

The *Value* InvestorTM

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July 2009 Issue

“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”

—Sir John Templeton



The economic deterioration that took place at the end of 2008 through the first part of 2009 was both swift and severe. Even though the fear and panic over this economic downturn has been far less than that of the 1930's, it did rise to heights not seen since that time. **In a matter of a few short months we had experienced a sharp pullback in manufacturing, a spike in job losses, a further weakening of the housing market, and a significant decline in consumer confidence — all of which took place against the backdrop of a crippling credit crunch. In other words, mid-September 2008 through the early part of March 2009 was the perfect storm.**

During our February 17, 2009, recorded call to clients, we made the following observations and comments that are important to review:

1. Upon review of different economic times and extreme market conditions such as the 1929 depression and the severe recession of 1974, we shared our belief that these and other difficult times have always had one thing in common: **the perception of an insolvable problem.** People rarely see how we can overcome such a crisis; many cannot see the solution to the problem, become extremely negative, and sell securities down to levels which would suggest there is no

hope. As the economy wrings itself out and as the worst fears are realized, people with opposite points of interest (examples: labor unions/management and borrowers/lenders) start to compromise in order to find solutions to problems that threaten both of them and recovery begins to take place. We believe the same kind of healing and economic repair is taking place today. Banks and financial institutions, other businesses, and consumers are recapitalizing or restructuring their balance sheets. Businesses and consumers are looking to cut costs and get back to basics, and many less than above board business practices, as well as outright fraudulent activities, are being brought to light and dealt with.

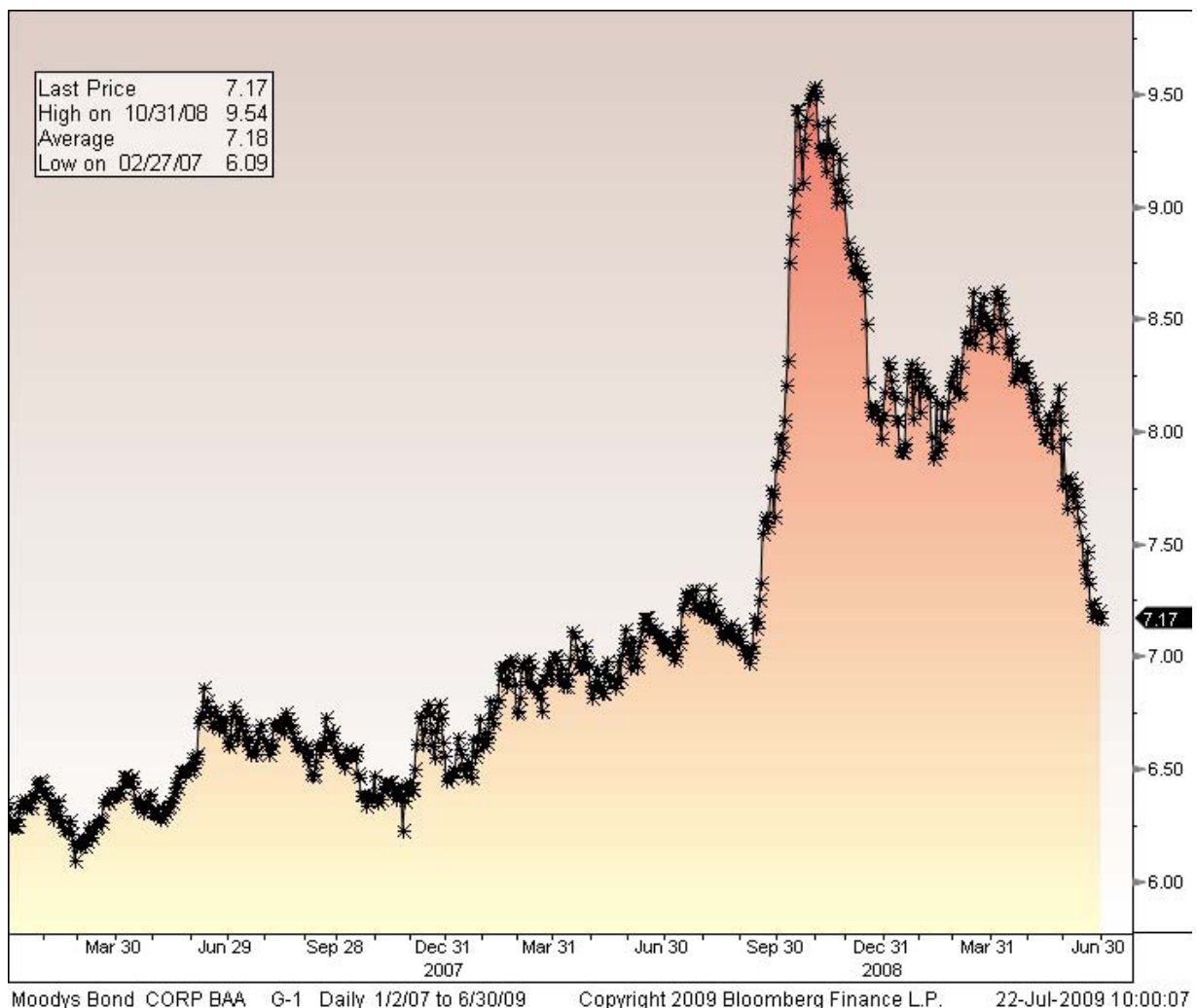
2. We mentioned that investors do not need to wait for the economy to recover for the market to move up. History has shown that stocks recover long before the economy when coming out of a bear market, and we expect that this time will be no different. As was seen in the severe bear market bottoms of 1932, 1974, and 1982, investor capitulation signaled the beginning stages of significant recoveries. For example, in 1932, from its bottom, the Dow Jones Industrial Average (DJIA) moved up 74% in two months; in 1974, from its bottom, the DJIA was up 45% in five months; in 1982, from its bottom, the DJIA was up 30% in two months.

3. We mentioned that credit was beginning to loosen, as could be seen with the average Moody's Baa Corporate bond yield declining from a peak yield of 9.54% (the highest yield since 1990) down to 8.18% (Baa ratings and higher represent bonds that are investment grade). While the Baa yield should eventually work its way closer to 7%,

it was certainly heading in the right direction. Lower bond yields and the easing of credit should help the stock market recover independent of other fundamentals. (Note on **Chart 1** that the Moody's Baa corporate bond yield closed at 7.17% on Tuesday, June 30, 2009.)

Chart 1: Moody's Baa Corporate Bond Yields from January 1, 2007 through June 30, 2009

In October 2008, credit for all intents and purposes stopped as investors fled to cash and U.S. Treasuries, wielding a heavy blow to corporate bonds as well as lending in general. Corporate bond prices and their performance sank, while bond yields rose to heights not seen since the 1990 recession over 18 years ago.



In September 2008, prior to the severe 35% +/- decline in the broader equity markets that took place from October 2008 through February 2009, the Value Line® Median P/E ratio, which represents the midpoint P/E for the 1,700 stocks found in the Value Line® Investment Survey (i.e. index), averaged 16.2. In our 35 years of experience, we have concluded that this index is a good proxy for the average stock.

After Lehman Brothers went bankrupt, credit tightened in just a few short weeks and remained tight for the next several months. **The speed at which credit tightened was of historic proportions. Once investment grade corporate bond yields rose over 9.5% and junk bond yields rose over 20%, our credit economy quickly became a cash economy and P/E ratios tumbled, thus bringing stock prices down with them. The Value Line® Median P/E went from its September 2008 average of 16.2 down to 10.1 on November 24. This decline of 37.65% closely mirrors the price declines experienced by the broader equity markets during that time.** This direct relationship between bond yields and P/E ratios exists because bonds are competition for stocks. Therefore, if an investment grade bond sells at a yield of 9.5%, then you would expect to see a market P/E of approximately 10.5 ($100/9.5 = 10.5$). If investment grade bonds sell at a 7% yield, you would expect to see a market P/E of approximately 14.3. As you can see, just a 1% to 2% change in bond yields can make a difference of a 20%, 30%, or 40% move in the market, both up and down. We said on our call that **“while the bad news is the market went down, the good news is that as credit loosens up the market has a chance**

to appreciate substantially without any major changes in earnings or fundamentals.”

4. Finally, we mentioned that from a statistical probability, the market was cheap. When the S&P 500 (a proxy for the general market) was at 741 on November 21, 2008, it was in the bottom 15% of all historical stock market valuations. This means 85% of the time the market had been higher than those valuations. We also said that when you get into the bottom quartile, and we were at the bottom 15% again in February 2009, more than likely the market will not stay there very long. That is not to say the market could not go lower, and we did believe that was a possibility. The following is an excerpt from the call:

But after listening to all the bearish arguments and different rationales we could find, along with considering all the different ways this economy could play out, we feel at this point (February 17, 2009) the worst case price for the S&P 500 is approximately 670 to 700. (The S&P 500 hit an intraday low of 666.79 on March 6, 2009.) There are people who believe it could go even lower, and let me tell you while anything is possible, we do not think that is very probable. When the S&P 500 gets into the 670 to 700 range, it would be in the bottom 10% of all the lowest valuations in 70 years. In order to get below 670 or thereabouts, you almost need to have either a depression or something very close to it. Since most bears do not really believe we

are going to have a depression, it is hard to imagine that the market could go as low as depression levels. So while opinions vary, we think the reasonable bearish case is for the market to hit the 10% lowest valuation zone, which would include the depression, and then we think you are covered. We think this incorporates most of the negative thinking you could do on this particular subject.

–Arnold Van Den Berg

During the next 14 days that followed our call, the markets and our portfolios continued to decline until reaching a bottom on Monday, March 9. With the S&P 500 closing at 676, it, along with the broader equity markets, was selling in the bottom 10% of all valuations in market history. It was at this point that the investing public at-large reached capitulation. Many chose to sell out their portfolios, **irrespective of prices and values**, and instead opted for cash. While the fear was understandable, selling was seemingly irrational. It is true no one can tell where the final market bottom will be; however, at those levels, the risk to reward ratio based on the fundamentals of each company was suggesting a much more favorable opportunity for those willing to stay in the market.

As of this letter, most people that went to cash any time during 2009 are no longer better off for it. While they indeed missed a lot of the market drama and sweaty palms, the average portfolio in our CM Value I composite is in positive territory over this time frame, recovering back approximately four of the most extreme five months of this bear market.

Our CM Balanced and CM Fixed Income accounts are also in positive territory.

The market volatility and subsequent events that have played out over this past year have caused many people to inquire about our forecasts on interest rates, economic growth, inflation, currencies, government debt, geopolitical events, commodity prices, and the future of the stock market. While we are happy to provide our forecasts and opinions, we believe that it is a mistake to extrapolate that these macro events will exclusively dictate all future performance.

We firmly believe that over the long-run there are three primary drivers that will dictate the majority of individual stock performance: interest rates, inflation, and the fundamentals of the companies.

Interest rates:

At this point, we expect interest rates to remain low and credit to continue to ease. Easing credit will be a slow process, but we do believe it will continue nonetheless. (The inflation section addresses many of the characteristics that we believe will help to keep interest rates low.)

Inflation:

We believe that inflation will not be a problem for the foreseeable future. Confirming our thoughts of low inflation, on June 24, 2009, the FOMC (Federal Open Market Committee), led by Chairman Ben Bernanke, stated that despite an easing of the recession, the economy remains weak enough to keep inflation at bay.

We wrote extensively about inflation on March 26, 2009, in a piece titled “Is Inflation in Our Future?”. (You may obtain a full copy of this letter on our website at www.centman.com.)

At the end of that letter, we listed eight sign posts we are monitoring that will alert us to future inflation. Below is an updated summary of our thoughts. **Out of these eight indicators, four are neutral between inflation and deflation and four show a greater risk of deflation, not inflation. The conclusion is that while we do not expect serious deflation, it is a greater risk at this time than inflation.** The pages that follow the summary below provide more details that support our conclusions.

“The crowd is most enthusiastic and optimistic when it should be cautious and prudent, and it is most fearful when it should be bold.”

—Humphrey Neil

Summary of Eight Inflation Sign Posts

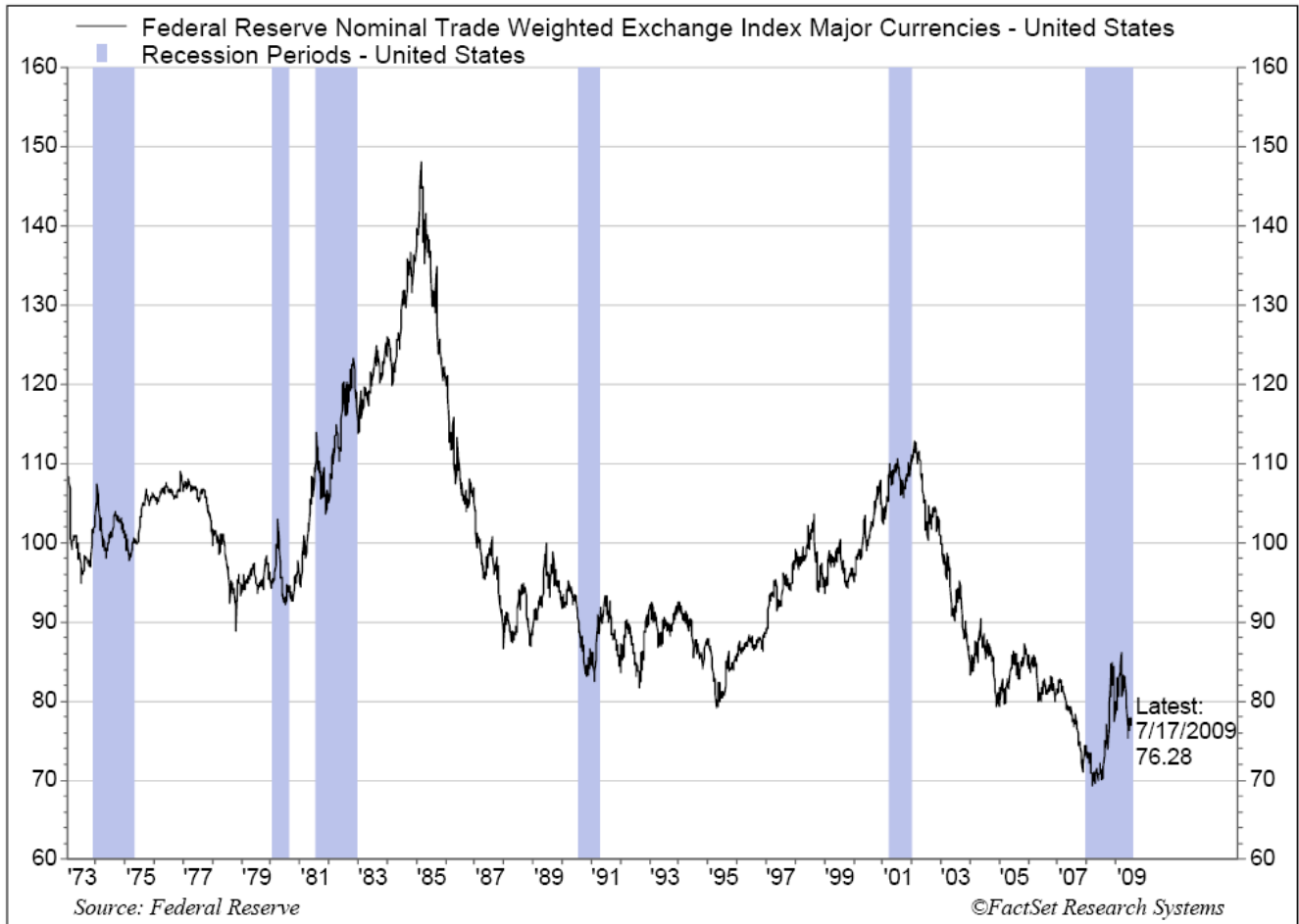
Changes in:

1. The value of the U.S. dollar
2. Bond yields
3. The velocity of money
4. Capacity utilization
5. Protectionism
6. Unemployment
7. Commodity prices
8. Real estate prices

CM Summary Conclusions:

neutral between inflation and deflation
neutral between inflation and deflation
risk is deflation, not inflation
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neutral between inflation and deflation
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neutral between inflation and deflation
risk is deflation, not inflation

Chart 2

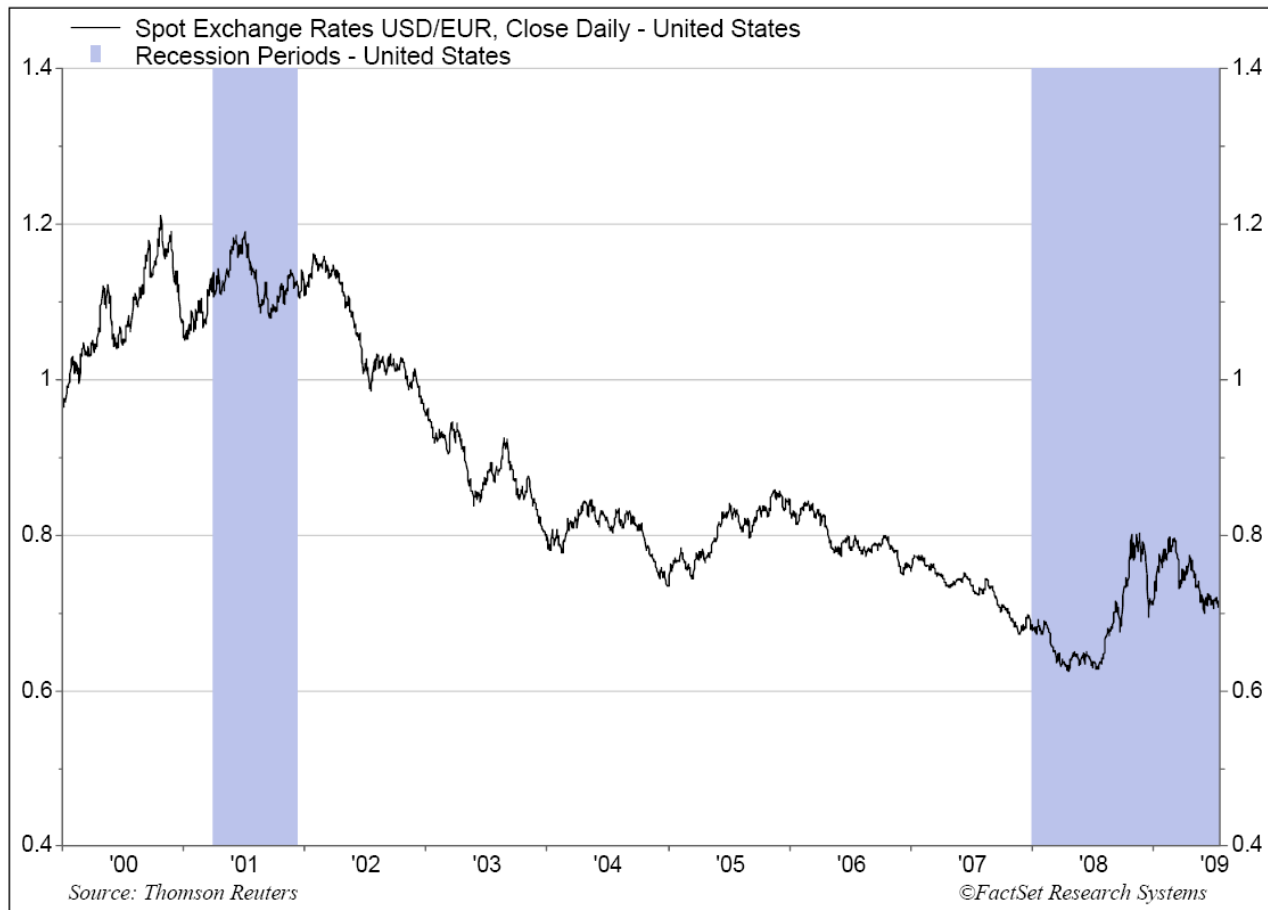


1. The value of the U.S. dollar (neutral between inflation and deflation): The U.S. dollar has declined recently but remains well above the lows set earlier this year. **Chart 2** shows the U.S. dollar compared to the weighted average of the major world

currencies. As of mid-July, it is approximately 10% above its 2008 low.

Chart 3 shows the U.S. dollar compared to the Euro. As of July 17, 2009, the U.S. dollar is up 13% from its 2008 low versus the Euro.

Chart 3



It is very important for a nation to have a sound currency since a declining currency would raise the price of imports, which would raise the rate of inflation as well as interest rates. Conversely, a strong currency would raise the price of our goods to foreigners and make our products and services less competitive around the world. This would create a decline in our exports and lower our gross domestic product (GDP).

We believe that the U.S. dollar is currently in a trading range and is fairly valued compared to most currencies around the world. While many economists and the media seem to focus on the U.S. dollar and our economic problems at home, many also fail to point out that most other countries have economic problems that

are worse than ours, and that many of these countries are dependent on the United States.

Moreover, approximately 90% of the world's currency transactions take place in U.S. dollars. **There is no other country in the world today like the United States that has the combined political stability, property rights, highly liquid and developed free markets, stability of purchasing power (inflation has averaged less than 2.5% for the past 10 years), established legal and accounting systems, along with the ability to protect itself against any enemy.** If you were a foreigner, would you want to put your money in any of the following: the Euro, Japan's Yen, China's Yuan, India's Rupee, Russia's Ruble, or some other currency found in Eastern Europe, the Middle East, Asia, or Latin America?

Thirty years ago (1979) when the U.S. dollar was in a major crisis, we wrote an article titled “Don’t Sell the Dollar Short”. In the last paragraph of this article we said, “In the long run, the overriding influences on the value of a nation’s currency are universal recognition, its store of value, scarcity, political stability, and integrity. While none of the currencies get high marks in each category, the U.S. dollar is still among the best alternatives.”

We believe that this is still the case today.

2. Bond yields (neutral between inflation and deflation): One way to measure inflation expectations is to look at the difference in yield between U.S. Treasury bonds and Treasury Inflation-Protected Securities (TIPS) of like maturities. TIPS are inflation-indexed bonds issued by the U.S. Treasury. The principal is adjusted by changes in the Consumer Price Index (CPI), the commonly used measure of inflation. The coupon rate is constant and paid twice per year with the inflation rate being added to the principal to protect the bond holder from inflation. Example: 3% coupon + 3% CPI inflation = 6% total TIPS coupon payment. For comparison purposes, the market typically looks at the 10-year maturities.

Making the comparison between traditional Treasury bonds and TIPS is one way to see how the market is discounting future inflation expectations. The difference in yields, termed

the “breakeven rate”, approximates the market’s view of future inflation. **Chart 4** shows that from January 1997, when 10-year TIPS were first issued, through July 15, 2009, the 10-year “breakeven rate” (e.g. inflation expectation) has averaged 2.04%. The actual year-over-year inflation rate has averaged 2.55% for the same time period. With a difference of only *0.51% over 10 years between the “breakeven rate” and the real rate of inflation, the bond market, where investors have trillions of dollars at risk, has a better record of predicting future inflation than listening to economists or the media at-large.

Chart 4 also shows that at the height of the financial turmoil, the Treasury market was pricing in a deflation/depression scenario with an expectation of negative inflation, or even deflation. Indeed, this deflation scenario has happened somewhat recently as the last reading on the Consumer Price Index was minus 1.4% on a year-over-year basis. As the economy and markets have recovered over the past four months, the “breakeven rate” has also adjusted and is now suggesting an inflation rate going forward of 1.73%, just under its historical average of 2.04%.

On July 15, 2009:

10-Year U.S. Treasury Bond	3.54%
<u>10-Year U.S. TIPS Bond</u>	<u>1.81%</u>
The difference	1.73%

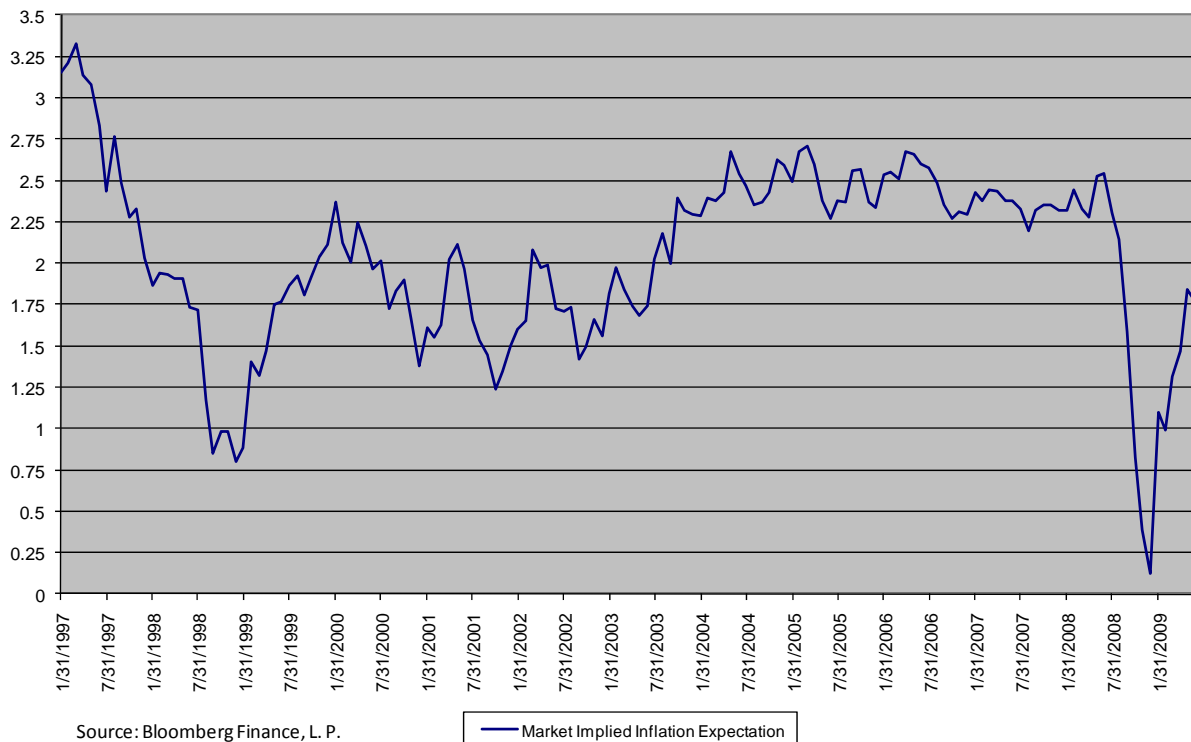
This suggests the market is expecting inflation to be 1.73%.

~

**The actual numbers would suggest the difference is closer to 0.15%. However, we are leaving off other technical adjustments for the sake of simplicity in this letter.*

Chart 4

Nominal 10-Year U.S. Treasury Yield Minus 10-Year TIPS Yield



Based on this measurement, we do not believe there will be a material increase in the rate of inflation anytime soon.

3. **The velocity of money (risk is deflation, not inflation):** The velocity of money (as measured relative to M_0) continues to decline, but at a slower rate. The Federal Reserve continues to inject huge amounts of cash into the financial system. Under normal conditions, such an injection of cash would be quickly loaned out by banks, thus creating easy credit that would drive up asset and consumer prices, resulting in inflation. **However, we are not in a normal environment.** Most of the money that the Federal Reserve has injected into the system is not turning over or is offsetting the loss of credit in the money market and other capital markets. In fact,

Chart 5 highlights that today's problem is one of deflation, not inflation.

Chart 5 plots the velocity of money from 1946 through the end of 2008. The velocity of money is defined as the gross domestic product (GDP) divided by the size of the monetary base (in this case we are using the M_0 —called “M-zero”—to measure this base).

The velocity of money shows the rate at which the monetary base (e.g. money supply) is turned over in the course of a year. It indirectly measures the degree to which borrowers are willing to borrow and/or lenders are willing to lend. Furthermore, as you can see by looking at **Chart 6**, recent events have caused a severe drop in the willingness of creditors to lend money. This is why the Federal Reserve has increased its

balance sheet. The total credit available in the economy depends on both the size of the monetary base and the degree of velocity. Because velocity has dropped nearly 50% over the past year, the economy continues to be in danger of being starved of the credit that is required for growth. **To counteract this, the Federal Reserve continues to expand its balance sheet by purchasing illiquid securities, such as collateralized debt obligations (CDO's), as well as other securities, to satisfy the demand for money without forcing the banks to liquidate these**

securities. This action has provided much relief toward the credit crisis and will ultimately spur an economic recovery.

When velocity is declining, it usually indicates that demand for cash and reserves is acute. In other words, consumers and banks currently have low appetites for risk, preferring to hold cash rather than borrow or lend. The latest Federal Reserve statistics confirm that bank credit has stagnated after contracting earlier this year.

Chart 5

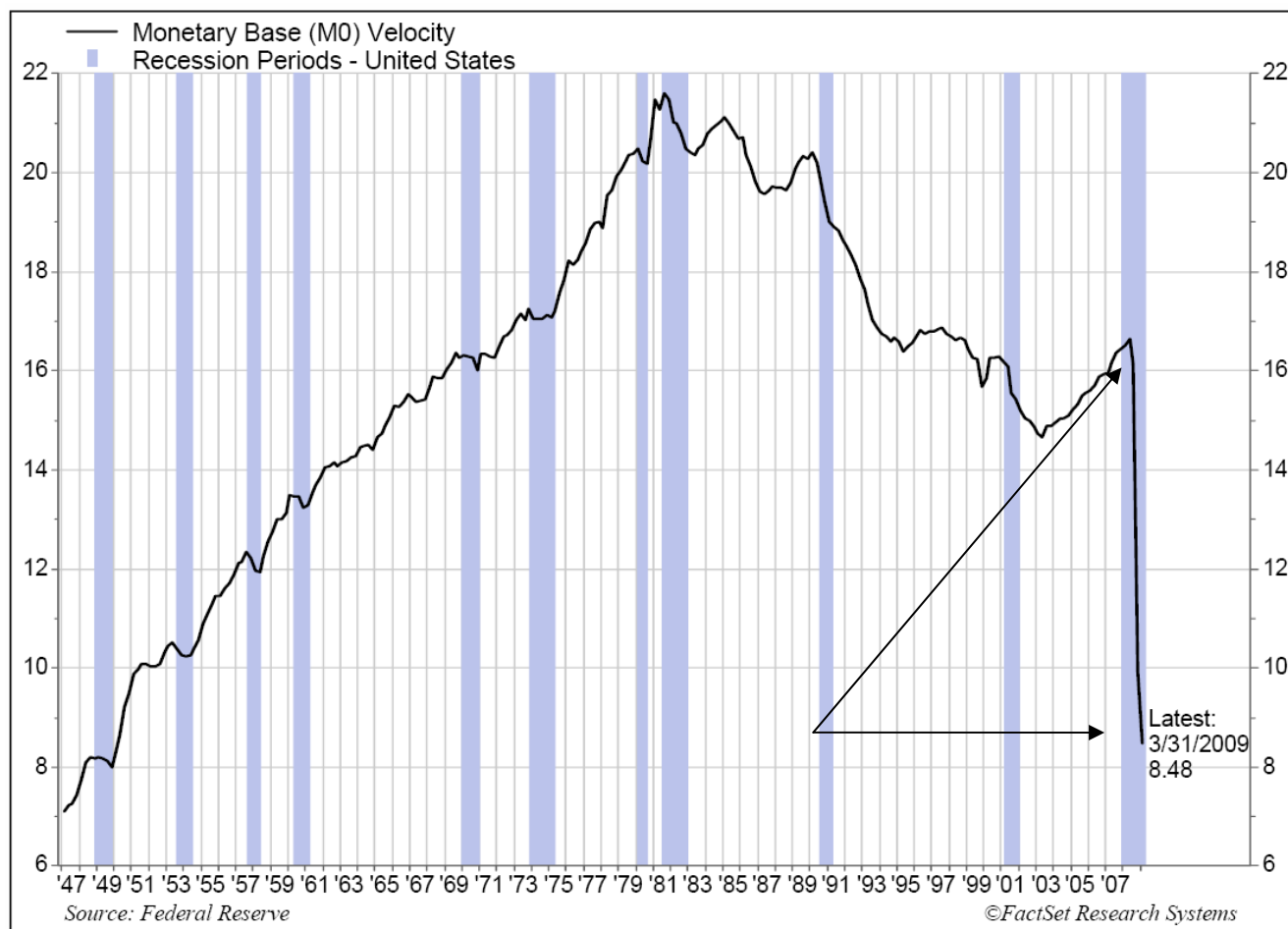
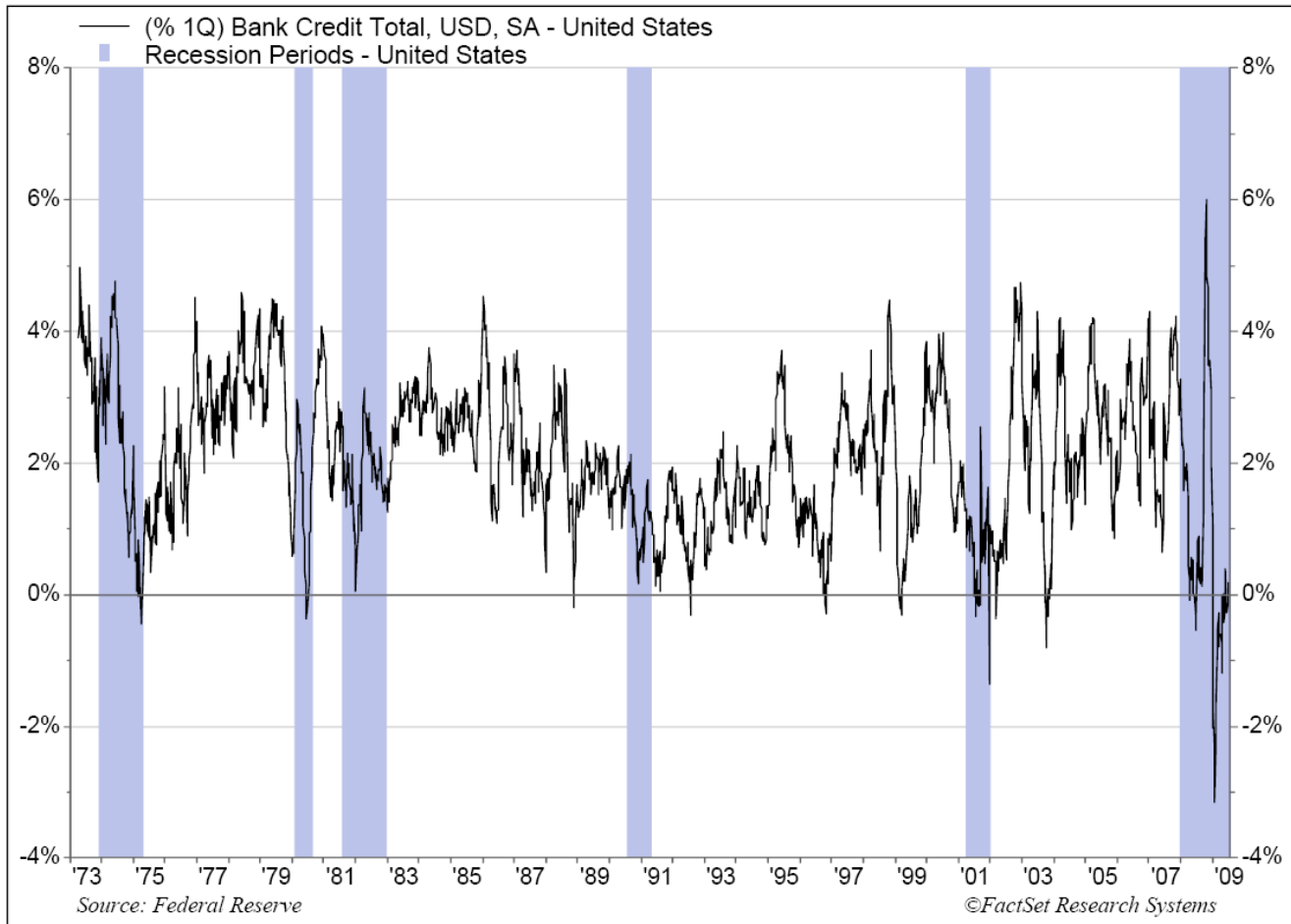


Chart 6



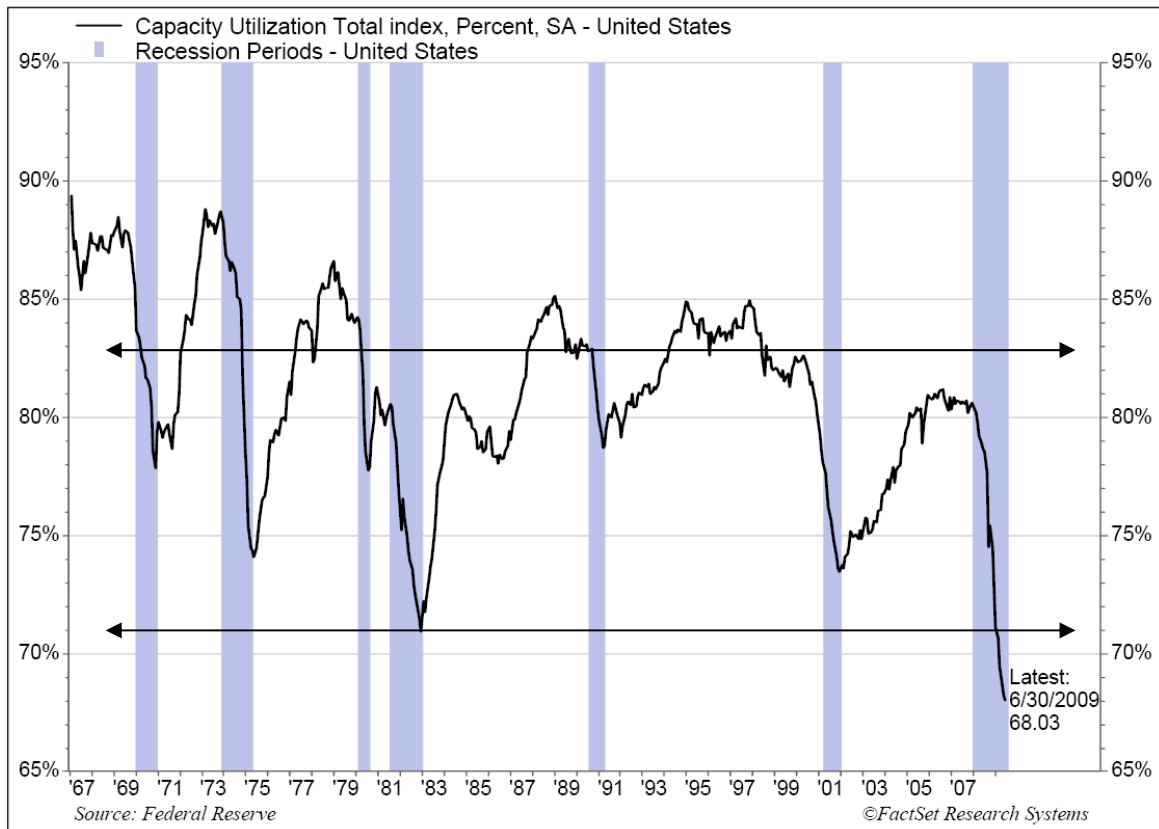
Despite efforts by the Federal Reserve to increase the money supply, and by the Treasury with its corporate bailouts, bank credit (lending) is not increasing.

4. **Capacity utilization (risk is deflation, not inflation):** This metric is used to measure the rate at which potential output levels are being met or used. Displayed as a percentage, capacity utilization levels give insight into the overall slack that is in the economy or a company at a given point in time. If a

company is running at a 70% capacity utilization rate, it has room to increase production up to a 100% utilization rate without incurring the expensive costs of building a new plant or facility.

Today, capacity utilization is at its lowest levels since the 1930's; this is even lower than the double-dip recession of 1980-82. This suggests that it would be very difficult for companies to raise prices in this current economic climate.

Chart 7



Typically, capacity utilization must exceed 83% for inflation to become a problem. At the current level of 68%, either demand must increase dramatically or substantial capacity must be eliminated for inflation to be a problem. **Chart 7** shows that it usually takes eighteen months to three years for this metric to fully recover from a recession. Due to the severity of this recession, it may take even longer for capacity utilization to increase to a more normal level.

Here is another way to think about capacity utilization and its influence on inflation. If a company is barely generating enough sales to cover its bills, is it really in a position to raise prices while most of its competitors are lowering prices? Imagine a restaurant that has 50 tables, but only 34 are filled with customers; this means that

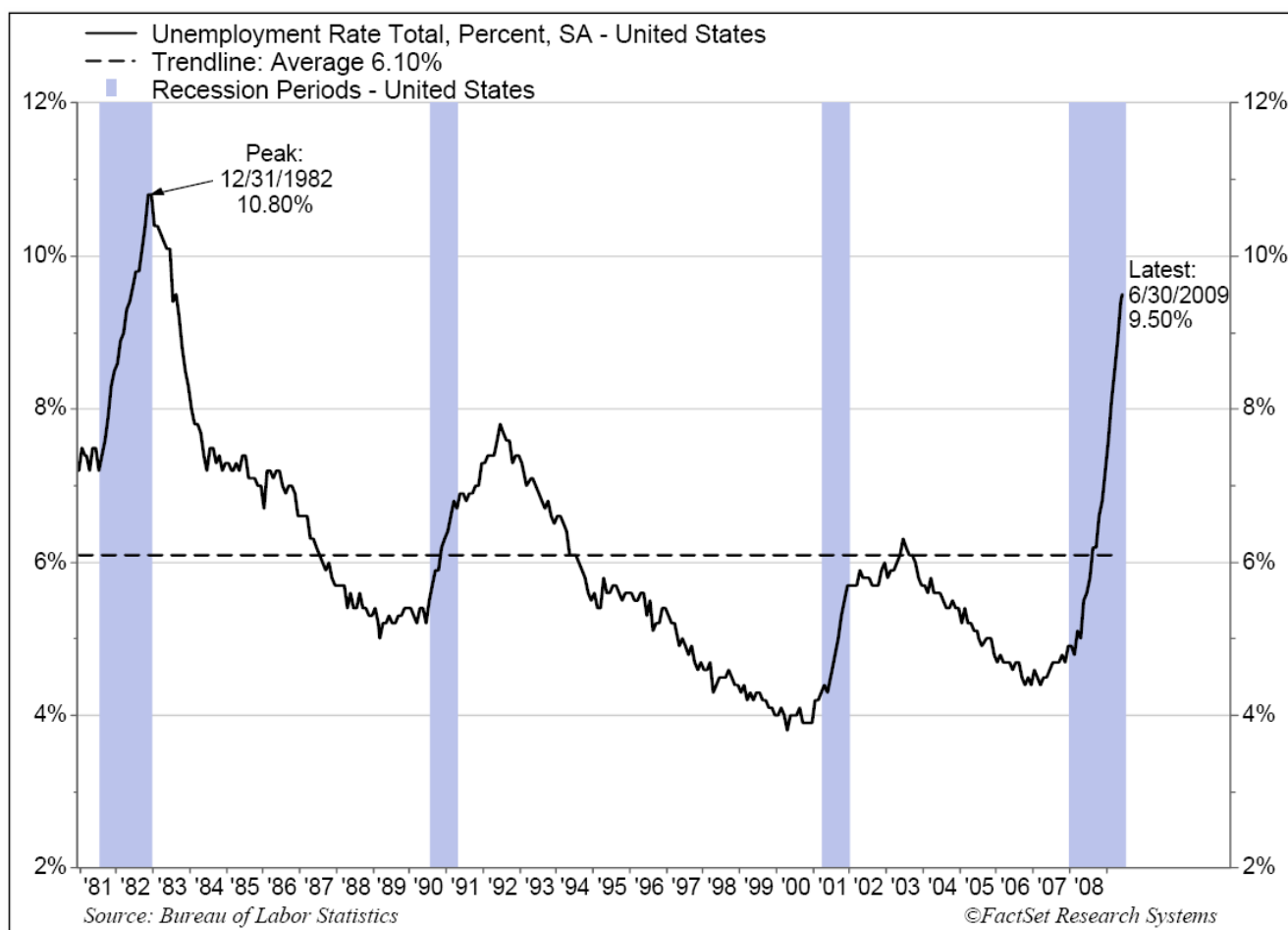
16 tables are empty. This restaurant is operating at a low capacity utilization rate of 68%. In this scenario, do you think the restaurant would be in a position to raise its prices, thus contributing to higher inflation? Probably not. Even if the restaurant had higher food/commodity and operating costs, it would be very difficult to pass those higher costs on to customers if the demand is not higher (e.g. lower capacity utilization). Conversely, if the restaurant had 42 or more tables filled leaving only eight or less, it would be in a better position to raise prices to cover higher food/commodity and operating costs. Corporations may be accused of greed, but most understand that raising prices will reduce sales and is not a wise thing to do during times of lower demand.

5. Protectionism (neutral between inflation and deflation): Congress has added “Buy American” provisions in the recently enacted stimulus packages, but so far most trade barriers have not been raised. As long as trade barriers remain low, protectionism will have little effect on general prices.

6. Unemployment (risk is deflation, not inflation): We are approaching the post-WWII unemployment rate high of 10.8% that occurred back in December 1982. **Chart 8** shows the unemployment rate from 1981 to present. The average unemployment rate during this period has been 6.10%.

While we have not likely reached the peak of unemployment during this recession, the rate at which unemployment has been increasing is beginning to slow. As long as unemployment remains above normal levels (approximately 6%), workers will continue to be in a poor bargaining position to get an increase in wages, thereby rendering wage inflation to be insignificant. Indeed, most companies, as well as many state and local governments, are cutting wages through reduced benefits, furloughs, and unpaid vacations. Since wage increases are a large part of inflation, it is difficult to see any persistent inflation without higher wage increases.

Chart 8



7. Commodity prices (neutral between inflation and deflation):

Many commentators and investors have been concerned about the recent rise in commodity prices—particularly oil. Since March 2009, oil prices have declined to approximately \$60 per barrel from near-term highs in the mid-\$70s.

According to the Environmental Information Administration, oil inventories are approximately 16% higher today than this same time last year. Furthermore, they are above what are considered to be normal seasonal levels. As such, we

believe crude oil prices will likely maintain a trading range from \$50 to \$70 for the rest of 2009. This translates into gas prices at the pump that should range from \$2.00 to \$2.50. Looking forward, should there be a significant drop in drilling activity, this will lead to price increases that could push oil up towards the \$100 per barrel range over the next few years. However, we do not foresee a repeat of the \$147 prices that we experienced last summer any time soon.

Chart 9

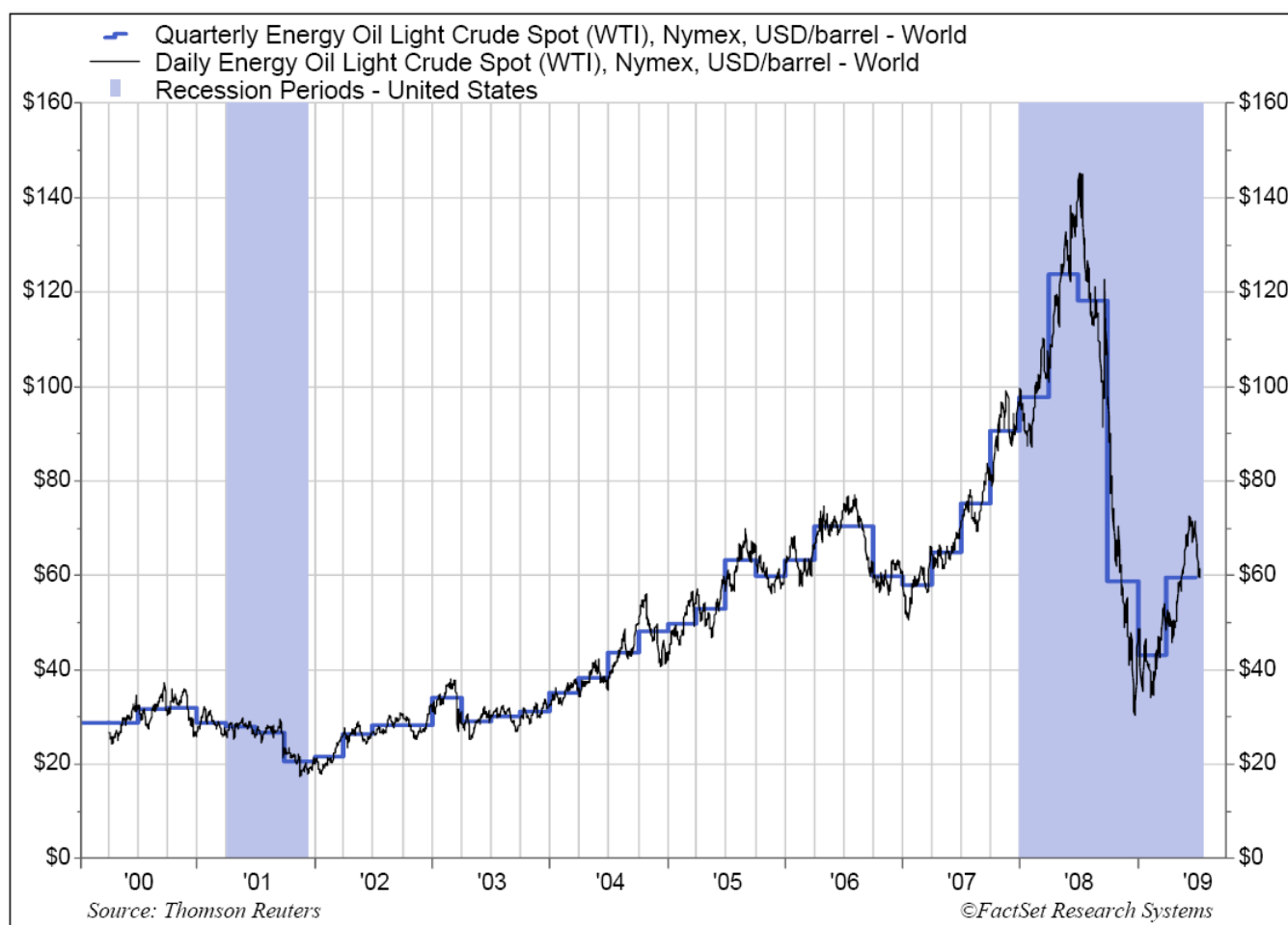


Chart 10 shows that natural gas prices have dropped significantly since last year and have not rebounded like oil. We expect natural gas to remain at these lower levels in the near-term because of excess supply and a severe drop in industrial demand. The good news is that this price

drop is reducing costs for consumers and commercial users alike. While long-term prices may go up to a more normal range of \$6 to \$7 as early as next year, we do not foresee a rise back to last year's \$14 range anytime soon.

Chart 10

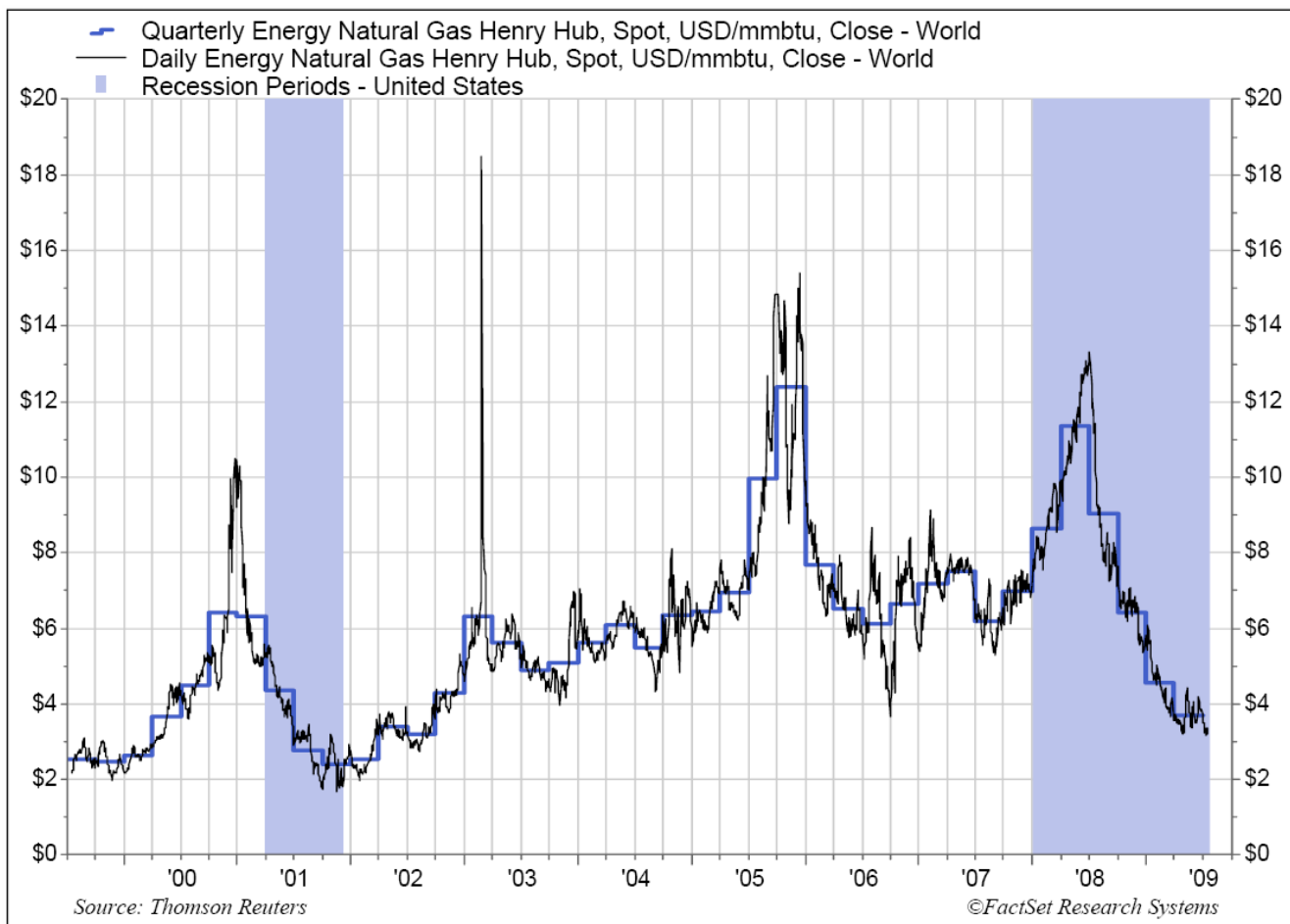


Chart 11

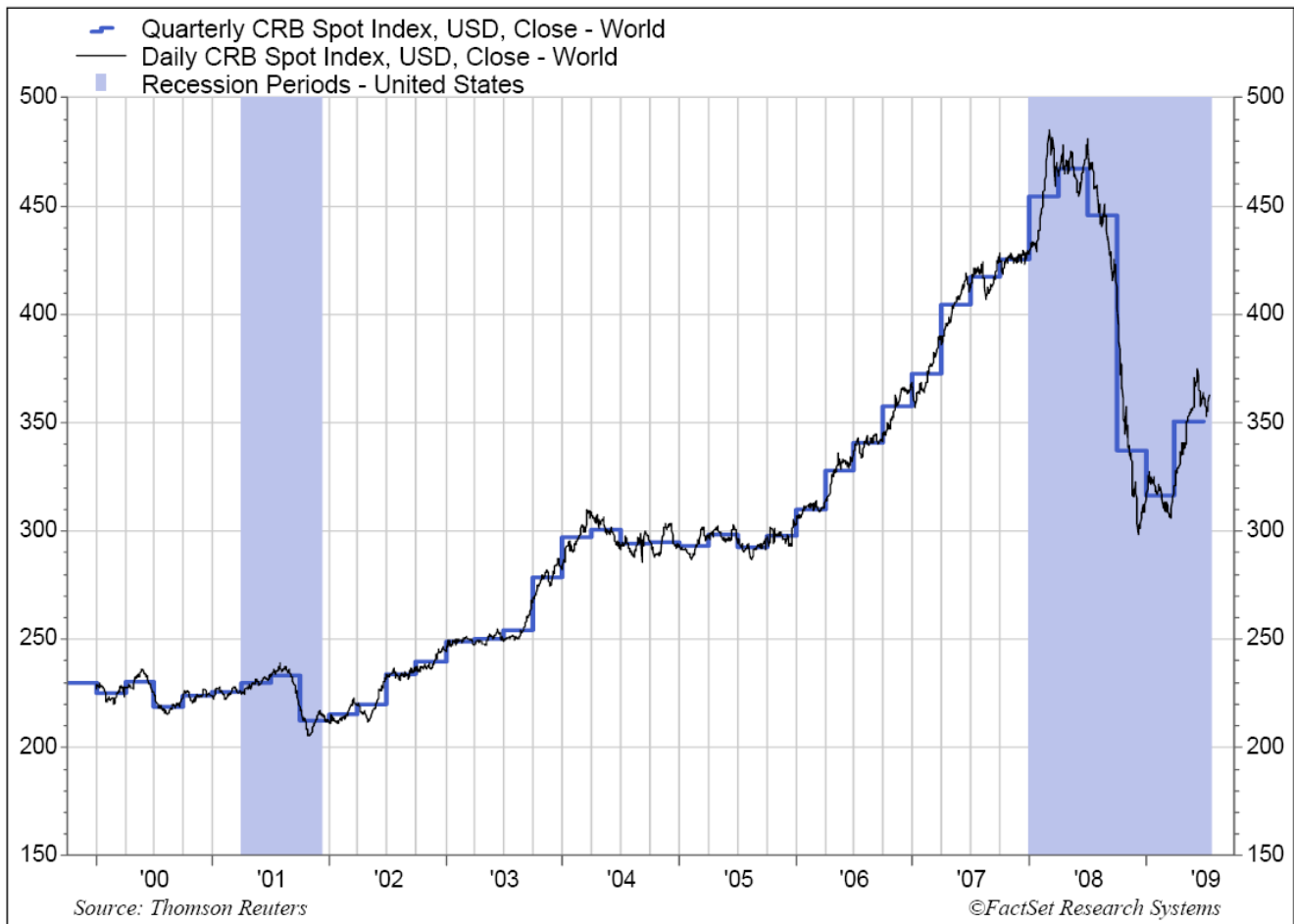


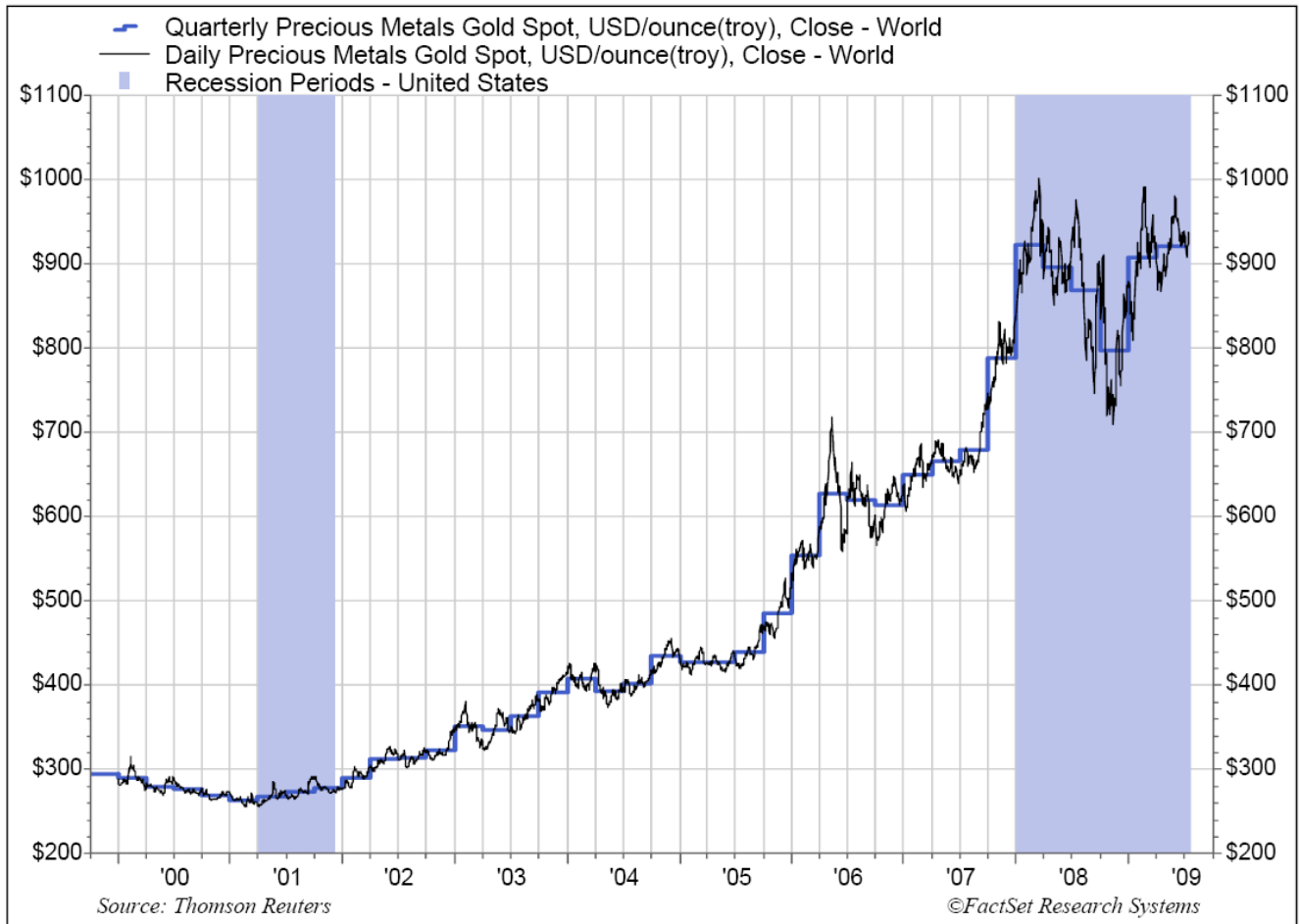
Chart 11 shows that all commodities, as represented by the CRB index, are starting to come off a near-term high. It also shows a recent spike in commodity prices. We believe that this recent spike was caused by a combination of stockpiling by the Chinese in preparation for use in their stimulus initiatives, and by speculation from institutional investors that wanted an inflation hedge.

Many use gold as an indicator of future inflation; historically this link has been weak. Typically, gold speculation is a bigger indicator of fear and panic among investors concerned about the financial stability of the economy rather than a predictor of future inflation. If it is a good

inflation indicator, its current signals are mixed. **Chart 12** shows that gold has recently been trading in a range of \$900 to \$1000.

We believe if you are going to use one single indicator for inflation, you should use the TIPS rather than gold. However, if you want to measure fear and uncertainty, you should use gold. We are not suggesting gold will not go up as fear is certainly not absent; we just do not think it is the best indicator of future inflation. Gold is more of a coinciding indicator of inflation rather than a predictor. After all, if you have inflation, almost everything goes up.

Chart 12



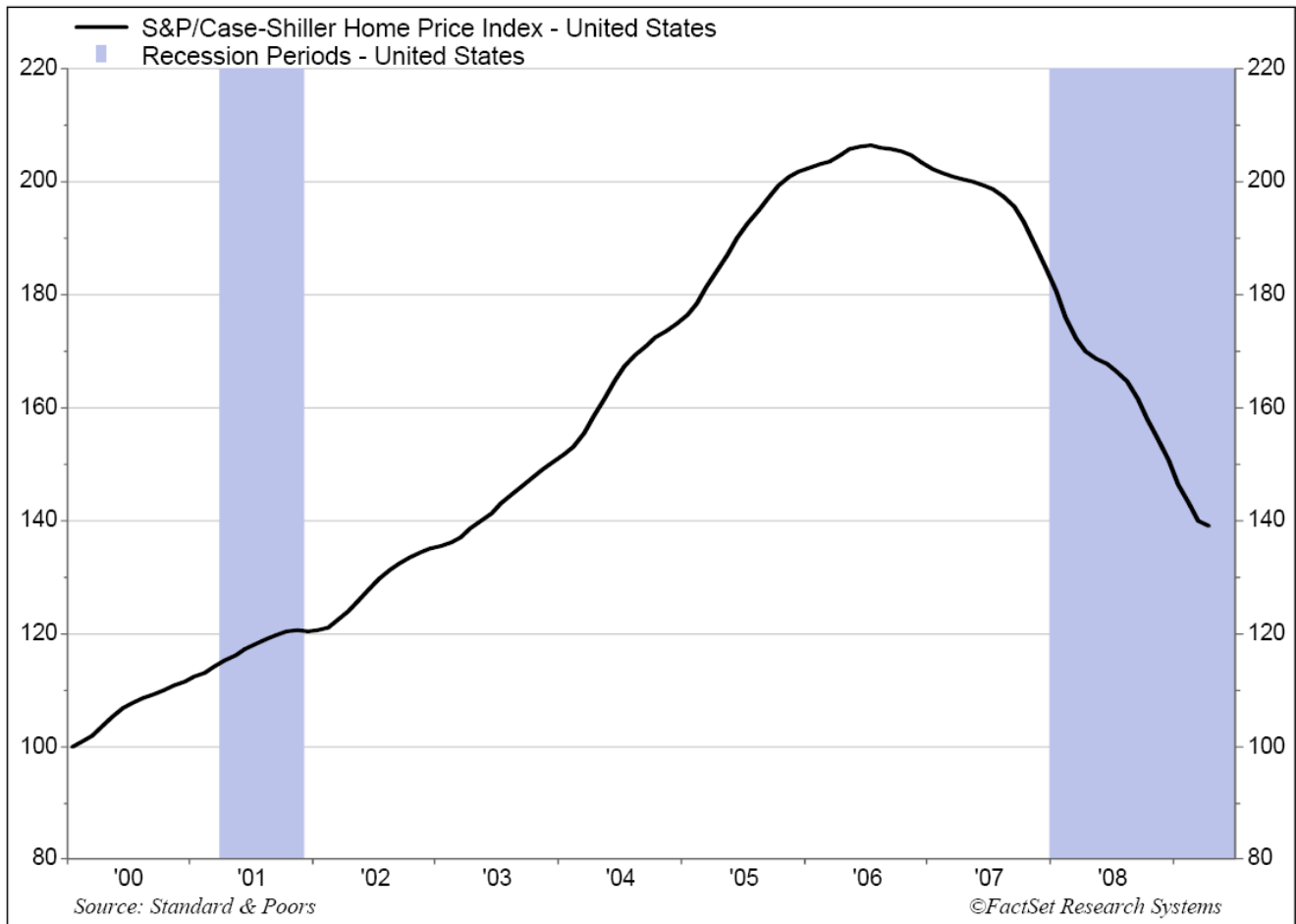
8. Real estate prices (risk is deflation, not inflation): Real estate should be assessed as two distinct sectors—residential and commercial—because each operates in a slightly different cycle. Typically, the residential market declines early in a recession, followed by a drop in the commercial real estate market a year or two later. This too has been the pattern in this market.

Residential:

One of the most influential factors in this housing downturn has been the decline in

home prices. While there are numerous housing price indices, each of which tracks and calculates changes in housing prices in a different manner, the most widely referenced is the S&P/Case-Shiller Index. Keeping in mind that real estate is very location specific, this index provides a national real estate perspective. However, it is important to note that this index is potentially distorted due to its heavy weighting in states that were greatly impacted during the housing boom.

Chart 13



On Chart 13, the S&P/Case-Shiller Home Price Index shows home prices are down 32% from the 2006 high. Various estimates suggest that on a national basis, prices could fall another 10% before hitting bottom.

Price declines are driven by numerous factors, two of which are excess inventory and foreclosures. Inventory is determined by the basic economics of supply and demand. For example, today there are an estimated 4.9% of homes in America, or 4.2 million units, listed for sale (3.9 million existing homes + 0.3 million new homes under construction). Over the past 20 years, on average, roughly 3.5% of the homes in America have been listed for sale on an annual basis. When we net out today's inventory of homes for sale from the historical

norm, it suggests there are approximately 1.1 million more homes listed for sale than usual. In addition, there are various estimates of unlisted distressed inventory (properties whose owners are seriously delinquent on their mortgages, homes that are in foreclosure, or homes that are now bank-owned properties) that could add another one to two million additional units to this inventory in the near future. On a national basis, this oversupply of homes for sale continues to weigh down home prices, helping to make this a buyer's market.

The housing market is realizing the consequences of originating loans to households that did not have sufficient financial means to own a home, regardless of

price. For the first half of 2009, approximately 1.5 million homeowners were two months behind on their mortgages. If we annualized this figure, it would suggest that approximately three million mortgages, or more than 5.6% of the total loans outstanding, are more than two months behind. In addition, approximately 7.2% of all mortgages are listed as seriously delinquent. This compares to just 1.89% in 2001. If foreclosures are added to delinquencies, roughly 13% of all home mortgages are in distress. This is more than double the near 30-year average of 6% (~1% foreclosures + ~5% delinquencies).

While we believe that the worst is probably over for the residential market, we do think it may take more time to correct the excesses of the past housing boom before home prices begin to appreciate. Recent numbers for the S&P/Case-Shiller Index suggest that the rate at which home prices are declining is beginning

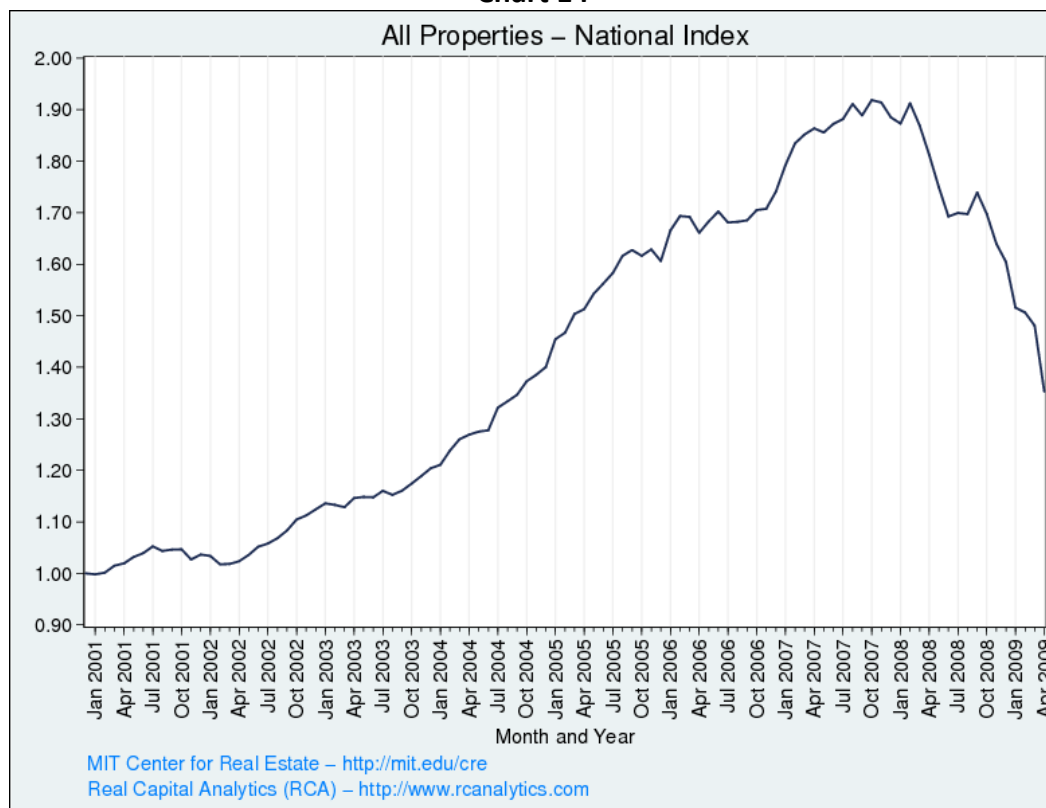
to slow. While this may be the case, barring various interventions such as moratoriums on foreclosures, we believe that home prices will continue to decline for most of this year and possibly into 2010; albeit this may occur at a much slower rate than we have seen since the peak in 2006.

Historically, once a real estate bubble has burst, home prices have typically not appreciated significantly for several years following the bottom. As of today, on a national basis, we do not anticipate price increases to exceed the inflation rate for the next two to five years.

Commercial real estate:

Commercial real estate is an area that has been largely ignored by the mainstream media. This is about to change. **Chart 14** shows commercial real estate prices are declining at an accelerating rate.

Chart 14



As of April 2009, prices are down about 30% from the peak in early 2008. Many analysts estimate at least a 40%, possibly even 50%, drop before prices stabilize. Cap rates (net operating income divided by price = cap rate) have been increasing due to lower prices, offset somewhat by lower operating income. Overall, we are seeing cash flows deteriorate as many businesses default on leases and rents decline. Office, industrial, and retail sectors have been hit the hardest, while multi-family seems to be holding up the best. Vacancy rates for office, industrial, and retail properties are approximately 15.5%, 13%, and 12% respectively. These numbers are likely to peak near 20%, and while apartments are the strongest of the commercial property types, on average their vacancy rates are up to 7.3%. As long as vacancies are increasing, there will be downward pressure on rents.

Most banks are deferring recognition of losses by extending maturities on their notes that are underperforming. Eventually, these losses will have to be recognized. In the meantime, bank lending will be circumspect and money will remain tight. It will take many years for most banks to gradually reduce their real estate exposure; this should serve as a restraint on credit and a drag on the economy for several more years to come.

The most disconcerting aspect of this situation is that much of this debt is held by small to mid-size banks that will not have the benefit of government bailouts. Already this year, over 50 of these smaller banks have been declared insolvent, and this will likely accelerate for the rest of 2009 (we could see as many as 150 small to mid-size banks fail this year). Small businesses may be particularly susceptible to

these failures and to tighter lending standards among bank survivors.

Real estate summary:

As long as real estate asset prices continue to decline, inflation should not be a problem. Declining residential prices will likely continue to have a negative wealth effect because consumers will tend to save more and spend less as they see their wealth dissipating. Furthermore, declining commercial prices will put stress on numerous banks. This will affect small business and consumer credit disproportionately.

The expanding United States balance sheet:

Many investors are worried that the Federal budget deficit and the high liquidity reflected in a large Fed balance sheet are proof that inflation—even hyperinflation—is inevitable. While we can appreciate that this could lead to high inflation, it is not a certainty and can be avoided. The proof of this statement can be seen in the Japanese experience, as they expanded their balance sheet more than eight times between October 2000 and February 2004, far exceeding the normal rate of increase and more than twice our 3.45 times expansion. Additionally, Japan has expanded its debt to GDP from roughly 50% to more than 160%. As of March 31, 2009, U.S. debt to GDP is 77.33% and will probably end up closer to 90% to GDP before this economic downturn is over. Yet in Japan, despite these terrible figures, annual inflation has ranged between -1.5% and 1% from 2001 through 2006.

In our future writing, we are planning to explain in great detail how Japan was able to expand its money supply and keep inflation at

bay. However, we did want to point this out briefly in this letter since many headlines are trumpeting that the expanded balance sheet

of the U.S. will inevitably lead to high inflation, even though many of the facts suggest otherwise.

Inflation summary:

- We have spent and will continue to spend a great deal of time studying and monitoring inflation. The reason is that inflation and interest rates are two of the key factors in determining a P/E ratio and are vital in understanding the value of a company.
- We do not believe inflation is a problem at this stage of the business cycle. Each of our eight indicators shows either deflationary or neutral forces at work. What we are experiencing is an economy with plenty of slack in resources and tight credit conditions. For inflation to rise, we must have an economy with easy money and tight resources. We believe we are a long way from that point.
- In addition, while many people believe that the rapid expansion of the Fed's balance sheet will lead to high inflation, we do not. Substantively all of the new credit creation by the Fed was to liquefy the banking system by exchanging *liquid Treasury securities for illiquid bonds and CDO's*. While high inflation could take place in the years to come, it is not necessary if this situation is managed well.
- Many people are fearful of inflation and rushing to buy investments to protect themselves from inflation. If inflation does not materialize, those investments may turn out to be poor choices. If inflation does remain low, they will miss out on opportunities from investments that benefit from low inflation, such as some stocks and bonds. It is critical to understand what investments you are going to use at the right time. For example, a life raft and a parachute are both life saving devices. However, if you need to eject from a plane, a life raft most likely will not do you much good. Conversely, a parachute would not be much help on a sinking ship.

"A final retrospective thought. When the young author entered Wall Street in June 1914, no one had any inkling of what the next half-century had in store...Yet if we confine our attention to the American investment experience, there is some comfort to be gleaned from the last 57 years. Through all their vicissitudes and casualties, as earthshaking as they were unforeseen, it remained true that sound investment principles produced generally sound results. We must act on the assumption that they will continue to do so."

—Benjamin Graham's closing thoughts as he was reflecting on his career

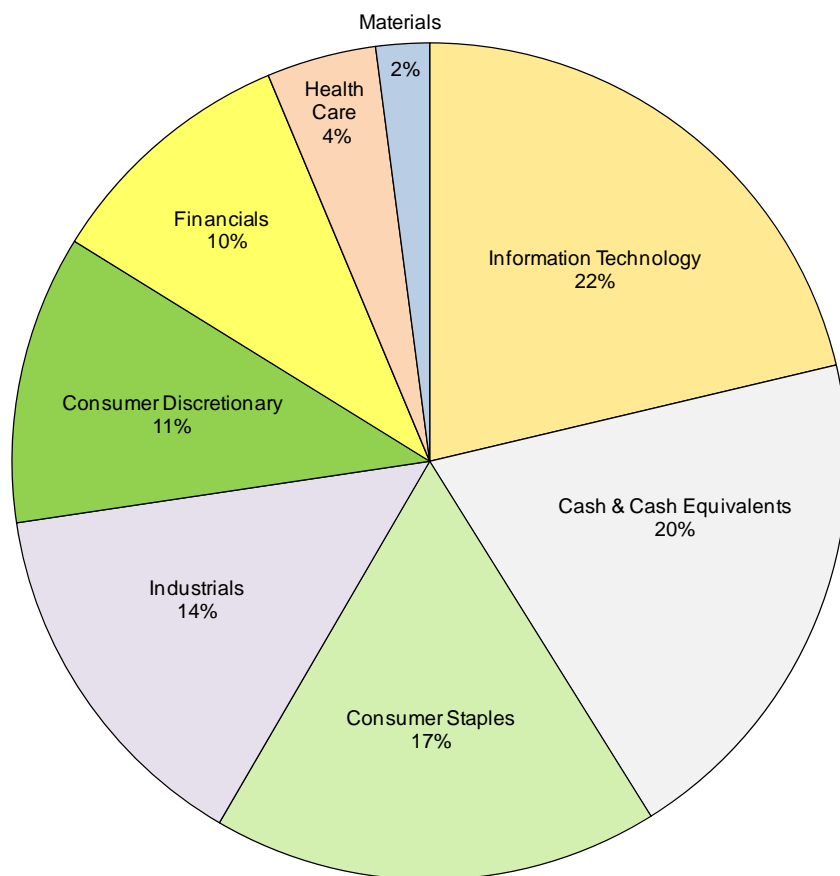
Fundamentals of our portfolios:

With regards to the fundamentals of the companies we own, we believe our collective group of stocks that make up your portfolios is in very good shape. **Chart 15** is a pie chart of our CM Value I composite (which represents our typical equity account) broken down by sectors as of June 30, 2009.

Today, approximately 59% of this composite is invested in large quality companies. Most of these companies produce reasonably consistent free cash flow, have strong balance sheets, and represent some of the leading

brand name products and services around the world. Many of these companies receive as much as 30% to 70% of their sales from outside the U.S. which will allow our portfolios to participate in worldwide growth. In addition, the portfolios in this composite hold approximately 20% in cash or cash equivalents. As such, we believe our portfolios continue to hold tremendous long-term value and opportunity.

Chart 15



Source: Factset, Century Management

Chart 16

CM Value I Composite	03/09/09	06/30/09
Price to Sales	0.38	0.61
Price to Enterprise Value	0.84	0.85
Price to Earnings	9.66	16.02
Price to Earnings (Future Year 1 Estimated Earnings)	9.68	14.54
Price to Cash Flow	4.27	7.36
Price to Book	1.35	2.08
Long Term Debt to Capital	32.85%	34.00%
Return on Equity	21.49%	16.66%
Net Margin	7.37%	5.69%
Dividend Yield	4.87%	2.50%
Bond Yields		
Fed Funds Rate	0.20%	0.22%
10-Year US Treasury Bond Yield	2.89%	3.53%
30-Year US Treasury Bond Yield	3.59%	4.32%
Moody's AAA Corporate Bond Yield	5.42%	5.37%
Moody's Baa Corporate Bond Yield (Investment Grade)	8.29%	7.17%
Source: Factset and the Federal Reserve		

Chart 16 is a snapshot of the value characteristics found in our typical CM Value I portfolio from the market low on March 9, 2009, through June 30, 2009.

Notice that the price to earnings ratio (third row from the top) has moved up from 9.66 to 16.02, an increase of 65.8%. The next line down shows that the price to earnings ratio using future one year estimated earnings has moved up from 9.68 to 14.54, or 50.2%. The expansion of this P/E ratio, as we discussed earlier, has been primarily due to easing credit. Moreover, as was the case in other extreme bear markets, without any major improvements in other fundamentals

surrounding stocks or the economy at-large, the increase in this P/E ratio has been the main driver for the sharp recovery from the March 2009 lows.

Chart 17 shows the high and low ranges for various valuation multiples (i.e. ratios) typically seen throughout market history. While at the highest and lowest extremes these multiples would likely change, hopefully this provides a better perspective of true value when you compare these “typical” historical ranges to the current characteristics of your portfolio.

Chart 17

Typical High and Low Ranges of Valuation Multiples for a Diversified Basket of Stocks		
Valuation Multiples	On the High Side	On the Low Side
Price to Earnings	18 to 20 times	8 to 10 times
Price to Cash Flow	10 to 12 times	4 to 5 times
Price to Book Value	2.5 to 3 times	1 to 1.25 times
Price to Sales	1.5 to 2 times	0.3 to 0.5 times
The valuation multiples shown above are not the exact historical highs or lows. Rather, they are the approximate high and low ranges that are typically seen throughout market history. These multiples are not adjusted for interest rates. Source: Value Line and Century Management		

With a forward-looking P/E of approximately 14.5 on our typical portfolio, a 14.20 forward-looking P/E for the S&P 500, and a median P/E of 14.70 on the Value Line® Index (which includes two quarters of forward-looking earnings and two quarters of past earnings), **we do believe we are operating in a fair value zone for the average stock.**

Fair value is the mid-point between the current buy and sell point. In more normal times, many stocks can and do trade at 10% to 15% above their fair values. There are also times when individual stocks trade higher than 15% above their fair values. Typically, when stocks trade at 20% to 30% or more above their fair values, they are considered to be fully valued.

The future growth for each company in our portfolio will depend on how quickly earnings start to recover. Remember, most companies today have been reporting depressed earnings. As these earnings recover and get back to more “normal” levels and beyond, the

future for many of the companies we hold looks bright. Thus, we continue to be positive as we look out over the horizon.

While the market is likely to be volatile over the next year or two, we believe the general trend will be up. However, since there is slack in the economy and with no firm economic bottom fully established as of yet, should stocks come in with lower than expected earnings, or if the recession takes longer than expected to recover, we could see some very sharp corrections in the market or at the very least in some individual stocks. If and when this happens, we will have an opportunity to invest some of our cash in existing stocks at lower prices, as well as invest in those stocks on our inventory list as they reach their buy points.

As of June 30, 2009, the typical portfolio in the CM Value I composite held approximately 20% in cash or cash equivalents. This is up from last year’s low of approximately 12.5%. The reason our cash position is rising is that while we have

made some timely purchases over the past month or two, we have done more selling as some individual stocks have reached what we believe to be their fair values. This is part of our dollar cost averaging strategy on the sell side. For the stocks that we believe have good long-term price appreciation potential, we are only selling part of the position at fair value. Furthermore, for stocks where we believe the long-term price appreciation has been negatively altered due to the events of the past year or two, or whose risk to reward ratio is no longer in our favor, the positions have been and will continue to be sold in full at their fair values.

Looking forward, regardless of their current prices relative to their costs, there are likely to be a few companies that are sold in full even though they are not at their fair values. If companies no longer appear to be in our favor after reviewing their time value of money prospects and their risk to reward opportunities, we will opt to sell these positions and move the proceeds over to more productive securities. **However, as long as stocks remain between their buy points and fair values, and they are companies we believe in for the long-run, we will continue to hold these positions.**

While sharp market downturns cause fear, panic, and economic dislocation, they are often a necessary precursor to an upturn as they force individuals, corporations, and even the government to get their balance sheets and financial statements in order. We believe this is taking place today as corporate and consumer debts are being paid down, excess costs and expenses are being reduced and eliminated, and savings rates are increasing. It is out of all this pain and discomfort that we believe the seeds of recovery are being

planted, and eventually substantial profits will be borne. **It is important to remember that the world is not ending, the majority of people will remain employed, most people will make their mortgage payments, and our country, with all of its global reaching products, services, and innovation, will continue to be an economic leader and force throughout the world. Successful investing over the long-run has always required patience and long-term perspective; this has never been more true than today.**

In the 2008 Berkshire Hathaway annual letter to shareholders, Warren Buffett said he is "certain the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall." **Buffett continued, "Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has, and it will continue to do so. America's best days lie ahead." We could not agree more.**

In closing, the most important thing we can urge you to do is look out two or three years instead of succumbing to the temptation to look out two or three months. While your portfolios are not likely to appreciate in a straight line, we do believe that two or three years from now they should be substantially higher than they are today.

All of us at Century Management thank you very much for your continued trust and confidence, and we look forward to performing for you in the years to come.

Sincerely,

The Century Management Team

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The audio of the February 17, 2009, call to clients is posted on our website at www.centman.com, or for the direct audio link go to <http://www.centman.com/UpdateConversation2-17-09.html>.

The *Value* InvestorTM

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