"Americans are not a perfect people, but we are called to a perfect mission."
- Andrew Jackson

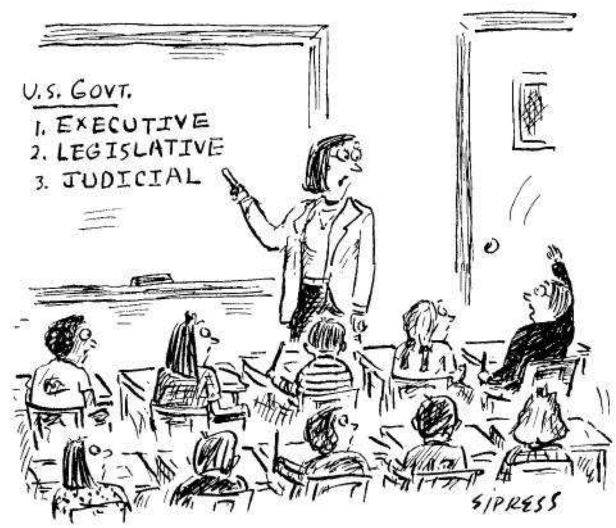
February 11, 2011

After a strong 2009, fear gripped investors in the first half of 2010. A 'Flash Crash' on May 6th punctuated worries about a European debt crisis and a possible double-dip recession that resulted in the biggest intraday point decline (998.5 points) in Dow Jones Industrial history. At mid-year, Barron's magazine proclaimed "Fear Makes a Comeback" as double-digit unemployment, volatile interest rates, and spiking bearish sentiment drove worldwide markets into negative territory.

Despite the fear, we remained invested in stocks. A quick poker lesson will help describe what drove our asset allocation approach in 2010.

In poker, when a player holds the "nuts," he has an unbeatable, unbreakable hand. Once a player is dealt a "nut hand," he is unafraid to raise the stakes because there is no chance of losing.

We did not quite have a "nut hand" in 2010, but the Federal Reserve provided a "tell" that they were giving us cards that would likely beat all of the problems around the table. Fed Chairman Bernanke told anyone who would listen that the purpose of Fed policy in 2010 was to push asset prices higher.



"What about business—which branch is that?"

If the economy did well, than stock prices would likely benefit. If the economy did poorly, the Fed would aggressively stimulate the economy to lift stocks. So not only did we possess a margin of safety in the securities we knew and understood, but we had a catalyst to move things in the right direction.

With short-term interest rates already close to zero and concern that the economy was not growing fast enough, in August 2010, the Fed decided to initiate a second round of quantitative easing (dubbed QE2) by buying $30 billion Treasury notes a month.

To further stimulate the economy, in November 2010, the Fed announced it would increase its program by buying $600 billion of Treasuries by the end of the second quarter of 2011. This was an extremely aggressive move, considering the entire Fed balance sheet was only $869 billion as recently as August 2007.

In a surprise move, Congress and the Obama Administration provided fiscal stimulus in December when they authorized an $801 billion tax cut and $57 billion in additional unemployment benefits. The bill extended Bush tax cuts for two years and provided a one-year payroll tax cut for most American workers.

The combination of monetary and fiscal stimulus produced its desired effect as U.S. equities finished the year on a positive note capped by a +6.5% December rally that marked the best December advance since 1991.

SOMEWHERE OVER THE RAINBOW

"It is said that the present is pregnant with the future."
- Voltaire

The market momentum at the end of 2010 has carried into 2011. Corporate earnings have been excellent, and we suspect the S&P 500 earnings will set a record of as much as $94/share in 2011. Valuations on an absolute basis as measured by 2011 cash flow, book value, payout ratios, and earnings yields appear to point to neither an extremely overvalued nor particularly cheap U.S. market.

What does it all mean? Our strategy for 2011 is strictly bottom-up. Our experience shows that good things are more likely to happen than not if you understand a few things with a high degree of certainty and conviction and apply this knowledge with confidence. This philosophy, which we have utilized for the last twenty years, works well for our wiring.

As we write to you in early February, we continue to hold a reasonable number of undervalued businesses. We are investing in bigger companies, while still seeking out appropriate hedges from time-to-time.

The biggest difference your Advisor sees in 2011 vs. 2010 is an ultimate need for the Federal Reserve to take its foot off the liquidity accelerator as inflation begins to inject itself into the engine of the economy. The positive takeaway here is that inflation should be the byproduct of a much stronger economy. The negative is that…. it's inflation. As President Ronald Reagan once observed (and someone else likely wrote for him), "Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man." Look no further than the unrest in the Middle East to see what happens when the prices of core consumer staples like food rise faster than income growth.

For the time being, Chairman Bernanke is willing to err on the side of the lesser of two evils, accepting some inflation to combat deflation. Publically he does not lack confidence in his ability to manage the issue. In an interview with 60 Minutes, Bernanke said that he is "100% confident" that he can act quickly enough to keep prices from rising rapidly. But coming from the same person who once estimated that the cost of sub-prime loans would be $100 billion (he was off by a factor of ten), forgive us if our enthusiasm is tempered.

A STOPPED CLOCK IS SUPPOSED TO BE RIGHT TWICE A DAY

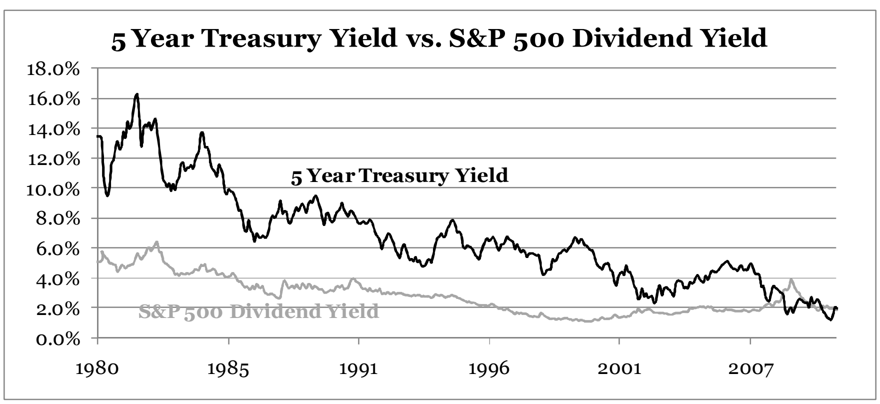
"Clarity is the counterbalance of profound thoughts."
- Marquis De Vauvenargues

Inflation is difficult to predict, and politically tricky to control. To protect client portfolios from inflation, we want to own businesses with liquidity, purchasing power, and the ability to raise prices to protect profitability.

This has drawn us to invest in large companies where we are seeing compelling values. There are several reasons why your Advisor is enthusiastic about some of the world's largest multinational companies.

In the aggregate, large capitalization businesses:

- Provide a credible hedge against future inflation given their pricing power and superior bargaining leverage with suppliers.
- Have strong competitive advantages, proven products, and brand names.
- Offer participation in the global economy.
- Are benefiting from tremendous operating leverage. Many have refinanced in this low interest rate environment, and have engaged in cost cuts that have yielded greater efficiencies.
- Have cash-rich balance sheets.
- Possess dividend yields that exceed the five-year Treasury note. When viewed historically, this is an extremely rare occurrence.



Above all, we believe that large-cap companies have inexpensive valuations on an absolute and relative basis. Over the past decade, large-cap stocks have dramatically underperformed small- and mid-cap stocks. According to Birinyi Associates, a stock market research firm, the Russell 2000, an index of small cap companies, is trading at a forward Price/Earnings ratio of 27.3. This compares to a P/E ratio of 13.5 for the S&P 500 Index, which we use here as a proxy for large cap companies. Over the last sixty years, the S&P 500 on average traded at a P/E of 15.

MINING FOR A MARGIN OF SAFETY

In addition to large capitalization businesses, we also believe companies that own real assets (real estate, commodities, etc) and those run by superior and nimble allocators of their firm's capital will benefit from the macro economic backdrop over the next several years.

Over the years, we have purchased the equity and debt of Leucadia (LUK). A quick overview of the company should provide insight into the types of businesses we like.

LUK is run by Ian Cumming and Joseph Steinberg, two managers who own 19% of the business and have compounded capital at a rate of 21.4% annually for shareholders since 1979. The company operates in a variety of industries including financial services, mining, manufacturing, real estate, and telecom.

Leucadia uses extremely conservative accounting. For example, Leucadia purchased a revenue-based note from an Australian company named Fortescue and values this note at $35 million on their balance sheet based on its original cost. Fortescue, on the other hand, values this note as an $825 million liability based on the future value of the note.

Even after three decades of stellar performance, there are no major Wall Street firms that follow Leucadia. Thus, the company is not well understood by most equity and bond investors.

For example, the bond rating agencies have assigned Leucadia a below investment-grade rating. In our opinion, LUK is more credit-worthy than the U.S. Government on most days (if only they could just print money)! In July of 2009, Leucadia sold one of its businesses, AmeriCredit for $830mm in cash. These proceeds, when added to the company's balance sheet, more than covered the company's modest amount of debt. The rating agencies, however, did not recognize this fact (they still have not figured it out). A result, we aggressively purchased as much LUK debt as we could get during this period and were able to lock in a higher rate of interest than would have otherwise been possible.

Our ability to invest meaningfully in Leucadia's bonds is possible because our size allows us to be nimble. LUK only has about $2 billion of debt outstanding. Large mutual funds like PIMCO Total Return Fund with over $237 billion in assets are unable to benefit from ideas like this.

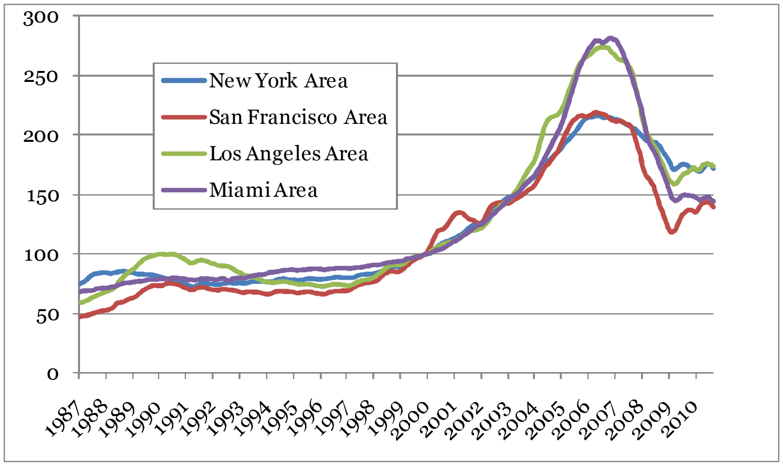
Any investment discussion is incomplete without an evaluation of the risks. Leucadia's two main businesses are in commodities and financial services. Negative developments in these industries or to Leucadia's underlying businesses could hurt the company's stock or bond prices. Furthermore, Cumming and Steinberg have contracts that expire in a few years. Will they continue? We feel the value in the company's capital structure clearly outweighs the risks.

Leucadia has its annual meeting the second week of May in NYC. Let us know if you would like to join us for the meeting.

Money Pit or Money Maker?

For most Americans, their home is their largest asset. Hence, we offer a few words (and pictures) on the topic:

Case-Shiller Prices by Metro Area

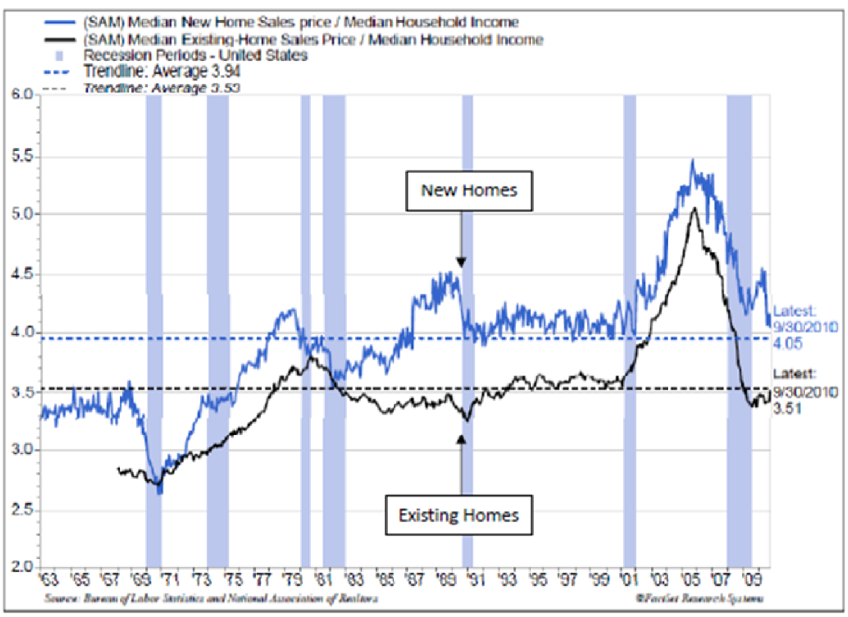


Note: The Case Shiller is calculated based on data from repeat sales of homes and is normalized to have a value of 100 in the year 2000.

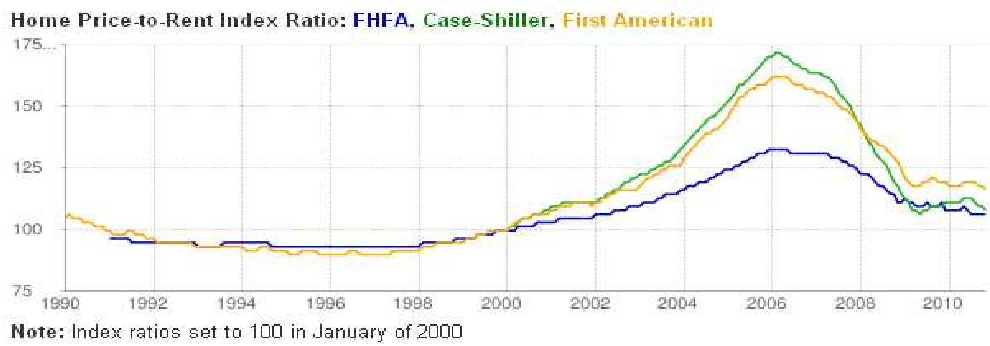
As the Case-Shiller chart above highlights, housing prices have receded to 2002 levels. While the drop in home prices over the past three years certainly hurt homeowners, two of the most commonly-used metrics to evaluate prices suggest that homes are now reasonably priced.

When measured by median incomes, median home prices are now within the range of fair value. Throw in historically low mortgage rates (30 year fixed rate under 5%) and the cost of owning a home is downright cheap in many areas.

Median Home Price to Median Income



Furthermore, price-to-rent ratios have reverted back to their historical trendline. The lower the price-rent ratio, the more attractive it is to buy a house and perhaps use it as a rental property. Stocks have PE ratios and real estate has a PR ratio.



In short, we think real estate in aggregate is reasonably valued given current interest rates. If you are on the fence (no pun intended) about home ownership, the current environment is no longer flashing red to buyers.

UPDATES

With our firm's growth, your Advisor found it advantageous to begin a new custodial relationship with TD Ameritrade. Our new relationship with TD has already led Schwab to reduce a number of fees for our clients. If you are interested in learning more, we are happy to review with you the value proposition of each of the respective firms.

In addition to our client letter, your 2010 annual report provides relevant information to assess your capital allocation program, tax data, and our form ADV II.

We are considering an electronic delivery of our client reports. They would get to you faster, kill fewer trees, and provide the type of convenience you have become accustomed to from other providers. If you have a strong opinion either way we would like to hear it.

TAXES

A few comments on taxes in 2011:

- The Federal exemption for your estate is now $5 million per spouse if titled correctly and the maximum Federal rate is 35%.
- Brokers in addition to reporting sales proceeds will now also report cost basis to the IRS.
- The annual gift tax exclusion remains at $13,000 for an individual and $26,000 for a married couple per recipient.
- IRA contribution limits remain at $5,000 ($6,000 if you are over 50)
- The 401(k) contribution limits remain at $16,500 ($22,000 if you are over 50)
- If you have not already done so, please contact us to conduct a cost-benefit analysis of converting your Traditional IRA to a Roth IRA.

CONCLUSION

Two thousand eleven marks our 20th year as Investment Advisors. This journey has been made possible by our client families whose lives are intertwined with us every moment of every day. We value your trust, and never take it for granted.

Stephen and his wife Joyce started the year with a bang. Zachary Shueh was born on January 5th. Their two older kids Grant and Audrey are very excited about their younger brother. Steve and Joyce are just waiting for him to sleep through the night.

Coincidentally, Howard's first child Ariella was born on January 5th seventeen years earlier. While Joyce was in labor, Ella was getting her driver's license, a symbolic and real sign of independence (another chauffeur for Howard's two other children) and some relief for Nancy.

George has a very special birthday coming up this year. Don't forget to remind him. Andrew and his wife Bonnie recently bought a house a few miles from the office (We tried to get him to live in his office but Bonnie didn't like the idea). Janet continues to take all comers on the tennis court. Janice is quite the Renaissance woman. Not only does she keep everything humming in our office, but she continues to quilt with the best of them.

We look forward to speaking with all of you in 2011, and wish you and your family the best for a healthy and successful year.

Very truly yours,

Howard Alter Stephen Shueh

George Andresen Janet Chen Andrew Lieu Janice Puccio