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When the dust settled on one of the most eventful and upended years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the S&P 500 Index, gained 6.04% in the final quarter, and finished 2009 with a 26.46% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar.

On the fixed-income side, returns varied widely in 2009. The iShares Barclays 7-10 Year Treasury ETF was down 6.4%, the Barclays US Aggregate Bond Index was up 5.93%, and the Barclays Municipals Index was up 12.91%. High-yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, instead crushed all, with Merrill Lynch U.S. High-Yield Index gaining 57.51% for the year.

Index Returns *Through 12/31/2009*

			Annualized Returns		
Index	Quarter-To-Date	YTD	2-Year	3-Year	5-Year
S&P 500	6.04%	26.46%	-10.74%	-5.63%	0.41%
Russell 1000	6.07%	28.43%	-10.48%	-5.36%	0.79%
Russell 2000	3.87%	27.17%	-8.24%	-6.07%	0.51%
MSCI EAFE	2.18%	31.78%	-13.62%	-6.04%	3.54%
Barclay Capital US Aggregate Bond	0.20%	5.93%	5.59%	6.04%	4.97%
Barclay Capital Municipals	-0.95%	12.91%	4.94%	4.41%	4.32%
Dow Jones AIG Commodity	9.03%	18.91%	-12.53%	-3.83%	1.96%
CSFB/Tremont Hedge Fund	3.13%	18.57%	-2.04%	2.60%	5.76%

Heading overseas, the story was emerging markets. Both equity and debt of emerging-markets countries left their developed-market counterparts in their dust. The MSCI Emerging Markets index tacked on 8.55% in the fourth quarter to bring its full-year gain to 78.51%, versus a gain for the predominately developed market MSCI EAFE index of 2.18% for the quarter and a still impressive 31.78% for the year.

We are currently cautious and are underweighted to equities based on our generally conservative bias. If we continue to see strong gains and risk taking, we would expect our portfolios to at least temporarily underperform. That said, we are pleased to report that our clients' portfolios benefited from the tactical allocation shifts which were made in the past year. The reasons are the strong gains of our tactical positions in both high-grade and high-yield bonds and in emerging-markets equities combined with strong overall showings from both our active fixed-income and equity managers.

As we'll note below, we aren't overly enthusiastic about the multiyear return potential from either stocks or bonds at current valuations, but are optimistic that periodic dysfunction in the markets will allow our managers to continue to find opportunities as well as allow us to take advantage of tactical opportunities. The incremental value of these opportunities may be much lower than it was this past year, where absolute returns were unusually high, but in a low-return environment they can make a material difference.

We've enjoyed strong absolute and relative returns this year after a difficult 2008.

We continue to believe that we are in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the buildup of our public (government) debt.

The key to the stock market valuation is earnings. Strong earnings should equal strong returns. With the headwinds that exist this scenario is very uncertain. As such, we continue to maintain significant diversification across cash, bonds, alternatives, and stocks.

Our goal is to wait patiently and then act when we see investment opportunities, which we believe can materially raise portfolio returns over our five-year investment horizon.

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As we look ahead over the next several years, we continue to believe that the weight of the evidence makes a strong case for a tough road for the economy and the financial markets, despite the beginnings of an economic recovery -- which at this point have been mostly government supported.

Debt, Debt, and More Debt

We continue to believe that we are in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the acceleration of the buildup of our public (government) debt.

Household Debt: Households have hit a debt wall and are in the process of deleveraging. Despite the huge government stimulus, this process is not close to being over.

Consumer Spending Headwinds: Because consumer spending is 70% of the economy it is hugely important to overall economic growth. The desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it very likely that consumption growth will be sub par compared to what we've been used to.

U.S. Government Debt Explosion: The U.S. Government's actions in aggregate probably saved us from a 1930s-type depression. However, the resulting leap in the government deficit comes at a terrible time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the U.S. faces extremely challenging times in the coming years.

As debt continues to grow, at some point it will become difficult to get investors to lend to a fiscally challenged U.S. in the amounts needed without paying a significantly higher interest rate. Though some increase in borrowing costs is likely soon, the risk of a sharp increase in rates is not imminent if the recovery is sub par (as seems very likely). But looking out over the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and spending will have to decrease. If this doesn't happen in a significant way, and maybe even if it does, there is a great risk of both a dollar and an interest-rate crisis that could be extremely painful for the U.S. and global economies.

There are still many variables in play that relate to these concerns, including a slower than anticipated recovery for the labor market; the wave of upcoming foreclosures and continued high unemployment; small businesses suffering from weak demand and a larger decline in profits than bigger firms; states and municipalities suffering from the steepest decline in tax revenue on record; and loan delinquency rates continuing to increase.

Given the challenges, there is risk of policy mistakes as the Fed and the Treasury attempt to maneuver through the next few years. Unwinding of the stimulus at the right time and in the right way will be one of the big challenges. At what point the economy can stand on its own remains an open question, not just in the United States but in most of Europe and Japan as well.

There are some positives, however. This is the largest global stimulus ever to occur in peace time. Strong emerging-markets economies are feeding back into the global economy, which is a positive for exports and manufacturing. Corporate balance sheets, outside of financials, are in good shape with the best liquidity in 50 years. Inventories are low and a rebuilding cycle is beginning, which will support growth. And, the severity of the economic contraction and cor-

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-porate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring (not likely in our view).

We don't dismiss the positives as they explain why some recovery is likely to be sustained. However, we continue to believe that the weight of the evidence makes a strong case for a sustainable but sub par economic recovery, with a risk of falling back into recession at some point in the next two years as the stimulus is unwound.

Return Expectations

With the run-up in prices of global equities, we believe stocks are at or near their appropriate valuations based on history, and may be overvalued if the sub par growth we expect becomes reality. A lot of stock valuations will depend on whether growth will continue throughout 2010 and thereafter and whether earnings can sustain themselves without the government stimulus. Corporate and high-yield bonds are not overvalued but they are no longer cheap. U.S. government bonds are priced to deliver poor returns over five years, barring a severe deflationary world. With historically low dividend yields of less than 4%, REITs are also overvalued. In short, no asset class appears priced to generate fabulous returns—though some asset classes will do better than others and there are specific investments that look somewhat attractive. Only in our most optimistic scenario are the expected returns for equities into double digits. We put a low probability on this optimistic scenario playing out. In most other scenarios, mainstream asset-class returns are in the single digits.

Bad Odds and Not Much of a Payoff

Investing requires one to make decisions with incomplete information and therefore uncertain outcomes. For this reason we believe we must have an understanding of the odds and the payoffs. In some respect, we play oddsmaker and must understand the upside we gain in exchange for taking risk. Ultimately we want the odds heavily in favor of the decisions we make. But having the odds in our favor does not mean that we will be right immediately or even at all, especially in the short run. But over the long run our discipline, which implicitly requires us to be willing to be wrong in the short run, has added value by putting us in a position to be right far more than we have been wrong.

Given the risks we see, coupled with the return outlook in most scenarios we've considered, we must conclude that we do not like the odds nor are we tempted by the potential rewards for taking risk. Risk reduction seems the prudent course of action and that is the decision we have made across all accounts. That leaves our overall equity exposure now below our neutral weighting and our overall risk exposure further reduced in all portfolios. We continue to maintain equity exposure 1) in case we are wrong and something akin to our optimistic scenario plays out; and 2) because we believe that over time our active managers will add value over the broad market indexes and get us closer to acceptable returns. We have already reduced our high-grade and high-yield bond exposures after benefiting from its huge run-up as credit spreads had continued to tighten throughout 2009.

Getting Paid to Wait

Looking forward over the next five years we believe higher returns can be captured by patiently waiting for compelling opportunities and then making aggressive tactical moves when they appear. Especially in a low-return world, this source of added return could be quite material.

We seek to do well when judged over the entire race, not just any particular mile. We're investing with that in mind, and as always appreciate your confidence and trust.

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