We had a very satisfying 2010

2010 is in the books and it was a good year for us as we finished with the best December in the market since 1991. For the year, the Dow was up 11% and the S&P was up 13%. Our equities were up 14.4% on average. Of all the money we manage, we have about 26% of our client assets in fixed income. We had a good year there as well as our fixed income portfolio was up 6.6% on the year while our benchmark was up 6.1%. Over the past two years, our equities are up 46% while the Dow is up 32% and the S&P is up 39%.

As we did in last year's letter, we will look back over the course of 2010 and pull out for you the defining moments of the year. The valuable lessons learned over the past two years will become assets for us in the future.

1/8/2010 2010 could be a very good year

As for 2010, we are already off to a good start. The first day of this year saw the market gain more than 1.5%. Since 1950, the market has gained more than 1% on the opening day of the year only ten times (*out of 60*). The good news is that in 9 of the 10 years when the market started the year with a 1% gain or more, the market was up for the entire year and the average gain for the year was 14.5%. The only year when the market started up and ended down was 1990 and that was the first year of a bad recession. So we think a strong opening day and a strong first week (*the S&P was up more than 2.5% this week*) bodes well for 2010. **A 14.5% gain this year would take the Dow to almost 12,000.** ***(Note: The Dow closed the year at 11,577…we were close!)***

2/5/2010 Should we sell if the market might correct?

A few clients called this week and asked, *"Should we sell?"* Our firm belief is that we should remain invested. While the short-term sentiment seems to have changed, nothing <u>fundamentally</u> has changed about the market or the companies we own. In fact, the fundamentals are improving with each quarterly report. Why would we sell because an additional 5% pullback is just *possible*? We wouldn't.

2/26/2010 Investing vs. Speculating

Investing is something truly different than speculating. It is partnering up as a partial owner of a business and giving that management team ample time to effectively grow the business and generate cash flow. You participate in the success of that business over a long period of time. We talk a lot about companies that annually increase their dividend and use their cash flow to buy back their shares. You <u>cannot</u> reap the benefits of these consistent dividend increases and share buy backs by flipping in/out of stocks. True participation takes time. It takes "ownership". It is a lot like owning a house. You cannot experience the satisfaction of a home that appreciates a percent or two a year and gradually paying off your mortgage by renting. In a home, you might pay $200,000 for it and in 20-25 years it is worth $400,000 and is debt free. You have built a lot of wealth in that home but you've done it slowly. **You cannot build wealth by renting**.

5/7/2010 Corrections will happen – don't let them deter you

Markets – *at times* – will ignore fundamentals as we cannot operate in a vacuum. Global events will shake the market from time to time but we don't think Greece will – in any way – deter the very powerful earnings story and corporate recovery unfolding. Since the market made its bottom in March of 2009, we have had four pullbacks of between 6-9%. This is the 5th one and it may well reach a 10% pullback. Given that we are up 65% off those March lows, these pullbacks are to be expected and are, in reality, quite healthy. Of course we wish the market went up every single week without a correction but that is very unrealistic. Corrections let off steam and remove excesses that can build in a market. We don't like them when they happen but we accept them as a reality of being an investor.

5/14/2010 Perception vs. Reality

The reason we study history is to protect our portfolios from ourselves. There is the perception of risk and the reality of risk. Usually when the perception of risk is high (*today*), the reality of that risk is really quite low (*and vice-versa*). Today people think bonds are safe because they killed stocks over the past 10 years. But bond yields are among the lowest in history while stock valuations are the cheapest they've been in 20 years.

5/21/2010 Ignore the frenzy of the media

Pascal once said, ***"All men's miseries derive from not being able to sit in a quiet room alone."*** It is when we go out into the crowds and news-driven world and listen to the pundits that we begin to get convinced that *"this is the end".* It is this frenzy of news that drives us sometimes to make emotional decisions with our capital. We lose sight of the fundamentals. We ignore just how small Greece is and begin to think all the world is about to default on all debt. We ignore that this economic recovery is still very much in place and that the falling Euro is actually quite stimulative for the EU economy. All we think is *"sell now, we can always buy it back later"* and then we realize we have all that cash out of dividend paying, quality stocks sitting safely in a money market earning 0%.

6/4/2010 You own stakes in real businesses…not the stock market

We own living, breathing businesses. The managements and employees of our businesses come to work every day trying to cut costs, be more efficient, create new innovative products, close big sales and look for new markets to expand into. Over a long period of time – *through good markets and bad, through wars, 9/11, debt crisis, impeachments, dot-com meltdowns* – they have proven very able to grow sales and grow earnings and generate high returns on shareholder capital. They pay dividends and buy back their stock. We are partnered with remarkable capital generation machines. There is a lot to worry about today but we are very confident that the future remains very, very bright for Wal-Mart, Microsoft, Johnson & Johnson, Intel, Illinois Tool Works, Emerson Electric, Target, ConocoPhillips, Medtronic, Automatic Data, Abbott Labs, Cisco Systems, etc. As Warren Buffett confidently says, ***"Don't sell America and capitalism short…our best days are ahead*"**.

6/11/2010 Don't take Wall Street's bait

Wall Street has not rigged the "game" against the small investor as long as that investor stays disciplined. A portfolio of high quality, growth stocks bought and put away can do just fine, thank you very much, over a long period of time. Yes, Wall Street does fight you on this. Brokers and their strategists <u>try</u> to get you to trade (*they need the commission revenues*). The media fuels this with internet access, CNBC, news stories saying *"Sell, sell, sell…"* hot new funds, ETFs, long/short and double leveraged products that are invented (*by Wall Street*) and they tempt us….**but** we <u>don't</u> have to take the bait. If we abandon our great stocks and our discipline to either panic or chase some fad it is only one person's fault….ours.

6/18/2010 CNBC is not your friend

This 24/7 sensational news very definitely has an impact on investors. Patient, long-term investing and the media don't mix. CNBC will be bullish and optimistic on good days in the market and will make you think the world is coming to an end on bad days. The major news networks don't really pick up on the market ***until*** we've had 4-5 bad weeks in a row. At that point, *"Wall Street's Plunge"* will be the lead story on the network news. Twenty years ago, there was no internet and there was no CNBC. If you wanted to know how your portfolio or the market was doing, you called your broker. Today, we can track portfolios minute by minute, day by day. In our opinion this instant access to information is probably counterproductive to successful investing.

6/25/2010 Patience is a virtue

Patience is a virtue. The definition of the word is to "tolerate delay". This implies self-control and forbearance as opposed to wanting what we want when we want it. Successful investing is aided by a healthy dose of patience and not "punting" simply because a stock hasn't provided us instant gratification. That patience is firmly supported by good research, rational thinking and good hypotheses.

7/9/2010 Wisdom from Warren

Warren Buffett said this week in an interview that *"It is the nature of humans when we are making money effortlessly and when we see neighbors making money effortlessly that people just want to get on the bandwagon. Rising prices (for assets like stocks, gold, beach houses) become a narcotic that induces people to do things that sane people wouldn't normally even consider doing."* Mr. Buffett also said this in the interview… *"If you buy a farm, you don't check the weather report every day and you don't get a bid on the farm every day. You look at the farm itself and say, "Is this farm going to produce so many bushels of corn and is that satisfactory for what I paid for the farm?" That's how you should invest in stocks. If you buy a cross section of American industry you're going to do well over 10-20 years but you're not going to do well if you try to dance in and out of the stocks on a daily basis."*

7/16/2010 Coming into the best season for stocks

Historically the third year of the Presidential election cycle is the best year for stocks. What is fascinating is that this trend actually starts in October-November of their second year and lasts through April of their third year. Oftentimes this is triggered by mid-term Congressional elections which tend to go against the President. We saw this in 1994 when Bill Clinton lost both Houses in the mid-term elections. The cycle that starts in November of the 2nd year and carries through April of the 3rd year of the Presidential cycle is <u>by far</u> the best time to be in stocks with a 16% median return. ***(Note: Since late November, the S&P is up 8% - perhaps history is repeating?)***

9/3/2010 Look forward when investing…not backwards

Whitney Tilson – another long-time money manager – said this week, *"The best opportunities we've ever seen are in big-cap high quality equities. There is a bubble in blue-chip **bonds**. Investors seem to accept any yield no matter how low on safe bonds and yet have no interest in safe ultra blue-chip stocks. For instance Johnson & Johnson issued 10-year debt paying 2.95% while their stock has a 3.7% dividend yield. The single best mistake investors make is to look backwards to make their investment decisions. 10 years ago blue chip stocks were trading for 25-30x earnings with 1.0% dividends and <u>everyone</u> wanted stocks. Now after 10 bad years in stocks, <u>no one</u> wants stocks but they trade for 11-12x earnings and have 3% dividend yields. Look forward when investing, not backwards at what has already happened".*

9/24/2010 In prosperity be prudent, in adversity be patient

Believe it or not, there <u>will</u> come a day when Greatmark will be advising clients to be cautious. There will again be a day when stock valuations are too rich and we are selling positions and trimming back others and in many cases we'll be selling some of our "hottest" and best performing stocks. At that point in time, you'll be tempted to call us to say, *"Are you crazy that's our best stock, why are you selling it?"* When we get to that point, the overwhelming sentiment will be extremely positive, money will be pouring into stock mutual funds and investors will be ignoring valuations. In that ***"prosperity"*** it will be our job as your managers to be ***prudent.*** It will be prudent at that time to trim back, take profits and build cash reserves. We'll be selling because the intrinsic values of the companies we hold no longer support the prevailing stock prices.

10/8/2010 Dow 13,000 ?

From the lowest level of the entire second year of a President's term to the highest level of the entire third year (*over the past 100 years*), the market has averaged a 49% upward move. Since 1990, during the last five Presidential cycles, the gain has averaged 37%. The Dow's low this year was 9,686. A 37% gain to some point next year would equate to the Dow crossing 13,000. We think there is a plausible chance, if everything falls into place, for Dow 13,000 to happen at some point next year. Why? $3+ trillion in cash still sits in low yielding bank accounts and money markets. As confidence returns, a lot of that cash will seek higher returns. Stocks are cheap and dividend yields on many great companies exceed the rate you can get on a 10-year bond.

10/22/2010 Time to think long-term

We heard an interview with Bill Miller of Legg Mason this week. He said, *"I will be surprised if the market isn't up 20% in the next 12 months. Fed policy is on your side, stocks are so cheap and inflation in non-existent. The sentiment today may well be worse than it was in 1982. We've had two bad recessions in the last 10 years, a 0% return on stocks and the worst financial crisis of our lifetime. That is why stocks are so cheap today. Memories are way too fresh. In that, you have your opportunity. It is the best time probably that we'll see to invest long-term. The last 10 years have conditioned people to think short-term, trading and tactical but now is the time to think long-term. Everyone wanted to think long-term in 1999 after 17 great years in stocks but that was the time to think short-term and defensive. Now, after 10 lousy years in stocks with rates so low, it is time to think long-term."*

11/12/2010 Gloom is no more permanent than boundless optimism

Roger Lowenstein (*a director of Sequoia Fund and Wall Street author*) recently wrote an editorial in the New York Times in August. In that article, he said, "*It is generally more lucrative to sell prophecies of doom than to act on them. What the herd tends to overlook is that stocks are not a bet on the odds of an apocalypse. The real challenge of investing is so cut-and-dried it is often forgotten. Stocks are simply a claim on future corporate earnings: if you can buy those claims at a discount, you should do very well. The S&P is trading at only 12 times the expected earnings of the underlying stocks over the next year. Inverting that ratio, stocks have an earnings yield of 8.5% (each $100 of stocks is backed by $8.50 in earnings). This compares to Treasury bonds on which the yield is a dismal 2.58%. Investors are flocking to bond funds and they are paying to avoid uncertainty – to avoid the prospect of financial Armageddon. People would rather overpay for bonds than underpay for stocks. It is a function of years of miserable stock returns and the general fog of gloom over the country right now. In markets, of course, gloom is no more permanent than boundless optimism."*

12/31/2010 Flow of money to bonds keeps us quite encouraged

Despite the market rising 24% in 2009 and being up 13% this year, investors still withdrew $28 billion from stock mutual funds this year and poured $266 billion into bond funds. Is the surge into bonds any wonder given the rampant pessimism we've faced against stock investing by the media? We have climbed a huge wall of worry over the past few years and your patience has been amply rewarded. The day will come when we look at investors yanking hundreds of billions out of bond funds and pouring them into equity funds. There will be a time when stocks are once again the media darlings they were in the past. There will come a time when everyone is giddy with their 401(k) balances and when investors will boast about how much money they are making in stocks and just how "easy" it is to make all that money. At that point, we'll be very cautious and we'll start to put some "hay in the barn". For now, the sentiment is still against stocks and perversely, that keeps us quite optimistic.

Closing note

We had a very good 2010 after an excellent 2009. We think 2011 can also be very rewarding. The fundamentals are excellent for the long-term focused, patient investor. We will face challenges this year. We will have corrections. Some may be quick and severe and once again, we'll battle the media urging you to sell. You'll fight the temptation to say, *"Let's just sell now because we can always buy it back."* That is a lot easier to say than it is to actually pull off. So there will be challenges (*there always are*) but the basic fundamentals are aligned to produce a very good year in 2011. We are most thankful for you and your partnership. It is a true joy and honor to serve you in this capacity.

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