The *CM Value* Investor™

The Century Management Newsletter
Value Investing Since 1974

November 2010 Issue

The November 2010 issue of The *CM Value* Investor™ newsletter outlines in detail our current views on the economy, the stock market, and our typical investment portfolio. We hope you enjoy this expanded edition of The *CM Value* Investor™ newsletter.

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Table of Contents

Disclosures 2

The Purpose for Writing This Newsletter 4

Overview........ 5

The Recession is Over........ 5

Unemployment........ 6

Consumer Confidence........ 15

Residential Real Estate........ 16

Savings Rate........ 27

Consumer Debt........ 30

U.S. Household Balance Sheet........ 37

Gross Domestic Product and the Monetary Base........ 39

U.S. Corporate Cash and Liquidity........ 46

Our Portfolio: Three Value Examples........ 47

Microsoft........ 48

Automatic Data Processing........ 51

Wal-Mart........ 54

Why Do Great Companies Get So Cheap? 56

Our Portfolio: Large-Cap Perspective........ 57

Our Portfolio: CM Value I Composite (Our Typical Equity Account) 58

Valuations and Scenarios (CM Value I Composite and the Dow Jones Industrial Average)…. 63

Comparing 1965-1982 (17 yrs.) to 1999-2015 (16 yrs.) 72

Conclusion........ 76

The Century Management Team........ 80

Please Visit the Century Management Website........ 81

Sources, Footnotes, and Websites........ 81

The Purpose for Writing This Expanded Newsletter

The scope of this publication is the greatest since our December 2004 issue of The *CM Value* Investor™ newsletter[1]. In our 2004 issue, we discussed how unusual it was for all major asset classes (stocks, bonds, and real estate) to be bid up to what appeared to be unsustainable levels, all at the same time. We also highlighted market conditions that our country had seen only four times in the previous 80 years. In addition, the 2004 expanded issue detailed the many imbalances that existed in the market and the economy, and how any resolutions would in large part be dependent on the specific actions taken by the federal government and Federal Reserve. What happened to the stock market and real estate market since that time, as well as how the federal government handled these economic imbalances is now history.

In this November 2010 expanded issue of The *CM Value* Investor™ newsletter, we discuss why many of our 2004 concerns are still with us, such as the overleveraged economy. However, we also point out that there are positive changes taking place for consumers, corporations, and even the U.S. government. For example, consumers are saving more and reducing their debt levels (see **Consumer Savings Rate, page 27** and **Consumer Debt, page 30**); corporations are increasingly productive by doing more with less as well as increasing their liquidity (see **U.S. Corporate Cash and Liquidity, page 45**); and the U.S. government is finally seeing change as there are now more than 240 pro-small business candidates on their way to the U.S. Congress in January (see **Unemployment**, **page 6** and the **Impact of Small Business on Job Creation, page 11**).

We also discuss the consequences of a general investing public who appear to be focusing on the negative economic headwinds that we face as a nation instead of the great investment opportunities that are building all around us. Yes, our economy will need time to heal, but now, just like 2004, is the time to look ahead. As this great nation begins to put its economic problems behind it, those investors who are willing to look ahead will find a much more favorable environment three to five years from now.

The world's population, prosperity, and middle class are growing. Through technological innovation, increasing productivity, and as underdeveloped nations industrialize, we believe the level of wealth that is going to be created will present one of the greatest investment opportunities seen in many years.

While the focus of this publication is to provide you with a general perspective and overview of today's market environment, we have not departed from our primary focus of buying individual companies in your portfolios. We continue to search for companies selling between 50% and 70% below their private market values. At this level of discount, stocks generally provide great opportunities for appreciation, as well as reduce the overall risk caused by uncertainties.

It is our hope that by reading this expanded issue of The *CM Value* Investor™ newsletter, you will gain a deeper understanding of both the current challenges facing our economy and the tremendous opportunities that lie ahead.

Sincerely,

The Century Management Team

"I will prepare myself and the opportunity will come."

Abraham Lincoln

Overview

The patient is out of intensive care and home from the hospital, but he will require more healing time than is typically needed in order to resume his normal activities. This is how we describe today's economy. The current economic difficulties and challenges have been with us for more than two years. Little to no growth among small businesses, the high rate of unemployment, the amount of excess real estate on or soon to be on the market, and the heavily indebted consumer are issues that continue to weigh on the economy. Fortunately, with time, none of these problems are unsolvable.

With that said, the economy, the stock market, and our portfolios have greatly improved over the past year and a half. Considering that the growth rate of the U.S. economy will likely be slower than its long-term historical average of 5% to 6% over the next few years, that corporate America is operating near peak profit margins, and that the Value Line® median P/E (includes 1,700 stocks) is 15.2, we believe the average stock is selling at or just above its fair value today. However, if we were to normalize earnings (i.e. use normalized profit margins instead of peak), and were to adjust interest rates to their long-term historical average, we believe the U.S. stock market is selling between 12% and 15% above fair value (see **Valuations and Scenarios** section beginning on **page 62**). This suggests that while we are optimistic in our long-term view, the short-term could be volatile and needs to be approached with caution.

On the other hand, if the growth rate of the economy were back to its long-term historical average of 5% to 6% and some of the issues surrounding unemployment and housing were improved; we believe the current price to earnings (P/E) ratios for stocks would be considerably higher, **especially when adjusted for the current inflation and interest rate environment**.

Overall, while the current economic recovery has been slow and there is still plenty of work to be done, progress is being made. Our goal in this letter is to bring perspective to these issues, quantify the time it will take to recover, and review the value that exists in our portfolios today. □

The Recession is Over

Although there is a great amount of improvement to be made in the economy and many people continue to struggle and experience difficult financial times, on September 20, 2010, the National Bureau of Economic Research (NBER)[2], a non-profit research group recognized as the arbiter of U.S. economic cycles, officially declared an end to this recession as of June 2009. While underscoring the slow pace of recovery, the NBER issued a statement confirming "the recession lasted 18 months, which makes it the longest of any recession since World War II. Previously the longest postwar recessions were those of 1973-75 and 1981-82, both of which lasted 16 months." (See **Chart 1** on page 6.)

The basis for the NBER's decision was due to the length and strength of the recovery that has taken place thus far. In determining that the economy bottomed in June 2009, the NBER did not conclude that economic conditions since that month have been favorable or that the economy has returned to operating at normal capacity. Rather, the NBER determined only that the recession ended and a recovery has begun. □

Recession: In the United States, a recession is defined as a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in a decline of real GDP, real income, employment, industrial production, and wholesale-retail sales. The trough of the recession marks the end of the declining phase and the start of the rising phase of the business cycle. Typically, economic activity is below normal in the early stages of an expansion, and it sometimes remains that way well into the expansion.

Chart 1

Recessions Post the Great Depression					
	Begin		End	# of Months	War Times
1	May 1937	to	Jun 1938	13	
2	**Feb 1945**	**to**	**Oct 1945**	**8**	**WWII**
3	Nov 1948	to	Oct 1949	11	
4	**Jul 1953**	**to**	**May 1954**	**10**	**Korea**
5	Aug 1957	to	Apr 1958	8	
6	Apr 1960	to	Feb 1961	10	
7	**Dec 1969**	**to**	**Nov 1970**	**11**	**Vietnam**
8	Nov 1973	to	Mar 1975	16	
9	Jan 1980	to	Jul 1980	6	
10	Jul 1981	to	Nov 1982	16	
11	Jul 1990	to	Mar 1991	8	
12	Mar 2001	to	Nov 2001	8	
13	**Dec 2007**	**to**	**Jun 2009**	**18**	**Iraq/Afghanistan**
Duration of Average Recession (*in months*)				**11**	
Source: National Bureau of Economic Research					

Unemployment

While unemployment numbers may go higher before the economy fully recovers, the rapid rate of job losses that occurred in 2008/2009 has leveled off and for the most part has stabilized (see **Chart 2**). **Chart 3** shows the unemployment rate on October 29, 2010, was 9.6%, down from 10.1% in October 2009. This rate measures the percentage of the total labor force that is unemployed but actively seeking employment and willing to work. **Chart 4** shows the most comprehensive measurement of unemployment, technically known as U-6, at 17.0%, down from a high of 17.4%.

The U-6 rate is increasingly referred to as the real unemployment rate. Proponents of this measurement contend that it represents the true nature of the unemployment problem, since it includes:

- People without jobs.
- Those who would like to work but have not actively sought jobs in the past four weeks due to issues such as childcare, family obligations, or other temporary problems.
- Discouraged workers who have stopped looking for work because they think it is futile.
- Underemployed people, which includes those who are actually employed but are working fewer hours than they would like.

Chart 2
Change in Nonfarm Payroll

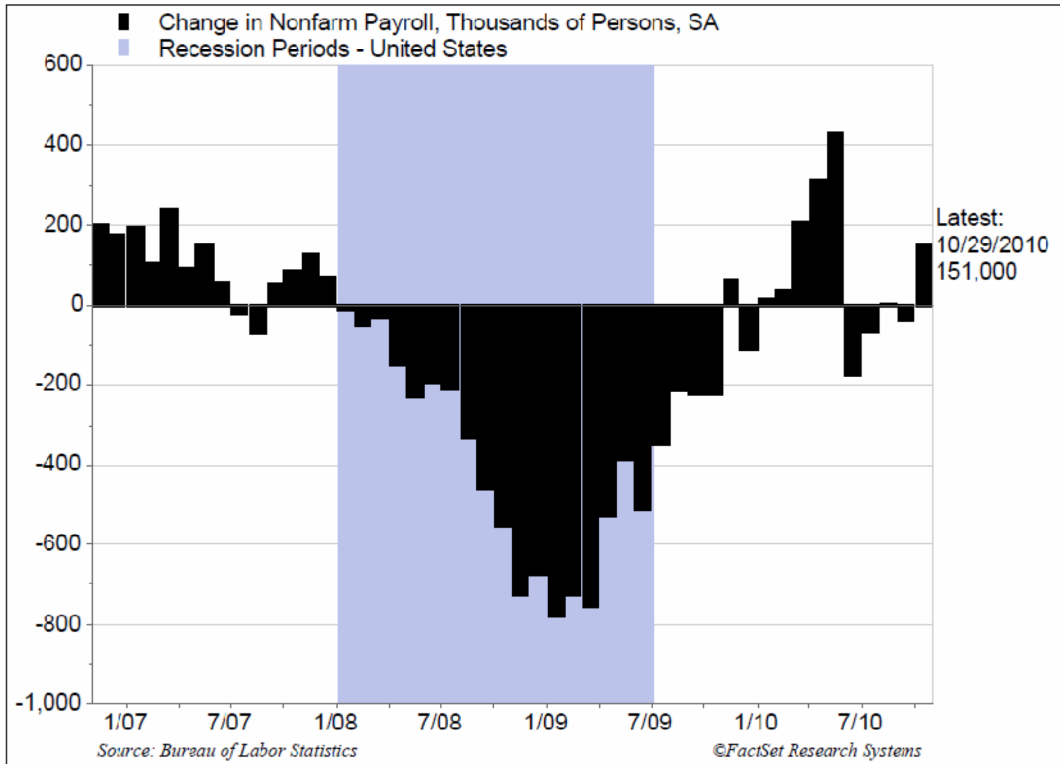


Chart 3
Unemployment Rate

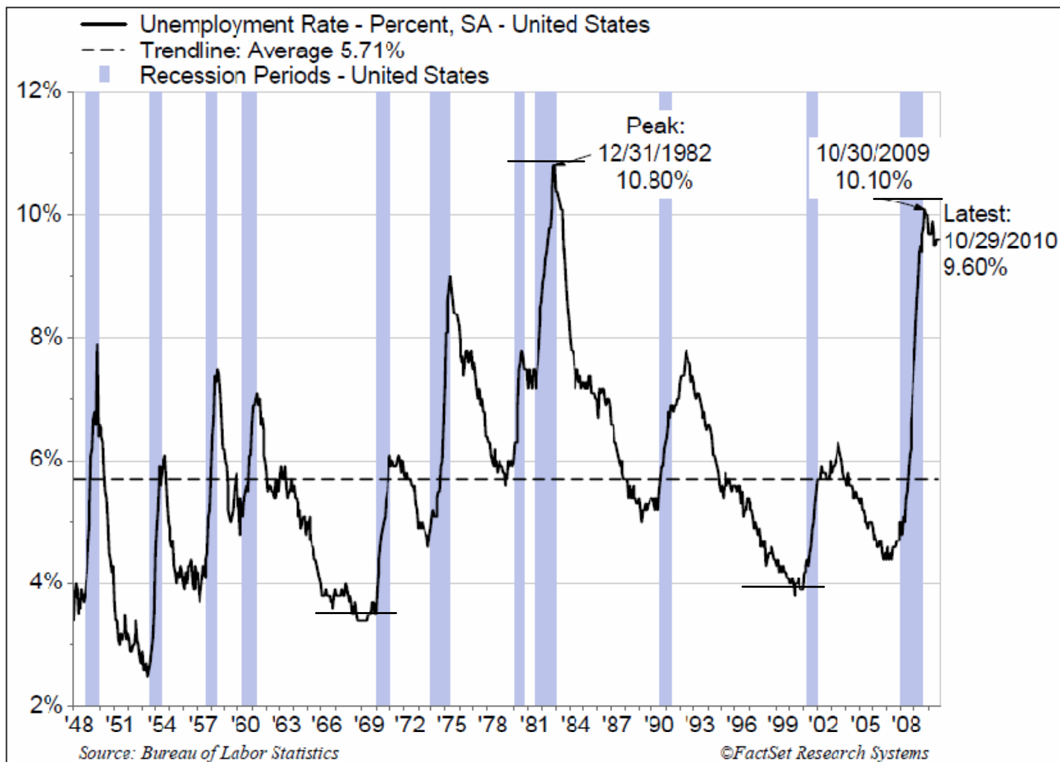


Chart 4
U-6 Unemployment Rate
(U-6 is the most comprehensive measurement of unemployment)

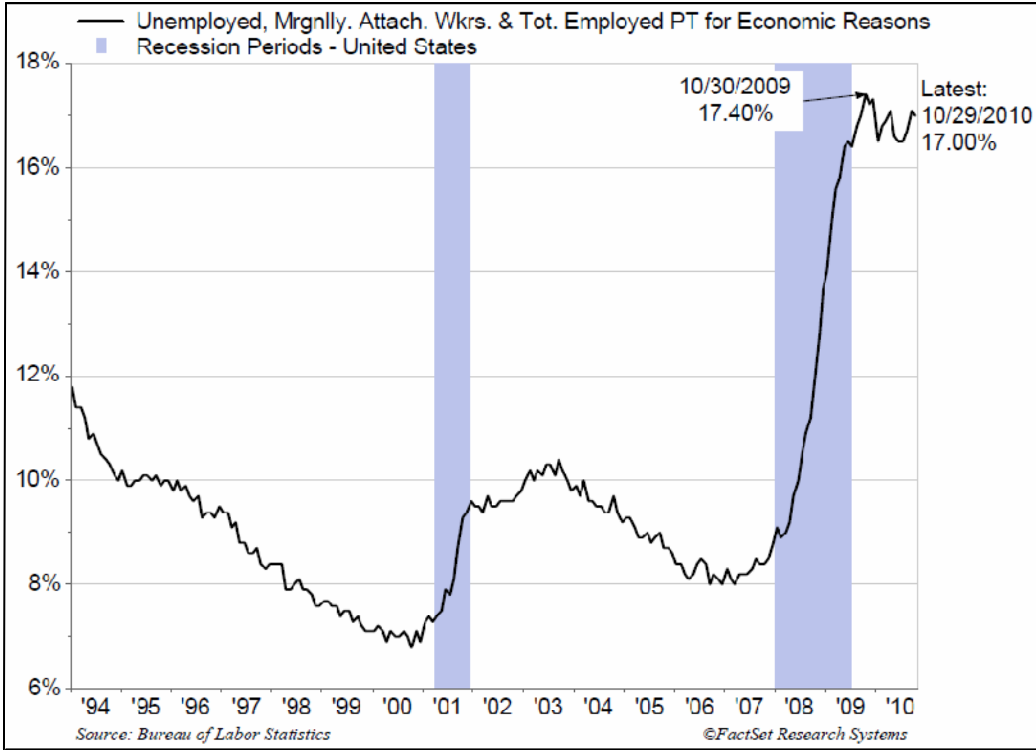
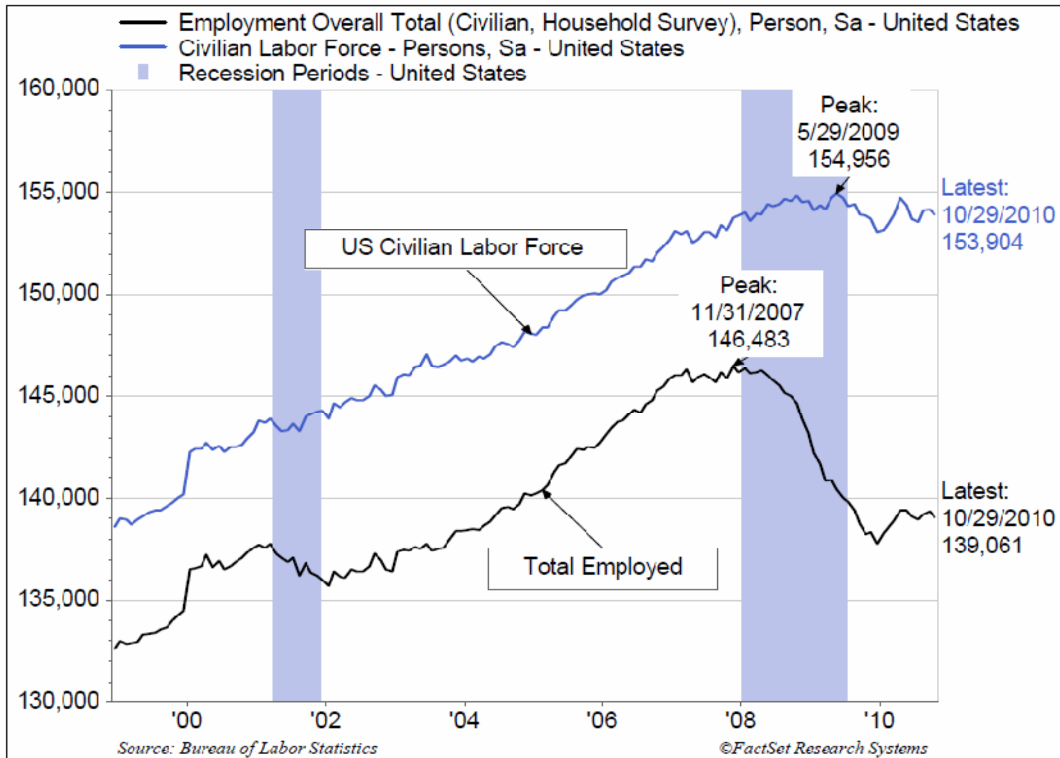


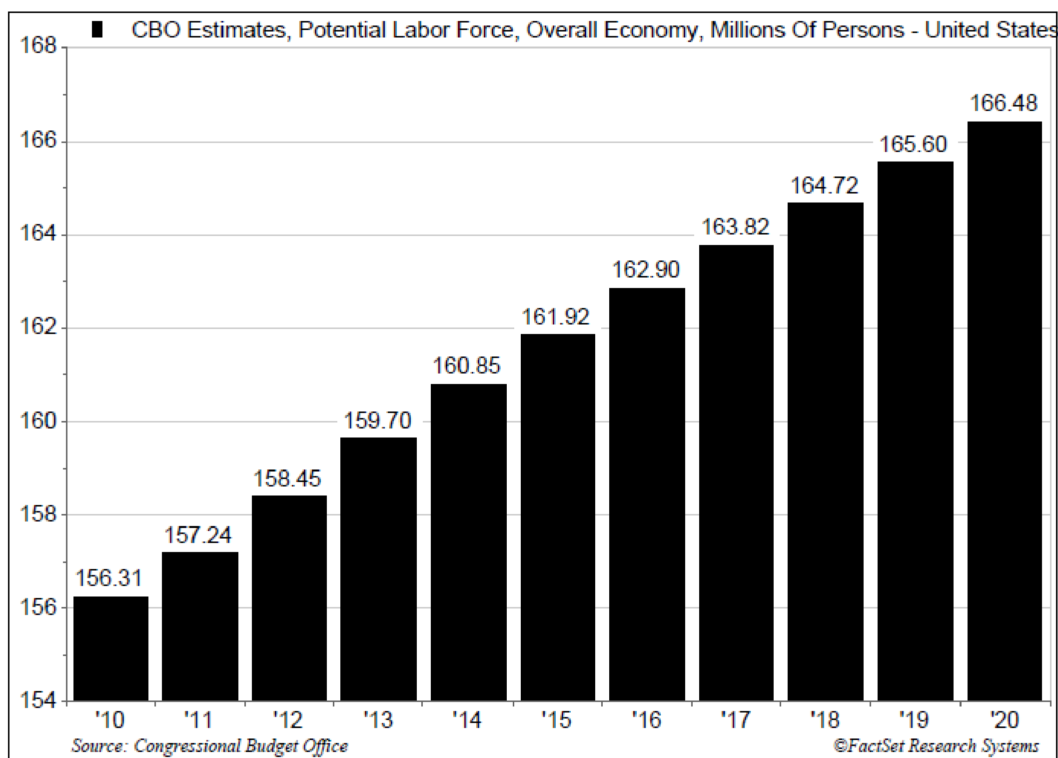
Chart 5
Total Labor Force and Total Employed



Though the unemployment picture is stabilizing, a lot of work remains to be done for the overall economy to grow at a faster pace. On **page 8**, **Chart 5** shows that the total labor force on October 29, 2010, was 153,904,000. This includes the people who have jobs, as well as those who are unemployed, eligible to work and actively looking. The number of people actually working was 139,061,000.

Since November 2007, when the unemployment rate was at 4.7%, over 7,422,000 people have lost their jobs. In addition to finding employment for these out of work Americans, the Congressional Budget Office (CBO)[3] estimates that by 2015, the total labor force will expand to 161,920,000 (see **Chart 6**). This means the total labor force will increase by 8,016,000 from the October 29, 2010, level.

Chart 6
Estimated Labor Force

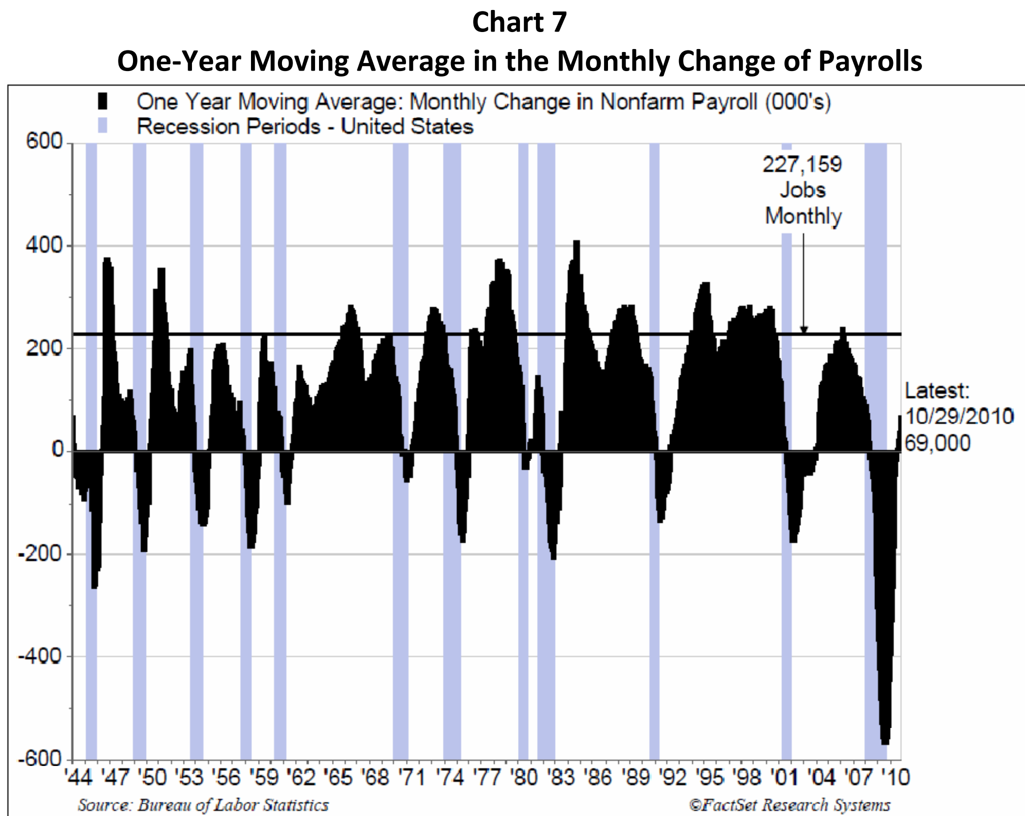


In order to replace the 7,422,000 jobs lost since 2008, find jobs for the 8,016,000 people that will be joining the labor force over the next five years, and bring the unemployment rate down to the 60-year average of 5.7%, we need to create a total of 13,629,560 new jobs, or **227,159 jobs per month for the next five years.** According to the Bureau of Labor Statistics[4], since October 2009, when unemployment reached a 28-year peak of 10.1%, through October 2010, 829,000 new jobs have been created for an average of 69,083 jobs per month. This is a far cry from the 227,159 monthly jobs needed.

158,820...the average number of monthly jobs created during the 15 years prior to this recession. Source: *Bureau of Labor Statistics*

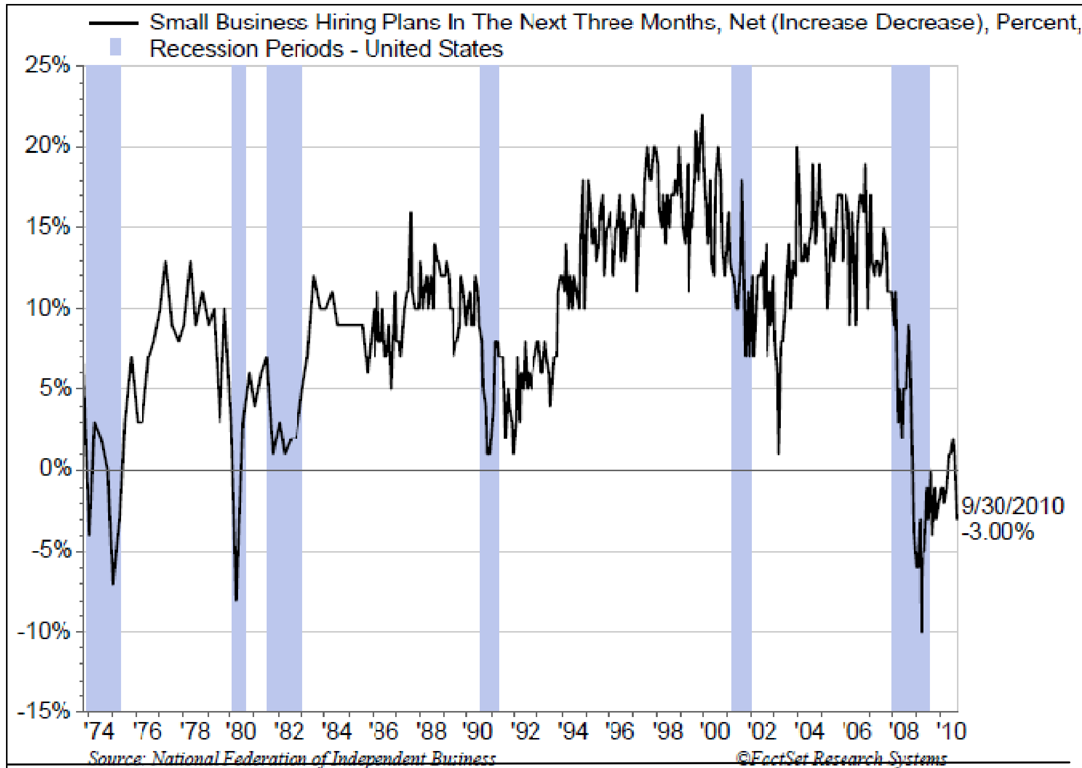
Chart 7 shows the one-year moving average in the change in payrolls over the past 65 years. In every recession period, as highlighted in blue on the chart, payrolls were reduced thus sending unemployment rates higher. As you can see, during this last recession, roughly three times more jobs were lost than in any of the 11 prior recessions. In addition, the speed at which these jobs were lost, as companies cut expenses at record levels, added to the severity of this recession. **Chart 7** also shows that within a year or two of the prior 11 recessions ending, there were more than 200,000 jobs being created on a monthly basis. Therefore, the 227,159 monthly jobs that need to be created over the next five years in order to bring the unemployment rate down to the long-term historical average and grow our economy should be attainable assuming we start to get pro-business policies and regulations coming out of Washington.

Chart 7
One-Year Moving Average in the Monthly Change of Payrolls



In order to reduce the unemployment rate as well as create new economic activity, small businesses, which account for 50% of the private nonfarm gross domestic product and have generated 65% of the net new jobs over the past 17 years, need to begin hiring again. According to the October 2010 Small Business Economic Trends Report by the National Federation of Independent Business (NFIB)[5], hiring plans by small businesses continue to underperform the recoveries that followed previous recessions. This can be seen on **Chart 8**, which measures the percentage of small businesses who plan to hire employees in the next three months. As of September 30, 2010, on a seasonally adjusted basis, it actually shows a negative 3%, meaning small businesses plan to lay off workers, not hire them over the next three months.

Chart 8
Small Business Hiring Plans in the Next Three Months



The Impact of Small Businesses in the United States:
Small business is defined as an independent business having fewer than 500 employees. In 2009, there were 27.5 million small businesses in the U.S. vs. 18,311 large businesses. **They represent 99.7% of all employer firms, employ 50% of all private sector employees, and pay 44% of total U.S. private payrolls.** They generated 65% of net new jobs over the past 17 years and created more than 50% of the nonfarm private GDP. Small businesses hired 43% of high tech workers (scientists, engineers, computer programmers, and others), made up 97.5% of all identified exporters, produced 31% of the export value in fiscal year 2008, and produced 13 times more patents per employee than large U.S. firms.

Source: Small Business Administration, U.S. Dept. of Commerce, Census Bureau and Intl. Trade Admin.; Advocacy-funded research by Kathryn Kobe, 2007 (www.sba.gov/advo/research/rs299.pdf) and CHI Research, 2003 (www.sba.gov/advo/research/rs225.pdf);U.S. Dept. of Labor, Bureau of Labor Statistics.

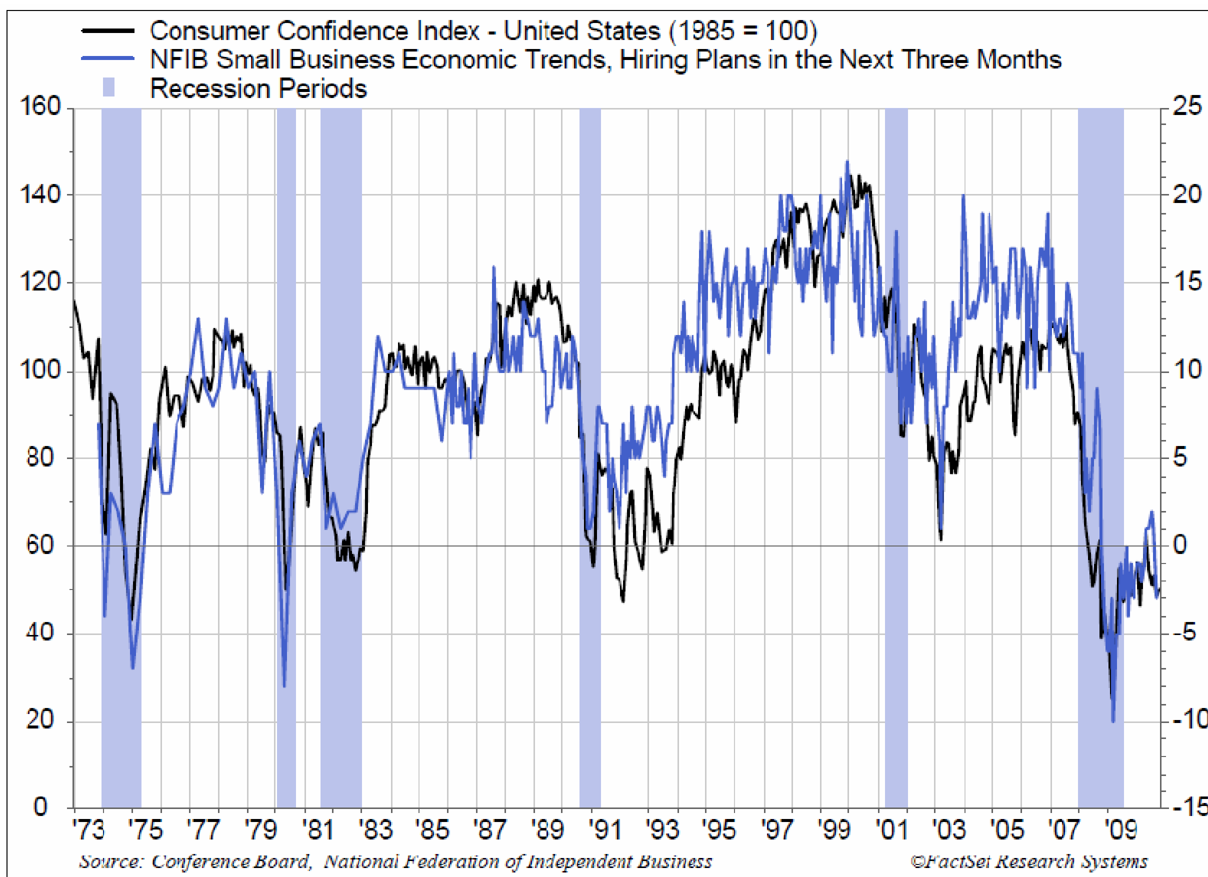
One of the primary reasons small businesses are not hiring is that they do not have confidence in our economy or in the policies and regulations coming out of Washington. This is very important to understand as confidence among small business owners is a key factor in job creation. **Chart 9** highlights the direct correlation between consumer confidence and the hiring practices of small businesses.

When there is little or no confidence, as is the case today, small business spending and capital allocation are in maintenance mode, not growth. Not only has this lead to a deterioration of jobs, but it has also kept capital spending at historically low rates. The

availability of financing is not the primary issue, as is often reported. According to the NFIB report, 91% of respondents reported that all their credit needs were met or that they were not interested in borrowing. A record 53% said they did not want a loan. Moreover, only 3% reported financing as their number one business problem; and most of those businesses looking for financing are looking for cash flow support, not funds to expand or hire workers. The bottom line is that many small business owners will not make spending commitments when sales prospects remain weak and important decisions, such as tax rates and labor costs (think health care reform and other new and proposed regulations), remain so uncertain.

Unless an environment is created that motivates companies, especially small businesses, to grow and invest in their businesses, unemployment is not likely to improve very much in the near future. In other words, if Washington does not create pro-growth policies supporting small businesses, putting Americans back to work is likely going to be a long process.

Chart 9
When Consumer Confidence is Up, Jobs Are Created



> **"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."**
>
> **Winston Churchill**

“The Voice of Small Business Was Heard” in the November 2010 Elections[6]

WASHINGTON D.C., November 3, 2010—“With 19 NFIB members—and more than 240 NFIB—endorsed candidates—now on their way to the U.S. Congress in January, this was a particularly significant election for the NFIB membership,” said NFIB President and CEO Dan Danner this morning. “It’s clear that the voice of small business was heard in this election.”

“More NFIB members, small-business owners and candidates with close small-business ties ran for Congress this year than ever before,” Danner said. “Many of them were among the 290 pro-small-business candidates endorsed by NFIB—more than 80% of whom won last night. This is outstanding news for America’s small-business community and job seekers because it means there will be a lot more people in Congress who understand that the best way to create jobs is to get out of the way, and off of the backs, of small business.”

“We expect the 112th Congress to listen closely to small-business owners in 2011, not only because so many members will hail from the small-business community, but because they know that small businesses are America’s job creators.”

NFIB is the National Federation of Independent Small Business (www.nfib.com)[7]

We are faced with many economic challenges, and job creation, in our opinion, is the biggest of those challenges. With that said, it is important to remember that often times there is a difference between the direction of the stock market and the direction of the overall economy, at least in the short run. For example, at the bottom of the Great Depression in March 1932, through March 1937 (5 years), while the unemployment rate averaged 18.46%, the Dow Jones Industrial Average increased 371%. Stocks were so cheap in 1932 that they discounted all the insoluble problems that eventually became solvable.*

The same thing happened at the end of 2008 / early 2009. When the stock market bottomed, stock prices appeared to be discounting the end of the world. Since that time, the unemployment rate, debt levels, and uncertainty are still high, yet the U.S equity markets, as well as our typical CM portfolio, are up 70% or more from the bottom (as of October 2010).

Chart 10 shows 11 recessionary periods over the past 60 years and the date at which the S&P 500, our proxy for the general market in this example, hit a bottom price. The chart also shows the peak unemployment percentage and the date at which that peak occurred. Just like the two preceding examples, in each of these 11 recessionary periods, stocks provided good returns from their bottom prices over the months that followed, even though the unemployment rate remained high and the economy had not fully recovered. When economic problems seemed unsolvable, stocks were oversold. Once the market realized the economic problems were solvable, stock prices recovered well before the economy.□

“A conclusion about the economy does not tell us if the stock market will rise or fall.”
Warren Buffett

***Disclosure Note:** We are not suggesting that stocks were as cheap at the bottom of 2009 as they were in 1932, nor was there as much uncertainty in 2009 as during the Great Depression. In addition, from 1930 through 1933, real GDP declined 26.7%, whereas real GDP declined 4.1% from June 2008 through June 2009. Furthermore, prices are not as cheap today as they were at the bottom of 2009.

Chart 10

The Date When the S&P 500 Hit a Major Bottom	S&P 500 Price on Bottom Dates	Peak Unemployment Percentage	Peak Unemployment Dates	S&P 500 Price on Peak Unemployment Dates	S&P 500 Return From Bottom Price…Even Though Unemployment Was Still High
03/09/09	$676.53	**10.00%**	12/31/09	$1,115.10	**65%**
10/09/02	$776.76	**6.20%**	06/30/03	$974.50	**25%**
10/11/90	$295.46	**7.60%**	06/30/92	$408.14	**38%**
08/12/82	$102.42	**10.70%**	12/31/82	$140.64	**37%**
03/27/80	$98.22	**7.70%**	09/30/80	$125.46	**28%**
10/03/74	$62.28	**8.90%**	06/30/75	$95.19	**53%**
05/26/70	$62.29	**6.00%**	09/30/71	$98.34	**58%**
10/25/60	$52.30	**7.00%**	06/30/61	$64.64	**24%**
10/22/57	$38.98	**7.40%**	06/30/58	$45.24	**16%**
09/14/53	$22.71	**6.00%**	09/30/54	$32.31	**42%**
06/13/49	$13.55	**7.00%**	12/31/49	$16.79	**24%**

This chart shows the price appreciation from the low price of the S&P 500 during a major market bottom to the date when the unemployment rate eventually hit a high for that period of time. The point being that the stock market can still produce good returns even though unemployment remains at high levels. Source: Bloomberg, LP.

Centuries ago, Adam Smith laid out the most comforting fact of capitalism:

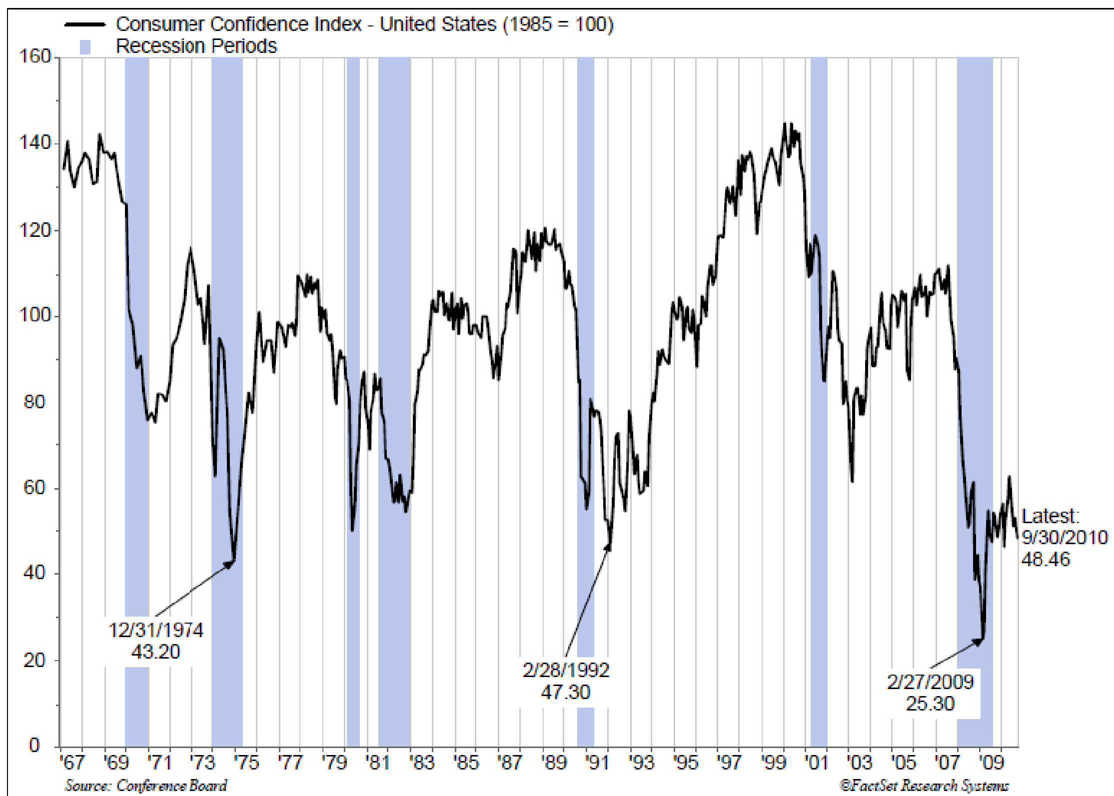
"We don't have to rely on the capitalist's generosity of spirit for our goodies; we can rely on his self-interest."

Consumer Confidence

Chart 11 shows that as of September 2010, consumer confidence is at a reading of 48.46. This is up from the February 2009 low reading of 25.3; however, a reading of 48.46 is only approximately half the average confidence level seen during other economic recoveries. Comparatively, after the 1974 bear market the confidence rating went from a low of 43.2 to 100 in just one year, eventually increasing to an index reading of 110 by 1978. In the 1981/82 recession, the confidence rating sank to a low of 58 only to rebound to 103 in 1984, eventually reaching 120 in the late 1980s. Then, in the 1990 recession, the confidence index dropped to 58, and eventually reached a low of 47.3 in February 1992. In 1994, just two years later, the confidence index was back above 100 and then proceeded to make an all-time high of 142 in 1999. After three years of declining stock values and a recession in 2001, the confidence rating made a bottom at 61.4 in March 2003, only to quickly recover and pass 100 by June 2004, before finally reaching a six-year high of 111.9 in July 2007.

Today, consumers continue to have a low level of confidence due to the many uncertainties and fears over unemployment, a variety of regulatory reforms (both recently passed as well as potential future reforms), and the potential of higher taxes. The Administration and Congress have created most of this uncertainty. For example, delaying tax reform makes it difficult for individuals and businesses to plan for the future. Another example is the uncertainty and ambiguity in the 2,310 page health care reform bill. Many consumers and small businesses have fears and concerns about their financial futures that are at such elevated levels they find themselves in a financially frozen state of mind.□

Chart 11
Consumer Confidence



Residential Real Estate

Although the housing industry continues to struggle, we are seeing some signs of stabilization. The root of this struggle stemmed from over-building. According to the U.S. Census Bureau, during 2004 through 2006, the heart of the real estate boom, housing starts averaged approximately 1.95 million units annually (see **Chart 12**). At the same time, net new household formations increased on average 1.04 million annually (see **Chart 13**), thus creating an imbalance.

Chart 12 shows that as of September 2010, there were 610,000 new housing starts, one of the lowest levels over the past 50 years. At the same time, demand for housing is also down as seen by the recent reduction in net new household formations. While this move toward equilibrium is positive, the over-supply of existing inventory created during the boom still needs to be worked off. *Note that part of the long-term disparity between housing starts and net new household formations is due to homes being demolished*.

Chart 12
Housing Starts

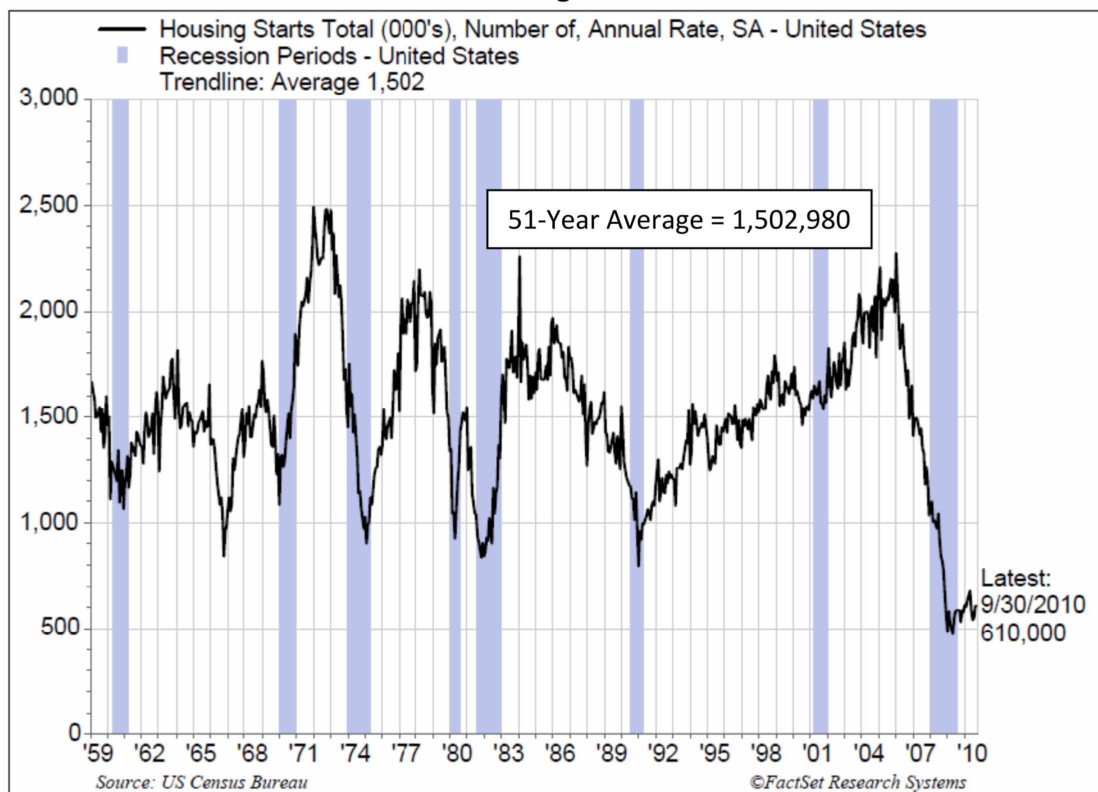
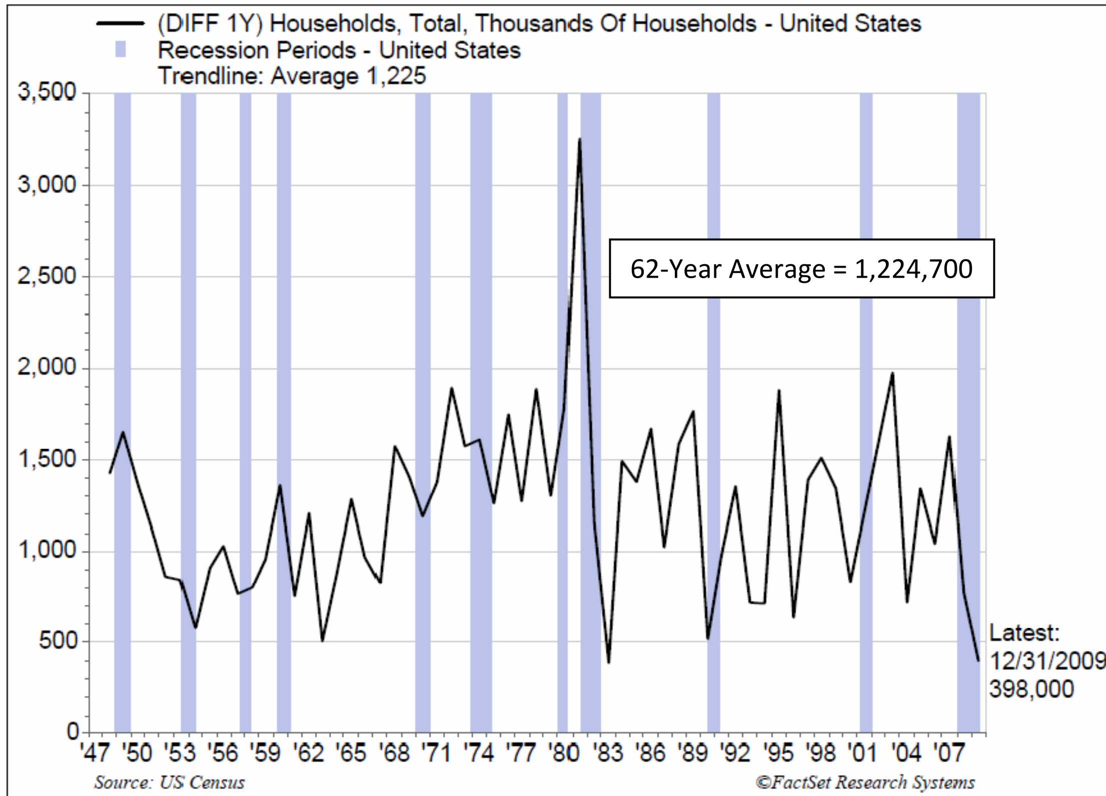


Chart 13
Net New Household Formations



According to the U.S. Census Bureau and the National Association of Realtors(R) (NAR), as of September 2010, there were 3,585,000 new and existing homes listed for sale (i.e. inventory) in the U.S. The NAR reported that on a seasonally adjusted annualized basis, there were 4,277,000 completed sales of new and existing single-family homes, townhomes, condominiums, and co-ops. This equates to a 10.1 month supply of inventory. In other words, at this annualized rate of sales, the current inventory of homes would be consumed in 10 months.

As a general rule of thumb, inventory of three months or less is referred to as a seller's market. In a seller's market, prices tend to increase as there are more would-be buyers than available inventory. Inventory of seven months or longer is referred to as a buyer's market. With greater inventory on the market than would-be buyers, prices tend to decrease; this is the environment we are in today. In a "normal / healthy" real estate market, the level of inventory is such that neither the buyer nor the seller has an extreme advantage, usually a period of 4 to 5 months.

Chart 14 quantifies how long it is likely to take to absorb today's excess inventory. If we divide the current annualized rate of sales by 12 months, we get an average of 356,417 sales per month. If we assume that 4.5 months of inventory is a healthy level for the real estate market to function at a normal rate of exchange, the current inventory needs to be reduced by roughly two million homes. If no new inventory is added, and an average of 356,417 homes sold per month, it would take approximately 5.6 months to absorb this inventory.

Chart 14

	Months of New and Existing Home Inventory That Needs to be Sold to Get Back to a "Normal/Healthy" Inventory Level- September 2010
3,585,000	New and existing homes listed for sale -i.e. inventory (September 2010).
÷	
356,417	Average number of new and existing homes being sold per month on an annualized seasonally adjusted basis--September 2010 (4,277,000 sales / 12 = 356,417).
=	
10.1	Months of new and existing inventory currently on the market.
4.5	Desired months of inventory for a "normal / healthy" real estate market (356,417 times 4.5 months = 1,603,877 of desired inventory).
5.6	Excess inventory that needs to be sold in order to return to "normal / healthy" real estate market (10.1 months of current inventory *minus* 4.5 months of desired inventory = 5.6 months of inventory needed to be sold or 1,995,935 units).
Source: National Association of Realtors and U.S Census Bureau	

There are, however, four areas of concern that could hinder or prolong a recovery for residential real estate:

1. Delays in foreclosure activity.
2. An increase in the amount of real estate referred to as “shadow inventory”.
3. Higher interest rates.
4. The removal of government housing stimulus programs.

According to CoreLogic®[8], the largest and most comprehensive U.S. real estate and loan performance database covering 97% of all U.S. residential real estate property records, 7.9% or 3,776,420 out of the 47,802,783 outstanding mortgages are in the **shadow inventory***. While not likely, if the entire shadow inventory hit the real estate market at once, there would be an additional 3,776,420 properties for sale. Most of these properties would have motivated sellers (banks) willing to reduce their prices as needed in order to remove this inventory from their books. In addition to putting downward pressure on home prices, an additional 3,776,420 properties would also lengthen the time to get inventory levels down to the healthy 4 to 5 month supply.

Based on what we see today, we have calculated two scenarios on **Charts 15** and **16** that we believe provide a conservative range of outcomes to work off the current and shadow inventory over the next four years:

- To begin, we take the total outstanding mortgages as of September 30, 2010 (which we hold constant during our four-year projection), and multiply them by the percentage of mortgages that are 90 days delinquent to arrive at the shadow inventory for both charts. On both charts we are projecting a decline in the percentage of 90-day delinquent loans in 2012 and 2013 as we anticipate improvement taking place in the housing market.

- **Chart 15** assumes that **50%** of the shadow inventory gets foreclosed and these homes enter the market as official inventory to be sold, while **Chart 16** assumes **85%**. We believe projecting an 85% foreclosure rate on the shadow inventory is very conservative as this would assume that 23.8% of all shadow inventory shown in our four year projection are foreclosed upon and listed for sale. (13,398,949 / 47,802,783 = 28% x 85% = 23.8%)

- We then project that the annualized rate of homes sold in September 2010 are sold each year over the next four years with no change in the number of homes sold.

- Last, we divide the number of foreclosed homes by the average number of homes sold per month to arrive at the number of months it will take to absorb the shadow inventory.

***Shadow Inventory:** The "shadow inventory" of homes includes all delinquent mortgages 90 days past due as well as real-estate owned (REO) property that has not reached the market for sale. REO properties are foreclosed homes taken back by banks for liquidation but are not yet on the market for sale. In other words, this is potential future inventory.

Chart 15
Total Months of Excess and Shadow Inventory if 50% of the Shadow Inventory Comes to Market

Year	Total Number of Outstanding Mortgages	Percentage of 90-Day Delinquent Mortgages	Number of Delinquent Mortgages (Shadow Inventory)	Projected Percentage of Foreclosures	Number of Foreclosed Mortgages	Monthly Sales	Months to Recover at Current Run Rate
2010	47,802,783	7.9%	3,776,420	50.0%	1,888,210	356,417	5.3
2011	47,802,783	8.0%	3,824,223	50.0%	1,912,111	356,417	5.4
2012	47,802,783	6.0%	2,868,167	50.0%	1,434,083	356,417	4.0
2013	47,802,783	5.0%	2,390,139	50.0%	1,195,070	356,417	3.4
Total months of shadow inventory if 50% of the 90-day delinquent mortgages are foreclosed and listed for sale from 2010-2013 (4 years)							**18.0**
Months of existing excess inventory							**5.6**
Total months of existing excess inventory + four years of shadow inventory if 50% comes to market							**23.6**
					In Years		**2.0**

Source: National Association of Realtors®, U.S. Census Bureau, CoreLogic®, and Century Management. Numbers have been rounded. Scenario results are subject to change without notice.

Chart 16
Four Year Projection to Absorb Shadow Inventory if 85% of Shadow Inventory Comes to Market

Year	Total Number of Outstanding Mortgages	Percentage of 90-Day Delinquent Mortgages	Number of Delinquent Mortgages (Shadow Inventory)	Projected Percentage of Foreclosures	Number of Foreclosed Mortgages	Monthly Sales	Months to Recover at Current Run Rate
2010	47,802,783	7.9%	3,776,420	85.0%	3,209,957	356,417	9.0
2011	47,802,783	8.0%	3,824,223	85.0%	3,250,589	356,417	9.1
2012	47,802,783	6.0%	2,868,167	85.0%	2,437,942	356,417	6.8
2013	47,802,783	5.0%	2,390,139	85.0%	2,031,618	356,417	5.7
Total months of shadow inventory if 85% of the 90-day delinquent mortgages are foreclosed and listed for sale from 2010-2013 (4 years)							**30.7**
Months of existing excess inventory							**5.6**
Total months of existing excess inventory + four years of shadow inventory if 85% comes to market							**36.3**
					In Years		**3.0**

Source: National Association of Realtors®, U.S. Census Bureau, CoreLogic®, and Century Management. Numbers have been rounded. Scenario results are subject to change without notice.

Chart 15 concludes that working off excess and shadow inventory will take 2 years, and Chart 16 concludes it will take 3 years.

If policies in Washington do not change to promote growth in business and confidence in the consumer, we would project no decline in the number of 90-day delinquent mortgages over the next four years and thus would project them to continue to represent 8% of all outstanding mortgages. If this were to happen, **Chart 15's conclusion would increase to 2.2 years, and Chart 16's conclusion would increase to 3.5 years.**

If the total number of 90-day delinquent mortgages continued to represent 8% of all outstanding mortgages, and if 100% were foreclosed and listed for sale, then it would take four years to work through the current and shadow inventory. However, this would mean that cumulatively, over the next four years, 32% of all outstanding mortgages today are foreclosed and sold. While possible, we do not think this scenario is very likely.

According to the National Association of Realtors® approximately 1.8 million foreclosed homes were sold in 2009. The annualized adjusted rate of foreclosed homes sold through the third quarter of 2010 is 1.4 million. So while the current 3,776,420 properties listed as shadow inventory look ominous, it is important to remember that over 3.2 million shadow inventory properties that actually foreclosed over the past 1.75 years were easily absorbed.

In summary, our most optimistic real estate inventory recovery will take two to three years and our most probable bearish scenario will take 3.5 years. These scenarios are addressing inventory levels, not price levels. Real estate prices are most affected by local markets. Therefore, price recoveries are likely to be impacted more by local factors than by national averages. Generally speaking, prices will take longer than inventory to recover back to peak levels.

While we mentioned four concerns that could slow the real estate recovery, there are several considerations that may decrease the current and "shadow" levels of inventory, thereby reducing the time it takes to return to a healthy real estate market:

- The shadow inventory might decrease. Fewer homes entering the market means it will take less time to recover.

- Less inventory being built. Housing starts remain at all-time lows (currently adding just one-third of the normal levels to inventory). Fewer homes entering the market means it will take less time to recover (see **Chart 12**).

- Net new household formations increase as the economy recovers, thus bringing with it new home buyers. Currently, net new household formations are near 62-year lows with just 398,000 in December 2009. With the 5-year average at 1.1 million per year and the 62-year average at 1.2 million per year, new household formations are likely to increase two to three times their current rate as the economy begins to recover (see **Chart 13**).

- As home prices continue to drop, more home buyers enter the market. For example, many renters are now finding that their monthly payments would be cheaper if they owned a home versus renting one. Lower prices give renters that extra incentive to buy a home. Affordability is at an all-time high (see **Chart 17**).

- When consumer confidence returns, would-be home owners who are now more certain about their financial futures will come back into the home buying market.

- As the employment picture improves, more home buyers enter the market.

- With the U.S. dollar under pressure, U.S. real estate becomes more attractive to foreign investors.

- While having slowed down during this past recession, if net immigration recovers to its 2000–2005 pace net new household formations will average about 1.48 million annually in 2010–2020. Even if immigration falls to half the Census Bureau's currently projected rate, net new household formations will still average about 1.25 million annually, right in line with the 62-year historical average and more than three times today's current rate (see **Chart 13**). This low-end estimate puts household growth over the next 10 years on par with the pace seen from 1995–2005. (Source: Joint Center for Housing Studies at Harvard University's 2010 State of the Nation's Housing study[9])

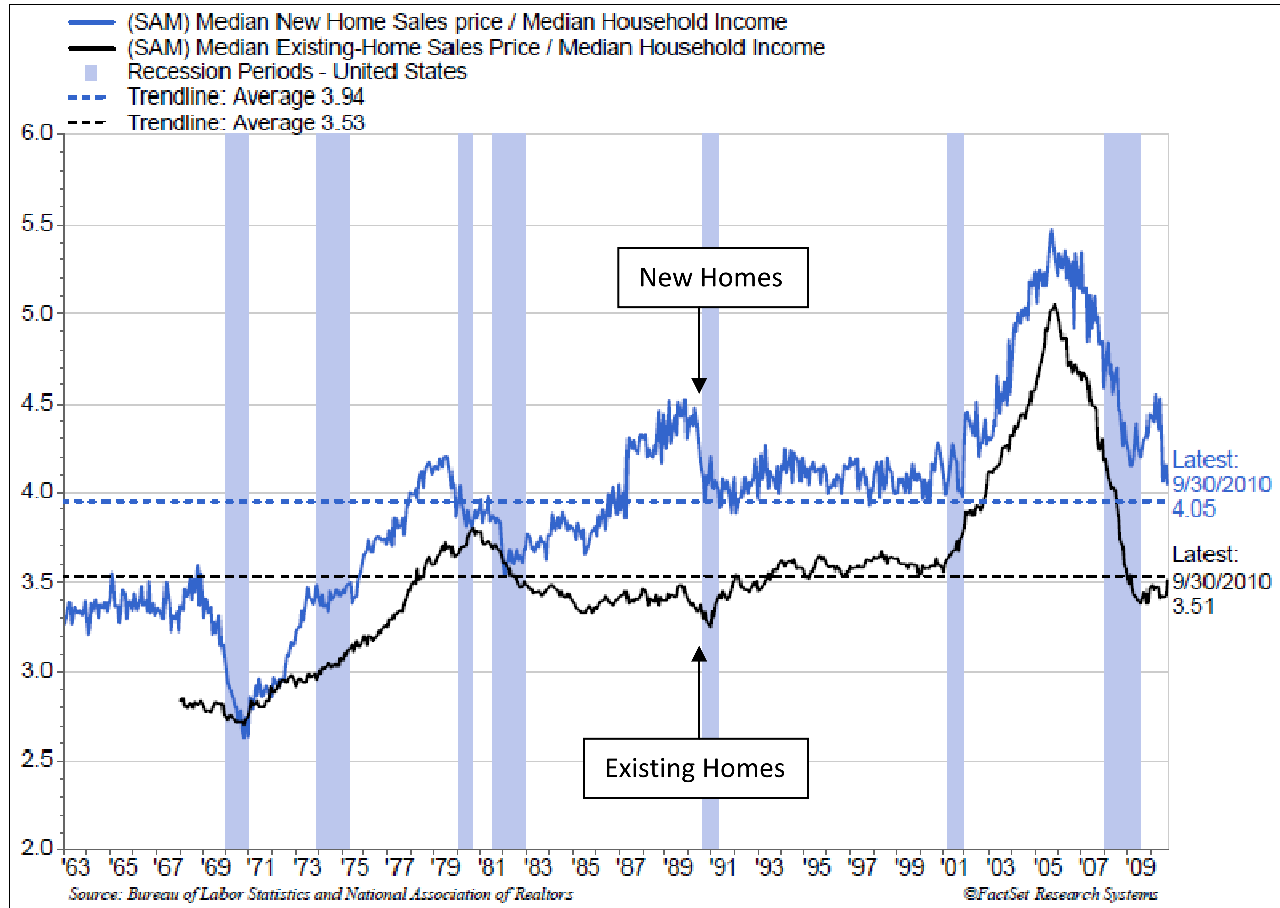
Some or all of the above could increase sales above the current 4.2 million annualized rate of homes sold as of September 2010. If the market just returned to the sales levels of the past three years, there would be an increase of at least one million units sold. For example:

- 2009: 5.5 million new and existing homes sold…*1.3 million more than today*
- 2008: 5.4 million new and existing homes sold…*1.2 million more than today*
- 2007: 6.3 million new and existing homes sold…*2.1 million more than today*

Measuring the affordability of the typical consumer is one of the best ways to measure the state of the housing sector. To arrive at an affordability multiple, we divide the median home price by the median household income. **Chart 17** shows that on a national basis, the median price of a **new** home is 4.05 times the median household income, down from its peak of 5.5 times. In other words, the median price for a new home is now 26.4% more affordable than in September 2005. Moreover, this 4.05 affordability multiple is just 2.8% higher than the 47-year average of 3.94 times.

Existing home prices are an even better deal. On a national basis, the median price for an existing home is 3.51 times the median household income, down from its peak of 4.99 times. In other words, the median price for an existing home is now 29.7% more affordable than in December 2005. Additionally, this 3.51 affordability multiple is 0.6% below the 47-year average, a level not seen since 1993.

Chart 17
Home Prices Relative to Income



Along with decreasing home prices, record low interest rates have also increased housing affordability for the consumer. According to Freddie Mac, the national average commitment rate for a 30-year conventional, fixed-rate mortgage fell to a record low 4.19% on October 14, 2010. As of the week ending November 5, 2010, this rate was slightly up to 4.24%. This is now 26 weeks in a row that the 30-year fixed-rate mortgage has been under 5%. **The last time 30-year fixed rate mortgages were this low was in April 1951. Fifteen-year fixed rate mortgages also fell to a record low at 3.62%**.

Today's mortgage rates are down considerably from just over a year ago when the 30-year fixed rate mortgage hit a high of 5.59% in June 2009. **Chart 18** on **page 24** shows just how significant lower interest rates are when it comes to housing affordability and pricing levels. While home prices vary by location, we have found that the existing national average home sales price is a good number to use for this exercise.

If we assume a homeowner puts 20%* down on a home priced at $219,000 (the national average price of homes sold in September 2010), he would need to finance a mortgage of $175,200. In June 2009, the monthly principal and interest payment on a 30-year mortgage would have been $1,004.68. As of November 4, 2010, the near record low interest rate of 4.24% would lower the payment down to $860.85. This is a monthly savings of $143.83 or 14.3%, and over the life of the 30-year mortgage a savings of $51,778 in interest costs. This monthly savings could be used for discretionary spending or investing; either of these would help fuel the future growth of the economy.

We recognize that down payments can vary. For example, VA loans allow for zero down payments, FHA loans require 3.5% down payments, and many lenders today are requiring 20% down on traditional loans. In the example shown on **Chart 18, we are using 20% as a down payment. However, the point that lower interest rates have a material impact on reducing the monthly mortgage payments applies regardless of the down payment required.*

Chart 18

Record Low Interest Rates Make Housing More Affordable Than Ever	
$219,000	Existing National Average Home Sales Price Per NAR®(September 2010)
$43,800	Assume 20% down*
$175,200	Loan amount
	June 11, 2009 (high interest rate for 2009)
$175,200	Loan amount
5.59%	30-year conventional fixed-rate mortgage
$1,004.68	Monthly principal and interest payment
$186,486	Interest payments over the life of the 30-year mortgage
	November 4, 2010 (Last time this low was April 1951)
$175,200	Loan amount
4.24%	30-year conventional fixed-rate mortgage
$860.85	Monthly principal and interest payment
$134,708	Interest payments over the life of the 30-year mortgage
	Summary
$143.83	Difference in monthly payment
14.3%	Percentage savings
$51,778	Total savings in interest payments over the life of the 30-year mortgage

The payments shown represent principal and interest payments only. Taxes, insurance, and any other fees associated with home ownership are not included. We also recognize that not every house will have a 20% down payment. The purpose of this chart is to highlight the savings achieved due to the change in interest rates. Therefore, down payment size, taxes, insurance, and any other fees would not impact this calculation. Source: National Association of Realtors® and Freddie Mac. Interest rates shown are the national average commitment rate per Freddie Mac. (http://www.realtor.org) and (http://www.freddiemac.com/pmms/pmms.30thm), and Century Management.

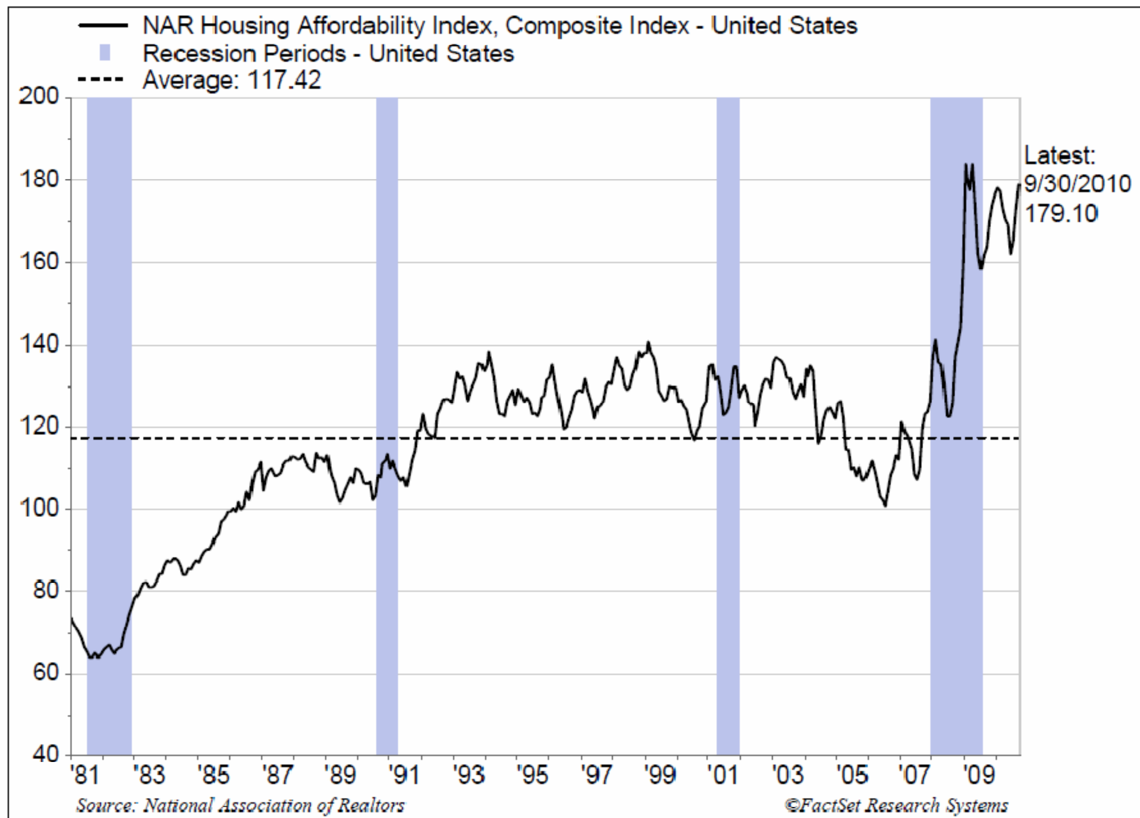
The last way to measure housing affordability is to use the National Association of Realtors® affordability index shown on **Chart 19**. As of September 2010, this index showed that a family earning the median income has 179.10% of the income necessary to qualify for a conventional loan covering 80% of the median-priced existing single-family home. This is 52.53% higher than the 30-year average.

When you take into account that home buyers are being helped by some of the highest levels of home affordability seen in decades, there remains a reasonable chance it will take less time to absorb today's excess inventory than by new household formations alone. Remember that for every seller

(or lender) hurt by this real estate debacle, there will be a buyer who benefits. With so much inventory to choose from, prices back down to 2003/2004 levels, and mortgage rates at record lows, there will be many who were once unable to afford a home now finding it well within their means.

Chart 19

National Association of Realtors Affordability Index - ***The Highest in More Than 30 Years***



Methodology for the NAR Housing Affordability Index

The NATIONAL ASSOCIATION OF REALTORS® (NAR) Affordability Index measures whether or not a typical family could qualify for a mortgage loan on a typical home. A typical home is defined as the national median-priced, existing single-family home as calculated by NAR. The typical family is defined as one earning the median family income as reported by the U.S. Bureau of the Census. The prevailing mortgage interest rate is the effective rate on loans closed on existing homes from the Federal Housing Finance Board and HSH Associates, Butler, N.J. These components are used to determine if the median income family can qualify for a mortgage on a typical home.

To interpret the affordability index a value of 100 means that a family with the median income has exactly enough income to qualify for a mortgage on a median-priced home. An index above 100 signifies that a family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home, assuming a 20 percent down payment. For example, a composite HAI of 120.0 means a family earning the median family income has 120% of the income necessary to qualify for a conventional loan covering 80 percent of a median-priced existing single-family home. An increase in the HAI, then, shows that this family is more able to afford the median priced home.

The calculation assumes a down payment of 20 percent of the home price and it assumes a qualifying ratio of 25 percent. That means the monthly principal and interest payment cannot exceed 25 percent of the median family monthly income.

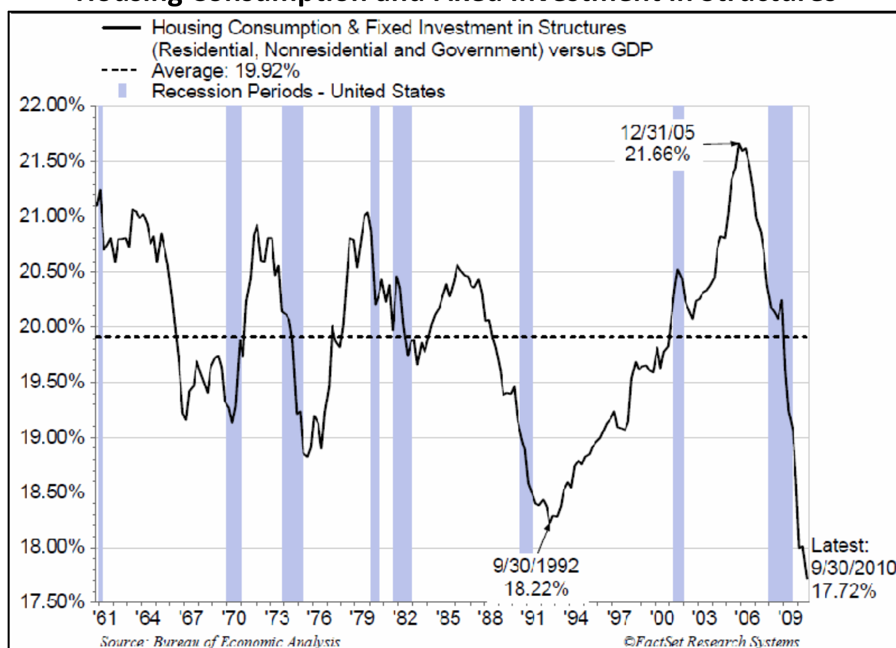
Resolving the issues surrounding residential real estate will go a long way toward improving our slow growing economy. According to the Bureau of Economic Analysis, over the past 50 years, real estate related consumption and investments typically generated 18.2% to 21.6% of all economic activity (see **Chart 20**). Because this is such a large percentage of our economy, a tremendous wealth effect is tied to real estate.

For example, in the 2005 research report W05-8 titled, "Housing Wealth and Retirement Savings"[10], William Apgar and Zhu Xiao Di of the Joint Center for Housing Studies at Harvard University, reported that households spend on average 5.5 cents a year out of every dollar increase received in house value. In other words, when a home increases $10,000 in value, the owner is likely to spend an extra $550. While this number might not seem like a large amount, its impact grows dramatically when we apply this to the $18.8 trillion of real estate shown on the U.S. household balance sheet displayed on **Chart 30 (page 37).** If this balance were to increase by 10% or $1.88 trillion, and household spending increased 5.5 cents for each dollar, consumers would increase their spending by more than $103 billion dollars. If real estate increased 20%, consumer spending would likely increase $206 billion; and at 30%, it would likely increase $310 billion. To put this into perspective, this would amount to 14% to 44% of the original $700 billion bailout program signed into law by President Bush.

Also important is that this additional spending hits its long-term average within one year of when the increase in home value occurs, making its positive effects felt almost immediately. The study showed this compares favorably to financial wealth creation through stocks, bonds, and other investments. Researchers found that households only increased their spending an extra 2 cents per year for every dollar generated from financial wealth creation. However, if we combine the net effect of the increase in real estate values along with an increase in financial wealth creation, spending will likely increase, on a weighted basis, 4.22 cents per year for every dollar these two asset classes increase. Looking forward to the U.S. household balance sheet displayed on **Chart 30 (page 37)**, there is a combined $29.6 trillion of real estate, as well as equities and mutual funds on the balance sheet. If this were to increase by 10% or $2.96 trillion, and household spending increased 4.22 cents for each dollar, consumers would increase their spending by more than $125 billion dollars.

Chart 20

Housing Consumption and Fixed Investment in Structures



The two main ingredients in solving the real estate problems are job creation and time. On a national basis, we believe the residential real estate problems as related to inventory should largely be behind us over the next two to three years. Areas that may take a little longer to recover are those that were overbuilt or that have a disproportionate number of higher priced homes. **While we do expect inventory levels to moderate in two to three years, depending on the local market, it will likely take a longer period of time before we get back to peak prices**. As the real estate market begins to recover, it will be a real boost to economic activity. In general, this should bode well for the stock market, especially for several positions in some of our portfolios, such as lender/bank **Wells Fargo**, home builders **Toll Brothers** and **MDC Holdings**, and home improvement and building product manufacturer **Masco**.□

Savings Rate

Consumers are saving again. There are two official ways to measure the personal savings rate, and each method is important because each answers different questions. First is the savings rate as defined by the U.S. Bureau of Economic Analysis[11] NIPA tables shown on **Chart 21.** This method of calculating the savings rate measures the amount of disposable personal income left after personal expenses. Capital gains, realized or unrealized, are excluded from this method. Think of this as the amount of savings that is left on the bottom line of your annual budget or your income statement. For example, let us assume that a couple earned $100,000 in salaries and bonuses for the year and had $95,000 in personal expenditures and taxes. After subtracting their expenses from their income, they are left with $5,000 in savings according to the NIPA personal savings method. Stated as a percentage, their savings rate is 5%.

Chart 21 shows the 52-year history of the NIPA personal savings rate. It hit an all-time low of 0.82% in April 2005. The steady decline in this personal savings rate over the past 20 years truly highlights the spending spree American households enjoyed via a drawdown in savings as well as a significant increase in debt. Since the April 2005 low, this savings rate has increased dramatically. As of September 30, 2010, it is 5.34%. This improvement suggests Americans are paying down their debt and getting their households in order. While there is still room for improvement, many Americans are making progress towards living within their means. Once households show a consistent personal savings rate above the 52-year historical average of 7%, we believe personal spending and investment activity will increase. This will help fuel future economic growth.

The second method of calculating the personal savings rate is the Flow of Funds Accounts report (FFA) produced by the Federal Reserve shown on **Chart 22**. This method is more comprehensive than the NIPA method because it measures the rate of change in net worth or wealth. In other words, it includes the change in the value of one's assets, not just net income left after expenses. For example, at the end of the year after you add up the change in value from the previous year for all your assets such as your home, stocks, bonds, savings account, money market funds, 401(k), other retirement plans, etc. and subtract all of your debts such as your mortgage, car loans, and credit cards, what is left over is what you saved according to this FFA method of calculating the personal savings rate. As of June 30, 2010, the FFA annualized savings rate is 9.75%, which is above its 65-year historical average of 8.55%. This material increase in savings (i.e. net worth) over the past year or two can be largely attributed to the increase in the value of stocks, mutual funds, and pension reserves.

Chart 22 shows the 65-year history of the personal savings rate according to the FFA method from the Federal Reserve. For the past 10.5 years, the average savings rate has been 2.4%. Furthermore, from 2000 through 2008, there were numerous periods where the annual rate of change in household net worth declined enough to cause this personal savings rate to go negative, eventually reaching a 65-year low in 2008 at minus 5%.

Due to the historical decline in stock prices from 2000 through 2002, many households experienced a significant decline in their personal investment accounts as well as their various retirement plans. This decline in stocks was so pervasive that it caused overall household net worth to decline even after adding gains from other asset classes such as cash, bonds, and real estate. As such, the savings rate as measured by FFA turned negative for that period. In 2008, the same thing happened again when home prices, in addition to stock and bond prices, declined significantly leaving few asset classes with positive gains to offset the negative change in net worth, thus resulting in the lowest savings rate in 65 years as measured by the FFA.

When using the savings rate to calculate the true wealth of households, we believe the more comprehensive FFA savings rate is the better method. Because it includes the change in asset prices (i.e. capital gains, realized and unrealized) in addition to income, this method is more relevant when calculating whether Americans have enough savings to retire or stay retired. Assets such as stocks, bonds, real estate, etc. provide another source of liquidity to generate cash. Though more volatile, we do expect the FFA savings rate to stay closer to its historical average and even possibly go higher over the next decade since we believe asset levels will increase household balance sheets over this time period.

An increase in the personal savings rate, as well as paying down debt, is a positive long-term trend for the future health of our economy. However, in the short run, the increase in the personal savings rate is one of the reasons why this economic recovery (not to be confused with the stock market recovery) is not as strong as previous ones. When consumers are saving their cash as well as holding on to their stocks, bonds, and real estate investments, they are not spending as much on goods and services. This tends to be a short-term drag on economic growth. Nevertheless, over time, these higher savings rates will provide the necessary confidence and funds for new capital investment, that in turn will power economic growth as well as raise the future consumption possibilities of households. Furthermore, increased personal savings will further help solidify the retirement preparedness of households and their ability to weather unexpected shocks to their income or expenses. Both the NIPA and the FFA savings rates are headed in the right direction which will help restore consumer confidence and eventually result in economic growth.□

Chart 21
U.S. Savings Rate - NIPA (U.S. Bureau of Economic Analysis)

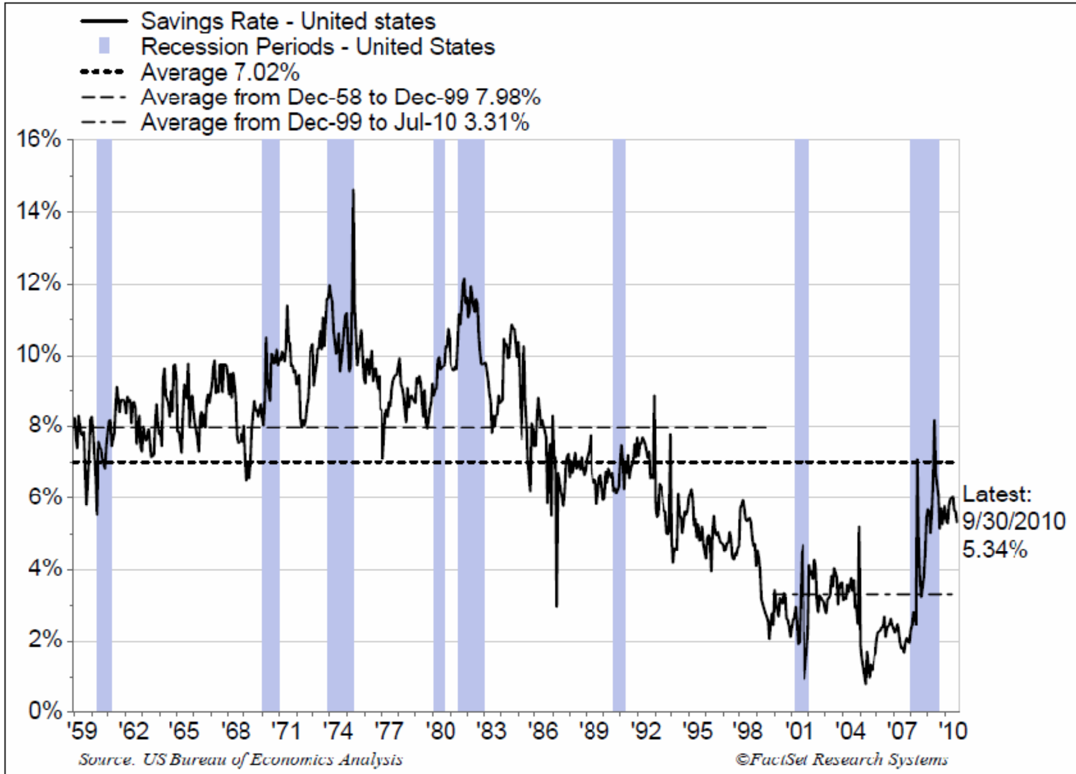
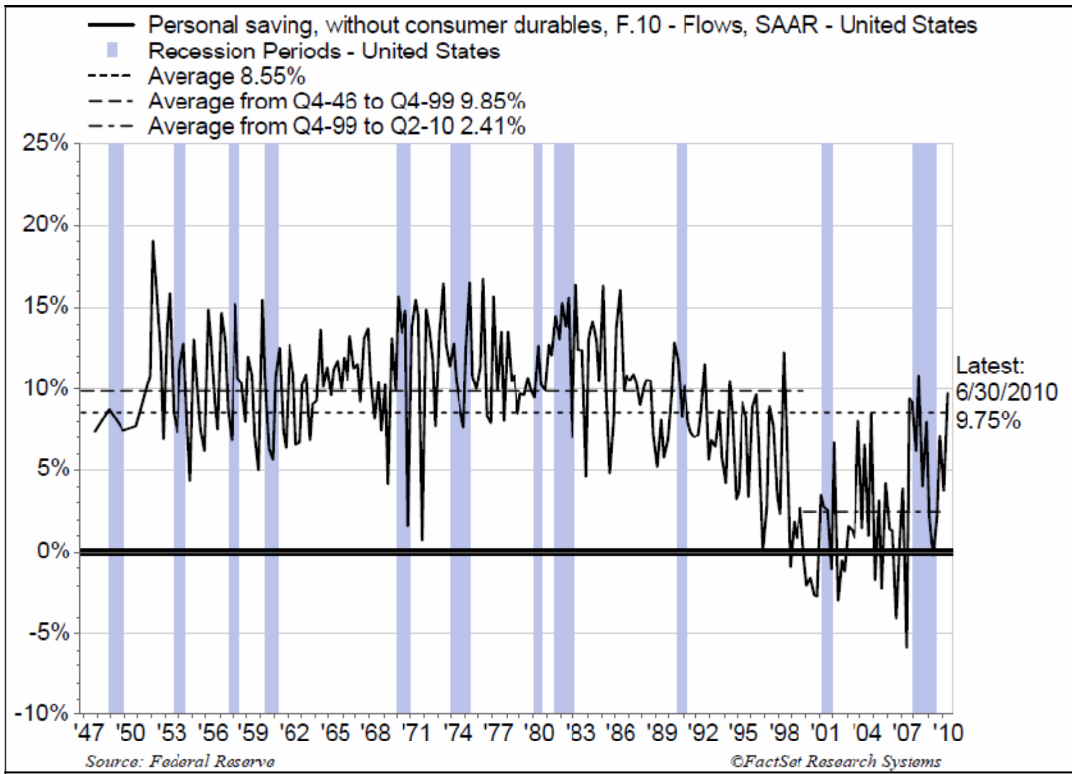


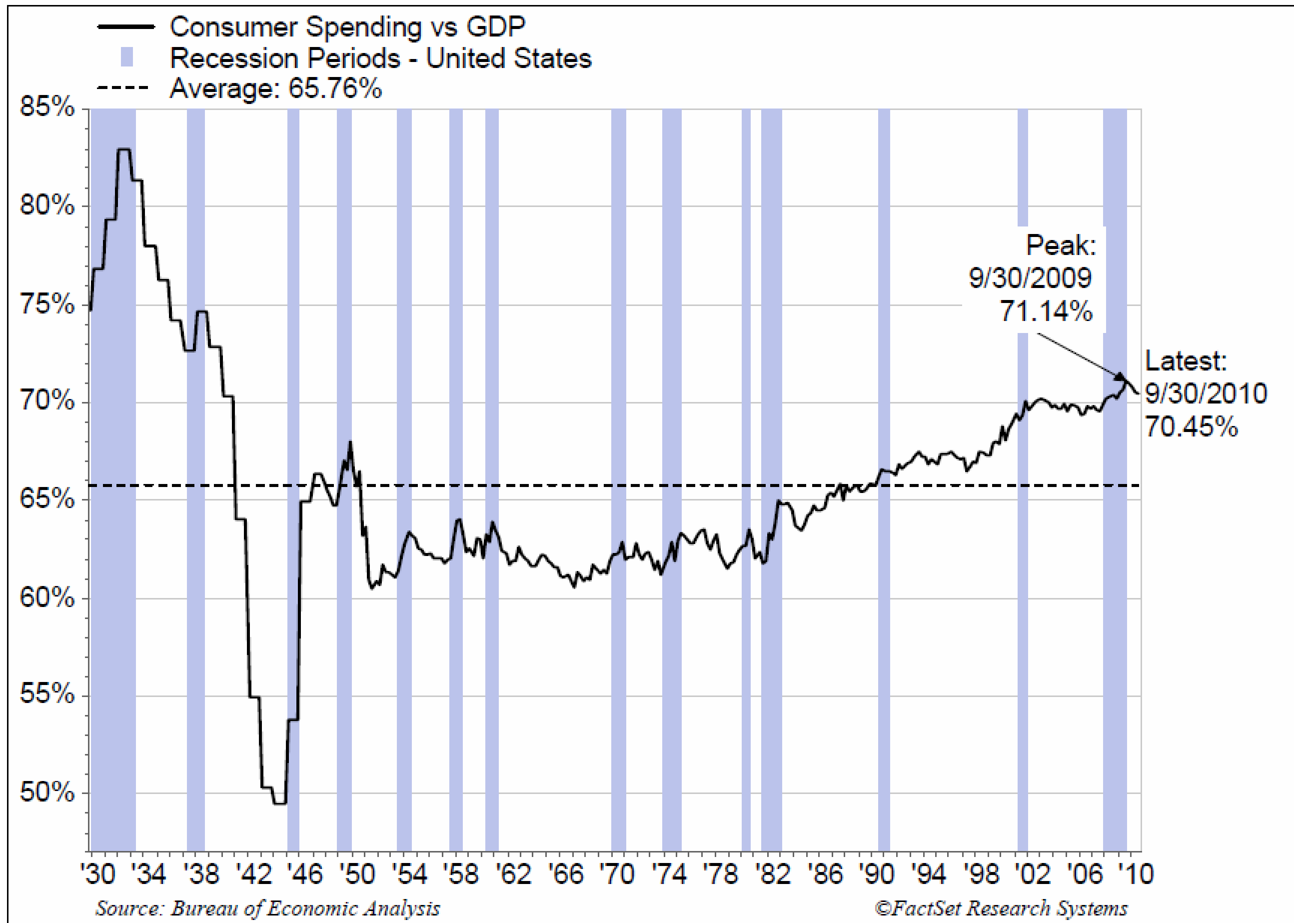
Chart 22
U.S. Savings Rate - FFA (U.S. Federal Reserve)



Consumer Debt

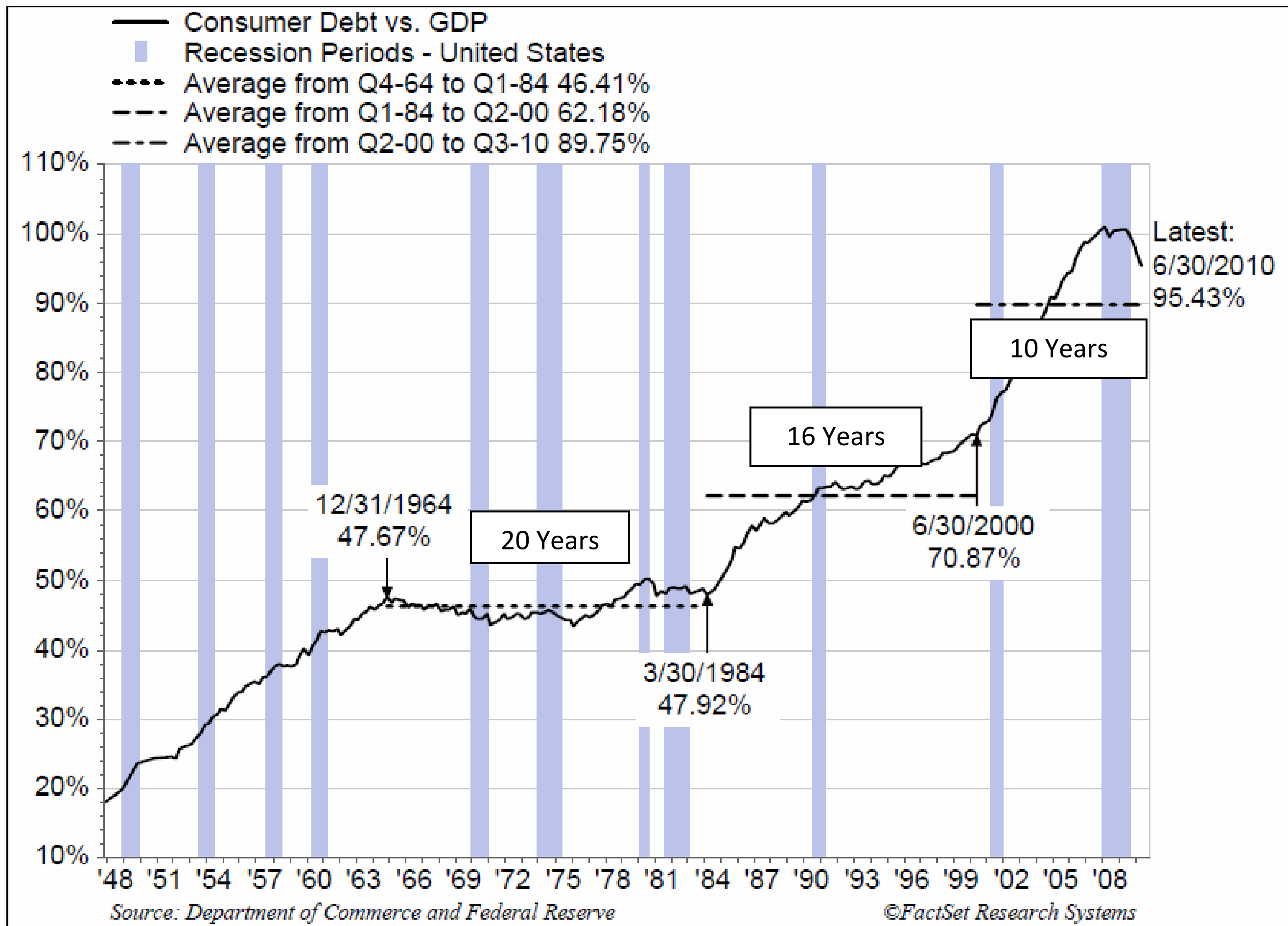
The consumer is a very important part of the economy. Unfortunately, he is still suffering from a financial hangover after a spending spree that lasted more than a decade. **Chart 23** shows that on average, consumer spending has been responsible for 65% of all economic activity over the past 80 years. While spending hit a post-WWII low of 60.57% of gross domestic product (GDP) in March 1967, it reached an all-time high of 71.14% in September 2009. As of June 2010, consumer spending represents 70.45% of all economic activity.

Chart 23
Consumer Spending vs. GDP



The consumer's expanded role in the economy has not been without a price. In the process of generating the highest economic activity on record since the Great Depression, consumers have financed greater portions of their goods and services than ever before (see **Chart 24**). For example, the average consumer debt to GDP percentage from 1964 through 1984 (20 years) was 46.41%. Over the next 16 years through 2000, it averaged 62.18%; and from 2000 through June 2010, the 10-year average consumer debt to GDP was 89.75%!

Chart 24
Consumer Debt to GDP



Not surprisingly, the increased financing of consumer spending habits can be directly tied to the drastic lowering of interest rates by the Federal Reserve. **Chart 25** shows the history of the federal funds rate. Between January and December 2001, the Fed aggressively dropped its **fed funds rate*** 10 times, bringing rates down from 6% to 1.5% in an effort to stimulate the economy enough to pull the country out of the 2001 recession. Rates continued their decline, finally hitting an effective low rate of 0.86% in August 2003. These record low interest rates made temptations too irresistible for most consumers to pass up, and thus they continued to spend at a feverish pace. Even as the Federal Reserve increased the short-term fed funds rate 17 times from 1% to 5.25% between 2004 and June 2006, consumers continued to spend like never before and in the process accumulated the highest debt on record.

***Federal Funds Rate:** The interest rate at which a commercial bank or other depository institution lends immediately available funds (i.e. balances held at the Federal Reserve) to another depository institution overnight. This is what news reports are referring to when they talk about the Fed changing interest rates.The Federal Open Market Committee sets a target for this rate, but not the actual rate itself (because it is determined by the open market). Because the Federal Reserve has significant control over the availability of federal funds, the rate is considered an important indicator of Federal Reserve monetary policy and the future direction of other interest rates: http://www.federalreserve.gov[12].

Chart 25
Fed Funds (Effective Rate)

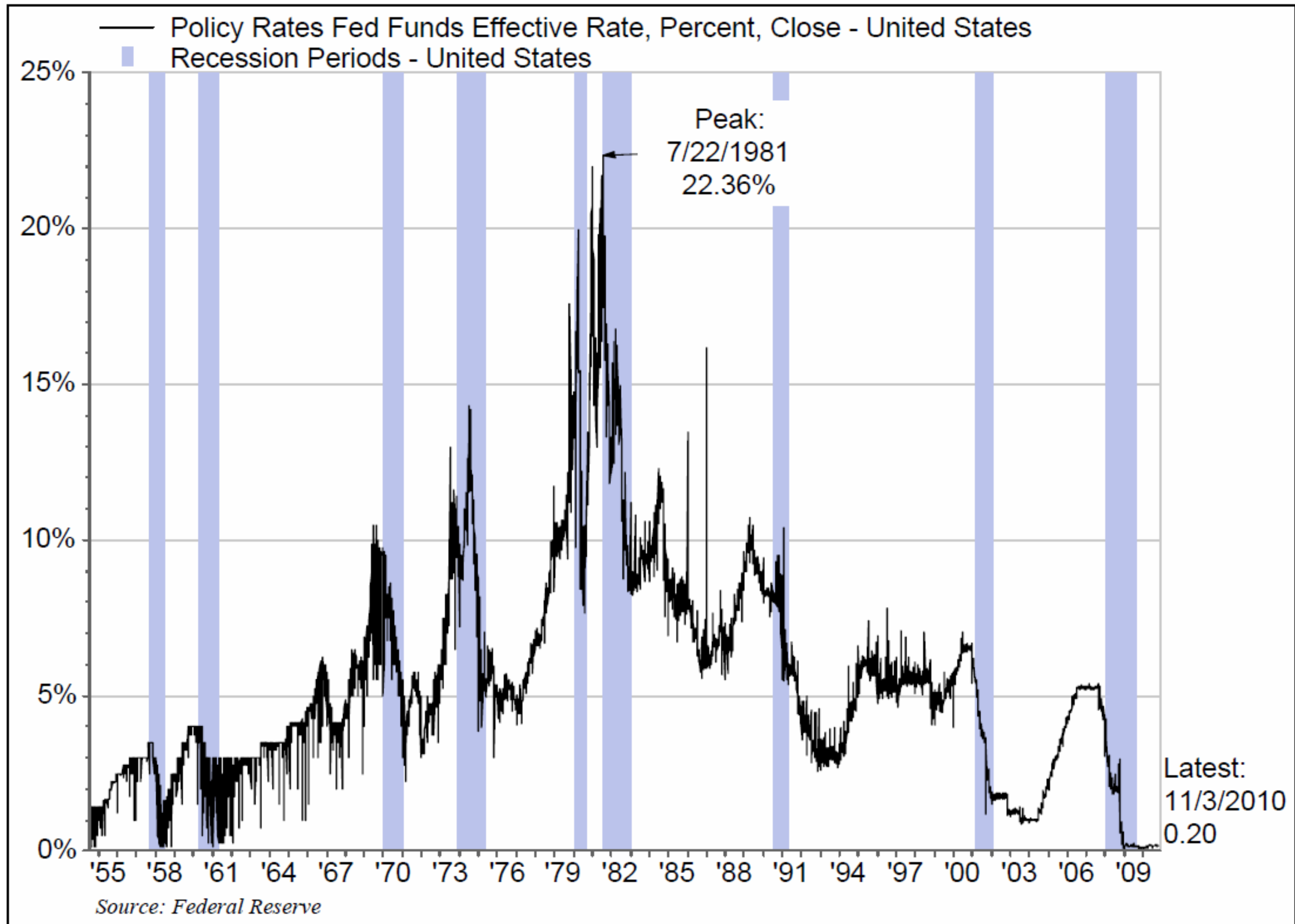
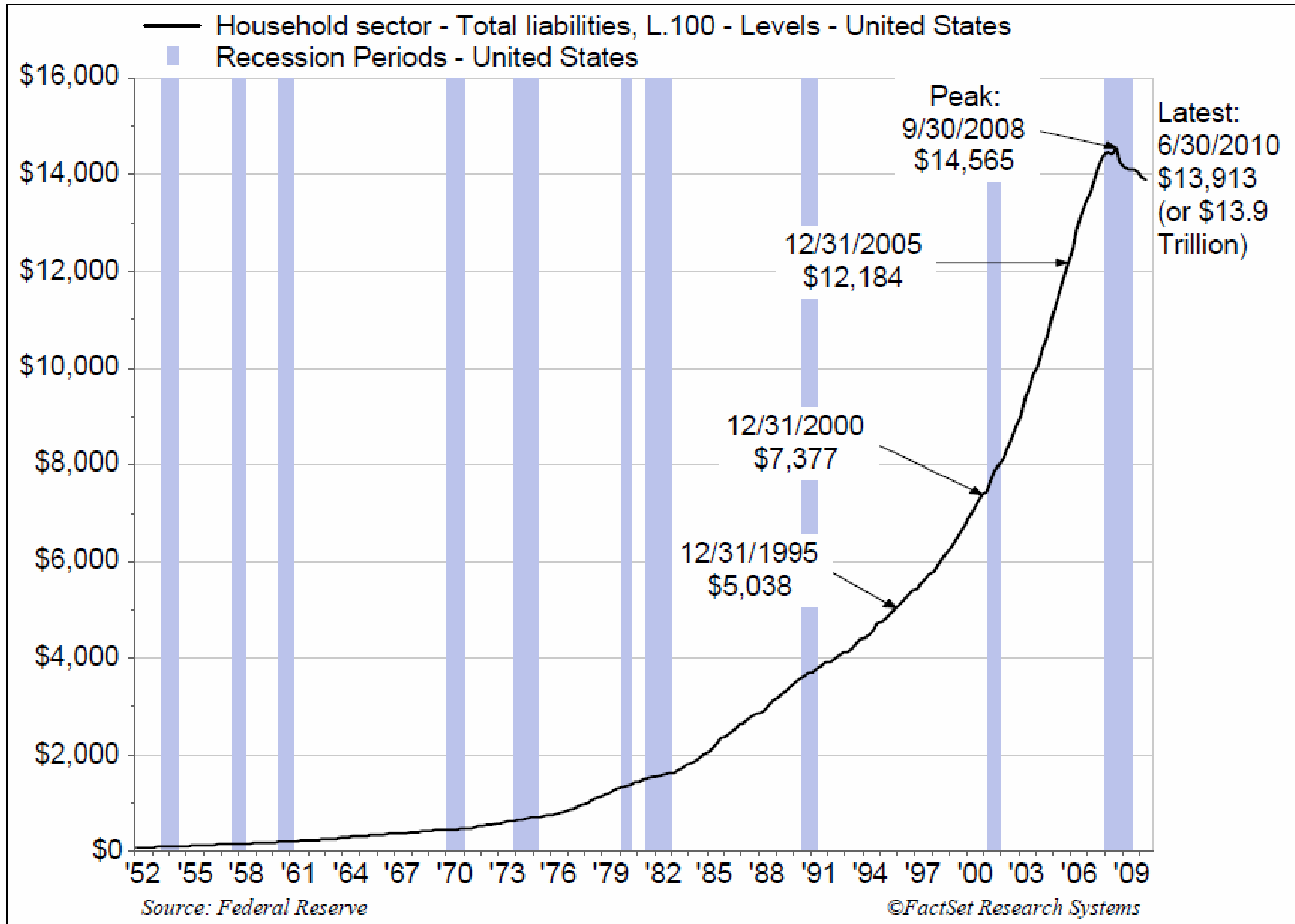


Chart 26 shows the total household debt outstanding from 1952 to present. While total household debt increased during the 1950's through the 1970's, it experienced a dramatic increase from the 1980's through 2008. During the five-year period between 1995 and 2000, total household debt increased 44%. Over the next five years ending 2005, consumers, armed with record low interest rates, increased the total household debt another 68%. Over the next three years ending 2008, the debt increased another 18.5%. In total, in just over thirteen years, total household debt increased 2.8 times, or 187%, to a record $13.9 trillion.

> ***"When we are living on this much borrowed money, we are also living on borrowed time."***
>
> **Paul Volcker**

Chart 26
Total Household Debt Outstanding



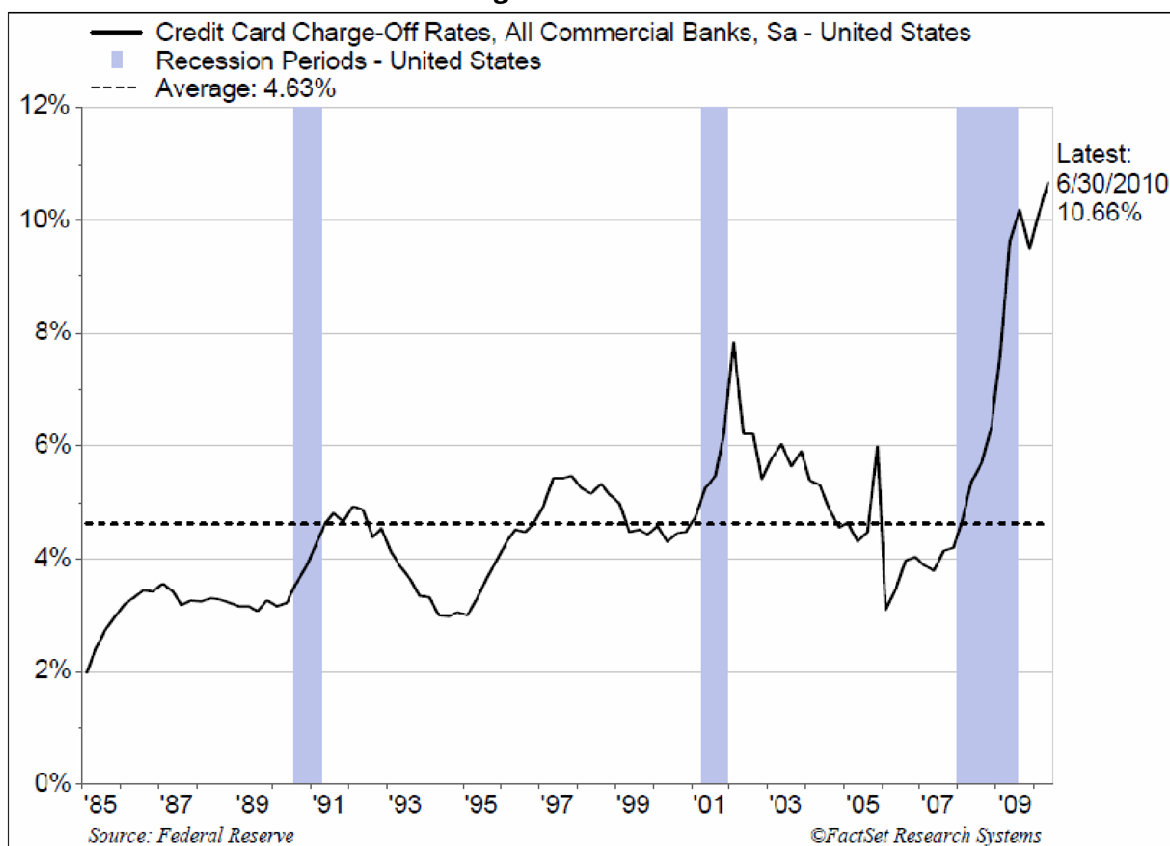
The greatest economic expansion this country has ever seen was fueled by the consumer using borrowed money. As a result, consumers have borrowed from the future, thus leaving themselves few options as to how much discretionary income they will have and where they will be able to spend it. In the past it was somewhat easy and customary for consumers to rollover and extend their debt payments for many years. They did this by refinancing and consolidating their debts as interest rates were lowered, or they extracted equity from their homes. In theory, if they kept rolling over and extending their debt, they would never have to pay it back.

Today's consumers find themselves in an environment of record low interest rates with little hope of these rates going materially lower. Furthermore, for many homeowners there is little in the way of equity to extract from their homes; or, at the very least, it is hard to find a lender willing to make an equity loan. The bottom line is that their debt is due and consumers must start paying it down in earnest and rebuild their balance sheets. While this is sure to be a long process, it is achievable; and progress is already being made.

One such example can be seen in the reduction of credit card debt. As of August 2010, the Federal Reserve reported that consumers continue to reduce their credit card debt at an annualized rate of 7.2%. Equally important is that this marks two straight years of monthly declines. Furthermore, overall borrowing by consumers has declined 18 out of the last 19 months ending August 2010.

Consumers are doing a better job of belt tightening and decreasing their debt; however, a bigger factor thus far toward the reduction in credit card debt is due to delinquent / bad debts being written off by banks. While this may be unfortunate for the individual consumer from a future credit rating perspective, and for the bank and its investors from a profitability perspective, the bottom line is credit card debt (i.e. consumer debt) is being reduced. In 2009, banks wrote off a record $81.5 billion in revolving credit card debt. This accounted for 85% of the $95.1 billion drop in consumer credit card balances reported by the Fed. Year-to-date through June 2010, banks have written off $43.5 billion, or 61% of the $70.6 billion reduction in credit card balances. **Chart 27** shows the annualized charge-off rate is now 10.66% of all consumer non-mortgage related debt, the highest amount in more than 25 years, and more than double the 25-year average of 4.5%. While sobering, debt is being reduced; and at the end of the day, this is progress.

Chart 27
Annualized Charge-Off Rates on Consumer Debt

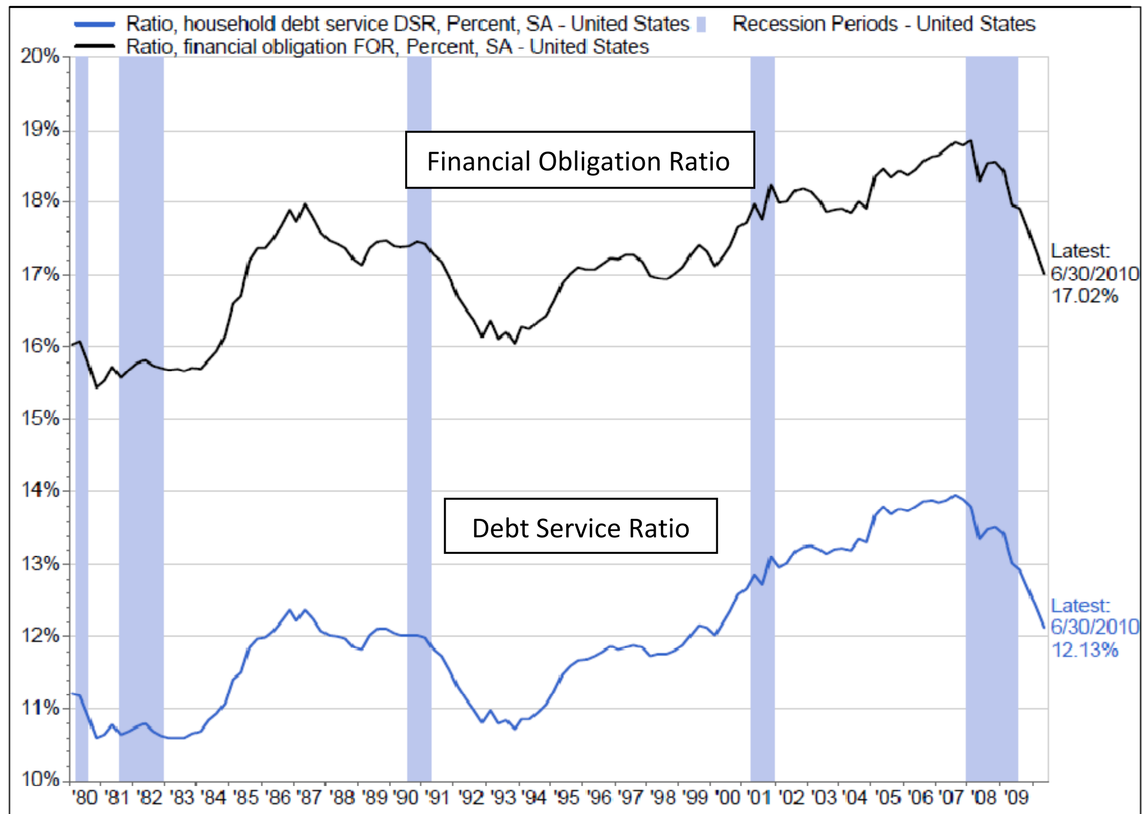


Another way to measure the progress of household debt reduction is to measure the quarterly **debt service ratio (DSR)**. This is a primary measure used by the Federal Reserve to provide a view of the financial health of the overall consumer sector. The DSR measures the share of disposable income committed by households for paying interest and principal on their debt. When the DSR is high, households have less money available to purchase goods or services. In addition, households with a high DSR are more likely to default on their obligations when they suffer adversities such as a job loss or an illness. **Chart 28** shows that the DSR peaked in Q3-2007 at 13.96% of disposable income. The good news, however, is that consumers have been reducing their monthly debt

service payments for the past 2.75 years. Through refinancing and debt reduction (via paying off the debt or defaulting on the debt), consumers are now spending 12.13% of their disposable income on interest and principal payments. This is a 13% reduction from the peak, a level not seen since March 2000.

Chart 28

Debt Service and Financial Obligation Ratios



Debt payments are not the only financial obligations of households. The Federal Reserve also calculates a more general **financial obligation ratio (FOR)**. This measure incorporates additional recurring household expenses such as rent on properties not owned (e.g. apartments), auto leases, homeowners insurance, and property taxes that might be subtracted from the uncommitted income available to households. **Chart 28** shows the FOR also peaked in Q3-2007 at 18.77% of disposable income. As of June 30, 2010, this ratio had declined 9.3% from the peak to 17.02% of disposable income, a level not seen since March 1999. Again, while there is still a long way to go, consumers have begun the long, slow, and painful process of reducing their monthly payments, as well as their mountain of total household debt outstanding.

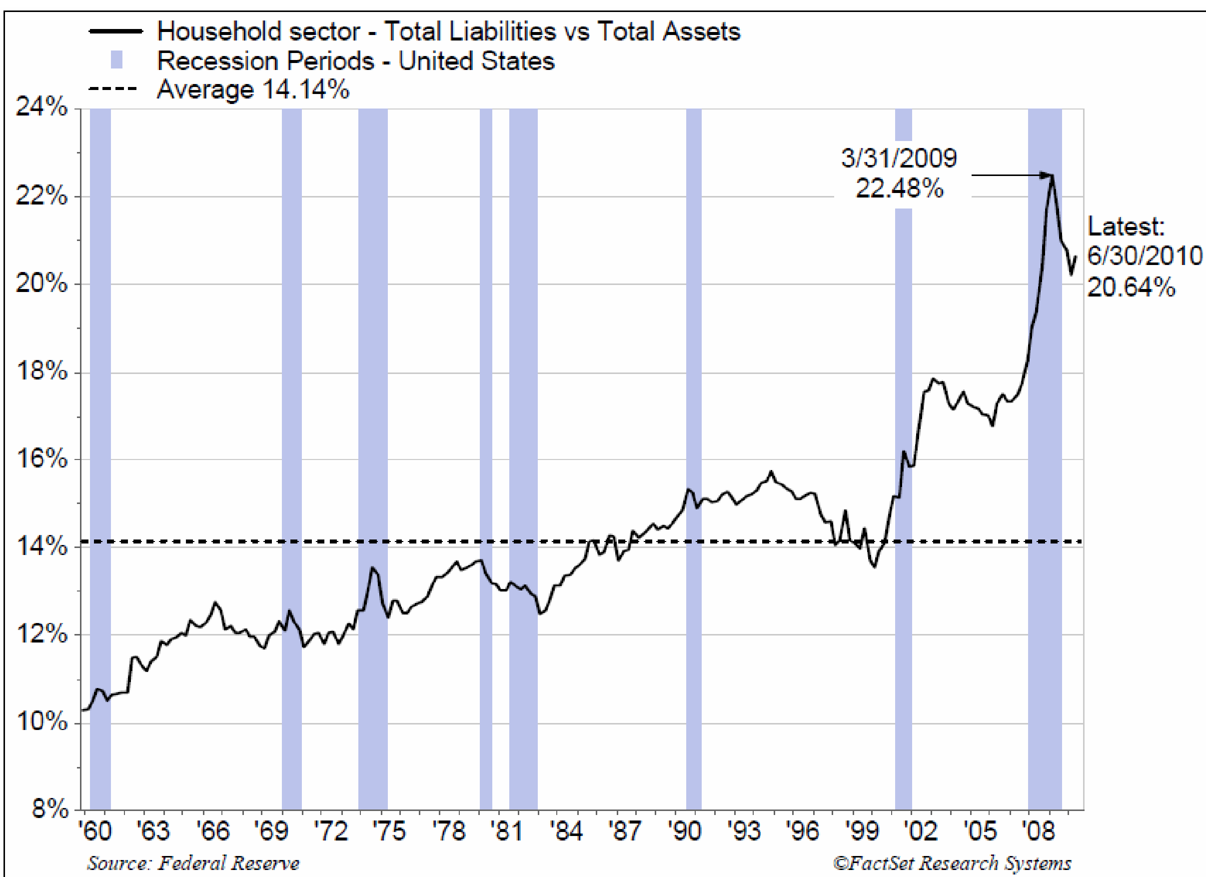
As long as the unemployment picture remains weak and the deleveraging process continues, the U.S. economy will face strong headwinds that will limit economic growth. However, as household debt ratios decline to more reasonable levels and we conclude that the majority of the deleveraging process has taken place, we believe many different forces will converge to create what is likely to be a major bull market, especially for U.S. stocks. This market environment will likely be characterized by relatively **low inflation*,** low leverage, high productivity, increasing profitability, and strong personal income growth.

*We are characterizing relatively low inflation as headline CPI being equal to-or-less than the 50-year average of 4%. See **Chart 53** on **page 65** for historical CPI data points. CPI = Consumer Price Index

We have done preliminary analysis on when we expect the deleveraging process to end and thus a major bull market to begin. This data shows us that over the past 50 years, the ratio of household liabilities to assets has averaged 14.14%. At the peak of the real estate boom in mid-2007, household leverage had risen to 17.5%. The decline in assets over the next seven quarters caused the household debt-to-asset ratio to spike to 22.5%--the highest ratio ever achieved. The ratio has declined to 20.6% as of June 2010 (the latest data available). We believe this ratio must be close to 16% or below for the majority of the deleveraging process to have worked its way through the system.

The deleveraging of households can be achieved two ways. First, assets can increase. Second, liabilities can decrease. In our analysis of this debt reduction, we have made assumptions about both factors and attempted to determine when the leverage ratio shown on **Chart 29** would reach 16%. **Based on our most likely scenario (in which assets grow at 5% per year from their currently depressed levels and liabilities decline by 2% per year), we estimate that the majority of the deleveraging process should take about four or five years. During this deleveraging period, we expect that stock market volatility will likely continue, and the economy could experience another recession.** □

Chart 29
Household Total Liabilities vs. Total Assets



The U.S. Household Balance Sheet

Though consumers are reducing their debt, it is still a heavy burden. The government's ever increasing mountain of debt and unfunded pension liabilities remain serious concerns as well. Add to these concerns the other front page macro-economic issues of high unemployment, a challenging real estate market, a slow growing economy, and continued uncertainty in Washington, and it stands to reason why many Americans have forgotten how wealthy we are as a nation and how great this country truly is.

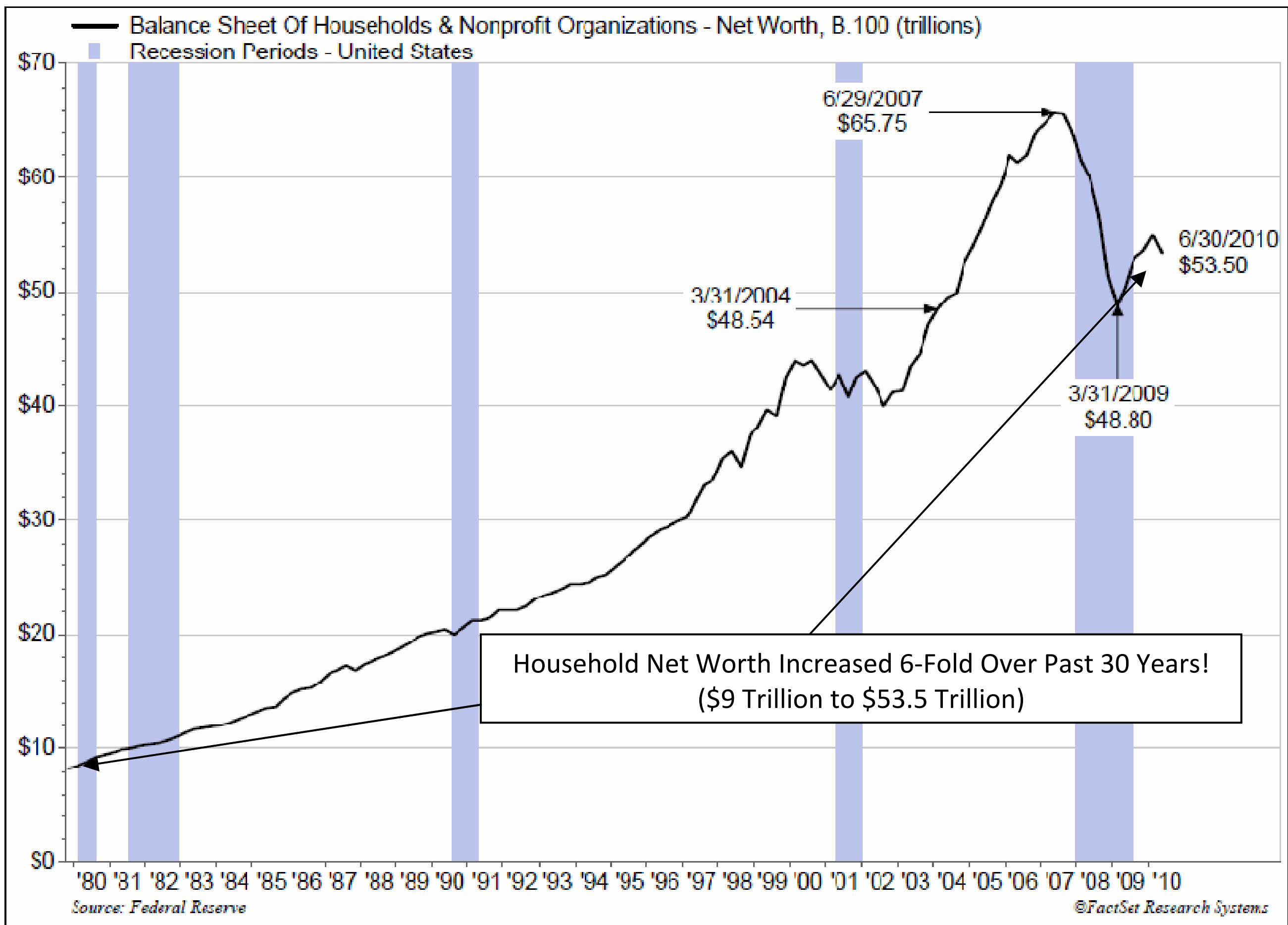
Chart 30 shows the U.S. household balance sheet from the Federal Reserve. In June 2007, American households had $79.68 trillion in assets, and $13.93 trillion in liabilities (including all $10.27 trillion in outstanding mortgages). When you subtract the liabilities from the assets, American households had an all-time high net worth of $65.75 trillion.

Chart 30
U.S. Household Balance Sheet

Balance Sheet of Households and Nonprofits Organizations
Federal Reserve Flow of Funds
Table B.100

								Peak			Bottom		
Assets (billions)	12/31/00	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06	6/30/07	12/31/07	12/31/08	3/31/09	12/31/09	6/30/10
Cash and Equivalents	$ 4,376	$ 4,376	$ 5,153	$ 5,349	$ 5,732	$ 6,140	$ 6,753	$ 7,013	$ 7,407	$ 7,926	$ 7,903	$ 7,743	$ 7,559
Fixed Income	$ 2,459	$ 2,353	$ 2,486	$ 2,723	$ 2,997	$ 3,325	$ 3,471	$ 3,601	$ 4,067	$ 3,956	$ 4,387	$ 4,054	$ 4,330
Equities & Mutual Funds	$ 10,852	$ 9,444	$ 7,381	$ 9,699	$ 10,912	$ 11,762	$ 13,832	$ 14,956	$ 14,222	$ 9,102	$ 8,115	$ 11,423	$ 10,824
Pension Fund Reserves	$ 9,171	$ 8,764	$ 8,190	$ 9,719	$ 10,635	$ 11,460	$ 12,751	$ 13,442	$ 13,391	$ 10,408	$ 9,888	$ 11,942	$ 11,654
Equity in Noncorp. Bus.	$ 4,883	$ 5,041	$ 5,248	$ 5,857	$ 6,748	$ 8,353	$ 8,817	$ 8,964	$ 8,796	$ 7,350	$ 6,915	$ 6,402	$ 6,616
Other Financial Assets	$ 1,610	$ 1,732	$ 1,779	$ 1,990	$ 2,192	$ 2,267	$ 2,465	$ 2,614	$ 2,730	$ 2,689	$ 2,612	$ 2,698	$ 2,755
Total Financial Assets	$ 33,351	$ 32,210	$ 30,236	$ 35,336	$ 39,217	$ 43,306	$ 48,089	$ 50,591	$ 50,663	$ 41,431	$ 39,820	$ 44,260	$ 43,738
Growth Rate:		*-3.4%*	*-6.1%*	*16.9%*	*11.0%*	*10.4%*	*11.0%*	*5.2%*	*0.1%*	*-18.2%*	*-3.9%*	*11.2%*	*-1.2%*
Real Estate	$ 13,443	$ 14,021	$ 16,160	$ 17,059	$ 20,523	$ 24,033	$ 24,972	$ 24,499	$ 23,271	$ 19,466	$ 18,337	$ 18,615	$ 18,807
Growth Rate:		*10.2%*	*9.0%*	*10.5%*	*14.9%*	*17.1%*	*3.9%*	*-1.9%*	*-5.0%*	*-16.4%*	*-5.8%*	*1.5%*	*1.0%*
Other Tangible Assets	$ 3,334	$ 3,509	$ 3,689	$ 3,856	$ 4,077	$ 4,285	$ 4,492	$ 4,589	$ 4,675	$ 4,796	$ 4,790	$ 4,835	$ 4,868
Total Tangible Assets	$ 16,778	$ 18,330	$ 19,849	$ 21,715	$ 24,600	$ 28,318	$ 29,464	$ 29,088	$ 27,946	$ 24,262	$ 23,127	$ 23,450	$ 23,675
Total Assets	**$ 50,128**	**$ 50,541**	**$ 50,085**	**$ 57,051**	**$ 63,817**	**$ 71,624**	**$ 77,553**	**$ 79,679**	**$ 78,609**	**$ 65,693**	**$ 62,947**	**$ 67,710**	**$ 67,413**
Liabilities (billions)													
Home Mortgages	$ 4,798	$ 5,305	$ 6,010	$ 6,894	$ 7,835	$ 8,874	$ 9,865	$ 10,268	$ 10,540	$ 10,498	$ 10,501	$ 10,335	$ 10,150
Consumer Credit	$ 1,741	$ 1,892	$ 1,997	$ 2,103	$ 2,220	$ 2,321	$ 2,416	$ 2,430	$ 2,555	$ 2,594	$ 2,518	$ 2,479	$ 2,404
Other Debt & Liabilities	$ 837	$ 810	$ 797	$ 868	$ 974	$ 989	$ 1,163	$ 1,228	$ 1,272	$ 1,174	$ 1,133	$ 1,254	$ 1,359
Total Liabilities	**$ 7,377**	**$ 8,008**	**$ 8,804**	**$ 9,865**	**$ 11,029**	**$ 12,184**	**$ 13,444**	**$ 13,926**	**$ 14,367**	**$ 14,266**	**$ 14,151**	**$ 14,068**	**$ 13,913**
Growth Rate:		*8.6%*	*10.0%*	*12.0%*	*11.8%*	*10.5%*	*10.3%*	*3.6%*	*3.2%*	*-0.7%*	*-0.8%*	*-0.6%*	*-1.1%*
Total Net Worth	**$ 42,752**	**$ 42,533**	**$ 41,281**	**$ 47,186**	**$ 52,788**	**$ 59,440**	**$ 64,109**	**$ 65,753**	**$ 64,242**	**$ 51,427**	**$ 48,796**	**$ 53,642**	**$ 53,500**
Debt as a % of Total Assets	**14.7%**	**15.8%**	**17.6%**	**17.3%**	**17.3%**	**17.0%**	**17.3%**	**17.5%**	**18.3%**	**21.7%**	**22.5%**	**20.8%**	**20.6%**
Total Liabilities & Net Worth	**$ 50,128**	**$ 50,541**	**$ 50,085**	**$ 57,051**	**$ 63,817**	**$ 71,624**	**$ 77,553**	**$ 79,679**	**$ 78,609**	**$ 65,693**	**$ 62,947**	**$ 67,710**	**$ 67,413**

Chart 31
Household Balance Sheet (1980-2010)



In March 2009, just twenty-one months after hitting its peak in June 2007, total household assets declined 21.6% or $16.7 trillion, while at the same time total liabilities increased 1.62% or $225 billion. **That is a tremendous change**. From the 2007 peak to the 2009 bottom, as a whole, stocks declined 45% while real estate declined 25%. In total, American household net worth declined 25.7% to $48.8 trillion.

Chart 31 graphs the 30-year history of U.S. household net worth. With the pickup in the stock market and the overall economy, households have already recouped $4.7 trillion in net worth. **As of June 2010, U.S. households have a collective net worth of $53.5 trillion**. So while still below its 2007 peak, our collective net worth has already returned to 2005 levels. We believe this is a very significant number.

While the media seem to concentrate on those having a hard time paying their bills, losing their homes, and even going bankrupt, it is important to keep things in perspective, especially when looking at our nation as a whole. **With $53.5 trillion in net worth, the fear that all Americans are on their way to going broke is just not supported by the facts.** □

Gross Domestic Product and the Monetary Base

Gross domestic product (GDP) is the monetary value of all the goods and services produced by an economy over a specified period. It is perhaps the best indicator of the economic health of a country. **Chart 32** is a snapshot of GDP, which is typically broken down by consumption, plus private investment, plus government, plus exports, minus imports. However, **Chart 32** goes one step further and breaks out several sub-categories in an effort to demonstrate how important residential housing and real estate related activity are to the general economy.

Currently, nominal GDP, before inflation, has grown at an annualized rate of 3.1% over the past five years. This is less than half its 81-year average of over 6.57%. One of the main drags on GDP is the slowdown of housing and other real estate related activity. As we stated in the real estate section, we believe that for the next two to three years residential real estate will be a headwind for the economy. However, after that time, we believe the majority of the problems facing the real estate market today will largely be behind us. **When this happens, we expect the economy to pick up from its slower rate of growth and begin to trend upwards towards its long-term historical average.**

Chart 34 shows that the U.S. dollar, on a trade-weighted basis, is near its all-time low. While we do not think it is a good policy to depress the dollar over the long run since this is an inflationary act by the Fed, it does have a short-term beneficial effect of making our exports more competitive. This weaker dollar policy is one of the reasons **Chart 33** shows exports now represent 12.51% of GDP and a major reason why our economy has stabilized since the third quarter of 2009. Increasingly, exports are a growing part of our GDP. For example, over the past 10 years through September 30, 2010, exports have increased 15.83% as a percentage of GDP. However, the actual increase in exports (i.e. the increase in the absolute number and not as a percentage of GDP) has been 64.6% over the past 10 years.

Chart 32
Gross Domestic Product

Gross Domestic Product (GDP) Breakdown with Real Estate					
	As of 12/31/2009	Average Since 2004	Average Since 1999	Average Since 1951	Average Since 1929
+ Consumption	70.84%	70.01%	69.63%	65.04%	65.80%
Housing Consumption*	11.19%	10.63%	10.53%	9.46%	9.20%
+ Private Investment	11.26%	15.55%	15.98%	16.07%	14.38%
Structures Residential	2.49%	4.63%	4.68%	4.57%	4.16%
Structures Nonresidential	3.20%	3.26%	3.11%	3.62%	3.37%
+ Government	20.65%	19.34%	18.77%	20.30%	20.49%
Structures	2.24%	2.07%	2.03%	2.34%	2.63%
+ Export	11.18%	11.18%	10.67%	8.34%	6.87%
- Imports	13.92%	16.08%	15.06%	9.75%	7.54%
Source: Bureau of Economic Analysis * Only available as an annual series					

Chart 33
As of September 30, 2010

Gross Domestic Product (GDP) Breakdown					
	As of 9/30/2010	Average Since 2004	Average Since 1999	Average Since 1951	Average Since 1929
+ Consumption	70.45%	70.08%	69.69%	64.71%	65.11%
+ Private Investment	12.87%	15.21%	15.72%	16.00%	15.48%
+ Government	20.49%	19.47%	18.94%	20.45%	20.31%
+ Export	12.51%	11.31%	10.80%	7.80%	7.50%
- Imports	16.32%	16.07%	15.27%	8.97%	8.41%
Total	**100%**	**100%**	**100%**	**100%**	**100%**
Source: Bureau of Economic Analysis					

Chart 34
U.S. Dollar (Trade Weighted)

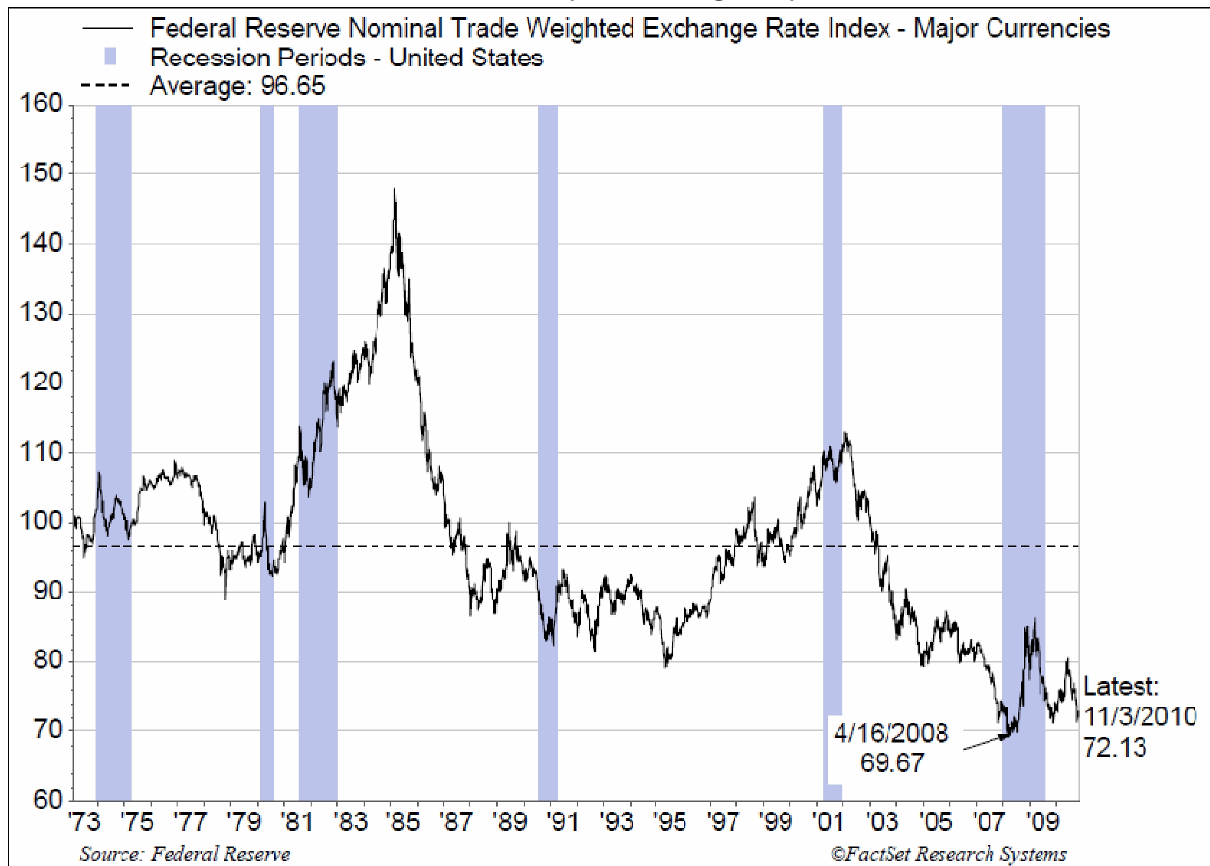
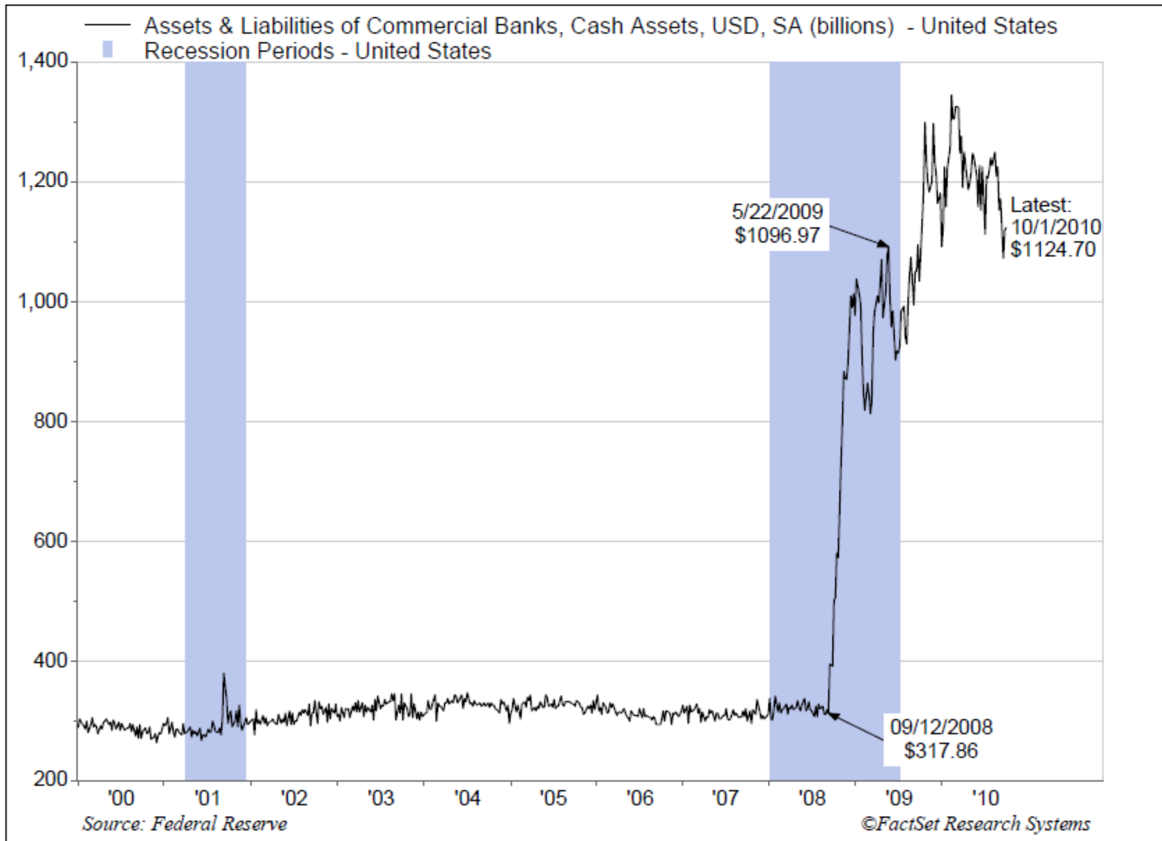


Chart 35
Increase in U.S. Monetary Base



Obviously this is what the Fed and Chairman Bernanke have in mind as they know that quantitative easing will lower the value of the dollar. It is their intent that as the economy strengthens they will pull the money out of the financial system, similar to what the Japanese did in 2005/2007, to prevent inflation and at the same time strengthen the U.S. dollar. **Chart 36** shows Japan pumping up its monetary base more than eight times and then pulling it out just a few years later. **Chart 37** shows that even though the Bank of Japan increased the monetary base, because it tightened monetary policy in such dramatic fashion just a few years later, the Japanese have had no inflation to speak of; rather, they have actually had to battle deflation. This is why you see on **Chart 36** that they are increasing the monetary base again.

"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt."

Marcus Tullius Cicero

Chart 36
Japan's Monetary Base

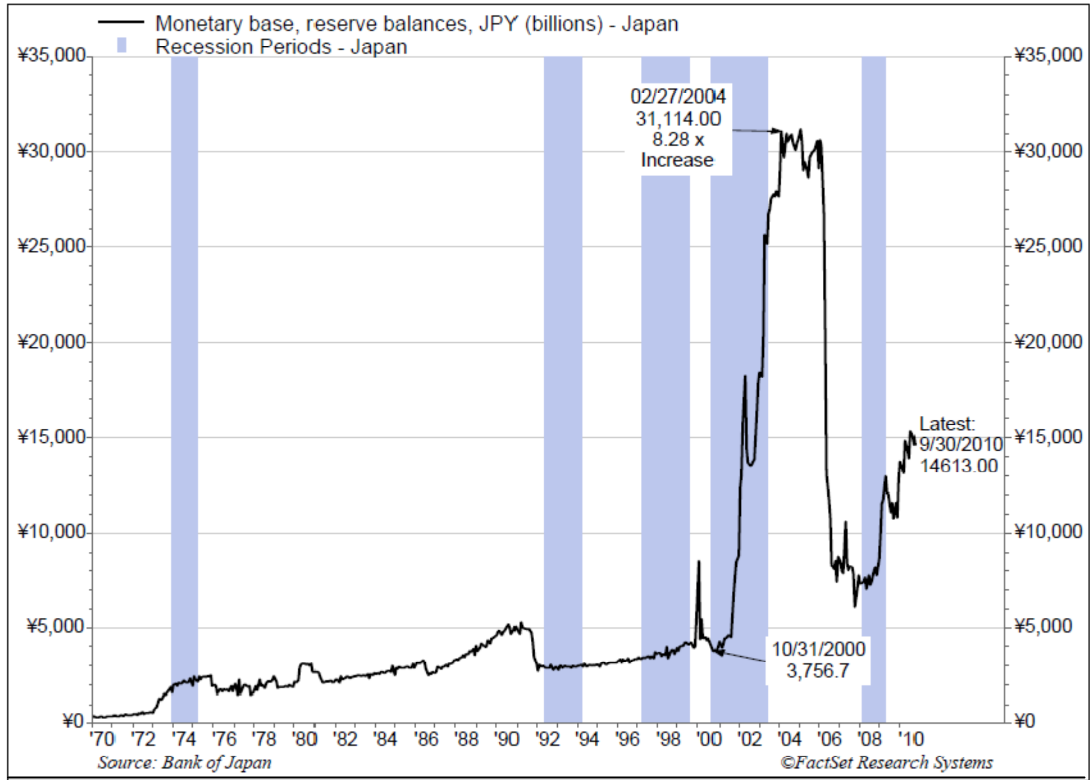
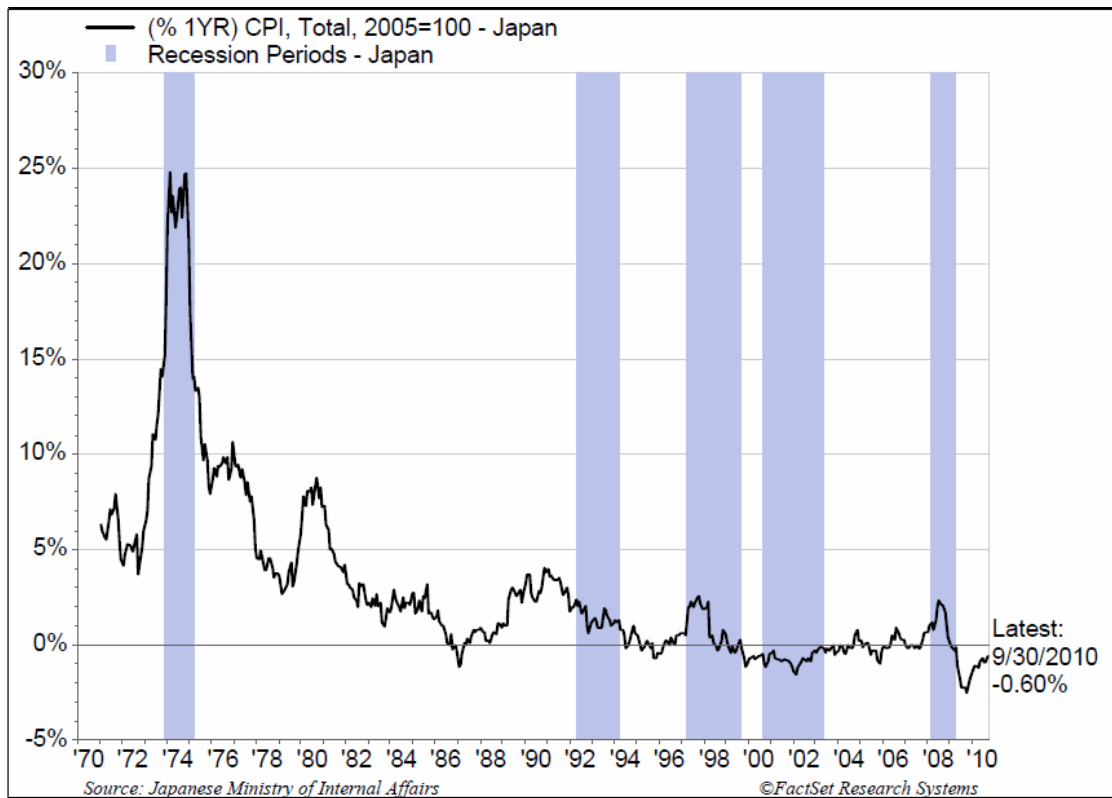


Chart 37
Japan's Inflation Rate



The Fed's ability to execute the withdrawal of this additional money out of the financial system is one of the things we worry about. While we are confident it is the Fed's intention, many times the political pressure is so great that there may not be enough political will to do it at the right time or in full force. It is for this reason that we need to have a Congress and an Administration that truly understand the risk of this easy money policy.

Overall, the economy has been making progress since its 2009 lows. **Chart 38 (page 45)** shows that gross domestic product (GDP) is now above 2008 peak levels. **Looking forward, while another near-term recession is possible, we believe the more likely scenario is that our economy will continue to stabilize and experience slow to moderate growth.** However, even if there were another near-term recession, we do not believe it would be nearly as severe for the stock market as this last recession was for the following reasons:

1. When this last recession began in December 2007, the market, as measured by the S&P 500, had closed as high as 1515. On Thursday, September, 30, 2010, the S&P 500 had a closing price of 1141. Therefore, with the U.S. equity market still down roughly 24.7% from the beginning of the previous recession, there will likely be less of a decline than what was experienced in late 2008/early 2009.
2. Companies have been building up liquidity on their balance sheets. As of June 30, 2010, non-financial corporations have $1.85 trillion in cash which is approximately 7% of total corporate assets. Part of this cash has come through cost savings and corporate profits, but most of it has come from new debt at record low interest rates. The net effect has been an increase in cash relative to total liabilities (see **Chart 39, page 47**).
3. In addition, companies have been refinancing their debt at lower rates and for longer terms. Companies have also continued cutting costs, squeezing out every penny of profit possible. As a result, profit margins are nearly back to 2007 peak levels. Overall, corporate America is in a much healthier position than it was in December 2007.
4. Gross domestic product (GDP), or sales of the economy, are now just ahead of peak 2008 levels. However, according to the U.S. Bureau of Labor Statistics, there are roughly 7.4 million less people employed since that time. While no one likes to see unemployment this high, the flip side is that employees and businesses are more productive and thus doing more with less. In other words, GDP, or sales of our economy, are now $14.73 trillion, which is $245 billion higher than the 2008 peak of $14.48 trillion; yet companies have 7.4 million less employees. This means, in addition to saving on wages, corporations are saving on payroll taxes. Furthermore, with fewer employees, many companies have also been able to save on their need for various plants and facilities. This is the reason many companies are running at record profit margins as well as building up record levels of cash during the worst recession since the Great Depression. This, too, will help profits hold up better than they did during the previous decline. *We recognize that as the economy recovers and businesses begin hiring and expanding their facilities, today's higher profit margins are likely to be reduced. However, in an expanding economy, these extra expenses will be partially offset by an increase in sales. In our individual stock analysis, we are using what we believe to be more conservative profit margins in our forecasts*.

5. The Chairman of the Financial Accounting Standards Board[13] (FASB), Robert Herz, who was the main driver behind the disastrous 2007 FASB mark-to-market rule, resigned on August 24, 2010. Equally important, the Board of Trustees is moving the FASB back to seven members instead of five. This will make it much more difficult to bring the destructive mark-to-market accounting rule back from its April 2, 2009, suspension.

   As we stated in our June 1, 2010, video conversation to clients (available on our website <www.centman.com>), "…they finally got rid of mark-to-market accounting in 1938, and it is no coincidence that after 1938 the economy, along with everything else, began to pick up, gathered steam, and did much better. During this period, 1938 until 2007, we never had the kind of wide swings in the economy that we did before The Great Depression."

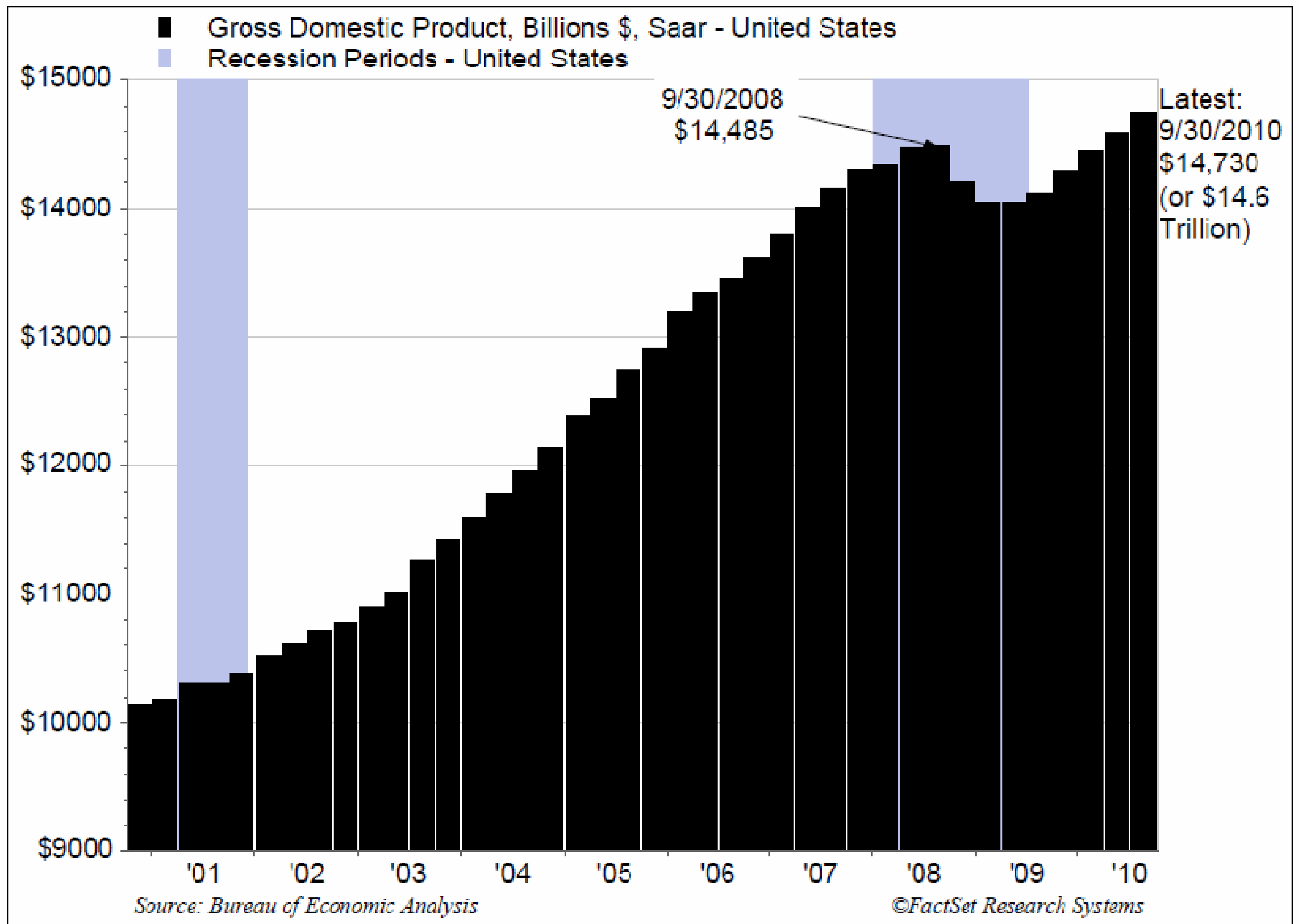
   "At the top of the market back in November 2007, the FASB, led by Chairman Robert Herz, reinstated the mark-to-market accounting Rule 157. Then, as the financial crisis developed, they realized that mark-to-market accounting was adding fuel to the fire and they needed to remove it. Just one week before the market bottomed in March 2009, the FASB made a statement that they were going to review mark-to-market accounting. On March 12, 2009, the House Financial Services Subcommittee met, and on April 2, 2009, they officially changed the rule. This was right at the market bottom; and I believe, outside of the fact that the market was extremely cheap, that removing this rule was a key part to the market turning around when it did. The main reason the market reversed course is that people realized that if the banks do not have to use mark-to-market accounting and they could work out their problems over the long run, just like we did through every other recession, they would not have to deal with the extreme write downs and losses. With that in mind, the market took off."

   In summary, this rule change now appears to be permanent; and we believe this is a very good turn of events for the equity markets.

6. The government continues to show a willingness to provide liquidity to the markets. On September 21, 2010, the Federal Open Market Committee[14] (FOMC) said it will maintain the target range for the federal funds rate at 0 to 1/4 percent; and it continues to anticipate keeping the fed funds rate at exceptionally low levels for an extended period of time. The FOMC also stated it will maintain its existing policy of reinvesting principal payments from its securities holdings, as well as continue to monitor the economic outlook and financial developments. Furthermore, the FOMC stated it is prepared to provide additional accommodation, if needed, to support the economic recovery and to return inflation, over time, to levels consistent with its mandate. While we do not agree that another round of quantitative easing is a good idea, it will prevent a liquidity crisis like we saw in 2008/2009.

> ***"There are plenty of good five-cent cigars in the country. The trouble is they cost a quarter. What the country really needs is a good five-cent nickel."***
>
> **Franklin Pierce Adams**

Chart 38
Gross Domestic Product



This economy has now passed 2008 peak levels and it has done so with 7.4 million fewer employees. This is one of the main reasons for the increase in business productivity and profits.

In summary, while possible, we do not believe a near-term recession is likely. But if we did slip back into a recession, we do not believe it would be as severe as the one that just ended nor do we believe it would last as long. This is not to suggest that we would not see a correction in stock prices. What we are saying is that in our view, should we experience a near-term recession, it would be a more normal correction, unlike what we experienced in 2008/2009.

U.S. Corporate Cash and Liquidity

Consumers are not the only ones increasing their liquidity. As of June 30, 2010, corporations had $1.84 trillion of cash on their balance sheets. This represents 6.96% of total corporate assets, a level not seen since 1963.

There have been many articles written that suggest this current level of cash means corporate balance sheets are in the best shape in decades. This would be true if all the cash was generated exclusively through cost cutting and actual profits. **While it is true, some of this increased cash has come from cost cutting and profits, the majority of it has come through the issuance of more debt**.

Why have companies continued to leverage themselves? First, as interest rates have come down to roughly 40-year lows, the attraction of "cheap" money has not gone by the wayside of many companies. Thus, borrowing money has been a cheaper source of capital than new equity offerings. **Second**, for many years companies have opted to keep a large portion of their borrowed money in the form of short-term loans. The reason short-term loans were typically preferred over long-term loans is that interest rates on short-term loans were generally lower. Furthermore, prior to the 2008 financial crisis, short-term loans were typically easy to rollover upon their due date, thus there seemed little reason to lock in a higher interest rate on a long-term loan in order to have continued access to capital.

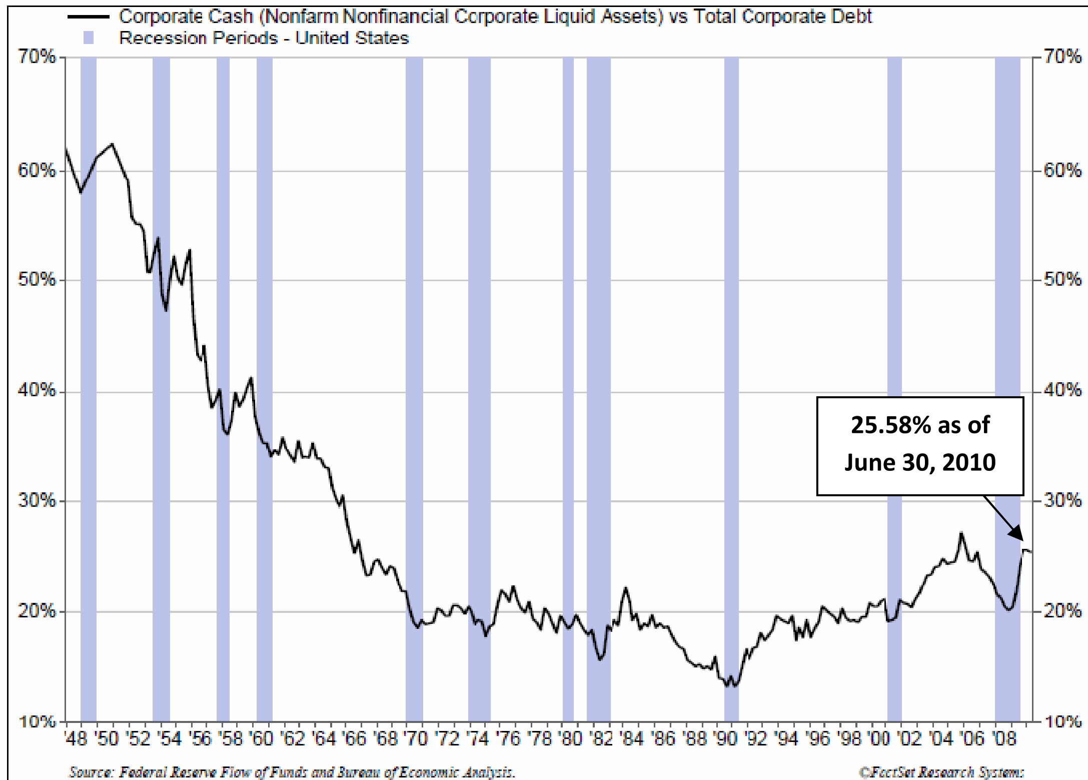
However, when the financial crisis occurred, unlike the November 1973 through March 1975 recession where capital was expensive, but available, **in 2008 there was very little capital available, regardless of price**. In other words, in 2008, access to cash was for all intents and purposes, cut off. This literally meant that during this period it was difficult to transact business as usual. **Having the capital markets come to a virtual standstill in such a short period of time is the major difference between this recession and market correction from times past.**

Having learned their lesson, and with rates continuing to remain at some of the lowest levels ever, companies have been refinancing their short-term debt for long-term maturities. In addition, companies have increasingly borrowed additional capital to insure themselves that if another financial crisis does appear, they will have plenty of cash on hand, **i.e. they will have liquidity**.

On **Chart 39**, we show total corporate cash as a percentage of total corporate debt. As you can see, while corporations have increased their debt, the net effect of this increase in cash has been an increase in liquidity. **As of June 30, 2010, total cash represents 25.58% of total corporate debt.** Other than a short time in 2005 when total cash increased to 27.26% of total corporate debt, this is the most liquidity U.S. corporations have had since March 31, 1966. If there is another liquidity crisis, many companies will not have to worry about being able to borrow money as they will already have the cash they need to whether the storm.

However, just like the consumer, as companies have been piling up cash and increasing their liquidity, they have not been investing as much as they otherwise could in the growth of their businesses, increasing dividends, or making as many acquisitions as times past. While holding on to high levels of cash puts a damper on the economy in the short run, it is a positive sign for the future as this cash will eventually be invested, thus driving future growth rates and eventually returns.□

Chart 39
U.S. Corporate Cash as a Percentage of Total Corporate Debt



Our Portfolio: Three Value Examples

During this last recession, consistent with the 12 others before it, the stock market bottomed and began its recovery well in advance of the official end to the recession. Historically, equity markets bottom out approximately three to six months prior to the end of a recession. The reason for this is that the stock market focuses on expectations about the future, leaving two critical questions for investors to answer: **First, what is discounted? Second, are the expectations reflected in market prices too high or too low?** In other words, is the fact that we have high unemployment, a challenging real estate market, a slow growing economy, and uncertain political environment/policies, along with all the other micro and macro headwinds, already represented in the price of stocks? The next few pages highlight three stocks held in most CM portfolios that we believe are selling at discounts to their intrinsic values and that have already priced in the majority of these macro headwinds.

IMPORTANT: For the three stocks we are highlighting in this expanded letter, we are pointing to their P/E ratios as a way to illustrate their value. However, we want to caution you that a P/E ratio should not be used as the sole measurement of value before investing in a security. We use numerous valuation metrics in our historical analysis of companies. Furthermore, in many cases we also use free cash flow models, leveraged buyout models, acquisition analysis, and a sum-of-the-parts/divisional analysis when we value companies for consideration into our portfolios.

Microsoft (MSFT)

All ratios and percentages are based on an ending date of September 30, 2010 unless otherwise stated.

Microsoft Corp. is the largest independent maker of software. With over 89,000 employees, it generated over $62 billion in annual sales in fiscal 2010 from a wide variety of products and services. Specifically, it generated 29.8% of its sales through Microsoft Business, 29.6% through Windows and Windows Live, 23.8% through its Servers and Tools, 12.9% through its Entertainment and Devices, 3.5% from its Online Services, and 0.4% from other products and services. Importantly, Windows finished the year with roughly a 92% market share, as well as an 80% market share among enterprise customers and a 63% market share in web browsing through Internet Explorer.

We realize that many believe Microsoft has fallen behind Apple on smart phones and tablets and that there is uncertainty surrounding the impact of Cloud computing on its business. We believe that smart phones and tablets address different needs and different markets than PCs, and thus expand the computing device market. PCs are primarily input and productivity devices while smart phones and tablets are primarily output and content consumption devices, though there is overlap. In other words, Apple has been extremely successful in expanding the overall market, not only for its devices, but also for computing devices such as PCs and Internet servers sold by Microsoft, Intel, and Dell, among others. Regarding Cloud computing, we believe that while there is considerable excitement surrounding it (much the same way there was excitement over the Internet 10 years ago), to the degree that it is adopted, it will make PCs more valuable and drive additional demand for PCs and laptops (as well as for other computing devices). We also believe that Microsoft is extremely well positioned to be a dominant player in Cloud computing. However, Wall Street has the attitude of 'shoot first and ask questions later', creating opportunities for patient long-term investors.

One quick and easy way to estimate whether Microsoft is cheap or expensive is to review the 24-year P/E history shown on **Chart 40**. Microsoft's median P/E over the last 24 years has been 33.67. This P/E is higher than what we would expect today given that this company does not have the same growth rate it had in the past. However, considering its average P/E over the last five years, which includes one of the worst years in market history, was 18.14, and its average P/E over the last two years, one of which was the lowest valuation in the company's history, was 13.6, its current P/E of 11.66 and forward-looking P/E of 10.42 both seem very cheap. As a matter of fact, at the bottom of 2009, Microsoft's P/E only dropped below 10 for a few months before turning around.

Chart 40
Microsoft Price to Earnings Ratio

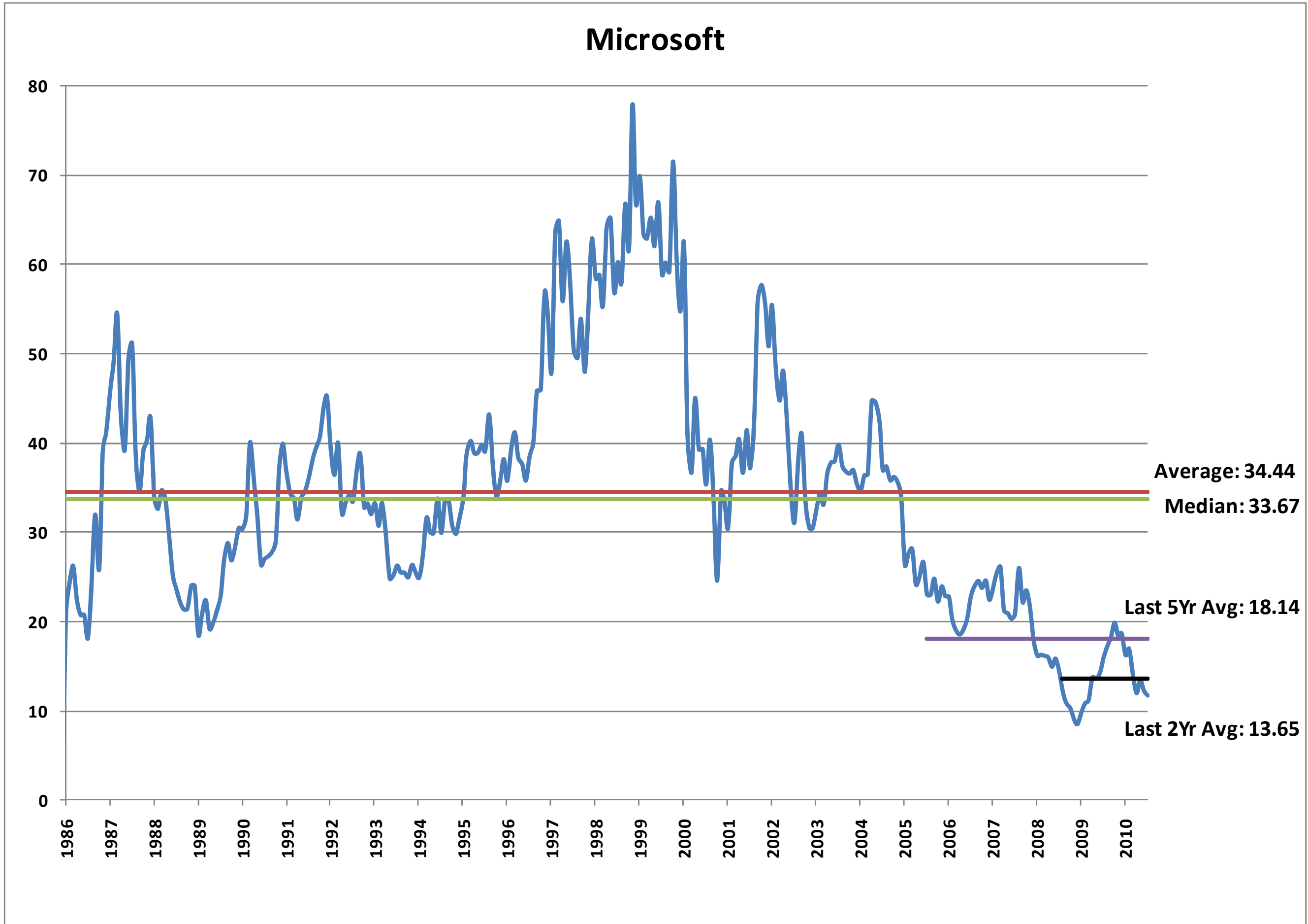


Chart 41 shows how Microsoft's fundamentals have performed relative to its price over the last two-, five- and ten-year periods of time. Again, over the past ten years there have been two recessions and several of the worst years ever recorded for the stock market. Through it all, sales, cash flow, earnings, and book value are all up. Microsoft has bought back shares, $60 billion worth in the last five years alone, and has begun a dividend program that presently yields 2.6%.

For the fiscal year that ended June 30, 2010, Microsoft paid out $13.5 billion, or $1.56 per share, to shareholders through share buybacks and dividends. In other words, the company generated such a large amount of free cash flow it could afford to pay out 74% of its earnings to shareholders and still manage to end up with $44.5 billion of cash and long-term investments on its balance sheet. As an aside, Microsoft continues to generate roughly $1 billion per month in free cash flow. Yet, after all this growth over the past five to ten years, the stock price is down 5% and 19% respectively.

Chart 41

Microsoft	Over past 10 years	Over past 5 years	Over past 2 years
Sales are up	220%	94%	9%
Cash flow is up	149%	94%	14%
Earnings are up	147%	81%	12%
Book value is up	32%	19%	34%
% of shares repurchased	15%	19%	5%
Dividend growth	No dividend 10 yrs ago	78%	45%
Change in price	-19%	-5%	-8%

Ending date for numbers above is September 30, 2010. Numbers have been rounded.
Source: Factset and Value Line

As one of the few remaining AAA rated companies, Microsoft has a financial statement so well respected that the bond market recently priced its bond offering almost on par with U.S. government notes and bonds (see **Chart 42**). **In total, Microsoft borrowed $3.75 billion in long-term debt that carried with it an after-tax rate to this company of just 2.3%.** One of the tranches sold was a three-year note that carried a 0.87% coupon. This was just 0.25% more than a three-year U.S. Treasury note. On an after-tax basis it will only cost Microsoft 0.66% per year. **When you consider this company earns more than 30% on its capital, this is a very good deal for shareholders.**

Chart 42

	Microsoft Debt Offering		U.S. Treasury Securities		
Term	**Yield-to-Maturity**		**Yield-to-Maturity**		**Difference**
3-year note	0.93%	vs.	0.68%	=	0.25%
5-year bond	1.71%	vs.	1.33%	=	0.38%
10-year bond	3.08%	vs.	2.56%	=	0.52%
30-year bond	4.56%	vs.	3.74%	=	0.82%

The yield-to-maturity for Microsoft is per the issue date of the bonds (September 22, 2010). The yield-to-maturity for the U.S. Treasury securities is priced on September 22, 2010, for comparison purposes. The difference is the premium Microsoft had to pay over US Treasury securities to debt holders.
Source: Bloomberg and Federal Reserve

We believe Microsoft is worth a premium to the average company. Our 36 years of research shows that large quality companies like Microsoft often get a 20% to 25% premium over the average stock, and rightfully so. If we were to add a 20% premium to the median P/E of the Value Line Investment Survey® (an index of 1700 stocks) over the last two years of 15.6, it would put Microsoft's P/E at 18.7 (15.6 2-year median P/E plus a 20% premium = 18.7 P/E). If we were to use the 5-year median Value Line P/E of 17.1 and add a 20% premium, it would suggest a P/E of 20.5.

While it is quite possible that Microsoft will grow faster over the next five years, we are only assuming a 5% growth rate. Under this scenario, we believe it has future earning power of $3.95. If we apply the 18.7 and 20.5 P/Es just calculated, it suggests Microsoft could sell for $73 to $80 per share. If we present value this back into today's dollars at 10%, it is equivalent to a current price of $45 to $50. If we take the average price of $24.5 over the past six months, this stock has the potential for a 5-year annualized return of 24% to 26%. Even if we just used the median Value Line P/E from the last two years of 15.6 and did not add a premium, it would suggest a 5-year annualized return of 20%. If you want to be extremely conservative, and just use the last two-year average, albeit depressed, P/E for Microsoft of 13.65, you will still have a 5-year annualized return of 17%. Add the dividend, and your total return potential is an annualized 19.7%

With a free cash flow yield of 9.1%, a dividend yield of 2.1%, plus our conservative future growth rate of 5%, we believe that Microsoft stock is a great value and a great investment. Furthermore, we do not believe the disparity between its value and price will continue for long; eventually the value will be recognized.

Given the return potential of this company, along with its AAA financial security, we have to ask the following question: Why would investors buy its bonds, or for that matter U.S. Treasury bonds, instead of Microsoft stock? □

Automatic Data Processing (ADP)

All ratios and percentages are based on an ending date of September 30, 2010 unless otherwise stated.

ADP is more than a payroll processor. It is one of the largest outsourced solutions providers offering a wide range of payroll, human resource, tax, and benefits administration solutions to more than 570,000 clients around the world. ADP is also rapidly expanding its international presence targeting multinational business with its multilingual, multicurrency solutions.

ADP's annuity-like business is a great model. For starters, it can bundle many of its services. This has helped ADP maintain fairly consistent after-tax profit margins in the 12% to 15% range for more than 10 years. Furthermore, this company has a reasonably predictable recurring revenue stream, as well as a very "sticky" business. For example, ADP has a 90% client retention rate; and the average client relationship is more than 10 years old. This is a sign of a great company.

ADP also has the opportunity to earn money on what is referred to as "float." This is the money that ADP collects for payroll taxes from its clients each pay period. It then holds this money on behalf of its clients until it is time for them to send these payroll taxes into the government. In other words, until this money is due to the government, ADP basically escrows this money for its clients throughout the year. The average daily balance or "float" it has at any given time is approximately $15 billion. Thus, ADP can ladder this "float" or "escrowed money" into various bonds and keep the interest income generated as profits. The investment income gained from this float currently provides approximately $600 million in pretax income to ADP. Eventually when interest rates go up, so will its profits on this float. **This company will likely do well in an inflationary environment.**

ADP also has significant competitive advantages because it is the largest in the industry and because of the scale and depth of its products. For example, ADP has the ability to service the small local employer of 1 to 50 employees, as well as the multinational firm with thousands of employees spread throughout the world. Currently, with only 20% of sales coming from outside the U.S., ADP has plenty of room to grow for many years to come.

Furthermore, **ADP is one of only six public companies that continue to earn an AAA rating from Standard & Poor's for financial strength**. It is easy to see why since it has $1.2 billion in cash net of debt on its balance sheet. In addition, because ADP has very little in the way of capital expenditures needed to run the business, 75% of its earnings are free cash flow (money this company can use to pay out dividends, buy back shares, or make acquisitions). Moreover, it has been very consistent in achieving a return of 18% to 20% on its capital over the years. **Chart 43** shows that over the past two-, five-, and ten-year periods of time, ADP's sales, cash flow, earnings, and book value are all up considerably more than the stock price. For example, over the past two years, while business fundamentals are up, the price is down 2% and for the ten-year period the price is down 30%.

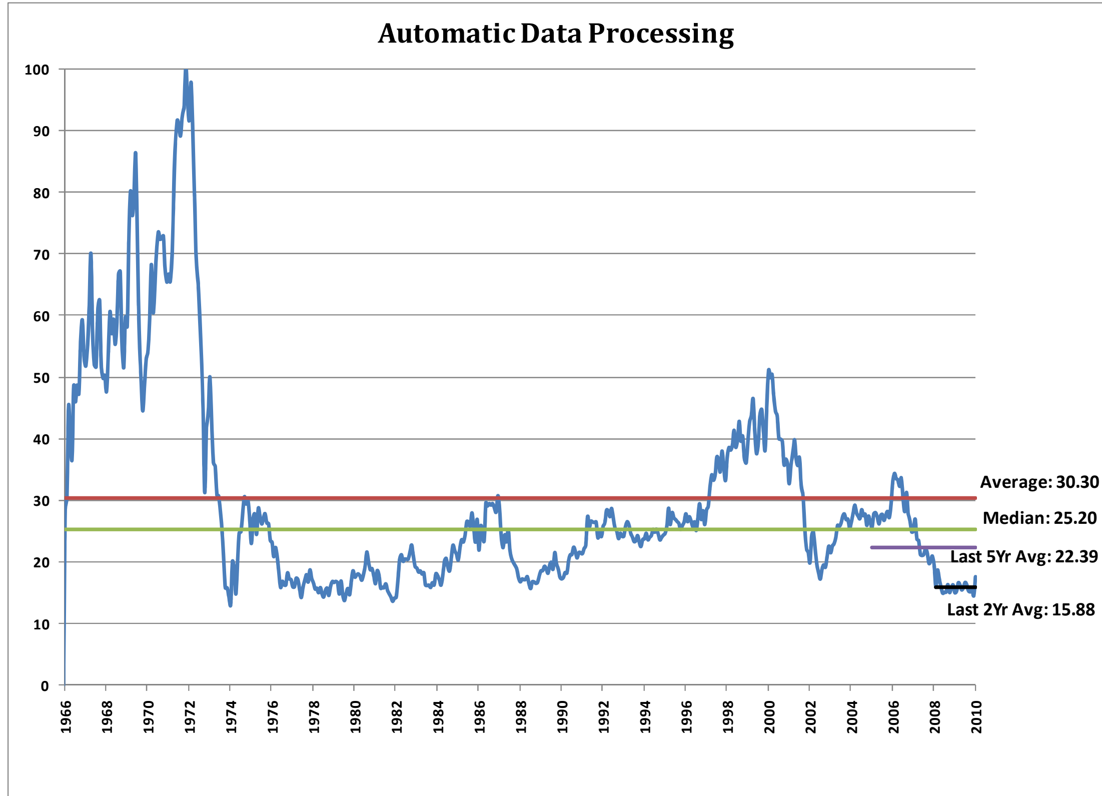
Chart 43

Automatic Data Processing	Over past 10 years	Over past 5 years	Over past 2 years
Sales are up	80%	23%	5%
Cash flow is up	63%	25%	7%
Earnings are up	81%	32%	8%
Book value is up	51%	11%	11%
% of shares repurchased	21%	14%	3%
Dividend growth	289%	119%	17%
Change in price	-30%	9%	-2%

Ending date for numbers above is September 30, 2010. Numbers have been rounded.
Source: Factset and Value Line

ADP is a meaningful position in our portfolios. As with Microsoft, when it comes to valuation, we can quickly illustrate whether ADP is cheap or expensive by reviewing its 44-year historical P/E ratio. **Chart 44** shows that the median P/E for ADP over the past 44 years has been 25.20. The two- and five-year average P/Es ending September 30, 2010, that again included one of the worst years in market history, was 15.88 and 22.39 respectively. The last time ADP closed with a P/E below this most recent two-year average was over 21 years ago in March 1989 when it closed with a P/E of 15.67. In other words, this stock does not typically stay cheap for long. As of September 30, ADP had a 17.59 P/E. This is still 21.4% below the five-year average of 22.39.

Chart 44
Automatic Data Processing (ADP) Price to Earnings Ratio



In our analysis, we are growing its earnings at the annualized rate of 9.7% over the next five years. Even during the past three years in a challenging economy with high unemployment, ADP grew its earnings at an annualized rate of 5.7%. We believe our growth rate is reasonable, especially when you factor in its rapidly expanding international business and the ability to bundle its various products and services.

Under this scenario, we believe ADP has future earning power of $3.75. If we were to use the five-year median Value Line P/E of 17.1 and add a 20% premium since ADP is much better than the average company, the P/E we would use is 20.5. If we multiply this P/E times the five-year earnings potential of $3.75, it would suggest a price of $76.9 for a potential five-year annualized return of 12.9% from today's price. However, if you add the 3.2% dividend yield to this return, there is potential for a 16% total return over the next five years.

Now, if we assume ADP gets back to its last five-year average P/E of 22.39, it suggests ADP could sell for approximately $84 per share. This means that from today's price of $42, this stock has the potential for a five-year annualized return of 15%. This does not include the 3.2% dividend yield that is paid out every year. If we include the dividend, the potential total annualized return would be 18.2% over the next five years. □

Wal-Mart (WMT)

All ratios and percentages are based on an ending date of September 30, 2010 unless otherwise stated.

Wal-Mart Stores is the world's largest retailer, employing roughly 2.1 million people and generating more than $400 billion in annual revenue (sales). It operates approximately 2,747 supercenters (which include sizable grocery departments), 803 discount stores, 596 Sam's Clubs, and 158 neighborhood markets in the U.S. In addition, it operates more than 4,112 foreign stores, mainly in Latin America, Asia, Canada, and the U.K. According to the U.S. Census Bureau, Wal-Mart is responsible for nearly 10% of all retail sales in the U.S. and 20% of all grocery sales. It is safe to say that Wal-Mart is an important part of consumers' budgets.

Wal-Mart's foothold continues to grow. Currently, Wal-Mart-U.S. operations account for 63% of sales. While this is a maturing portion of its business, it is well entrenched. Next, there is Sam's Club that makes up 12% of sales. The real bright spot and fastest growing portion of Wal-Mart's business is coming from outside the U.S. Currently, international sales represent roughly 25% of total sales. While U.S. based sales are basically flat, international sales are currently growing at an impressive rate of 11%. We believe these international sales can continue to grow at an annualized rate of 9% to 11% for an extended period of time.

Wal-Mart operates its business with tremendous efficiency and consistency. For example, over the past 10 years its profit margin has ranged between 3.1% and 3.6%. Its return on capital has been between 13.6% and 14.8%, and its return on equity has been between 19.1% and 20.8%. In addition, Wal-Mart has a free cash flow yield of 4.4%, a dividend yield of 2.2% and it continues to buy back stock. Year-to-date, cash returned to shareholders through stock buy backs and dividends has been $9.37 billion, or $2.57 per share. Assuming no more share repurchases, Wal-Mart will have paid shareholders $3.28 per share for the full year. This is 82.4% of the yearly earnings and represents a yield to shareholders of 6.4%. **Chart 45** shows that over the past two-, five-, and ten-year periods, its sales, cash flow, earnings, and book value are all up considerably more than the stock price. However, even though business fundamentals are up, over the past two years, the stock price has actually shown a decline of 11%.

Chart 45

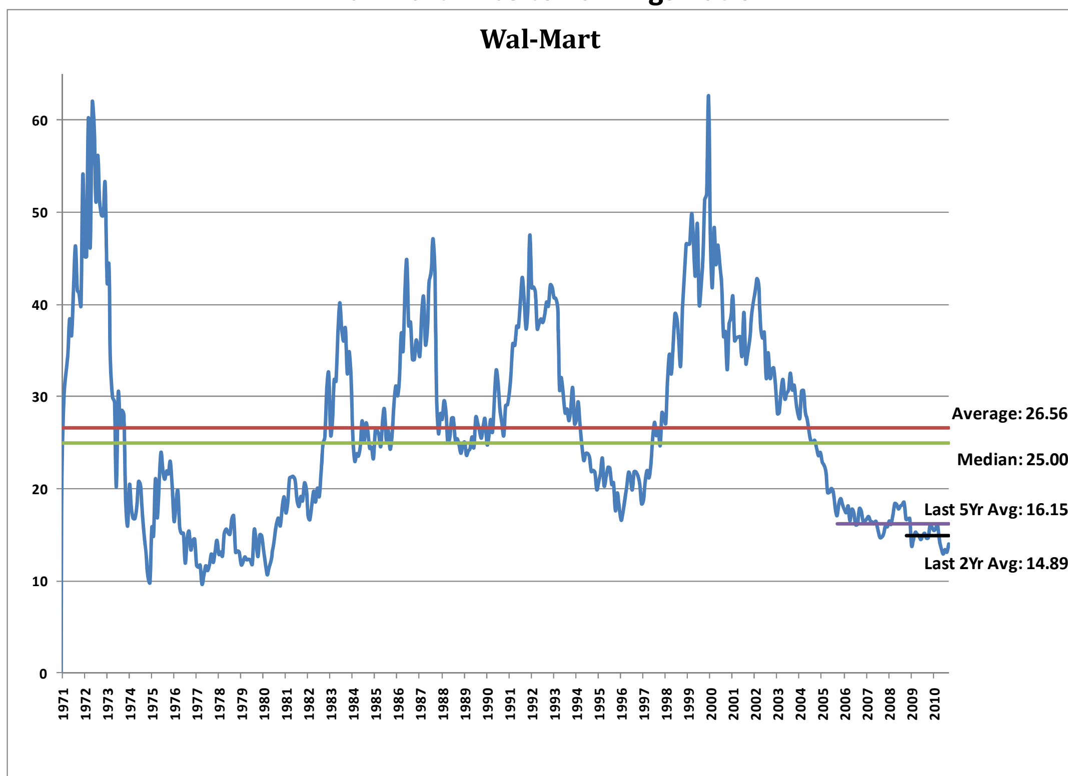
Wal-Mart	Over past 10 years	Over past 5 years	Over past 2 years
Sales are up	176%	57%	13%
Cash flow is up	202%	64%	15%
Earnings are up	189%	54%	18%
Book value is up	192%	61%	15%
% of shares repurchased	19%	13%	5%
Dividend growth	404%	103%	28%
Change in price	11%	21%	-11%

Ending date for numbers above is September 30, 2010. Numbers have been rounded.
Source: Factset and Value Line

Wal-Mart is a top five position in most of our portfolios. When it comes to valuation, we can quickly illustrate whether Wal-Mart is cheap or expensive by reviewing its 39-year historical P/E ratio on **Chart 46**. The median P/E for Wal-Mart over the past 39 years has been 25. The two- and

five-year average P/Es ending September 30, 2010, that again included one of the worst years in market history, were 14.89 and 16.15 respectively. Outside of the past two years, Wal-Mart has never had a P/E below this last two-year average. The low point of 12.57 in July 2010 was short-lived. As of September 30, 2010, Wal-Mart had a 13.97 P/E. This is still 6% below the two-year average and 13.5% below the five-year average. As a large quality company with a global footprint and great fundamentals, we believe that Wal-Mart should be selling for a higher P/E than it is today.

Chart 46
Wal-Mart Price to Earnings Ratio



In our analysis we are growing Wal-Mart's earnings 7.7% over the next five years. Under this scenario it would give this company earning power of $5.77 five years from now. If we multiply these earnings times the five-year median Value Line P/E of 17.1 and do not give Wal-Mart a 20% premium as we did in our Microsoft and ADP examples, it would suggest a price of $99 for a potential five-year annualized return of 13% from today's price. However, if you add its 2.2% dividend yield to this return, there is potential for a 15.3% total return over the next five years.

If we did give Wal-Mart the 20% premium that we believe is justified given this company's strong financial statement and potential to grow at a rapid pace outside the U.S., it would suggest a P/E of 20.5. If we multiply this by $5.77 in earnings five years from now, it would suggest a price of $118, translating into a potential 17% return. Add the dividend, and you get a potential 19.3% total return.

If we take one more scenario and assume Wal-Mart only gets back to its last five year average P/E of 16.15, it suggests Wal-Mart could sell for approximately $93 per share. This means that from today's price of $53.52, this stock has the potential for a five-year annualized return of 11.7%. If we include the 2.2% dividend, the total annualized return would be 13.9% over the next five years. □

How do great companies get so cheap? Are there not thousands of other analysts, money managers and market participants looking at these stocks every day? Why are these professionals and market participants not seeing the same values we are and snapping up the bargains?

These questions can be answered by explaining the four emotions that investors often go through when owning stocks:

1. **Apathy**. Many people have no interest in owning companies that have declined or gone sideways for an extended period of time, as is the case for Microsoft, Automatic Data Processing, and Wal-Mart, as well as numerous other stocks, especially in the large-cap space.

2. **Disgust.** After having watched an investment drop significantly or go sideways for an extended period of time, or both, many investors reach the emotional stage of disgust and they just want to sell such a stock as they are tired of looking at it in their portfolios. In addition, many investment managers or brokers will throw in the towel as they are tired of taking heat from their clients on stocks that have behaved in this fashion and they no longer wish for them to appear on monthly statements.

3. **Fear or panic.** In times of great concern and anxiety over the state of our economy, investors who have not truly quantified the value of the company will often times sell their stock for non-business reasons. Without the analysis to determine a company's true price potential, many investors and even processionals succumb to their emotions that in turn can lead to panic selling. This happens more than you might think.

4. **Anger.** Investors who have watched their stocks go nowhere but down, often reach the emotional stage of anger. Typically, this occurs at or around the time when a stock's price reaches what we call capitulation. Financially hurt and psychologically wounded, investors are ready to surrender and just give up. It is at this time that stocks are priced as cheap as they are going to sell as many furious investors just want out regardless of price.

While many analysts and money managers do recognize the same values that we see, at times it can become difficult to reason with clients who have experienced these emotions. In the end, it is the client's money; and money managers are often ordered to sell a particular stock or mutual fund, even though from a fundamental value perspective it does not make sense. For example, many investors in U.S. equity mutual funds, as well as many pension and endowment funds, have been reducing their exposure to U.S. equities in favor of bonds and international equities over the past two years. This reduction has ranged from 10% to as much as 50% among some of the major corporate pension plans and endowments.

The irony in the timing of this move is that this is taking place after having already realized sizeable losses in U.S. equities during one of the worst recessions and market extremes seen in more than 30 years, while at the same time watching bonds and international equities perform relatively well. The fact is that a good part of the rise in bonds and international equities is a direct result of major changes in asset allocations from large institutional investors, as well as from the fear and panic of many individual investors, and not business fundamentals. Furthermore, it would appear that current valuations on many fixed income investments and numerous international equities are richly priced given current fundamentals, potentially setting up these new investments for a

disappointing performance relative to the U.S equities currently being sold.

In other words, this shift in asset allocations away from U.S. equities in favor of bonds and international equities appears to be taking place due to investor apathy, disgust, fear/panic, and anger, not business fundamentals. The business fundamentals of our three examples have strengthened over the last two, five, and ten year periods of time. We believe there are a number of U.S. stocks, especially large cap stocks, trading at bargain level prices and that the patient, disciplined investor will likely be the beneficiary of their improving business fundamentals in the years ahead. □

Our Portfolio: Large-Cap Perspective

The stocks highlighted in this newsletter are just a few of the many examples of value present in our portfolios. Like Microsoft, ADP, and Wal-Mart, we have purchased many other stocks over the past few years that we believe were, and still are, selling at wide discounts to their true intrinsic values. **Throughout our 36-year history as an all-cap manager, we have found some of our best bargains in smaller companies and believe this will continue into the future. Typically they are less followed, less understood, and therefore more likely to be mispriced. It is only over the last few years that we have found a greater number of large quality companies selling at wide discounts to their intrinsic values.**

These larger companies bring with them a greater global footprint, easier access to capital, greater economies of scale, dominant competitive positions in the market place, and the ability to attract great talent. When you can buy all of this at a bargain price, it is hard to pass up. It is for this reason that our typical portfolio currently holds between 55% and 60% of its assets in larger, high quality names. This is only the third period of time in our firm's 36-year history where we have had this higher percentage weighting to large-cap stocks in our portfolios.

How can such well-known, highly followed companies be so mispriced by the marketplace relative to their true values? For many who invested in large-cap stocks over the past decade, these stocks have been nothing but a disappointment. For example, investors who bought the S&P 500 ten years ago have no profits to show for it. Add to this four major market declines and two severe recessions in the past ten years, many investors have become psychologically and emotionally exhausted, and in some cases, financially devastated.

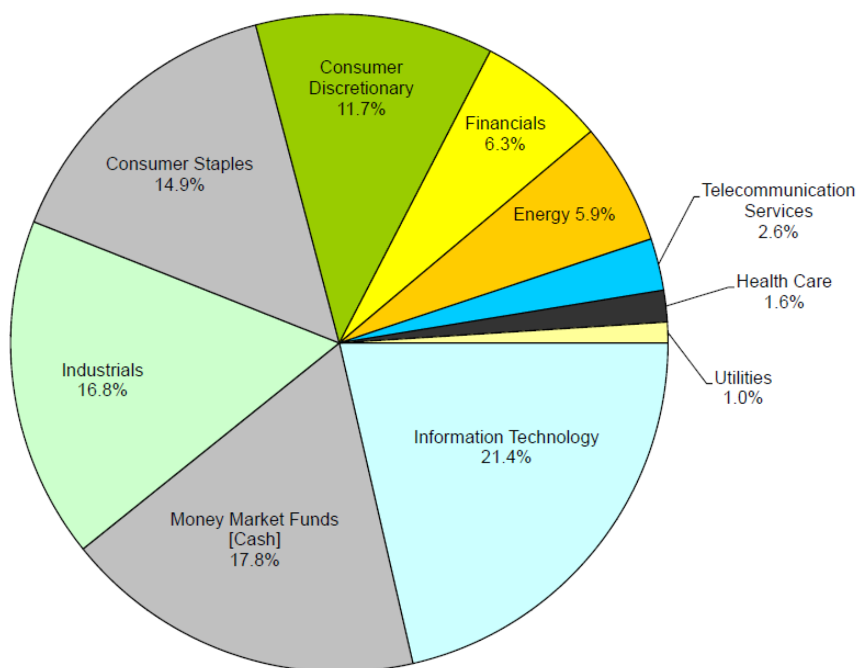
But here is where true value investing comes into play. While many of these stocks might have sold for higher prices than what their growth rates, margins, and other business fundamentals would have dictated over the past five to ten years, these companies have now become lean and mean. **Many have expanded their client base and market share, reinvested in their businesses, cut expenses, and invested in technology; and the results are favorable. Sales are up, earnings are up, dividends have been increased, acquisitions have been made, cash is building, high profit margins are being maintained, and a large number are buying back shares, all during one of the most economically challenging decades in our country's history. However, because of the pain suffered, many investors do not seem to care that their prices are down and trading at bargain levels. This is truly extraordinary.** Why should the best companies in the world, many that have the opportunity to do business with China, India, Europe, Latin America, and with the rest of the world, be selling below their prices from a decade ago when their business fundamentals and future opportunities have made such significant progress? The fact of the matter is this will not continue for too much longer. Eventually their values will be recognized. As Benjamin Graham

said, “in the short run the market is a voting machine; in the long run it’s a weighing machine.” We firmly believe that as we look out over the next three to five years, the value in most of these companies will become realized; and it will be reflected in the returns of our portfolios.

Our Portfolio: CM Value 1 Composite (Our Typical Equity Account)

Chart 47 breaks down how the collective group of stocks making up the CM Value I composite is allocated as of September 30, 2010.

Chart 47
CM Value I Composite GICS Sector Breakdown
September 30, 2010



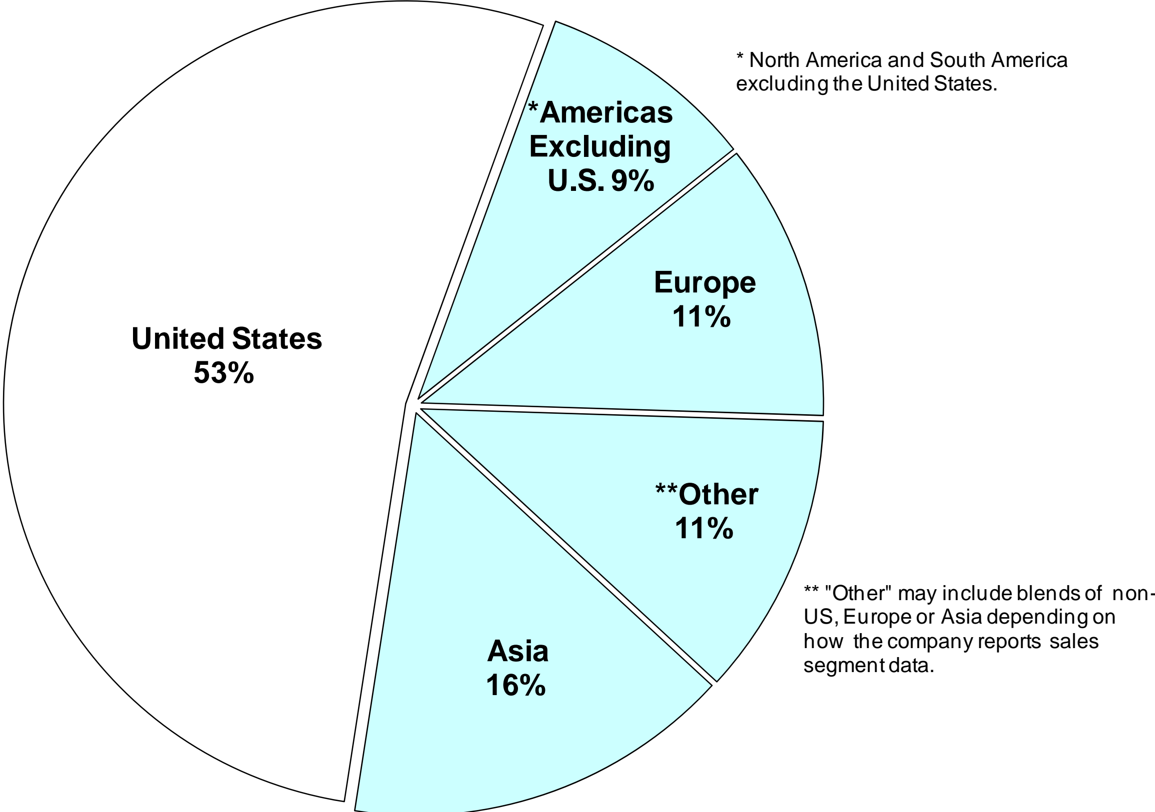
Source: Factset and AXYS

As of September 30, 2010, approximately 56% of the CM Value I composite, or 69% of the equities (if you exclude cash), are invested in large quality companies. Most of these companies produce reasonably consistent free cash flow, pay dividends, have strong balance sheets, and represent some of the leading brand name products and services around the world. For many of these companies, the fastest growing part of their business is selling their products and services to customers outside the U.S.

Chart 48 breaks down just how much of their sales are coming from outside the U.S. As a group, the companies in our portfolios generate approximately **47%** of their sales from outside the U.S. on a weighted basis. By owning premier companies based in the U.S., we have the opportunity to benefit from growing economies around the world but with a lot less risk. Though we have invested in several international companies in the past and are open to global opportunities in the future, we believe, based on a variety of factors, many of our large U.S. based companies offer some of the most attractive values in the global market place.

Chart 48

Breakdown of Sales From Stocks in the CM Value I Composite, on a Weighted Basis, as of September 30, 2010



Source: FactSet Research Systems

Chart 49
Percentage of Foreign Sales for Companies Held in the CM Value I Composite
As of September 30, 2010

	Sample of 20 Companies Held in our Typical CM Equity and Balanced Accounts	Percentage of Foreign Sales
1	Texas Instruments	89%
2	Intel Corp	85%
3	Applied Materials	80%
4	Coca Cola	75%
5	Colgate-Palmolive	74%
6	3M Company	63%
7	Procter & Gamble	62%
8	Emerson Electric	55%
9	General Electric	53%
10	Marsh & McLennan	53%
11	Dell Inc	47%
12	News Corp Class A	46%
13	Microsoft Corp	42%
14	American Express	32%
15	FedEx Corporation	28%
16	Wal-Mart Stores Inc.	25%
17	United Parcel Service	24%
18	Walt Disney	24%
18	CDI Corp.	22%
20	Masco Corp	21%
Source: Factset		

As of September 30, 2010, the largest allocation represented in the CM Value I composite is to the information technology sector at 21.4%. In this sector, we have great companies such as Microsoft, Intel, Texas Instruments, Dell, and Applied Materials. The second largest allocation is to cash and cash equivalents at 17.8%. Our third largest allocation is to the industrial sector at 16.8%. In this sector, we own names such as 3M, GE, Emerson Electric, and Jacobs Engineering. Our fourth largest weighting is to consumer staples at 14.9%. Here we have positions in Wal-Mart, Colgate-Palmolive, Coca-Cola, Walgreen, and Proctor and Gamble. While only a small weighting of 5.9% at the present, we have begun to increase our exposure to the energy sector, a sector in which we performed well in the early and mid 2000's. Currently we have positions in Exxon Mobil, Valero Energy, Tidewater, and Frontier Oil, and will increase our weighting as the opportunities present themselves. Please note that in addition to these direct energy sector holdings, many of our industrial sector companies have portions of their businesses that are significantly related to the energy sector. They too will likely profit from the same long-term economic drivers that will eventually benefit specific energy sector holdings.

Chart 50 takes a snapshot view of the value characteristics found in a typical CM equity portfolio as measured by the CM Value I composite as of September 30, 2010. To put some of these ratios into perspective, **Chart 51** gives you the typical high and low ranges of median valuation multiples for a diversified basket of stocks. While not the exact historical highs and lows, they are

approximate high and low ranges typically seen throughout market history. These ranges are best used when applied to a basket of stocks rather than any individual stock that might deserve a premium or discount from these general market guidelines. Furthermore, they are not adjusted for interest rates.

Chart 50

CM Value I Composite	09/30/10
Price to Sales	0.71
Price to Earnings (Trailing 12 Months)	15.69
Price to Earnings (FY1 Estimated Earnings)	14.59
Price to Cash Flow	7.94
Price to Free Cash Flow	13.30
Price to Book	1.91
Long Term Debt to Capital	28.87%
Return on Equity	17.68%
Return on Invested Capital	10.95%
Net Margin	9.27%
Dividend Yield	2.23%
Free Cash Flow Yield	7.52%
Bond Yields	
Fed Funds Rate	0.15%
10-Year US Treasury Bond Yield	2.53%
30-Year US Treasury Bond Yield	3.69%
Moody's AAA Corporate Bond Yield	4.54%
Moody's Baa Corporate Bond Yield (Investment Grade)	5.58%
Source: Factset and the Federal Reserve	

Chart 51

Typical High and Low Ranges of Median 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 for any individual stock or composite. Rather, they are the approximate high and low ranges of median multiples that are typically seen throughout market history. These ranges are best used when applied to a basket of stocks, rather than any individual stock that might deserve a premium or discount from these general market guidelines. Multiples shown are not adjusted for interest rates. Source: Value Line and Century Management.

The current price to sales ratio of 0.71, as shown on **Chart 50**, suggests our portfolio is priced between its buy point and fair value. The one-year forward-looking price-to-earnings ratio of 14.59 is at the low end of fair value when you adjust for normalized interest rates. In addition, our price-to-cash flow ratio of 7.94 and price-to-book ratio of 1.91 suggests the portfolio is currently priced between the buy point and fair value.

At first pass, the net profit margin of 9.27% shown on **Chart 50** appears to be on the high side of long-term historical averages. According to the Bureau of Economic Analysis, U.S. corporate profit margins have averaged 5.9% over the past 60 years. However, over the past 15 years corporate profits have averaged 7%, and over the past five years they have averaged over 7.5%. The reason we believe profit margins have been increasing over the decades is threefold:

1. U.S. businesses continue to shift the balance of our economy from a manufacturing base to a service base. Service companies are typically driven by the intellectual property and higher profit margin aspects of their businesses, while at the same time outsource the lower profit margin manufacturing components. We have seen many examples of U.S. companies performing the higher profit margin areas of design, marketing, and distribution responsibilities, and outsourcing the lower profit margin manufacturing portion of their business to lower cost countries typically found in Asia and South America. This activity has lead to higher profit margins.

2. By increasing the use of technology, companies have become more efficient. As we pointed out earlier, gross domestic product (GDP) is now just ahead of 2008 peak levels. However, according to the U.S. Bureau of Labor Statistics, there are roughly 7.4 million less people employed since that time. While no one likes to see unemployment this high, the flip side is that employees and businesses are more productive and, thus, doing more with less. The lion's share of this extra productivity can only be done through the many uses of technology and innovation. Doing more with less leads to higher profit margins.

3. In recent years, companies have been able to obtain cheaper financing in which to operate and expand their businesses. The positive side to the immediate financial situation is that many companies have been able to refinance their debt at record low rates as well as move their debt from short-term to long-term. Lowering the interest expense and locking up these rates for 10 to 30 years will help maintain higher margins into the future.

While many companies have experienced a significant decline in revenues over the past few years due to the recession, most did a great job cutting costs and streamlining operations. This has allowed companies to operate at higher margins, albeit with a lower level of revenues. However, as an economic recovery gets underway, companies will first likely experience a rapid increase in margins. As they add revenues, margins will likely decline, though overall profits should continue to rise.

Because our largest allocation in the portfolio is to the technology sector, a sector with very high profit margins, our specific basket of stocks is carrying an above average profit margin. Over time, as we find more values in the energy and industrial sectors, we fully expect that the profit margins of the companies in our portfolios will decline and be more in line with the averages of the last 15 to 20 years. □

Valuations and Scenarios

Stocks and bonds are always in competition for investors' capital. For that reason, one of the best measurements of value is to compare the potential returns offered between stocks and bonds. An easy way to do this is to compare the free cash flow yield of our CM Value I composite (i.e. our typical equity portfolio) to the yields offered by bonds. A stock is typically trading at a bargain price when its free cash flow yield is equal to or greater than the bond yield. When you buy a bond, the yield is fixed and will not grow over time; however, when you buy a stock, not only do you get the free cash flow yield, you also get to participate in the earnings growth of the company. Therefore, if your stock has an equal or greater free cash flow yield than a bond, over time the stock will typically give you the superior return.

Chart 52 shows that the basket of stocks in our CM Value I composite is providing a greater free cash flow yield than government or investment grade bonds. In other words, collectively, the stocks in our CM Value I composite are a better value than these bonds. In addition, unlike these bonds, our portfolio of stocks will likely experience earnings growth over the next five years, thus making them even more attractive.

Free Cash Flow (FCF): Free cash flow is the surplus cash not needed to run the business. Free cash flow can be used to pay out dividends, buy back shares, or make acquisitions.

Free Cash Flow = Net Income *plus* Amortization/Depreciation *minus* Changes in Working Capital *minus* Capital Expenditures

Chart 52

CM Value I Composite Free Cash Flow Yield vs. Bond Yields

Let's Compare	
7.52%	CM Value I composite free cash flow yield
vs.	
5.58%	Moody's Baa investment grade corporate bond yield
4.54%	Moody's AAA highest quality investment grade bond yield
2.53%	10-year U.S. Treasury bond yield
Source: Federal Reserve and Century Management. As of September 30, 2010	

Another way to measure the value we have in our portfolios is to take a snapshot of today's earnings from our collective companies, grow them out over the next five years using our estimate of what we believe is probable, and then multiply these estimated earnings by a range of P/E ratios to arrive at five-year estimated return for our CM Value I composite and the Dow Jones Industrial Average (DJIA). By including a range of P/Es reflecting different inflationary environments, we are able to provide you a range of scenarios, including what we believe are most probable.

To begin, as of September 30, 2010, we are estimating a 12.4% rate of earnings growth. This estimate is based on a bottom up analysis of individual securities over the next five years for the collective holdings in our CM Value I composite. We are projecting this higher than normal rate of growth over the next five years for three main reasons:

- **First**, we have many cyclical companies with well established businesses and strong balance sheets that are in the low part of their earnings cycle. For example, we have some companies in the CM Value I composite that are currently earning less than $1 per share that have the potential to earn anywhere from $2 to $4 per share over the next five years depending on the company. Once these companies are operating within a more normal environment, these higher earnings growth rates will be reduced to more normal levels.

- **Second,** roughly half of the companies we own are generating their earnings from outside the U.S. The companies whose earnings are generated from foreign markets are generally growing faster than the average U.S. company whose earnings are virtually exclusive to U.S. sales.

- **Third,** many companies in our portfolio are using a portion of their free cash flow to repurchase shares. Everything else being equal, if the outstanding share count is cut in half, you effectively have doubled your earnings per share. As of September 30, 2010, our top 10 holdings, which represent 37.3% of our equities, on a weighted basis, are projected to reduce their share count by 1.6%. Reducing share count is another way earnings per share grow.

In addition to growth rates, inflation is a key in determining the appropriate P/E ratio and, thus, must be understood. **Chart 53** shows the 96-year history of the consumer price index. Like interest rates, inflation, as measured by the CPI, has been coming down for the better part of the last 30 years. According to the Bureau of Labor Statistics, over the last 12 months ending September 30, 2010[15], inflation has been 1.1%. Historically, this is about as low as it gets. Looking forward, we believe it is a reasonable assumption that inflation will be somewhat higher than it is today. This belief is supported by the fact that Federal Reserve Chairman Ben Bernanke on October 15, 2010[16], said, "…the FOMC is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation over time to levels consistent with our mandate." In our view, while the Fed may desire a slightly higher level of inflation from what we have today, if history is any guide, they have a tendency to overshoot. While we are not projecting the inflation of the early 1980's, we do believe that over the next five years inflation could easily range between 3% and 4%, if not higher. This would be more consistent with the 30- to 50-year averages shown on **Chart 53**.

Chart 53

Consumer Price Index (Inflation)				
Beginning Date		Ending Date	Number of Years	Annualized Rate of Inflation
1913	to	2009	96 Years	3.26%
1959	to	2009	50 Years	4.08%
1969	to	2009	40 Years	4.51%
1979	to	2009	30 Years	3.68%
1989	to	2009	20 Years	2.78%
1999	to	2009	10 Years	2.48%
2004	to	2009	5 Years	2.58%

Source: Bureau of Labor Statistics: www.bls.gov

Chart 54 summarizes the historical relationship between inflation and P/E ratios. We segregated inflation data from 1968 through November 2010 into two categories: **low to long-term average inflation** and **above average inflation.** We then listed the corresponding median P/E multiples for these environments. We have omitted less than 1% inflation and deflation scenarios due to the scarce number of applicable data points since 1968. However, in a sustained deflation scenario, we would expect stock prices to trade lower as earnings would likely decline.

We believe that over the next five years the probable range of inflation is between **1%** and **3.5%,** which corresponds with a **16.3 fair value median P/E**. Under an above average inflation scenario the median fair value P/E would likely drop to **11.2**. Since 1968, the median weekly Value Line® P/E has been **14.8.** Note the 1968-2010 time period includes a wide range of inflationary environments (see **Chart 53**).

Chart 54

The Impact of Inflation on Value Line's® Median P/E Ratios

The Impact of Inflation on Value Line's® Median P/E Multiples	Low to Long-Term Average Inflation	50-Year Average CPI Inflation	Above Average Inflation
Potential CPI Inflation Rates	**1% to 3.5%**	**4%**	**4.5% to 5%**
Fair Value P/E	**16.3**	**14.8**	**11.2**

CPI = Consumer Price Index (i.e. inflation). See long-term averages on **Chart 53**. Less than 1% inflation and deflation scenarios are not included in this chart. However, in deflation, we would expect valuations to contract. Note, the November 16, 2010, median Value Line® P/E was 15.2. Source: Century Management, Value Line® and the Bureau of Labor Statistics.

Chart 55 shows a range of P/E ratios and our estimated five-year earnings for the CM Value I composite, on a weighted basis, as of September 30, 2015. We arrived at this combined earnings estimate through a bottom-up analysis of the individual securities within this composite. In addition, we assumed no changes to our holdings or to our current asset allocation, though we fully expect our holdings to change during the next five years.

On **Chart 56**, we are taking the price of our composite on September 30, 2010, and assigning it a starting value of 1,000. We then calculated the annualized rate of return to the five-year estimated price shown on **Chart 55** and added a 2.2% dividend yield to arrive at our five-year annualized total estimated return.

While we show a range of scenarios, we have highlighted three that are more probable:

- **Fair value P/E during low to long-term average inflation:** In this scenario we estimate our total annualized five-year return to fair value to be **17.42%**. However, if it takes eight years instead of five for our earnings to materialize, the total annualized return to fair value would be **11.46%.**

- **Fair value P/E if we use the long-term Value Line® median P/E:** In this scenario we estimate our total annualized five-year return to fair value to be **15.22%**. However, if it takes eight years instead of five for our earnings to materialize, the total annualized return to fair value would be **10.15%.**

  (Value Line's Investment Survey®, provides, in our opinion, one of the most accurate P/E measurements for the market-at-large, as well as long-term perspective for three reasons: **1)** They use a median P/E instead of an average P/E. **2)** They have a large universe of 1,700 companies. **3)** They blend two quarters of forward earnings and two quarters of trailing earnings in an effort to smooth out earnings volatility and extremes.)

- **Fair value P/E during above average inflation (between 4.5% and 5%):** In this scenario we estimate our total annualized five-year return to fair value to be **9.09%**. However, if it takes eight years instead of five for our earnings to materialize, the total annualized return to fair value would be **6.45%.**

> ***"The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances."***
>
> **Benjamin Graham**

Chart 55
CM Value I Composite Estimated Range of Prices for 2015

Fair Value P/E During:	P/E		Estimated 5-Year Earnings		Estimated 5-Year Price
Above Average Inflation (5% to 7%)	**9**	**x**	**124.6**	**=**	**1,121.4**
	10	x	124.6	=	1,246.0
	11	x	124.6	=	1,370.6
Above Average Inflation (4% to 5%)	**11.2**	**x**	**124.6**	**=**	**1,395.5**
	12	x	124.6	=	1,495.2
	13	x	124.6	=	1,619.8
	14	x	124.6	=	1,744.4
Value Line® 42-Year Median P/E	**14.8**	**x**	**124.6**	**=**	**1,844.1**
	15	x	124.6	=	1,869.0
	16	x	124.6	=	1,993.6
Low to Long-Term Average Inflation	**16.3**	**x**	**124.6**	**=**	**2,031.0**
	17	x	124.6	=	2,118.2
	18	x	124.6	=	2,242.8
	19	x	124.6	=	2,367.4
	20	x	124.6	=	2,492.0

"Investors repeatedly jump ship on a good strategy just because it hasn't worked so well lately, and, almost invariably, abandon it at precisely the wrong time."

David Dreman

Chart 56
CM Value I Composite Estimated Range of Returns (Including Dividends)

P/E	Sept. 30, 2010 Price	Growing To	Estimated 5-Year Price	*Returns if Estimated Earnings Growth Took:* 5 Years	6 Years	7 Years	8 Years
9	1,000.0	to	1,121.4	4.52%	4.13%	3.85%	3.64%
10	1,000.0	to	1,246.0	6.70%	5.93%	5.39%	4.99%
11	1,000.0	to	1,370.6	8.71%	7.59%	6.81%	6.22%
11.2	**1,000.0**	**to**	**1,395.5**	**9.09%**	**7.91%**	**7.08%**	**6.45%**
12	1,000.0	to	1,495.2	10.58%	9.13%	8.11%	7.36%
13	1,000.0	to	1,619.8	12.33%	10.57%	9.33%	8.41%
14	1,000.0	to	1,744.4	13.97%	11.92%	10.47%	9.40%
14.8	**1,000.0**	**to**	**1,844.1**	**15.22%**	**12.94%**	**11.34%**	**10.15%**
15	1,000.0	to	1,869.0	15.52%	13.19%	11.55%	10.33%
16	1,000.0	to	1,993.6	17.00%	14.39%	12.56%	11.21%
16.3	**1,000.0**	**to**	**2,031.0**	**17.42%**	**14.73%**	**12.85%**	**11.46%**
17	1,000.0	to	2,118.2	18.40%	15.53%	13.52%	12.04%
18	1,000.0	to	2,242.8	19.73%	16.61%	14.43%	12.82%
19	1,000.0	to	2,367.4	21.01%	17.65%	15.30%	13.57%
20	1,000.0	to	2,492.0	22.24%	18.64%	16.13%	14.29%

This chart calculates our estimated annualized rate of return, including 2.2% in annualized dividends, for the CM Value I composite over the next five years beginning September 30, 2010. To arrive at this price, our CM analysts have analyzed each company in the composite and then calculated their earnings impact on a weighted basis. We also show what the return would be if our five-year earnings estimate took six, seven, or even as much as eight years to materialize given different P/E ratios. Returns are annualized and gross of all fees. **This estimate is not guaranteed. Any changes to the weightings or the inclusion or exclusion of stocks in the CM Value I composite will change the outcomes. Do not rely upon this estimate when making investment decisions. Individual account results will vary.** Source: Century Management and FactSet.

In addition to measuring the current value of our CM Value I composite, we have also measured the current value of the Dow Jones Industrial Average (DJIA). While we could have chosen a variety of indices, such as the S&P 500, for this exercise, we chose the DJIA as it only has 30 stocks that require in-depth review and bottom-up value based analysis. Furthermore, over the long-term, the DJIA tracks extremely well to the larger indices like the S&P 500. This analysis of the DJIA gives us a view of the market's overall valuation range, thus allowing us to compare these valuations to the stocks that meet our investment criteria.

Chart 57
Dow Jones Industrial Average Estimated Range of Prices for 2015

Fair Value P/E During:	P/E		Estimated 5-Year Earnings		Estimated 5-Year Price
Above Average Inflation (5% to 7%)	**9**	**x**	**1193.22**	**=**	**10,739.0**
	10	x	1193.22	=	11,932.2
	11	x	1193.22	=	13,125.4
Above Average Inflation (4% to 5%)	**11.2**	**x**	**1193.22**	**=**	**13,364.1**
	12	x	1193.22	=	14,318.6
	13	x	1193.22	=	15,511.9
	14	x	1193.22	=	16,705.1
Value Line® 42-Year Median P/E	**14.8**	**x**	**1193.22**	**=**	**17,659.7**
	15	x	1193.22	=	17,898.3
	16	x	1193.22	=	19,091.5
Low to Long-Term Average Inflation	**16.3**	**x**	**1193.22**	**=**	**19,449.5**
	17	x	1193.22	=	20,284.7
	18	x	1193.22	=	21,478.0
	19	x	1193.22	=	22,671.2
	20	x	1193.22	=	23,864.4

Chart 58
Dow Jones Industrial Average Estimated Range of Returns (Including Dividends)

				Returns if Estimated Earnings Growth Took:			
P/E	**Sept. 30, 2010 Price**	**Growing To**	**Estimated 5-Year Price**	**5 Years**	**6 Years**	**7 Years**	**8 Years**
9	10,788.1	to	10,739.0	2.21%	2.22%	2.23%	2.24%
10	10,788.1	to	11,932.2	4.34%	3.99%	3.75%	3.57%
11	10,788.1	to	13,125.4	6.30%	5.62%	5.14%	4.78%
11.2	**10,788.1**	**to**	**13,364.1**	**6.68%**	**5.93%**	**5.41%**	**5.01%**
12	10,788.1	to	14,318.6	8.13%	7.13%	6.43%	5.90%
13	10,788.1	to	15,511.9	9.83%	8.54%	7.63%	6.94%
14	10,788.1	to	16,705.1	11.44%	9.86%	8.75%	7.92%
14.8	**10,788.1**	**to**	**17,659.7**	**12.66%**	**10.86%**	**9.59%**	**8.65%**
15	10,788.1	to	17,898.3	12.96%	11.10%	9.80%	8.83%
16	10,788.1	to	19,091.5	14.39%	12.28%	10.80%	9.70%
16.3	**10,788.1**	**to**	**19,449.5**	**14.81%**	**12.62%**	**11.08%**	**9.95%**
17	10,788.1	to	20,284.7	15.76%	13.40%	11.74%	10.51%
18	10,788.1	to	21,478.0	17.07%	14.46%	12.64%	11.29%
19	10,788.1	to	22,671.2	18.31%	15.48%	13.49%	12.03%
20	10,788.1	to	23,864.4	19.51%	16.45%	14.31%	12.73%

This chart calculates the estimated annualized rate of return, including 2.3% in annualized dividends, for the Dow Jones Industrial Average (DJIA) over the next five years beginning September 30, 2010. To arrive at this price our CM analysts have analyzed each company in the DJIA and then calculated their earnings impact on a weighted basis. We also show what the return would be if our five-year earnings estimates took six, seven, or even as much as eight years to materialize given different P/E ratios. Returns are annualized and gross of all fees. **This estimate is not guaranteed. Any changes to the weightings or the inclusion or exclusion of stocks in the DJIA will change the outcomes. Do not rely upon this estimate when making investment decisions. Individual account results will vary**. Source: Century Management and FactSet.

Using the same fair value P/Es shown in the **low to long-term average** categories on **Chart 54 (page 65),** our five-year estimated annualized rate of return, including dividends, for the DJIA would be **14.81%**. However, if it took eight years for our earnings estimates to materialize, the total annualized return would be **9.95%**.

Comparing the potential five-year to eight-year returns of the CM Value I composite and the DJIA illustrates two key points. **First**, stocks bought at value prices suggest equity investors will be well rewarded over the next five years to eight years. **Second**, the stocks in the typical CM portfolio offer higher return potential than the DJIA.

These five- to eight-year estimated returns also compare favorably to bonds (see **Chart 52, page 63)**. Moreover, if inflation stays within a 1% to 4% range over the next five years, we are comfortable with our range of projections on **Charts 56** and **58**, as we have normalized today's interest rates to take this level of inflation into account.

What could go wrong with these scenarios?

Because inflation is at its lowest level in decades, we should assume that over time inflation will increase and return to its long-term historical average. Additionally, the Federal Reserve has greatly expanded our monetary base (shown on **Chart 35, page 41**) and has said they would like to see inflation and employment return to levels that are consistent with their mandate. In other words, looking out over the next five years, **inflation will likely be higher than it is today as the Fed continues to leverage its balance sheet. If the Federal Reserve does not reduce the monetary base significantly (withdraw liquidity), we could see much higher inflation. While we are not predicting it, if inflation does increase above 7%, we expect P/E multiples to decrease to the 6.5 to 8 range, thus lowering stock prices and returns.**

Over the past year-and-a-half, we have had a number of clients expressing concern over the risk of inflation. We responded to these concerns in our March 2009 and July 2009 *CM Value* Investor™ newsletters, as well as during our June 2010 video conversation review for clients, by outlining eight key indicators that show whether there is a risk of inflation, a risk of deflation, or if the indicators are neutral. At those junctures, our eight leading indicators showed there was a greater risk of deflation, not inflation. **Chart 59** shows our current summary of these eight inflation sign posts.

Today, the concern surrounding deflation is on the front page of the business section; and the Fed is stepping in and continuing its quantitative easing program (i.e. increasing the monetary base). While in the short run this could give the economy a boost, over the long run, if not handled properly, it could lead to higher rates of inflation (i.e. higher than the 1% to 3.5% low to long-term average inflation shown on **Chart 54**, **page 65**.)

Chart 59

Summary of Our Eight Inflation Sign Posts

	Changes In		CM Summary Conclusions
1	The value of the U.S. dollar		Risk is towards inflation
2	Bond yields		Neutral between inflation and deflation
3	The velocity of money		Risk is towards deflation
4	Capacity utilization		Risk is towards deflation
5	Protectionism		Neutral between inflation and deflation
6	Unemployment		Risk is towards deflation
7	Commodity prices		Risk is towards inflation
8	Real estate prices		Risk is towards deflation

In our July 2009 *CM Value* Investor™ newsletter, four of the eight categories were showing signs of deflation and four were neutral. As of November 2010, this summary is now showing two signs of inflation, two signs that are neutral, and four signs that are deflationary. Source: Century Management

For example, over the two-year period from February 1973 through February 1975, inflation increased from 2.76% to 11.68%. This was the primary contributor to one of our country's most painful and longest lasting recessions (16 months) occurring from November 1973 through March 1975. A second example is the two-year period from May 1978 through May 1980. Inflation increased from 6.77% to 13.28%. This dramatic rise led to a six-month recession from January 1980 through July 1980. Furthermore, because inflation stayed at these high levels (9.5% to 11.80%), one year later in July 1981, our economy went into another extremely deep recession. The recession lasted 16 months, finally ending in November 1982. It is no coincidence that as inflation began its dramatic decline from these highs, the stock, bond, and real estate markets dramatically rebounded. As a point of reference, o*ver the past 28 years, inflation has averaged 2.96%.*

Now if we had the confidence that our Fed would implement a tight monetary policy when necessary as the Bank of Japan accomplished (Charts 36 and 37 on page 42), we would not be as concerned about long-term inflation. Also, we would not have to worry about potentially needing to make adjustments to our P/Es and other ratios. It is not that the Fed will not seek to withdraw the money out of the system in a timely manner; rather it might not be politically acceptable or easy for them to do since there will likely be a lot of pressure to keep the foot on the gas when it should be applied to the brakes. ▫

An Aside:
Century Management started in 1974 during the bear market and deep recession that was taking place on the belief that stocks were discounting just about everything imaginable and, thus, were selling at extreme bargain prices. It is important to remember that while the stock market had been going down for the better part of six years and the economy was dealing with high inflation, high interest rates, high unemployment, low consumer confidence, as well as a host of other major concerns and worries, during the first 10 years of Century Management (1974 through 1984), our CM Value I composite had a ten-year, net of fees, annualized return of 19.51% versus 14.76% for the S&P 500 and 12.95% for the DJIA.

In other words, stocks in general were selling at such deep discounts to their intrinsic values they had priced in all the bad news and were able to increase in price even though the economy was still under tremendous pressure. Moreover, as an all-cap value investor, we were able to selectively build diversified portfolios of common stocks that on an individual basis were cheaper than the broader market indices. **Takeaway:** The lesson for investors is that even though the economy may not be in great shape, when stocks sell at deeply discounted prices relative to their intrinsic values, thus accounting for all the seemingly insoluble problems of the time, stocks should be bought aggressively.

Comparing 1965 through 1982 (17 Years) to 1999 through 2015 (16 Years)

The 1942 through 1968 bull market went largely uninterrupted, eventually ending for many of the same reasons as the last major bull market that ended in 2000. If we go back to 1965, just three years before the final peak in 1968, we can see that the broader market indices, as measured by the Dow Jones Industrial Average (DJIA) and the S&P 500 Index, moved sideways for the better part of the next 17 years (1965-1982). During this period there were multiple opportunities to buy stocks in the value zone only to sell into a higher priced market three to four years later. This period

was a great time to trade based on values. On the other hand, those who owned an index fund with the buy and hold forever outlook and did not pay attention to valuations had little to no returns by the end of this period.

The top portions of **Charts 60** and **61** show the DJIA and S&P 500 from 1965-1982. For roughly half of this sideways moving stock market, the economy was healing from the worst recession (1973-1974) since the Great Depression. In addition, this period included high unemployment, which peaked at a post-Depression high of 10.8%. Interest rates were as high as 15% and inflation rates reached 12%. It took many years to work out the excesses of the previous bull market.

Six years into this period the stock market made an extreme low in 1974. Investor sentiment was very pessimistic. After more than a decade of poor stock market performance, coupled with a continuation of troubling and difficult economic times, in 1979, BusinessWeek wrote its now infamous article entitled, **"The Death of Equities**" (see excepts from **"The Death of Equities"** on **page 75**). Although the stock market continued to have its ups and downs, it never went that low again. After reaching its final low in August 1982, both the DJIA and the S&P 500 entered into another bull market that produced annualized returns of 19% over the next 17.5 years (August 1982 through March 2000).

A similar situation appears to be unfolding today. The bottom portions of **Charts 60** and **61** show the DJIA and the S&P 500 from 1999 to present. We believe that in March 2009, the stock market made an extreme bottom, very much like it did in 1974. However, the pessimism in March 2009 was even greater than in 1974 (see **Chart 11**, **Consumer Confidence**, **page 15**). It is quite possible, just like 1974, that we may never again see the stock market reach the lows we saw in March 2009, as stocks were discounting the insoluble problems, including what seemed to be the end of the world. **As Warren Buffett said, "at some price you don't pay anything for the future, and you even discount the present."**

The economy, as a whole, has improved since the bottom of 2009; however, as we have mentioned throughout this letter, more work needs to be done. Over the next few years we believe the broader stock market indices will continue to go back and forth similar to 1965-1982 (see **Charts 60** and **61)**, but their overall trend should be higher. If we measure the beginning of this current market cycle from the end of 1999 and add another five years from today, it will be 2015, or 16 years, since the end of the last major bull market. If history repeats itself, and we believe it is quite possible as our economy should be much improved within the next five years, the stage should be set for the next bull market. □

Note, from 1974, the mid-point of the period shown on Charts 60 and 61, there were two major market corrections, two recessions, and two major buying opportunities before the market entered a sustain bull market that lasted 17 years.

"There will always be bull markets followed by bear markets followed by bull markets."

Sir John Templeton

Chart 60

Dow Jones Industrial Average 1965 through 1982 (Top) and 1999 through 2015 (Bottom)

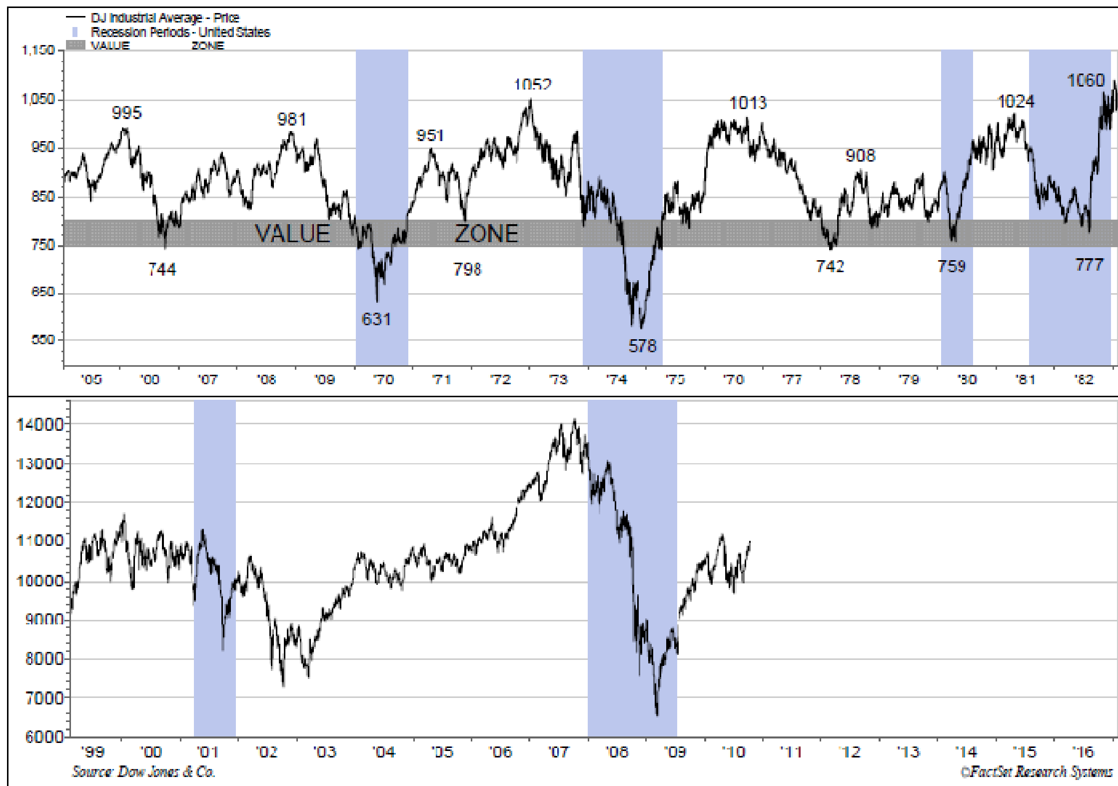


Chart 61

S&P 500 1965 through 1982 (Top) and 1999 through 2015 (Bottom)

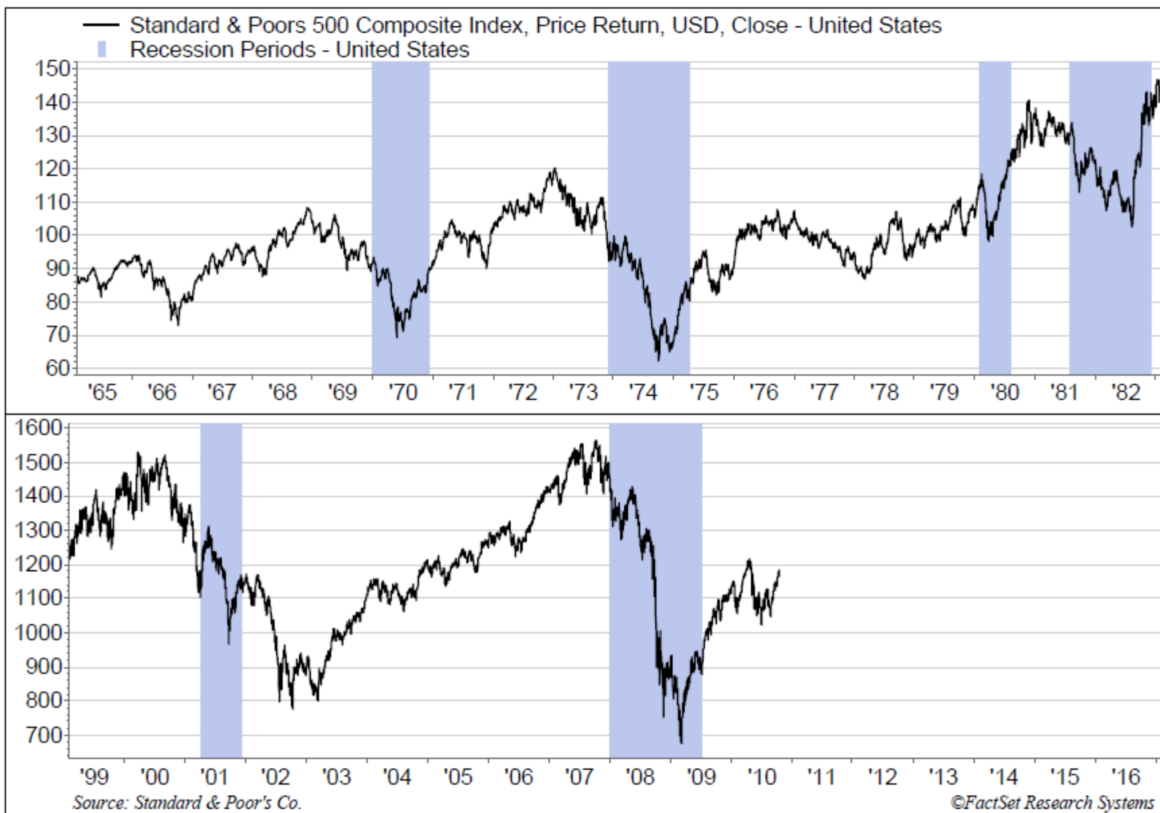


Chart 62

Excerpts From BusinessWeek "The Death of Equities" August 13, 1979

The following eight excerpts from the infamous August 13, 1979, BusinessWeek - Money and Banking- article "The Death of Equities"[17] ***sound a lot like the market sentiment we have had, and to a large extent still do have, regarding the stock market today.***

Excerpt 1:

"…Now the pension funds--the market's last hope--have won permission to quit stocks and bonds for real estate, futures, gold, and even diamonds. The death of equities looks like an almost permanent condition--reversible someday, but not soon."

Excerpt 2:

"At least 7 million shareholders have defected from the stock market since 1970, leaving equities more than ever the province of giant institutional investors. And now the institutions have been given the go-ahead to shift more of their money from stocks--and bonds—into other investments. If the institutions, who control the bulk of the nation's wealth, now withdraw billions from both the stock and bond markets, the implications for the U.S. economy could not be worse. Says Robert S. Salomon Jr., a general partner in Salomon Brothers,' We are running the risk of immobilizing a substantial portion of the world's wealth in someone's stamp collection.'"

Excerpt 3:

"Undeniably, the U.S. is in the midst of a fundamental shift—aided by government monetary and fiscal policies—away from investment in favor of immediate consumption. 'Savers are subsidizing borrowers, and debt has become more attractive than capital formation,' points out Coleman of SMU. Indeed, the Japanese on average save 25% of their disposable income. Americans, by contrast, save 6%."

Excerpt 4:

"Clearly, money market funds—most of which allow investors to write checks on their accounts—will prosper until interest rates begin to ease. But even when rates do fall, the money will not flow back into the stock market from which it came. Indeed, putting life back into the U.S. equity market will be a long and difficult process. Says David Silver, president of the Investment Company Institute: 'It would take a sustained bull market for a couple of years to attract broad based investor interest and restore confidence.'"

Excerpt 5:

"Undoubtedly, another reason for the surge of investment in foreign stocks is the negative attitude toward business in the U.S. 'The Japanese do everything they can to make their strongest and most competitive companies do well. Americans attack their largest and most successful companies,' says Andrew J. Hutchings, an equity manager for Royal Trust Co. in Toronto."

Excerpt 6:

"Gershon N. Mandelker, associate professor of business administration at the University of Pittsburgh contends that the current Administration is capitalizing on this anti-business sentiment.' People like to have villains, and Carter is blaming the oil companies for our economic problems.'"

Excerpt 7:

"'…we are all thinking shorter term than our fathers and our grandfathers,' says Manuel Alvarez de Toledo, of Shearson Loeb Rhoades Inc.'s Hong Kong office."

Excerpt 8:

"'Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared,' says a young U.S. executive, 'Have you been to an American stockholders' meeting lately? They're all old fogies. The stock market is just not where the action's at.'"

Conclusion

These challenging economic and market conditions have shaken the confidence of many investors. In an environment where the majority of economic news is bad, many investors have shortened their time frame when making investment decisions and continue to add to and maintain large amounts of their investable net worth in cash and bonds. Meanwhile the stock market has appreciated 70% from the bottom of 2009.

One of the hardest things for investors to understand is that the stock market does not always follow the pattern of the economy. It tends to discount bad news and uncertainties, sometimes to great extremes. The stock market is always forward-looking; it is a barometer, not a thermometer. In other words, the market tries to predict the future, rather than current conditions. For example, the stock market bottomed in March 2009, three months before the recession officially ended.

History teaches us that after a period of bad times, lessons are learned, adjustments are made, and eventually markets move back towards their long-term average returns and many times reach new heights. For example, over the past 60 years there have been 13 bear markets and recoveries. While the average bear market was relatively short-lived with an average duration of 13.2 months, the average expansion that followed lasted 39 months. **Investors who maintained their long-term focus and perspective have typically been well rewarded.**

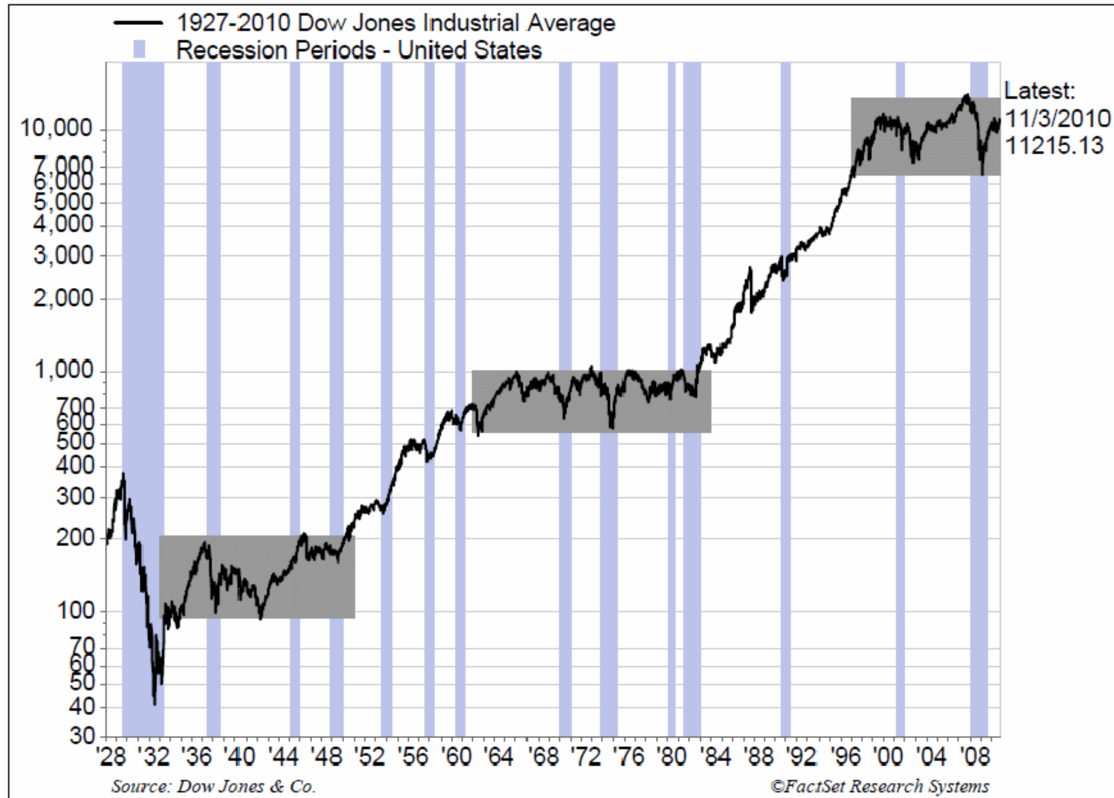
Chart 63 shows some of the major events that our country has faced over the last 100 years. Through the wars, the high inflation, a multitude of major political events, 13 recessions, a major depression, and every economic variable you can imagine, common stocks have proven to adjust and adapt, and over the long run, protect investors' capital better than any other asset class.

Chart 63

Major Events	
1914	World War I (1914-1918)
1929	Great Depression (1929-1932)
1939	World War II Begins in Europe (1939-1945)
1941	Pearl Harbor Attacked
1945	U.S. Government Debt to GDP was 112% (As of June 2010 it is 90%)
1950	Korean War Begins
1962	Cuban Missile Crisis
1963	President Kennedy Assassinated
1968	Vietnam War (1959-1975)
1973	Arab Oil Embargo-Oil Prices Go From $2 to $10 Per Barrel
1974	Major Bear Market in Stocks / Price Controls / President Nixon Resigns
1980	18% to 19% Federal Funds Rates
1981	16% to 18% 30-Year Mortgage Rates
1987	U.S. Stock Market Crash / Dow Drops 22.48% in One Day
1991	Gulf War Begins
2000	Beginning of Three Year Stock Market Decline / NASDAQ Eventually Declines 78%
2001	Terrorist Attack on World Trade Center (9/11) / Afghanistan War Begins
2003	Iraq War Begins
2008	Major Stock Market Decline / Credit Crisis / National Real Estate Decline
Plus 13 Recessions Since The Great Depression - Average Duration 11 Months	

Chart 64 shows the Dow Jones Industrial Average from 1927 through 2010. From a price of 197 back on September 30, 1927, through the closing price of 10,788 on September 30, 2010 (83 years), this index has had an annualized return of 9.76% (including dividends).

Chart 64
Dow Jones Industrial Average 1927 through 2010



Common stocks outperform over time because they are able to combine capital, assets, and human ingenuity to maximize returns. Within a free enterprise system, this combination results in the most productive investment of any asset class. We firmly believe that capitalism and a free enterprise system are the best solutions to our economic problems, not government's central planning.

Economist Milton Friedman said it best during an interview in 1979 regarding a free enterprise system, **"The world runs on individuals pursuing their separate interests. The great achievements of civilization have not come from government bureaus. Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way. In the only cases in which the masses have escaped grinding poverty, the only cases in recorded history, is where they have had capitalism and largely free trade. If you want to know where the masses are worse off, it is exactly in the kinds of societies that depart from that. The record of history is absolutely crystal clear, there is no alternative way so far discovered of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system… Is it really true that political self-interest is nobler somehow than economic self-interest? Where in the world will you find these angels who are going to organize society for us?"**

As we showed in our estimate of the CM Value I composite (see **Chart 56, page 68**), as well as for the Dow Jones Industrial Average (see **Chart 58, page 70**), stocks, while not at bargain-basement prices, are selling at price levels that we believe give them the potential for good returns over the next five years, especially when compared to other asset classes. These returns are not projected to go in a straight line as we fully expect that the stock market will continue to be volatile. In addition, we could experience another mild recession lasting two or three quarters, although nothing like the recession that just ended. By sticking to our value discipline, this market volatility should present us with the opportunity to buy stocks when they are selling at prices that discount insoluble problems, i.e. bargain prices, only to sell them at higher prices as their individual, industry, or greater macro economic problems are solved. When we cannot find bargains that meet our investment criteria, we will hold cash.

The U.S. household balance sheet on **Chart 30 (page 37)** shows the enormous wealth this country has created over the past 30 years with an average of 250 million people. Today, the U.S. is just 3.4% of the world's population with 310 million people. Consider the wealth that will be created in the coming years as China and India, a combined 36.8% of the world population, with 1.34 billion and 1.19 billion people respectively, begin to add a middle class. In addition, there are many other countries around the world enjoying the benefits of an improving economy, an increasing standard of living, and an improvement in their total net worth.

There is much work to be done to overcome the economic problems that we face today; however, with a little time these "insoluble" problems will work themselves out, just as they have done for the last 100 years. As we explained, we believe:

- Over the next two to three years, the majority of the residential real estate problems should be behind us.
- Over the next three to five years, consumer debt should be reduced closer to its long-term historical average.
- Consumers and corporations will likely continue to build their cash savings that eventually will be used to fuel the future economic growth of our economy.
- With enough pressure brought to bear by the American people, there is hope for pro-business regulations and tax policies from Washington, which in turn will help expand the labor force.
- With a pickup in the overall economy, unemployment levels should begin a significant decline over the next four to six years.
- We should see an increase in consumer confidence over the next five years.

As the country begins to overcome its economic challenges over this next five years, the pain will begin to fade, and the healing will begin. As this is taking place, the U.S. stock market will likely suffer some setbacks along the way, but the overall trend should be higher. Once we get beyond this five-year period, we believe the economic growth the world should experience will be very impressive. In addition, U.S. companies and their corresponding stocks are likely to be in another great bull market.

For those of you who believe you do not have a three to five year time horizon, stocks may not be appropriate for you. If you are going to need your money over the next year or two, cash or cash equivalents are your best investments. Period! However, if you do have enough cash and investments to afford a longer time horizon, we believe that maintaining a diversified portfolio of common stocks bought at discounts to their intrinsic values will serve you best. Successful investing and true long-term wealth accumulation requires keeping an eye on valuations, comparing values, and making investment decisions for the long run where time is on your side.

In closing, though very optimistic about the long run, we are fully aware of, and prepared to deal with, the economic challenges and uncertainties that we face in the short run. To help put these time frames into perspective, we would like to share with you a quote we have shared in the past. It is from the book **The Intelligent Investor** written by the late Benjamin Graham. Please keep in mind that the 57 years Mr. Graham wrote about included World War I, the Great Depression, World War II, the Korean War, the Vietnam War, 12 recessions, and many challenging political events. We hope this quote will mean as much to you as it has to us in making financial decisions in difficult markets.

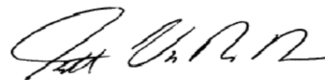
After reviewing his career, Benjamin Graham wrote in his book, The Intelligent Investor:

"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. (The stock market did not even suspect that a World War was to break out in two months, and close down the New York Stock Exchange.) Now, in 1972, we find ourselves the richest and most powerful country on earth, but beset by all sorts of major problems and more apprehensive than confident of the future. Yet if we confine our attention to 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."

From all of us at Century Management, we would like to thank each of you for your continued trust and confidence. If you have any questions regarding the contents of this letter or your account, please give us a call at 1-800-664-4888 or 512-329-0050.

Sincerely,

Arnold Van Den Berg, President
CM Board Member



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"To no force in the universe belongs such power as minds united in one purpose."

~ Prentice Mulford

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