Ponderosa Investment Group LLC

INVESTMENT LETTER

Second Quarter 2009 • V13

The overall environment has improved, but plenty of problems remain.

Macro issues are unusually important in this environment, and there are several key areas I'm assessing to help make portfolio-level decisions.

Highly significant questions include when housing will bottom, what the longer-term impact will be of government stimulus and other policy actions, and whether investors will remain risk averse in the years ahead.

The current portfolio positioning has a modestly conservative bias.

In all but my most optimistic scenario, the returns I expect from broad asset classes are not exciting in the years ahead. But I think continued tactical opportunities and value added from the money managers improve the return outlook.

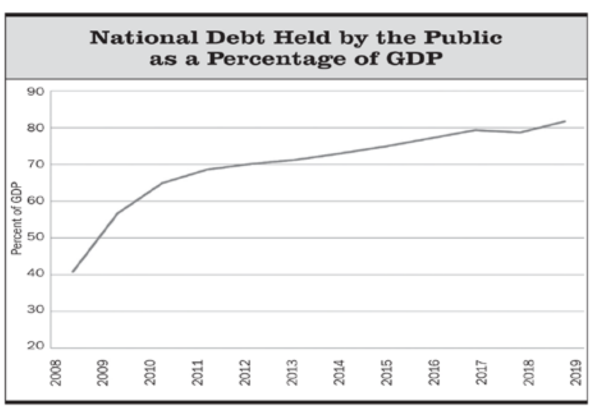
Quarterly Investment Commentary

As I look back on a tumultuous first half of the year, I'm struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years. Clients portfolios, boosted by successful tactical shifts in our portfolio allocations (especially a large weighting to high-yield bonds), and by significant outperformance from the managers, did considerably better than their market benchmarks.

2009 Index Performance	2nd Qtr.	YTD
Citigroup 3 Month T-bill Index	0.05%	0.09%
Barclays Cap. US Aggregate Bond Index	1.78%	1.90%
M.L. US High Yield Master II Index	23.19%	29.37%
S&P 500 Index	15.93%	3.16%
Russell 2000 Index	20.69%	2.64%
MSCI EAFE N$ Index	25.43%	7.95%
Dow Jones – AIG Commodity Index	11.67%	4.62%

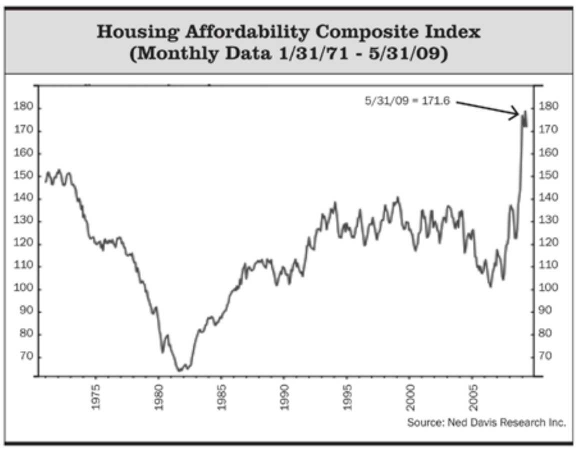
The Market and the Economy – Uncertainty Reigns

The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears past; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. And though economic activity continues to worsen, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of huge debt bubble continue to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the level where it might have been without the artificial boost of the credit bubble. While it probably allowed us to avoid a

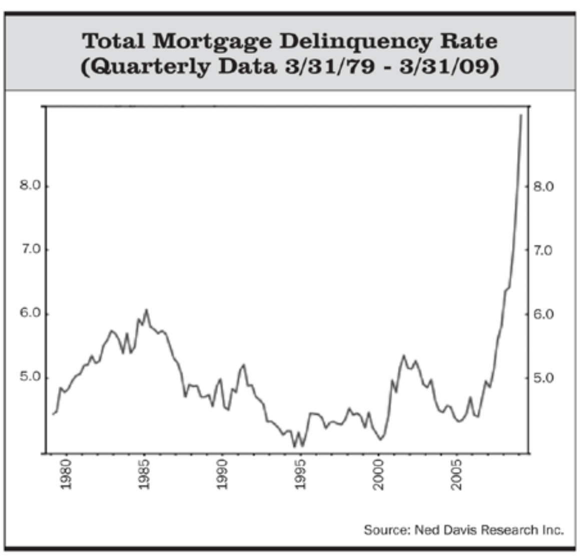


depression, the massive bailout and stimulus spending (along with longer-term demographic factors such as spiraling health-care and other entitlement spending) is causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

Other conflicts are at play that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have recently been a few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There is more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse.)



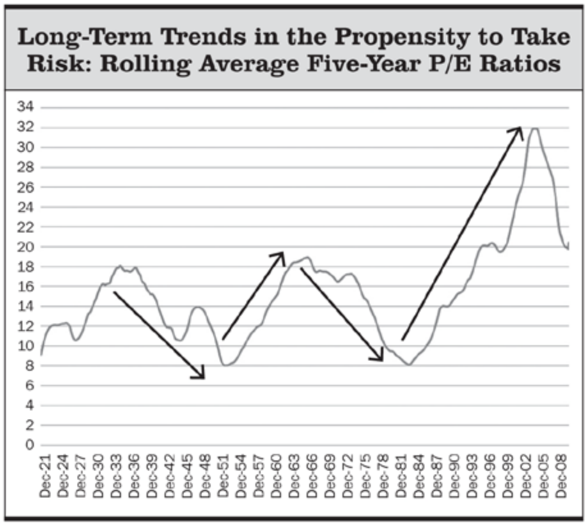
Higher points indicate greater affordability.



Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Demand-driven inflation also is unlikely. Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.

That brings me to another issue, which is the tightrope that policy makers have to walk with respect to stimulus. I believe that in aggregate, government intervention probably saved us from an economic depression, but have we dodged the only bullet? Given the actions to date, the Fed and the Treasury are clearly committed to doing whatever it takes to help the economy find a floor so that it can grow again. On the other hand, if there are no more bullets to dodge, it will be difficult to know when the timing is right to unwind the stimulus. If it is unwound too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to budgetary woes. In any event, there will be great political pressure to deal with on both sides of the issue.

Investment returns will also be influenced by investors' willingness to take on risk, which tends to build during bull markets and break down in bear markets. The degree of investor risk aversion is an unknown that will impact returns in the years ahead. My working assumption is that it is more likely than not that higher-than-normal risk aversion will subside very gradually and that stock P/E multiples in five years will be average or below average relative to the last 50 years. This partly explains why expected returns in most of the equity scenarios are generally quite low.



Looking at 5-year average P/Es makes it easier to see the tendency for multiples to go through lengthy periods where they rise and fall.

I Consider a Range of Outcomes in Making Portfolio Decisions

Broadly speaking, these conflicts create a very wide range of possible outcomes. I recognize that no amount of analysis will determine exactly how the coming years will unfold, so I direct my analytical efforts toward thinking carefully about what would happen across a range of outcomes. This process of scenario analysis gives me important insights about how to position the portfolios.

In all but my most optimistic scenario, I believe returns from stocks and bonds over the next five years will be no more than mediocre – resulting in average annual returns for the typical balanced asset allocation portfolio that probably won't get above mid-single-digits. Fortunately, as I invest for my clients I'm not limited to just what the markets give us, and this is a source of optimism for me. Because this is an environment in which many securities have traded at prices below what their fundamentals suggest they are worth, the managers I use have made investment selections that added a lot of value over their market benchmarks this year. While some of the lowest-hanging fruit may have been taken, pricing disconnects remain that I think could continue to give the managers a tailwind over the next couple of years. Importantly, this includes the bond managers, who are also using their flexibility to take advantage of undervalued areas of the bond market when they consider the long-term opportunity to be sufficiently compelling.

Pricing disconnects exist at the asset class level as well, though they are not as compelling as what I witnessed earlier this year. Clients have already enjoyed strong returns from the tactical position in high-yield bonds which was added at the beginning of this year. I also added a tactical position in emerging-markets equities in the second quarter, based on the analysis that over the next five years emerging-markets equities will have higher returns than large-cap U.S. equities. I recognize that emerging markets may be more volatile in the shorter-term, but I'm prepared to accept that because of my confidence in the potential longer-term reward.

While asset class opportunities as less compelling than they were earlier this year, I believe that we will experience further periods of high volatility that could provide us with additional tactical opportunities. Here is a quick review of some of the asset classes I'm watching closely and how they would fit into the portfolio strategy and macro-level thinking.

Emerging-Markets Currency Exposure: This would be through an emerging markets bond fund of some sort—possibly PIMCO Developing Local Markets (which I've owned in the past) or PIMCO Emerging Local Bond (whose duration is not as short as its sibling). I believe the dollar is likely to weaken over time versus many emerging-markets currencies. So this investment would provide clients some dollar hedge, though the primary driver of the decision will be the potential returns from interest income. Based on the current analysis, returns could range from high single-digits to very low double-digits. From a return standpoint the asset class already looks attractive to me, but I'm still in the process of assessing the risk in these markets from the global recession.

Non-Agency Mortgages: This is an area that was at the center of the bubble that triggered the global economic collapse. The research suggests that very high-quality non-agency mortgages (bonds issued by commercial entities such as banks versus government-sponsored agencies such as Fannie Mae) are now priced at levels that should deliver attractive returns (high single-digits and potentially quite a bit better) for investors willing to brave potential near-term risk if the housing market proves more disappointing than investors already expect.

Opportunistic Fixed-Income Funds: There are still portions of the bond market that appear attractive. The bond funds clients own are taking advantage of opportunities but we are also researching several other funds that can be even more opportunistic and invest more heavily in inefficient niches of the market. Some of these are hedge-fund-like with flexibility to move aggressively into and out of bond sectors and the ability to short portions of the bond market that are overvalued.

What's happening at Ponderosa Investment Group, LLC

I have added a new investment strategy called Tactical Market Opportunity "TMO" to the investment lineup. The development and refining of this strategy has taken place over the last six to seven years. I started investing my personal money in this strategy beginning February 2009 and included a small portion of some clients in this strategy during the second quarter. This strategy is difficult to explain and is proprietary in nature, but basically it exploits a trading pattern anomaly that exists in the S&P 500 index. This anomaly varies in the number of times it exists per year but tests show that it exists anywhere from six to 25 times a year on average. The performance for the TMO is up approximately 24% year to date through June. Last year the model, or back tested results, was up 16% for 2008.

In Conclusion

Overall, the portfolios have a modestly conservative bias. The equity weighting is a bit below that of the models, though several factors offset some of that risk reduction. The high-yield bond exposure has some equity-like risk, though I expect much less than a pure equity play. The emerging-markets equity exposure has the potential to be more volatile than the standard U.S. large-cap equity exposure from which it is funded. The flexible fixed-income managers I use could experience more short-term volatility than the overall bond market, but I'm willing to make this trade-off because I believe the holdings offer much better long-term value. So this all nets out to somewhat below-benchmark risk exposure but not as low as it may appear on the surface.

Looking ahead, I believe that prudence is called for given the high level of uncertainty in the economy and financial markets, but that good investment opportunities do exist. I will continue to work hard to identify and take advantage of these opportunities.- (7/31/09)

Best Regards

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