Ask yourself this question—who benefits the most from low bond interest rates? The answer is the borrower. The US government is very much benefiting from low interest rates. They are temporarily avoiding the day when they have to pay a reasonable interest rate on national debt. Importantly for investors, US corporations now are refinancing their debt, to grab the historically low borrowing costs.

The refinancing of US corporate debt will directly boost US corporate earnings. And with earnings go prices. I consider this a major development, and a major reason to remain invested.

Consumers are also benefiting from the low interest rates. Those who qualify and have some equity in their home and have strong enough earnings are able to refinance their household debt – either through home equity loans for car loans or through mortgage refinancing and this is shoring up the US consumer's household finances. It's not across the board but I heard anecdotally that there are record levels of refinancing at this time. That coupled with the increased US savings rate for individuals means that US consumers are doing a better job financially and are coming to the point where they can be considering more discretionary spending.

Let's spend some time on the US political situation. It is very ugly out there and certainly in Delaware we know that quite well. Both sides are portraying the other as having plans to ruin the country. The Democratic majority in the US House and the US Senate may well reverse on November 2<sup>nd</sup>. What should an investor do about this?

Likely, an investor should celebrate the gridlock that has seized Washington DC and is likely to continue even stronger after November 2<sup>nd</sup>. Nothing major happens in DC when there is gridlock. Markets don't like major changes. Companies like to know what the operating environment will be for the next few quarters and years, and we are well on course to slow down any big changes in DC as far as policy and laws.

There are still serious problems for our country, and gridlock means that problems will not get better. Most of them will get worse just by simply doing nothing. However at least nothing is likely to happen that 49% of the country opposes. When the country is mixed in their opinions of what is the best policy, gridlock prevents the country from going in a direction that a large minority of the country disagrees with. So I think that all the pundits are pointing out is what's happening in DC. For investors I think what it means is things are going to go slower, and slower is generally something that investors, markets, and companies like to see. Fast changes scare people.

Now let's get back to the economy. We are at risk of a second, double-dip recession, however it is possible that the Fed and the Congress and Administration will enable us to avert this, as we were able to avert another Depression two years ago. There is still a risk of a double-dip recession, but the risk does seem quite modest.

We are at risk of rising inflation. However, frankly inflation should be a wonderful thing right now with the economy so slow. The Fed would welcome inflation right now. What we don't need is spiraling inflation in five years out. That is what keeps the Fed up at night. Preventing that will require a Congress and Administration working together to make solid progress on reducing the annual budget deficit. Gridlock won't help that, except to the extent that it keeps us from digging the hole deeper.

So as investors, what can we do? The main answer is the answer I have always harped on— plan your play and play your plan. Identify what proportion of stocks you can stomach in your portfolio, and maintain that. When it feels the most foolish to do so, that is the time that is wisest to maintain your level of stocks.

Let's talk about what you can control and what you can't. There are a lot of people out there who claim to know when you can get in and out of the markets. I don't feel that I have that ability at all, and actually I don't feel that anyone else does either. You often hear that economists have forecast four of the last two recessions. There's a lot of false signals out there – people who are confident in their calls and most of those calls turn out to be wrong. When you get out of the market you need to be very right twice – when to get out and when to get back in. So I don't believe you can control getting in and out of the market. You can control the exposure you have to the market. That gets back to planning your play and knowing how much proportion of stocks you can have in your portfolio and sticking to that both in good and in bad times.

Another thing you can control is rebalancing – making sure that you don't let your portfolio drift. Most investors during 2008 and 2009 saw their stocks drift very low and stocks were losing money. Many investors who were able to rebalance and buy back some of the cheap stocks in late 2008 and early 2009 benefited greatly. Just as did some investors who took some profits in the past year and a half out of the stocks that had recovered from the lows of March 2009.

What we try to focus on are the things that we think are dependable. One thing that is dependable is to keep your costs low. Another thing that is dependable is to work very hard to recognize that bad times will come and plan what you are going to do at those times. And the best plan in my opinion is to stick to your approach – how much you have in stocks – 60% in stocks – 40% in stocks. Whatever it is, stick to that in the good and the bad times. You can control that. The third thing you can control is the use of rebalancing. Rebalancing by its definition is selling high and buying low, looking at your portfolio periodically – weekly, monthly yearly - whatever it happens to be. We often work quarterly with clients. You know, we just had a very strong, good quarter in the markets. So our reports right now are recommending that we pull some of the profit out of stocks, put it on the sideline, put it in cash and bonds. Then in three months if we have a terrible three months and the market's down 5% then we are going to take some of those dollars we put in cash and bonds and buy back some stocks that are now on sale. And doing that regularly can build up and you can get that benefit that will compound for you. Those are the things we can control. Those are the things we think are the best approaches and best practices for investors.

Let me talk a little about the stocks and bond markets. I want to start with bonds - that usually doesn't get enough press. Actually that is where sort of most of the action is. Indeed we have very low interest rates and that is very challenging for investors. As I said, low interest rates benefit the borrower not the lender. If you are an investor and are buying bonds, you are a lender. That means low interest rates are not good for you. This is a very challenging and in a sense a financially dangerous time to be a bond investor.

So what are my risks out there? We have a recession and we have a possibility of a continually recovering economy, but at a very low rate. This is what PIMCO and their "New Normal" describes - a 'muddle through' recovery with economic growth easing upward at a very low rate. We could have a breakout good economy. I find that the likelihood of that very, very small. So with bonds what we do is prepare for both a weakening economy and a strengthening economy, prepare for both interest rates going down and them going up. If interest rates go up, then long term bonds are going to go down in value and you can have losses there, so we are avoiding long term bonds. For our high quality money we are splitting our money between short and intermediate term, with a preference towards short term. To the extent that we have a strengthening economy, which is what my expectation is, we are

using high-yield bonds and we are using foreign bonds also as a way of protecting against a weakening dollar. Sticking to our general balance is 5% of our bonds are high yield, 15% are known as multi-sector that can go anywhere, including high quality and low quality, both inside the US and abroad.

We have been using about 10% now in bank loan funds, also known as floating rate bond funds. These are from corporations that are borrowing not at a fixed interest rate but rather an adjustable rate, just like an adjustable rate mortgage. What low interest rates help on is the borrower. But if the borrower will have their interest rate rise, adjustable in the future, then they are not really the beneficiary the way they are if they locked in a low fixed rate. So as a lender, as an investor in bonds, investing in floating rate bonds is an approach that should bear fruit when interest rates are rising. So we are doing some of that also. We've got our bond eggs in many baskets. It's because the future economic course ahead of us is uncertain. So we've got a little bit covering one situation, another little bit covering another scenario and we still maintain at least 70% of our bonds in very high quality bonds, so we don't have too much betting on the economy necessarily being very strong.

With stocks we've had strength in the past quarter up and down the road. Large companies, small companies, US companies, foreign companies all did well. Right now where I look for opportunities I still find that there is strong growth beyond our borders - certainly Latin America and parts of Asia. Also the international stocks have not been as strong in the past few years. So I think there's a little bit more value there. Obviously you can't just paint international markets with a single brush. Continental Europe is a very different environment and Southeast Asia's very different from Brazil and the rest of Latin America. So you have to be careful out there, but I do like foreign stocks.

And the other area where I think valuation is important is in large US companies. Large US companies are essentially global companies. They certainly are doing much of their sales overseas and they generally have larger and more stable dividends and they have not risen in price as much as the smaller companies have since we hit our low in March of 2009. Therefore, I think that we have better opportunities in the large US companies than the smaller ones. We continue to prefer a 60/40 balance of our stocks with US stocks at 60% of our stock and 40% of our stocks being overseas. That still seems to be a fairly comfortable balance at this point. So we haven't really made any changes there.

I do want to mention real estate and recognize that the bulk of investment real estate that a typical investor is going to invest in is going to be commercial real estate and get it through a real estate investment trust (REIT) stock or they're going to get it through a real estate mutual fund. Keep in mind that is different from the houses down the street from you. Many of these real estate investment trusts are companies that manage generally commercial real estate. They actually have fairly good finances and there are some individual commercial property owners that are using fire sales to dump properties. If these REITS that are able to, as long they have money in the bank, and most of them do, are able to grab some good values at this point. Real estate has actually jumped quite well. It's one of the strongest sectors in the past year, up 29% through September 30th. I normally don't like mentioning as a great opportunity something that has done very well recently (I prefer investment areas that have been ignored). But I do think that a lot of investors gave up on their real estate holdings as the whole US residential real estate market went south. I think that is a bit premature. I think that there are good opportunities for many years in commercial real estate in the US. I think that the headlines that you are hearing about are more the individual real estate operators rather than the institutionalized ones, the ones that are the real estate investment trusts (REITS), Vornado and Simon property, being two examples there.

Regarding income tax - we have a Cinderella that is going to turn into a pumpkin at midnight. The current income tax level was reduced under President Bush from the levels it was at under President Clinton. If nothing is done by the end of the year we go back to the rates as they were in the previous decade. While that is an incremental change in some areas, it's a monumental change in other areas. You will hear about the top rates going from 35 to 39.6%. I don't consider that a gigantic change. What I do consider to be a gigantic change is qualified dividends for top taxpayers, which are currently being taxed at 15%. Those dividends are set to be taxed next year at 39.6%. That's more than a doubling. That's really tremendous. The capital gains going from 15 to 20%, to me is a marginal change. To me the biggest change is going to be the taxation of qualified dividends. While it is most significant for those in the top tax bracket, it will still be felt by people in middle tax brackets.

No one knows what, if anything, Congress is going to do by year end. There are lots of ideas floated. One is we do nothing and let them go back to the level of 2000. Another is that we freeze them for lower taxpayers. 97% of the country isn't in the top bracket, those earn less than \$200,000 for an individual, \$250,000/year for a couple. And then there's a proposal to make them all permanent. Then there is another approach, to extend them for one year or two years – provide some breathing room. Let the economy recover and then we'll do things.

I'm not a betting man. I don't know which way it's going. I would like to think that at least the non-highest bracket taxpayers will see their rates frozen for one or two years. And I do not know the likelihood of changes for those in the top tax bracket. I would like to see a continuation of the qualified dividends and rather have it phased, if it's going to change, rather than jump from 15% to 39.6%. But I'm not the one making the rules there. In once sense at least we've known this for years. When the law was written it said it expires on December 31, 2010. It's not a big surprise, but everyone expected Congress to do something before December 31, 2010. So, as investors you want to realize that your taxes in 2011 may be quite a bit different from 2010 if Congress does nothing. And the thing you want to pay the most attention to are the taxation in your bracket of qualified dividends. There is a special line on your 1040 where your qualified dividends are listed and that's the income that as of January 1, 2011 will be taxed at a much higher rate if Congress doesn't do anything.

Estate taxes are another issue up in the air. Right now there are no estate taxes. And I heard someone say that the family of George Steinbrenner is celebrating this fact. But as of January 1<sup>st</sup> we're back to an exemption of \$1 million, and tax rates on the excess ranging from 37% to 55%. That is a big change. The general feeling is that a fair level would be a an exemption level between \$3 and \$6 million, and then amounts above that taxed at 45% or perhaps start at 35% and go up from there incrementally. This is a complex issue that requires Congresspersons to work together. As I said in my opening remarks, we aren't seeing much evidence of that. If everyone had an interest in having something more reasonable done for estate taxes, there is incentive for representatives from both sides of the aisle to work on this and get this fixed by year-end. But I've not seen any progress at this point, on either estate or income taxes. If nothing is done on the estate tax level, what does that mean for investors who have more than a million dollars as an individual or two million for a couple? They need to get back to the estate planning we've had the luxury of being able to ignore for several years as the levels have been so much higher than they are going to be on January 1, 2011.