



2010 Review

Dear Investor,

Following a strong rebound in 2009, the primary theme for 2010 was that of the economy and the financial markets struggling to find their footing in a very complex post-bubble environment. Over concerns of a double-dip recession, the Fed was exceptionally active with various Quantitative Easing programs. This environment continues to rapidly evolve, as does the ongoing response by governments around the world as they try to manage the fallout.

It is now clear that the housing bust that began in 2006 was only the initial phase of a larger credit bust. The housing bubble peaked when the economy and financial markets reached a saturation point with housing related debt. Following that inflection point, home prices declined rapidly as demand disappeared and a debt-induced liquidation commenced.

While the housing bust has been dramatic, the change in consumer attitudes towards spending and debt is a more significant factor for our economic growth going forward. Unemployment remains high, home prices remain near their lows, and a large segment of the population is nearing retirement. In response, consumers have shifted their focus from spending toward rebuilding their net worth. This has resulted in a higher national savings rate as consumers save and pay off debt. This phase of the credit bust will likely influence the economy far into the future.

Meanwhile, the third phase of the credit bust will likely be the unwinding of unsustainable government deficits and debt. Just as home prices were able to remain buoyant as long as the financial markets continued to supply more debt, most western economies, including the US, remain out of recession solely because the markets continue to absorb large sovereign debt issuance. History shows that governments cannot perpetually prop up their economies with ever increasing debt, and events over the past year in Europe have given us a peek at what happens when the financial markets reach their saturation point. Just as the looming housing bust was *the* major issue to focus on going into 2007, the impact of large government deficits appears to be the major issue on the horizon heading into 2011.

In this annual letter we'll examine a few of the key economic issues that will likely have a large influence on the US and most major economies in the next few years. We'll also look at the current state of the markets and the main trends we see going forward. We'll then discuss our portfolios and what we anticipate for 2011.

<u>Stock Indexes</u>	<u>2010</u>	<u>Market Indexes</u>	<u>2010</u>
S&P 500 Index	+15.1%	HFRX Global Hedge Fund Index	+5.2%
MSCI World (ex USA) Index	+6.2%	US Dollar Index	+1.3%
Amex Oil Index	+13.6%	CRB Commodities Index	+17.4%
Gold and Silver Index	+34.7%	Gold (Continuous Contract)	+29.6%

An Economic Summary

Although in past years this section has been used to offer a broad summary of current economic issues and general trends as we move into the new year, this year's summary will take a narrower look at a few key issues that will likely have a large impact on the economy and markets over the next 2-3 years. We'll begin with the current economic recovery and the need for more government stimulus, and conclude with comments on the ongoing debt crisis.

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Those who believe the US has just gone through a standard business-cycle recession tend to have a fairly optimistic view of what is in store over the next few years. Certainly the economy went through a deep trough, and the early cyclical indicators have turned up: stock prices are well off their lows, and private businesses have been rebuilding their inventories and adding jobs (modestly). According to the standard post-war recession template, the economy should now transition into a more robust rate of growth that will ignite gains in employment and fuel further gains in asset prices.

Gross domestic product has been expanding for close to a year and a half, since mid-2009. GDP has now surpassed its 2007 peak—erasing the 4% contraction that occurred during the recession. Although the rate of growth has diminished over the past few quarters from its peak in the fall of 2009, the economy is still growing and overall jobs are being added, just not at a sufficient pace to reduce the unemployment rate.

However, despite this rebound in GDP, the Federal Reserve started a second quantitative easing (QE) effort, a \$600 billion program buying Treasury bonds in an effort to lower interest rates and boost the economy. Shortly after the Fed's program started, the Obama administration and congressional leaders announced a plan that would keep the Bush-era tax cuts in place, temporarily cut payroll taxes and provide additional funds for various programs, such as unemployment benefits. The total cost of the plan would be around \$900 billion over the next two years, to be paid for entirely by adding to the national debt.

With \$1.5 trillion in brand new economic stimulus from the federal government and the Federal Reserve, you would think we were in the middle of a severe recession, not a year and a half into a recovery. However, when we start to look into the details of this recovery, we see why government officials feel the need to provide additional stimulus. The main reason GDP has recovered to near its 2007 high has very little to do with growth in the private economy. Instead, the recovery has everything to do with massive growth in government spending.

While GDP has indeed fully recovered from its 4% drop, it has done so while the government has increased its deficit spending to around 10% of GDP from less than 2% just prior to the recession. This means that government spending has filled a hole left by the private economy with a boost equivalent to 8% of GDP, which has been enough to fill the 4% gap created by the recession, with change left over.

However, without the government's deficit spending, overall GDP would still be far below the peak seen prior to the recession. One way to see this is to remove spending by federal, state and local governments from overall GDP. When we do this we are left with the "private economy." As shown by the blue line in the chart on the next page, the private economy remains far below its 2007 peak—5.4% below its peak as of June 2010, to be exact.

Over the past 60 years, counter-cyclical deficit spending by the government has been used to soften the impact of recessions. As the private economy contracted, government would increase spending even as tax receipts fell, in order to maintain a higher level of GDP than would be possible otherwise. After the private economy began to grow again and tax receipts increased, the government's deficit would shrink back to

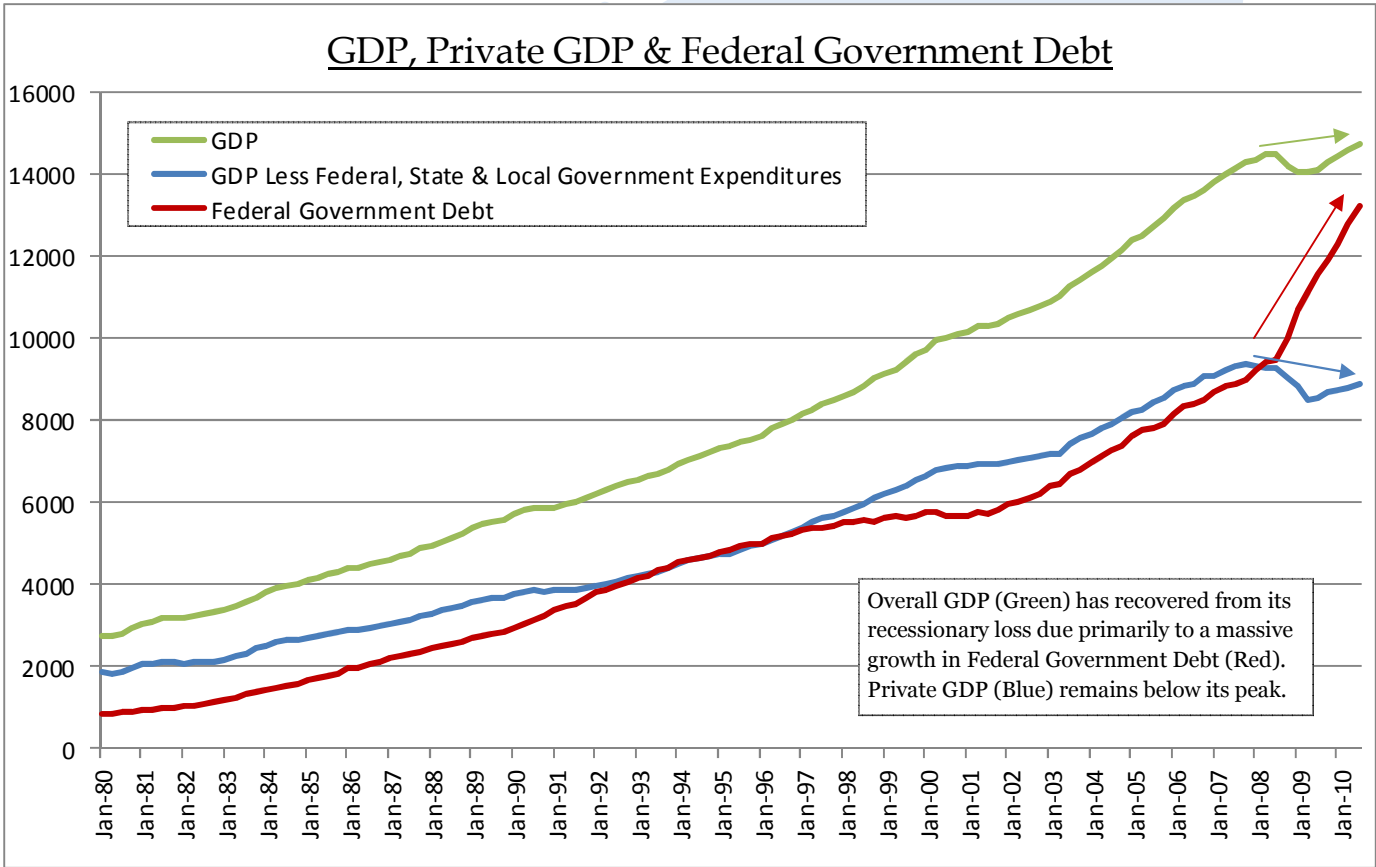
pre-recession levels. The thinking was that if the overall economy is kept from shrinking until demand from the private economy recovers, the economy as a whole would leave the recession on a stronger footing.

While this strategy has generally been successful in most post-war recessions, it does require the private economy entering a sustainable recovery that will reduce the government’s deficit relatively quickly, *before* the level of public debt becomes unsustainable and/or before the government’s ability to borrow at sustainable interest rates dries up.

As the effects of this recession have lingered and deficits around the world remain high, there is a growing realization that this recession has been different from most post-war recessions. In prior recessions, the amount of stimulus enacted over the past two years would have been enough to incite a massive boom in growth and inflation. Instead, the private economy remains subdued, and significant increases in consumer prices remain nonexistent.

At the same time, a number of western countries have reached a debt “saturation point” while they continue to support their economies. As markets have become increasingly skeptical about the lack of a sustainable recovery and the ability of some countries to continue servicing their burgeoning debt load, buyers have backed away from sovereign debt auctions and interest rates have risen. When rates rise to the point where maturing debt cannot be rolled over at rates that would not bankrupt the government, there is a risk of default.

This is basically what happened to Greece early in 2010, and what happened to Ireland more recently. Instead of facing a default, they accepted bailouts from the European Union and the International Monetary Fund that allowed them to roll over maturing debt at lower-than-market interest rates. Had Greece and Ireland not been able to do this, they would have certainly been on the path towards a default within a year.



Since the EU-IMF bailouts of Greece and Ireland are only temporary, they are still likely on the path to an eventual default. These smaller European countries are still trying to gain control of their *deficits*, which is the rate at which they are adding to their national debt. They have not begun to address their *debt* issue, which will almost certainly come later. However, the bailouts have bought them time to get their government budgets on a more sustainable path, with the *hope* that market confidence will return by the time they need to access the credit markets again.

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Here in the US, we have not run into a problem with the markets not buying our debt—yet. However, the situation faced by the US and other western countries is not that dissimilar to that of Greece and Ireland. In addition to the ongoing *cyclical* deficit from the recession, we now have a *structural* deficit, and there are few signs that either of these deficits will mend themselves anytime soon.

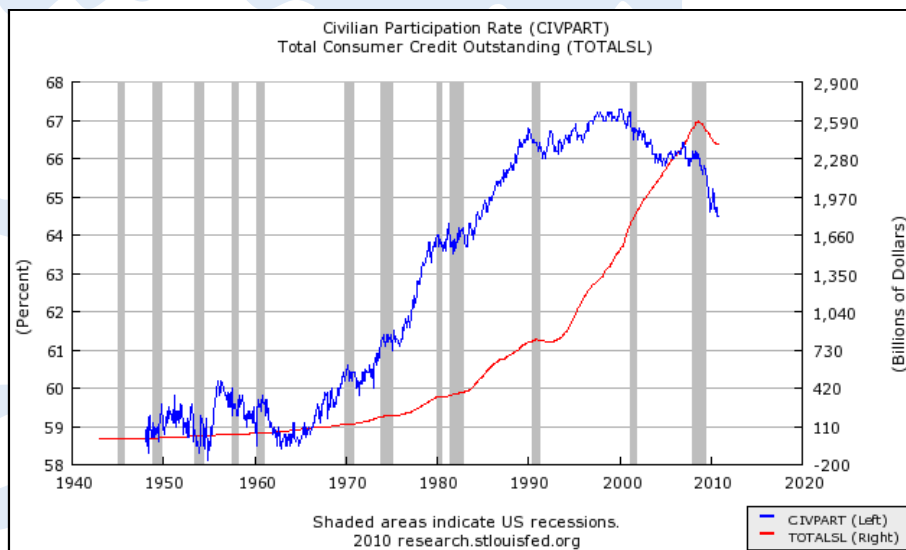
There are a number of reasons the private economy has not rebounded as robustly as it has in the past. Demographics, employment and the bursting of the credit bubble are three main issues, and the two data series in the chart below highlight these underlying trends, which we have touched on in recent client letters.

Despite the gains in GDP, the civilian participation rate (blue line), which is essentially the percentage of the US population that is working, continued to decline over the past year. This trend began in 2000, but most of the negative economic effects of the initial decline in the employment ratio were temporarily masked by a large increase in consumer credit (red line); although fewer people were working, we maintained our collective lifestyle by taking on more debt.

This came to an end with the end of the housing bubble, and since then both the employment ratio and consumer credit have been contracting.

From 1985 to today, average hourly earnings have risen 123% and the number of people working has risen 32% from 151 million to 200 million.

During the same period, however, consumer debt has risen much more.



One measure of consumer debt—total consumer credit outstanding—grew 392% from 1985 through 2008, more than 3 times the income growth. Scaled to the income of a larger workforce in 2010, total consumer credit outstanding is approximately 82% greater today than in 1985.

This growth in debt over the last 25 years helped fuel an economic boom in the US, in which employment and spending rose more than would have otherwise been the case. The stock market and housing bubbles were directly and indirectly fueled by this rapid growth in debt. Only in 2008 did consumers change their behavior and begin to cut back. The red line in the previous chart shows that total consumer credit outstanding has continued to decline since 2008, even as interest rates—both short-term and long-term—have hit record lows.

This modest decline in consumer credit helped create a large “demand gap” in the economy, which the government has stepped in to fill. In short, since consumers are unwilling to increase borrowing and spending, the government has become the “borrower and spender of last resort.”

This dynamic of government spending taking the place of private spending is exactly the situation Japan has been in for the better part of the last 20 years. Despite the 80% decline in stock and property prices, and the emergence of deflation in consumer prices, Japan’s nominal GDP has actually *risen* since 1990. The reason Japan’s economic output didn’t decline is largely because government spending was able to fill the hole left by spending in the private economy.

Economist Richard Koo wrote a book in 2008 in which he distinguishes moderate cyclical recessions from more severe “balance sheet recessions.” While a normal cyclical recession can be characterized as a healthy pause within a larger economic expansion, a balance sheet recession occurs when the private economy begins a process of deleveraging from the previous boom.

During these balance sheet recessions, consumption and debt levels fall as consumers and private businesses rebuild their net worth after a long period of taking on too much debt. In Japan, as stock and property prices fell in the 1990s, businesses found themselves holding a lot of debt on assets that were not worth as much as during the boom—often leaving them with a negative net worth. This started them down a 10-year path of paying down debt to repair their balance sheets and bring their net worth into positive territory. Over that time, demand from corporations fell by 22% of GDP. Japan’s economy would have contracted dramatically had the government not stepped in and compensated for that decline with additional spending.

There are a number of signs that the US has entered its own balance sheet recession, the first since the Great Depression. In response to a stagnant stock market and the housing bust, consumers have been reducing debt and spending in order to repair their net worth. In such an environment, when the private economy is actively deleveraging, normal policy tools such as interest rates are relatively useless for stimulating growth in the economy because people are not interested in more debt—even at zero interest. This is exactly what we have seen as the Fed has held short-term rates at 0%, to no obvious effect.

What has had an effect over the past 2 years is the fiscal stimulus in the form of government spending. However, that growth has come at an enormous cost, as the federal debt has ballooned by \$4 trillion since 2007, and it will likely increase by another \$3 trillion over the next 2 years. This represents a doubling of federal government debt in just 5 years. Although it did prevent a steeper fall in GDP that may have marked the start of a downward spiral similar to the Great Depression, the price is a rapidly increasing government debt burden which will eventually have to be reckoned with.

Many economists, including Richard Koo, argue in these circumstances that increasing government spending to counter the decline in the private economy is the best way to prevent a repeat of the 1930s. However, this apparent solution depends entirely on the government’s ability to continue borrowing as much as it needs to fill the hole in demand until the private economy begins to borrow and expand again. Without a continued ability to borrow, the entire bailout would fall apart.

Japan has been able to borrow continuously for almost 20 years in order to keep propping up its economy. Its current debt/GDP ratio is near 200%—the highest of all major economies. It has been able to do this because Japan entered its downturn with enormous domestic savings, and today 90% of Japan’s sovereign debt is held by its own citizens, pension funds and institutions. As stock prices and consumer prices have continued to fall, and the yen has continued to rise, these investors have only been too willing to guarantee themselves a positive return by owning yen-denominated government debt.

Greece and Ireland have recently found themselves in a very different situation. Like Japan, they were running enormous deficits in a bid to support their economies, but unlike Japan, they failed to keep investor demand high enough to support their large debt sales.

As market confidence in Irish and Greek debt dissolved and interest rates rose, the governments would have become bankrupt and forced to default had they not been given temporary loans by the EU and the IMF. However, those loans have come with conditions that require Greece and Ireland to rein in their budget deficits, effectively taking their economies off public assistance. Since then, both countries have plunged back into recession.

In addition to the problem of maintaining large deficits, it remains an open question what a country is to do with the leftover mountain of government debt piled high from propping up an economy through a period of deleveraging. Economists like Richard Koo don't have many answers for this, offering only that coming out of a balance sheet recession with a lot of public debt is better than having gone through a deflationary spiral. That assertion is debatable, yet even if correct, it ignored the likelihood serious aftereffects.

For example, in Japan's case, there is now significant risk of a severe devaluation of the yen. Up to this point the Japanese government has been able to borrow at rock-bottom interest rates to fund its deficits: the 10-year yield of Japanese government bonds currently sits near 1.15%. But with debt now approaching 200% of GDP, any move higher in bond yields would effectively bankrupt the government and force the Bank of Japan to print yen with abandon. All that stands between the sanguine environment of today and a crash in the yen is investor confidence in Japan's debt.

Most arguments that claim building up massive government debt is the best solution to counter a deleveraging private economy usually don't take into account the eventual cost when those debts come due. In Japan's case, its citizens and institutions have run up their tab supporting their economy, but they have yet to pay the bill. It will be up to future historians to judge whether the Japanese people were better off for having run up public debt in support of their economy, or whether it would have been better to let the economy liquidate the bad debt from the previous boom on its own.

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Our economic and financial situation in the US is different from that in Japan many respects, but so far the policy response by our government is shaping up to be an even more aggressive Japanese-style response. Whether the markets *allow* the US and other governments to continue down this road in the years ahead is the \$64,000 question.

These are very important issues for investors in the US, because they will be *the* dominant factors influencing our economy in the next few years. Our annual deficit over the past 2 years has been near 10% of GDP. With the recently announced stimulus package, it appears the deficit will remain near that level for the next few years at least.

With this high level of deficit spending, the overall increase or decrease in GDP no longer reflects underlying economic conditions in the private economy. The private economy remains relatively stagnant, and it will likely stay that way for some time as consumers continue to decrease debt, save more and spend less.

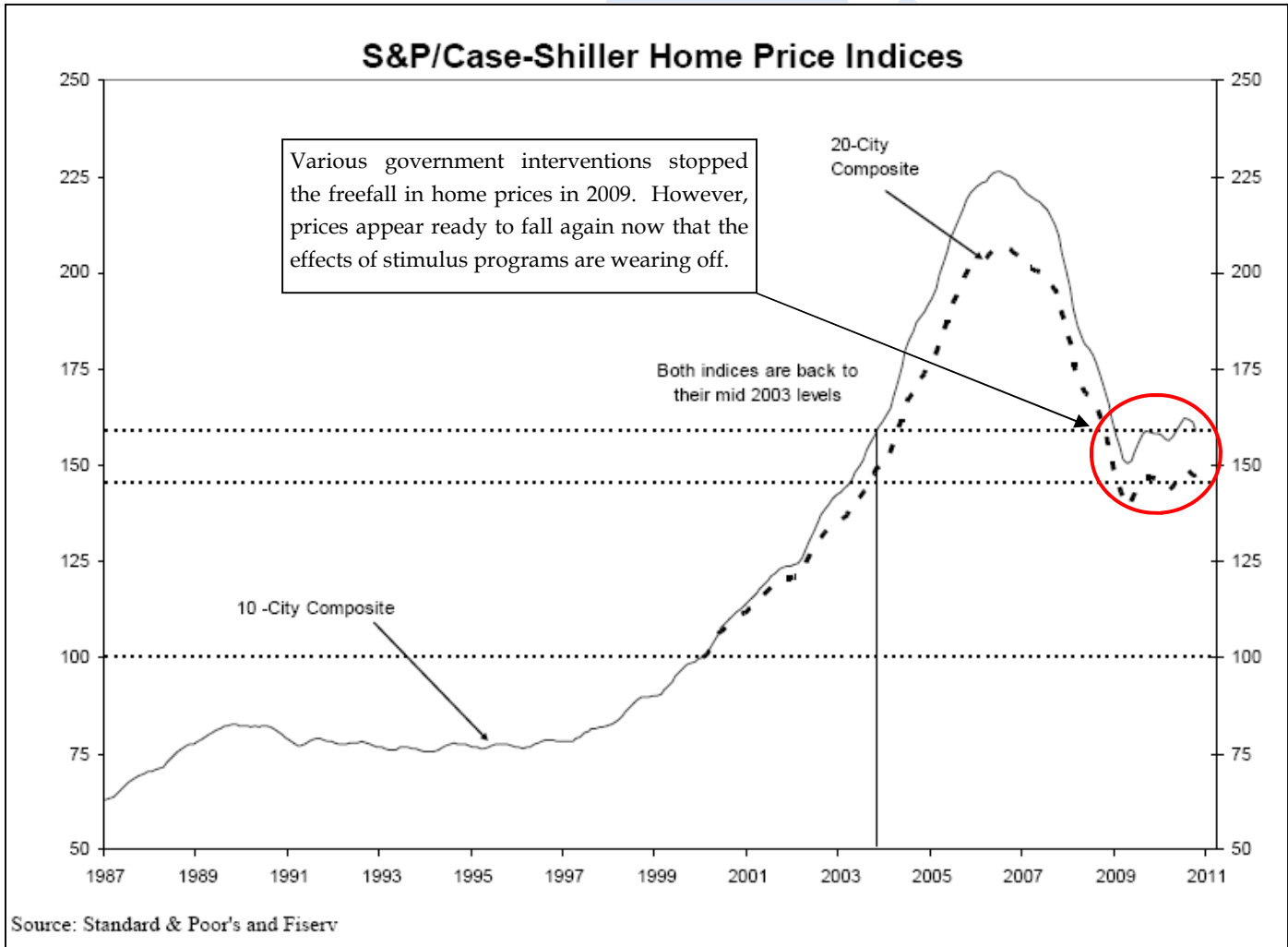
In the year ahead, there may be modest employment gains in the private economy, but those gains will probably be offset by cutbacks in state and local government employment. After closing budget gaps with temporary fixes and federal government assistance over the past 2 years, it appears state and local governments will reduce spending significantly in the coming year.

In fact, it appears that the dire situation in many state governments could be a possible trigger for another debt crisis. Although the federal government has been able to pile on debt to fund its expanding operations, the situation in the states has grown progressively worse. Many states, especially Illinois and California, clearly remain on an unsustainable path. So far they have been able to borrow to meet their funding needs, but they have also been neglecting other, significant obligations – notably pensions.

As happened during the sub-prime mortgage crisis, state and local governments have a lot of debt that is “off the books” and hidden from view. As an example, it has been estimated that total *unfunded* liability for state and local pensions is nearly \$3.5 trillion. Pension contributions have largely been sidelined in favor of more important priorities over the last few years, but that has only made the problem worse. At some point, these unsustainable finances will matter to the bond market—but, as in Japan, there is no way to know when that will happen.

In the housing market, after stabilizing in late 2009, it appears that home prices have begun to fall again in late 2010. According to Zillow Inc., 23% of homeowners with mortgages – representing 11 million homes – were underwater in the third quarter of 2010, meaning they owed more on the home than it was worth. Another 2.4 million homes had less than 5% in equity. As of October, the Case-Shiller 20-City Composite Index was 29% below its mid-2006 peak.

Estimates vary, but there is general agreement that home prices have at least another 5%-10% further to fall before coming back in line with fundamentals. However, prices often undershoot their “fundamental” value during a bust, and there are reasons to believe home prices could fall another 20% before forming a



durable bottom. In either case, it is likely we'll continue to see the numbers of distressed properties and foreclosures mount over the next few years.

The current inventory of delinquent loans, foreclosures and bank REOs sits near 7 million homes, which would take more than 3 years to clear at the current rate of sales. If prices decline, it's likely we'll see a portion of the 13.4 million homes with less than 5% in equity added to this pool, thereby increasing the number of years until the housing market is free from the weight of distressed sales.

In our view, there is no reason to suspect a durable rebound in home prices is on the horizon. In fact, with the expiration of the first-time homebuyer's tax credit, it appears home prices may begin another trend lower over the next few years. This will be a key factor affecting consumer behavior in the coming years, as well as state and local government budgets.

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If we look back a few years, the unsustainable gains in home prices turned into the housing bust when the financing that fueled the bubble was cut off. Near the peak of the bubble it was largely additional debt that propelled prices higher (remember 105% mortgages for new homes?), so when that flow of credit slowed it was enough to spark the beginning of the bust.

In a similar way, governments at various levels in the US and around the world are now propping up their economies using amounts of new debt that in the long run are clearly unsustainable. This is being done out of the belief that the markets will absorb all the debt that is needed until private economies recover and deficits shrink back to pre-recession levels.

During a normal cyclical recession, this is a reasonable approach. It can soften the downturn for nearly everyone and leave the economy primed to resume expansion when inventories are cleared and demand from the private economy returns.

However, the recent recession was not a normal cyclical recession—it was a downturn following a huge real estate and credit bubble. Recovery from these types of busts usually takes a very long time as consumers reduce debt and repair their personal balance sheets. In addition, the approaching retirement of the baby boom generation means the tendency towards saving at the expense of spending will likely be even greater. In this context, the demand from the private economy could take a very long time to recover.

It is impossible to know if the markets will indeed absorb all the debt the US government will have to sell in order to maintain GDP at its current level in the coming years. It could very well be that, as happened in Japan, the markets continue to buy US debt for many years to come even as the debt to GDP ratio climbs beyond 100%. It could also happen that the markets, in very short order, begin to recoil from sovereign debt auctions globally, and interest rates rise to levels that impact the real economy and the ability of governments to efficiently issue new debt and refinance existing debt.

What we do know is that over the past year the markets have grown keenly aware of unsustainable debt growth, and the most financially unsustainable governments have already been forced to capitulate. As we begin 2011, credit-default swaps are already signaling a rising risk for bond holders in other European countries beyond Greece and Ireland.

In the end, it appears likely the debt issues of local, state and national governments will serve as a second act to the debt-fueled housing bust. The incremental gains made by the economy over the past year could continue in the year ahead. However, these gains are being achieved by an unsustainable rise in government debt, and exactly how this is resolved will be the dominant economic theme over the next few years.

Market Summary

Despite many of the fundamental challenges facing the markets in 2010, stocks, commodities and bonds ended the year with gains. The market action throughout the year oscillated between “risk on” and “risk off” modes, with all risk assets more or less rising or falling together. In general, most markets traded up and down throughout the year before ending 2010 at or near their highs.

In this market summary, we’ll start with a discussion of the US and global stock markets before moving into bonds, currencies and commodities.

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Stocks in the US and in many markets around the world performed relatively well in 2010, considering the potential challenges posed by the European debt crisis and the “flash crash” that struck in May. The S&P 500 finished the year with a 15% gain, while the MSCI World (ex USA) Index finished with a 6% gain.

After thinning the workforce by millions of people during the recession, corporate profits rebounded in late 2009 and 2010 to surpass the previous high reached in 2006. This was accomplished in large part by a surge in the profits of financial companies, which were the biggest beneficiaries of the government bailouts in 2008 and 2009. Profits of non-financial companies have recovered most of their recessionary decline, but not all.

Depending on how closely you follow the financial markets, it may be surprising to learn that profits are at new highs even though stock prices, as measured by the S&P 500, are still 20% below their highs. In other words, new highs in profits haven’t translated into new highs in stock prices. If we go back even further, after-tax corporate profits soared 175% from the first quarter of 2000 through the second quarter of 2010. However, during that same time, stock prices fell roughly 15%.

In fact, there is nothing novel about a period of falling stock prices and rising earnings. Since the end of World War II, corporate profits have more or less trended continuously higher, with only minor interruptions during recessions. However, stock prices have gone through long periods in which they trended sideways or down, even though earnings continued to rise. From 1966 to 1980 after-tax corporate earnings rose 244%, but the price of the S&P 500 rose only 18% during that period. In contrast, earnings grew only 112% during the next 14 years from 1980 to 1994, but the S&P 500 rose 327% over that time.

Although very short-term returns are influenced by corporate earnings, beyond the short-term it is not trends in earnings but *valuations* and *trends in valuations* that determine stock market returns. In short, when valuations are low and increasing, long-term stock market returns are high. When valuations are high and decreasing, long-term stock market returns are low – even negative at times of peak valuations.

There are many ways to measure the valuation of the stock market, but relatively few ways that have value when they are applied across many types of bull and bear markets. Over the past year we have focused on the price-to-earnings measure popularized by economist Robert Shiller, which uses a 10-year average of earnings. Since earnings have at times fluctuated wildly in the short run, a 10-year average captures a much more reliable snapshot of the long-term profitability of public companies.

As you probably know, the stock market peak 10 years ago was the largest bubble in this country’s history. Previous bull markets ended with a 10-year P/E ratio in the 23–33 range, with the high point being the peak in 1929 at 33, just prior to the Great Depression. However, the bull market that ended in 2000 recorded a peak 10-year P/E ratio of 44, a valuation that was 33% higher than in 1929.

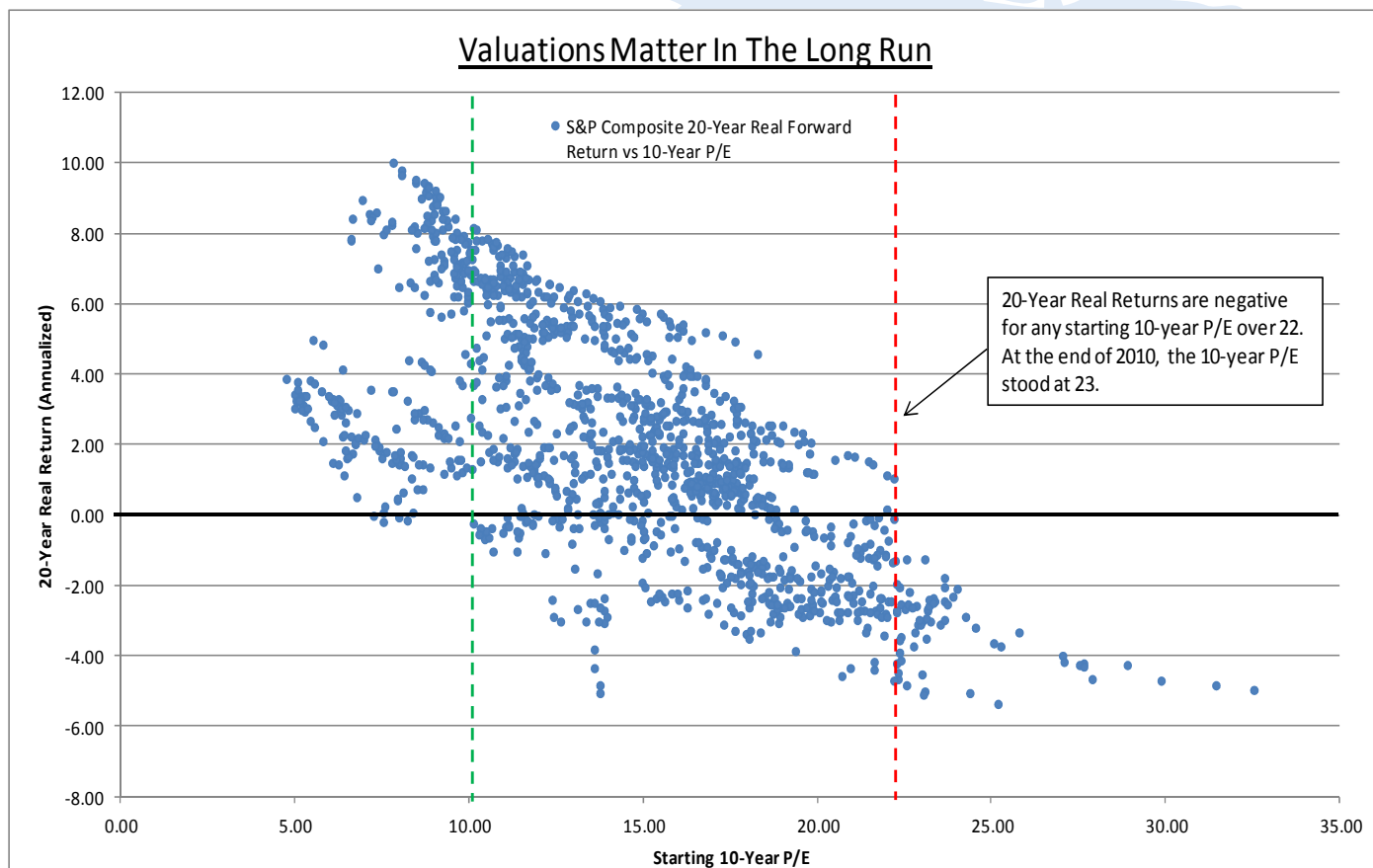
To really understand on a practical level how high valuations were at the peak in 2000, it helps to look at market returns from different valuation levels before the bubble in the 1990s. The chart below has a blue dot for every month from 1881 through 1990. The horizontal axis at the bottom shows the 10-year P/E of the S&P Composite during that month, and the vertical axis to the left shows the subsequent 20-year inflation adjusted return of the market.

Prior to 1990, each month in which the 10-year P/E was under 10 (to the left of the green line) had a positive inflation-adjusted return over the next 20 years. That means that at those low valuations, you could confidently buy-and-hold stocks for the long term and know that the market would beat inflation over time – often by a significant amount.

However, for 10-year P/E ratios above 22 (to the right of the red line), there is not a single month between 1881 and 1990 in which the market had a positive inflation-adjusted return in the subsequent 20 years. And for P/E ratios above 25, past returns have approached -10% annualized, a rate of return that gives an 88% inflation-adjusted loss over 20 years.

Since 1995, the market had been above 10-year P/E valuations of 22 for 13 consecutive years, until July 2008. After a brief decline in 2009 into valuations that would be considered “average” historically, the market ended 2010 with a 10-year P/E of 23. Although this is about half of the peak valuation in 2000, it is still above valuation levels that have produced positive inflation-adjusted returns in the past.

With a peak 10-year P/E ratio of 44 in 2000, it is no mystery why returns over the past decade have been poor. On a consumer price index adjusted basis, the S&P 500 ended last year 31% below its 2000 peak, for an annualized return of -3% . Although we’ll have to wait another 10 years to see the S&P 500’s 20-year inflation-adjusted return from its record P/E of 44, it is almost certain to be a negative number – and probably a large negative number.



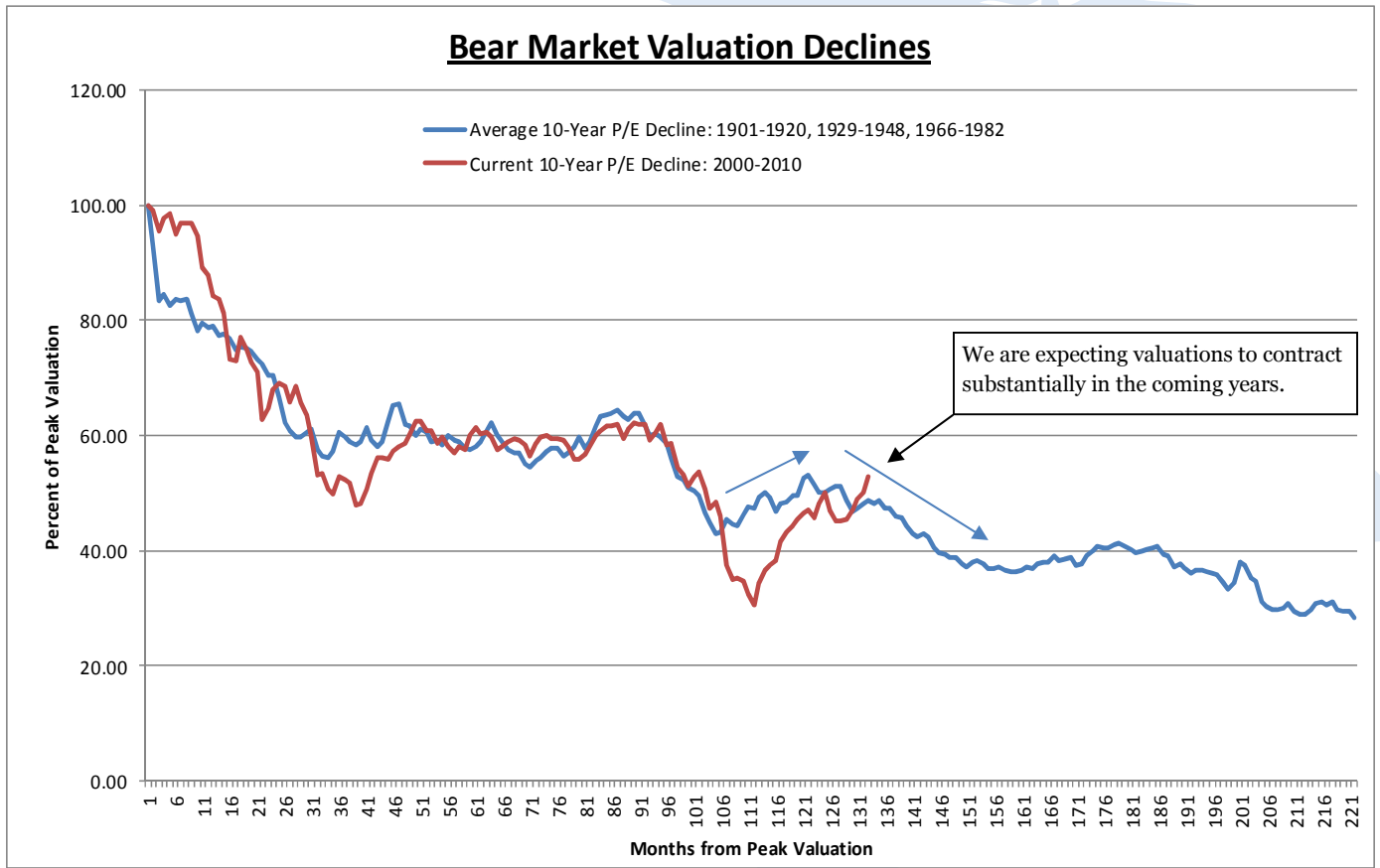
As we discussed early last year, the decline in the 10-year P/E ratio since 2000 is more or less following the average decline in past long-term bear markets. The blue line in the chart below shows the average P/E decline in past long-term bear markets in 1901-1920, 1929-1948 and 1966-1982. The red line shows the current bear market.

What this chart doesn't show is that during the first 10 years there is a wide variance in how valuations declined in past bear markets. For example, the valuation decline from the peak in 1929 was severe—the market's 10-year P/E ratio declined 80% within 3 years, and then rebounded modestly. In contrast, the decline from the peak in 1966 was gradual, as the market's 10-year P/E stayed well above the average for the first 7 years.

However, things seem to change around the eighth year of each previous bear market: from that point on, there is very little variance in how valuations decline. In the latter half of all previous bear markets valuations declined steadily, falling by at least half over the subsequent 9-11 years.

One plausible explanation for these consistently declining valuations starting midway through a long-term bear market is it may be the point when the public finally begins to throw in the towel. This is certainly what we have seen over the past couple of years, as investors have continuously pulled money out of US stocks. Despite the recovery in the stock market, investors pulled more than \$80 billion out of domestic stock funds in 2010, which is the fourth consecutive year of outflows. This comes after 22 years of almost uninterrupted *inflows* into the market.

When valuations are declining, generating positive returns in the stock market is like trying to swim up a river. Even if earnings are increasing, prices are being dragged lower and lower by the weight of declining valuations. Inflation makes real returns even worse.

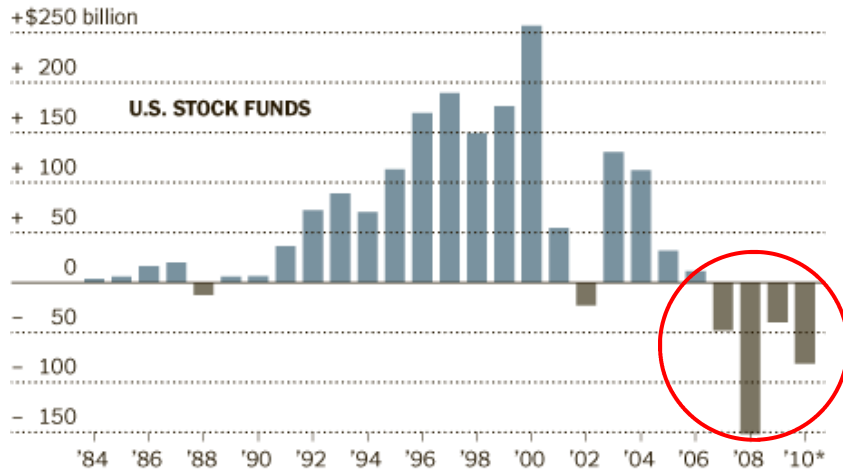


Although these trends may be difficult to detect early on in a long-term bear market, the public eventually realizes what is going on and begins to pull money out. At that point, sentiment towards stocks begins to turn decidedly negative for good.

It's clear we reached such a sentiment pivot point in 2007-2008.

Along with this change in sentiment, as more baby boomers enter retirement in the coming years and shift assets out of stocks into more conservative investments, there will likely be a continued leakage of funds out of the market in the coming years.

Net cash flows into mutual funds



This exodus will continue to drive valuations lower in the coming decade, and at the end of this process we'll likely have a stock market that is truly *undervalued*. From today's 10-year P/E of 23, we'll likely see that ratio drop under 10 in the years ahead, leaving the market with a truly appealing long-term potential return.

Most analysts and strategists now forecast S&P 500 earnings to continue to rise in 2011 and over the next few years, and they expect stock prices to follow. We are now hearing calls for the S&P 500 to rise back to its 2000 and 2007 high near 1500; because earnings are making new highs, expectations are that stocks prices will as well.

Although these market expectations are contrary to all past experience in long-bear markets, in the short-term they have fueled a surge in optimism that helped stock prices rise into year end. However, even though prices have continued to rise, the gains have come amid more signs of technical weakness, not strength. These technical signs have kept us cautious about the market's prospects in the short-term, just as valuations have kept us cautious about the long-term.

In a healthy market advance, there are usually a number of signs that confirm the advance is strong and therefore likely to continue. For example, when the market as a whole is making new 52-week highs, we expect to see the number of stocks making new 52-week highs keep pace to show that there is broad participation in the advance.

However, what we saw at year end was the opposite. As the S&P 500 and a number of other major indexes were making new 52-week highs late in the year, the number of stocks making new highs kept falling. By the first trading day in 2011, they had fallen by nearly half. This is one indication that fewer and fewer stocks were powering the rally later in the year, which is something we tend to see near the end of major uptrends.

There are a number of other technical signs that indicate the market is on shaky ground, many of which we have covered in client letters of the past year—so we won't belabor the point again here. In the past these market conditions have been seen prior to severe bear markets, as in 2007. They have also been seen prior

to weak advances that trend higher for years but make little net progress. Recent examples of this are 2004 and 1992, in which the market chopped higher by ~10% over the following 2 years. This leaves us today with a market that appears to have a limited potential return along with a high risk of a significant decline.

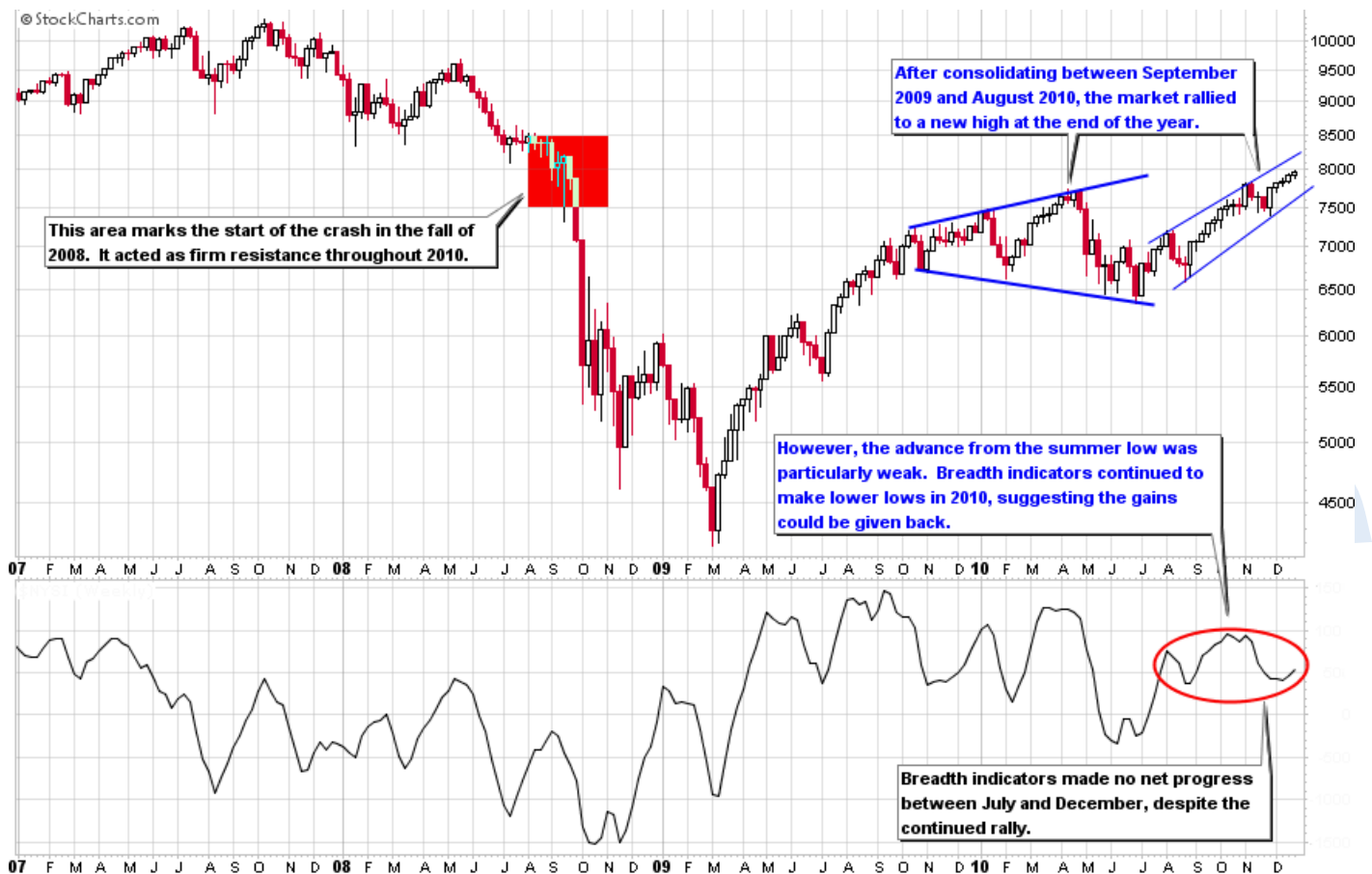
Since these conditions first appeared the fall of 2009, the market has continued on the “limited potential return” side of this equation. After rising 73% from March 2009 to October 2009, the NYSE Composite has since oscillated higher and lower before ending the year 10% higher than it was in October 2009.

During this time, the NYSE Composite has been capped by resistance from the start of the crash in the fall of 2008. Although the markets had been declining throughout 2008, the bankruptcy of Lehman Brothers was the spark which ignited the crash that began in September. The NYSE was near 8200 at the time, which is just above where the index ended 2010.

At various time scales, markets often return to the start of these types of “dislocations,” before resuming their larger trend. The question going forward is whether the market is going to move above and beyond the start of the crash in 2008, or whether this entire rally from March 2009 has been a typical post-crash technical rebound that will give way to another decline once it is complete.

If the underlying technical condition of the market were to strengthen, we would be open to increasing exposure to stocks in all of our portfolios. However, the current historically high valuation of the market (10-year P/E at 23) and the potential debt problems that lie ahead reinforce our current outlook, based on technical factors, for at best modest gains in stocks and at worst significant losses over the next 2 years. In that context, we need to see very strong short-term market action to take on significant exposure to stocks, which is something we have not seen over the past year.

The NYSE Composite Index, 2007-2010



* * *

The Treasury bond market, along with sovereign debt in many countries around the world, went through a number of ups and downs in 2010. Through the spring, yields rose modestly as the focus remained on the potential inflationary impacts of government stimulus programs. The yield on the 10-year Treasury hit a high of 4.01% in April.

From that high in April, the 10-year Treasury yield fell precipitously to a low of 2.33% in October. During that time, the focus changed from the potential inflationary impacts of the stimulus programs enacted in 2008 and 2009 to a realization that, despite record stimulus, the economy did not strengthen as planned.

Following the Fed's announcements that it would recycle funds from maturing mortgage bonds into Treasury purchases and also start a separate \$600 billion program to buy additional Treasury bonds, yields began to rise again as the market again turned its focus back to potential inflation. By the end of the year, the yield on the 10-Year Treasury was back up to 3.3%.

30-year Treasury yields followed 10-year Treasury yields lower mid-year, and also rebounded into the end of the year. Yields on both have risen back to the top of their long-term declining channel, which has defined the bull market in Treasury bonds since the 1980s (see chart below).

Many analysts and fund managers have gone on record to say that the Fed's announcement of QE II will mark the end of the bull market in bonds. That could very well be the case, although not necessarily for the reason most often cited – inflation.

It remains very unlikely that there will be any broad-based inflation in the years ahead. If there is one take-away lesson from past demographic transitions, it is that prices generally rise prior to the peak earning years of a population bulge and then generally fall following peak earning years as the ratio of retirees/population grows. The chart of the civilian participation rate back on page 4 basically tracks the progress of this demographic shift over the past 60 years.

This does not mean prices for *everything* will follow this demographic pattern. Commodities, which are subject to *global* forces of supply and demand, will be at the top of the list of asset classes that will likely

30-Year Treasury Bond Yield, 1980-2010



buck this general trend. However, the parts of the economy which are dominated by supply and demand within the US, such as credit growth and housing, will continue to be significantly influenced by these demographic changes.

This distinction between things that are dominated by global supply and demand and those dominated by domestic supply and demand is the key to understanding the outlook for inflation. Rising copper and oil prices now have little to do with the prospect for general inflation in the US, and more to do with economic trends and inflation in China and other countries that have been growing more rapidly. This may negatively impact the cost of living in the US through increasing commodity prices, but those price gains are not being fueled by a broad-based trend of increasing credit, rising wages and asset prices in the US.

Instead of inflation, the largest risk to the Treasury bonds is that the markets start to focus more on unsustainable deficits and debt. Yields on Greek 10-year bonds have risen above 13% not because of inflation (the recent rise in Greek inflation rates is due to large one-time tax increases from the austerity plan), but because of a lack of confidence that holders of Greek bonds will get their principal back whole.

The US itself will likely be one of the last high-deficit high-debt countries to become the focus of any real fear of inflation/default risk. However, if the next few years are characterized by debt problems at the state and national level, Treasury rates could rise if inflows from a flight to safety do not compensate for outflows due to a general repudiation of sovereign debt securities. In other words, if the rolling debt crisis continues and intensifies, US Treasury bonds may not escape unscathed.

For these reasons, we have become more cautious on Treasury bonds in recent months. Although inflation remains subdued and sentiment on Treasury bonds remains extremely negative (which is usually bullish), we will likely trend more lightly in the Treasury market in the year ahead because of these other risks.

* * *

Like Treasuries, sentiment on the US dollar is extremely negative. However, we enter 2011 with a positive outlook for the dollar, largely the result of a negative outlook on the euro and other major currencies.

The euro zone economies are being forced to deal with their unsustainable deficits and debt before other regions, because of their common currency. They are still early in this process, and over the next few years the euro appears likely to weaken as high deficits are scaled down and fears of default persist. In the end it is likely there will indeed be defaults in some euro zone countries, and this could drive the euro down substantially versus the relative safety of the US dollar.

The yen has been rising against the US dollar since 2007, as the housing bust and credit bust ravaged through US markets. However, as we discussed earlier, it appears to be just a matter of time before a debt crisis hits Japan, and when it does the yen will likely weaken substantially. There is no way to know when that will happen, but current events make this more likely in 2011 than it has been in recent years, and when it does happen the US dollar would benefit.

Although it has received little attention recently, China is suffering from a growing inflation problem. China has been a major demand source driving many commodities higher over the past 2 years, but it now must deal with quickly rising food and property prices. In response, China's central bank has been raising interest rates and bank reserve requirements in recent months, in an effort to slow credit growth.

If China fails to engineer a sufficiently soft landing, economic growth may slow and demand for commodities may soften. This could in turn impact currencies such as the Australian dollar and the Canadian dollar – countries which also are dealing with extremely high property prices.

If commodities decline and/or property prices in Australia and Canada begin to decline, the US dollar would likely benefit.

The US Dollar Index itself has been in a broad trading range for the past several years.

After a number of lower highs and higher lows, that trading range is contracting in a way that suggests an eventual breakout is building.

Such a breakout, either higher or lower, will result in a trend that lasts several years.

U.S. Dollar Index 1998-2010



It appears there are a number of fundamental dollar-positive trends in place, and also a number of *potential* issues that could be positive for the dollar in 2011. In addition, on a technical basis, it appears the dollar index will likely trade higher within its trading range in the coming months. For these reasons we expect the dollar to strengthen, and beyond that we'll continue to monitor the dollar's long-term outlook.

* * *

Gold prices gained nearly 35% in 2010, which was part of a broad advance by commodities over the past year. The CRB Commodities Index gained 17%, propelled by gains in energy, metals and agriculture prices.

If there were any lingering doubts about the bull market in real assets, the recovery to new highs in many commodities over the past 2 years should have put those to rest. Stocks gained in 2010 along with commodities, but the Dow/gold ratio ended the year trading near the lows it set in 2009. In other words, despite the dramatic rise from the March 2009 low, stocks have only managed to keep pace with gold over the past 2 years.

Although the Dow has now lost more than 80% of its value relative to gold since 1999, it would take another 80% decline to reach the lows set in 1980 and 1933-1935. As we have discussed many times in prior letters, it appears most likely that the continued decline in the ratio of stocks to gold in coming years will come from both a rise in gold and a decline in stocks. We haven't seen anything over the past year that would change that long-term forecast.

What has changed over the past year is the risk of a short-term pull back in gold and other precious metals. After the high-profile gains in 2010, in which gold gained nearly \$400/oz and silver gained 83%, it would be natural for prices to consolidate or correct. However, any pull-back in gold in 2011 would likely be a correction within an ongoing long-term bull market.

There are many who feel that gold is in a bubble, and they may be correct. However, there is a big difference between being *in* a bubble and being *at the end* of a bubble.

Back in 1996, many, including Fed Chairman Alan Greenspan, went on record saying stocks were in a bubble. And they were right—stocks *were* in a bubble. But they were not at the end of their bubble. Between 1996 and the end of the stock market bubble in 2000, the S&P 500 gained another 130% and the Nasdaq

Composite rose from near 1100 to over 5000 – a gain of more than 350%.

It seems likely that the current gold bull market will end in a speculative frenzy similar to the one that marked the end of the previous gold bull market in 1980. This is also how the stock market bubble in 2000 and the real estate bubble in 2006 ended. More often than not, bull markets end that way.

Not only will sentiment be extreme at that point, but the valuation of other assets (like stocks) will likely be at or near the end of their bear markets. Then, and only then, will it be time to shift from a buy-and-hold approach in gold and real assets to a buy-and-hold approach in stocks.

Outside of precious metals, energy prices continued to recover in 2010, though they remain far below their 2008 peaks. Oil traded above \$90 after ending 2009 at \$79/barrel, and gasoline prices ended 2010 at a 2-year high.

While the long-term outlook for energy prices remains very positive, there are a number of issues that could lead to short-term corrections in the price of many commodities – energy included. The prospect of a significant rally in the US dollar in the coming months could impact energy prices, especially if the strength in the dollar was being fueled by negative events in the ongoing debt crisis and/or a slowdown in China. A significant rise in interest rates could also dampen economic growth and energy prices.

However, any weakness in energy, precious metals and other commodities in the coming year would be viewed as additional buying opportunities to accumulate real assets. The bull market in real assets still has a long way to go, and it's highly likely investments in gold and other commodities will continue to outperform stocks and bonds over the next 5–10 years.

Gold (top) and Dow/Gold (bottom)



* * *

Portfolio Summary

Now that we have emerged from the bear market and recession in 2008 and 2009, there are basically two main groups of investment managers. The first group is mostly concerned with company-specific metrics like valuations, business trends, and so forth. This group is mostly bullish these days, because many sectors of the market are now cheaper than they have been in nearly two decades. In addition, the economy *should* continue to gather steam (even though, as we discussed earlier, the recovery will likely be modest).

The second group is mostly concerned with the macro situation we find ourselves in, both here in the US and abroad. This group is more bearish, because there are some significant, unsustainable issues that will have to be resolved sooner or later—and the impact on the markets will likely be severe.

Sitka Pacific is in the latter group, because successfully navigating investments through a long-term bear market requires an awareness of the larger cycles at work. Investing today continues to be an exercise in *preserving capital* from the effects of declining valuations, inflation and the fallout from the stock, real estate and credit bubbles.

As we continue to align our portfolios with the opportunities and risks we see over both short-term and long-term time horizons, there will be many periods when our portfolios outperform the markets, and many periods when our portfolios underperform the markets. However, our overall goal remains the same: to get your assets to the next bull market in better shape than simply holding cash or remaining fully invested.

Valuations are certainly cheaper today than they have been in a long time, and that is mostly due to the fact that valuations reached such extremes in the 1990s and early 2000s. Because of those extremes, valuations today seem low even though they remain quite high by historic standards.

By the end of this bear market, valuations will likely be the cheapest they have been in *many* decades, and it will be those investors who have remained aware of these larger trends who will benefit the most when valuations begin expanding again in the next bull market. We aim to be in that group.

Over the next few pages we'll discuss each of our portfolios' performance, allocation and expectations for the coming year. Our official GIPS-compliance results for each portfolio will be posted on our web site when they become available.

Absolute Return

Absolute Return had a modest positive return in 2010. We remained conservatively positioned throughout the year, and as a result the portfolio's net return was near the return of the average hedge fund in the HFRX Global Hedge Fund Index.

Absolute Return benefited from the continued rally in precious metals and commodities, the rally in Treasury bonds in the middle of the year, and our modest equity holdings. The largest drag on portfolio performance was our hedges against a decline in the stock market.

In our March 2010 client letter we looked at a chart of Japan's Nikkei 225 average, and commented how an investor could have achieved a sizable return by staying invested only in the middle half of each of the 7 major rallies over the course of the Nikkei's 80% decline. The main message was that in a long-term bear market it pays to buy stocks when conditions are extremely favorable, but investors must be willing to move to the sidelines when conditions are not ideal.

Conditions in the stock market were far from ideal in 2010, which is why we hedged our stock and commodities holdings to protect against a decline. Our intention was to keep a positive bias, so that the portfolio would rise modestly with continued gains in the markets, while at the same time quickly becoming fully hedged in the event of a larger market decline.

The decline in equity markets over the summer did not turn into a more significant downturn, and instead stocks have rallied back to extreme valuations on a very weak technical foundation. During a long-term bear market, these are not the conditions that support sustainable gains. We remain hedged as we enter the new year because the markets still appear vulnerable to a significant decline.

We held significant exposure to Treasury bonds as yields fell throughout the summer, and managed to reduce our exposure by half near the lows for the year in October. However, we did not anticipate the speed and strength of the selloff in bonds in November and December. As we discussed earlier, there now appears to be significant external risks to Treasury bonds in the coming years, so we will likely tread lightly in this asset class going forward.

We continue to hold gold and gold mining stocks, though we trimmed our allocation to mining stocks early in 2010 after the dramatic rally in 2009. Our current holdings represent a “core” allocation to gold, which we will likely continue to hold even through a short-term correction. Although gold is beginning 2011 in a relatively weak short-term technical position, there are too many fundamental reasons why gold should continue to rise in the coming years to try and time too many short-term trades in and out of this sector.

However, we have recently traded in and out of silver. After adding exposure to silver and silver mining stocks last August, we very recently sold those positions. After rising dramatically late in 2010, silver seems to be ripe for a more significant consolidation or correction at the same time as the US dollar appears to be preparing for a rally. We’ll continue to watch silver in 2011, but remain on the sidelines for now.

The year ahead may prove to be another modest year for Absolute Return. We have entered 2011 with most of our risk assets hedged against anything more than a modest decline in stocks and energy. In the context of current market conditions, we believe it is far more important to be focused on capital preservation until better short-term opportunities present themselves.

Hedged Growth

After a difficult 2009, 2010 proved to be another tough year for shorting and for Hedged Growth. We remained defensive for most of 2010, owning solid dividend-paying companies and shorting companies that possess qualities associated with stocks that tend to underperform over time. However, *over time* does not mean all the time, and 2010 was another year that proved to be an exception to the long-term averages.

Despite another negative year in 2010, the long-term performance of Hedged Growth remains good. The annualized return of Hedged Growth from inception in 2005 remains positive, and higher than the S&P 500. During that time, the S&P 500 has been extremely volatile and suffered a 58% drawdown. Hedged Growth has been far less volatile than the market, and gone through a 20% drawdown.

Although that last year and a half has been difficult, the overall approach of Hedged Growth will likely outperform over the course of this long-term bear market. During a period of falling valuations, buying high quality dividend paying stocks carries less risk than the broader market. At the same time, shorting lower quality stocks will, over the course of the entire bear market, enhance returns.

When the bear market re-asserts itself, Hedged Growth will likely again provide positive returns as we are currently positioned. The portfolio has not done well as stocks have returned to lofty valuations that have only been seen a few times over the past 130 years, but we view this as another unsustainable bear market

rally that will eventually give way to another decline. This is the main reason we continue to recommend that Hedged Growth be part of your overall strategy.

From a technical perspective, the market appears more stretched as we enter 2011 than at any other time since the high in 2007. At that time stocks continued to make incremental gains, with each new high technically weaker than the last. However, the downturn that followed took back all of those late-stage gains in only a few months, and the market today appears at risk for a similar outcome.

As a result, we remain conservatively positioned in Hedged Growth as we enter 2011. This approach did not pay off in 2010, and it will likely not pay off until the stock market begins a new trend lower. However, in light of the market conditions a defensive stance remains the most appropriate.

Dividend Growth

Like Hedged Growth, Dividend Growth declined in 2010. After taking advantage of the rally in 2009, the market in 2010 offered more risk than potential reward, and we remained defensive throughout the year.

Dividend Growth's performance in 2010 would have been better had we anticipated valuations returning to today's lofty levels. After the bear market in 2008 and 2009, it seemed likely the market was done with historically high valuations. However, with the recent rise to a 10-year P/E of 23, that obviously was not the case.

As with all of our portfolios, our emphasis on long-term returns sometimes leaves us with little exposure to the market when the risk of a decline is high. During a long-term bear market, our focus on managing significant short-term risks is just as important, if not more so, than focusing on potential returns on individual investments.

Given the present fundamental and technical market conditions, and the fact that we are heading into what appears to be another phase of this ongoing debt crisis, the market risks are clearly slanted to the downside. We feel our current defensive stance will ultimately be rewarded with a far better opportunity to increase our market exposure, even if that takes some time to realize.

Commodities Focus I

As precious metals rallied in 2010, Commodities Focus I had a good year. As we enter 2011, we remain long-term investors in gold and gold mining shares, while remaining cautious on other commodities.

As was mentioned earlier, there is the chance that precious metals and commodities in general could correct at some point in 2011. However, since the Federal Reserve will likely respond to any setback in the markets with more quantitative easing, it is worth taking a long-term perspective with gold through any short-term volatility.

As in Absolute Return, we have traded in and out of silver over the last 6 months. While silver is part of the long-term bull market in precious metals, its huge rally late in 2010 appears somewhat overdone. We remain on the sidelines with regard to silver, but may scale back into the market if the risk of a more significant correction dissipates.

Energy stocks will likely become attractive as long-term investments at some point in the next few years. However, like the broader stock market, energy stocks appear quite vulnerable to another decline over the next year or two. Potential inflation issues in China and the debt issues we have discussed could dampen energy prices from current levels, at which point many energy investments would likely be at attractive prices. Until then we have taken a cautious stance in anticipation of that buying opportunity.

* * *

On a more personal note, two books I read over the past year gave some nice insights into today's markets, even though that was not their primary subject. The first was *Lords of Finance: The Bankers Who Broke the World*. This biography followed the central bank heads in the U.S., Britain, France and Germany during the years leading up to the great depression, focusing mainly on WWI and the 1920's. It is a fascinating read of a time that, while certainly different from the present time in many respects, portrays some of the same core issues we are facing today.

More than anything else, the book was a stark reminder that central bankers, then and now, are more or less making policy up as they go along. In the wake of the housing and credit bust, the Fed today is trying to do what it can to foster conditions for more robust economic growth. However, like in the 1930's, they do not have the power to counter every negative trend.

The second was *The Snowball: Warren Buffett and the Business of Life*. This is a biography of Warren Buffett, with an emphasis on his investing roots and career from his early childhood to the present day. It was a fascinating record of his life, a life every serious investor should be familiar with.

Although there are a number of important themes in the book, one in particular relates to what we have discussed in this letter. Warren Buffett started seriously buying stocks in 1949, which was at the very tail end of the long-term bear market that began 20 years earlier in 1929. At that time the 10-year P/E of the market was under 10, the dividend yield was 7%, and valuations were set to rise significantly. The subsequent annualized 20-year real (inflation adjusted) return of the market from 1949 was 15%. In short, as he has noted many times himself, he was fortunate to begin his investing career at a time when the markets were primed to deliver very strong gains.

We have faced the opposite situation over the last 10 years that Buffett faced in 1949. Instead of an undervalued market with a very high potential return, we have had an overvalued market with a very low potential return. This has called for a very different approach to the markets over the last 10 years, one that focuses more on risk management and absolute returns.

I have no doubt that we will once again see market valuations that will allow us to confidently invest in stocks for the long-term, knowing that history will be on our side in doing so. When we see valuations similar to what Buffett saw in 1949, we will be ready to shift to a more value-oriented, buy-and-hold approach. Unfortunately, although valuations have come down significantly in the past 10 years, they have a long way to go before stocks are truly undervalued.

We very much appreciate your trust in us to manage your assets. As always, if you have any questions about your account or any of the topics in this letter, feel free to send us an email.

Sincerely,
Brian McAuley

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