

RCB Manager Commentary  
April 1, 2009

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The first quarter of 2009 was another tough period in financial markets, although it truly hewed to seasonal metaphors by coming in like a lion and out like a lamb.

What is making life so difficult and volatile in the financial markets is the seismic intersection of political and economic dynamics in today's world. The economy is in lousy shape and is likely to look worse in the short run, as we are still in the middle of running through a vicious inventory cycle that is overlaying a core softness. Believe it or not, that's the good news. Inventory corrections tend to play out over a few quarters, thus potentially setting up a "stronger" second half of 2009, admittedly a low hurdle. But since we adhere to the statement that "good things happen to cheap stocks," we don't need much good news for a resumption of market stability or dare we suggest, a sustainable advance.

The overhang on this perfectly rational set of events is the size and breadth of our government's interest in the economy. Frank Kent, a political columnist for The Baltimore Sun, observed, "One project follows another so rapidly that they baffle the hardest mind... The whole business has become fantastic. The activities are on so many fronts, the experiment so numerous, varied and vast that confusion reigns and many on the inside are as perplexed as those looking on." Mr. Kent's observations were printed in a 1934 edition of The Sun.

This has complicated affairs in the short run. There is NO doubt in our minds that buying real businesses with durable economic models at reasonable to absurd discounts to intrinsic value (or asset values) has not changed as a rational and profitable course of action for investors with a long time horizon. Many of the issues facing the global economy are cyclical in nature and inexpensive valuations created by cyclical challenges have created eminently buyable opportunities. In the short run, it is easy to be swayed off a course that has proven durably profitable and focus on headlines and grand statements. Prudent investing is quiet, focused and requires reflection and consistency, traits which are diametrically the opposite of what passes for discourse in the political arena.

Our challenge remains balancing intermediate term political risks with a universe of compelling values and not be scared off prudent decisions as it is highly likely the market is overpricing risk today as surely as it under-priced risk 18 months ago. In our Large Cap Value strategy we have sold Cigna and IMS Health, whose valuations and prospects do not compensate for political risks while adding Cisco, Total SA, and Yahoo! where we believe the risk/reward, regardless of the environment, is compelling. In our Small Cap Value strategy we added Autoliv believing the company has both the balance sheet and secular product set in auto safety products to ensure not only survival but also respectable prosperity in the inevitable recovery of auto unit sales globally. We have not abandoned poor performing stocks whose business prospects and valuations have not changed anywhere remotely like the price of their stock and added to our existing positions in both strategies. We continue to allocate to quality companies as a sensible hedge against a raft of uncertainties.

As for positive signs of life, we note that asset class returns are beginning to diverge and on a modest scale, equity sectors are showing distinctive returns. In other words, some investors are



differentiating between stocks, countries and asset classes versus being dominated by central cortex fear factors.

Regardless of political issues, it is likely that current spending levels on top of the previously noted inventory cycle correction will prove to be sufficient to restore the economy to at least a standstill in the second quarter. The recent market rally in stocks suggests that many stocks are discounting Woody Allen's cheery variant of life: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly." Now those are words to rally around.

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