

Dear Client,

While economic reports continued to reflect meaningful expansion throughout most sectors, the stock market suffered its worst quarterly decline in over a year as confidence faded. The headlines were dominated by global crises concerning the stability of several Euro-zone members, a slowdown in the Chinese economy and the Gulf oil spill. Perhaps as great a factor as any in the precipitous decline, was the 'Flash Crash' on May 6th. Investors witnessed a near 10% correction in a matter of minutes due primarily to an apparent computer glitch and the intense volatility proved too much for many to digest so soon after the severe recession.

In the long run, stock appreciation is directly correlated to earnings growth, which is our primary investment thesis, but psychology is a material consideration in near-term valuations. There is considerable uncertainty in the U.S. and throughout the world as countries face the difficult task of implementing austerity programs to address crippling deficits. The continued rise in gold prices indicates that many sophisticated investors believe a flood of liquidity will ultimately lead to inflation. Last year's cost cutting has enabled many companies to experience significant earnings increases this year, but as these comparisons anniversary, it is hard to see demand reaching a sufficient level to sustain above average earnings growth. As the recovery began in 2009, it was apparent it would be more muted than typical due to consumer deleveraging and planned tax increases; however not enough positive attention has been paid to the stellar balance sheets enjoyed by corporate America. High cash levels provide financial flexibility for share buybacks, opportunistic acquisitions and dividend payments and these factors, combined with forward multiples well below historical norms, make stocks attractively priced in a very low interest rate environment.

The threat of further sovereign ratings downgrades and continued sluggish demand despite an aggressive bailout program, will continue to pressure the Euro. German manufacturing will benefit from the devalued currency and many companies have meaningful offsets of Euro denominated cost centers, which suggests that the effect on U.S. stocks will be manageable and will vary on a case-by-case basis. A stronger U.S. Dollar and slower global expansion have suppressed the price of oil. The major energy headline has been the devastating impact of the accident in the Gulf on the environment and local community. The administration's response is understandable and intended to satisfy public outcry for necessary regulation, but a ban on deep water drilling will have a long-term adverse effect on the price of oil and present an additional future headwind for the economy.

As we approach the mid-term elections, the Administration will likely seek to support growth initiatives and in some cases reduce costly regulatory and tax-hike plans. This was evident in the significant, but watered down version of the Financial Reform Bill and will be necessary as limited policy drivers for the economy remain available with interest rates near zero and the stimulus plan beginning to expire. While not as severe as the sacrifices required in Greece and other parts of the world, the U.S. will likely be forced to

accept a reduced standard of living as ongoing high levels of unemployment and a sluggish housing market weigh on consumer confidence.

High quality growth stocks represent an excellent investment opportunity at current levels. An analysis of mutual fund flows indicates that investors have moved away from equities and are pouring money into bond funds, despite the low yields and meaningful risk to principal should inflation ultimately appear and rates rise. Warren Buffet has been widely quoted as saying one should “be greedy when others are fearful and fearful when others are greedy.” While more pronounced at the peak in 2000 and trough in 2009, it appears investors’ emotions are running too high and there is too much fear of stocks and unfounded optimism toward bonds, which suggests their fates will reverse over the next couple of years. It is reasonable over time to expect equities to enjoy earnings growth at mid to upper single digit rates and also experience slight multiple expansion, which should provide returns that will more than compensate for the additional volatility of the stock market.

Earlier in this letter we addressed the psychological fears of investors and feel this is a positive contrary indicator. We have always maintained a long-term viewpoint in assessing the prospects of our holdings and remain highly confident in the ability of our portfolio to outpace the market with less volatility over time. Thank you for your continued confidence and support.

Sincerely,

David Klaskin
Chairman and CIO