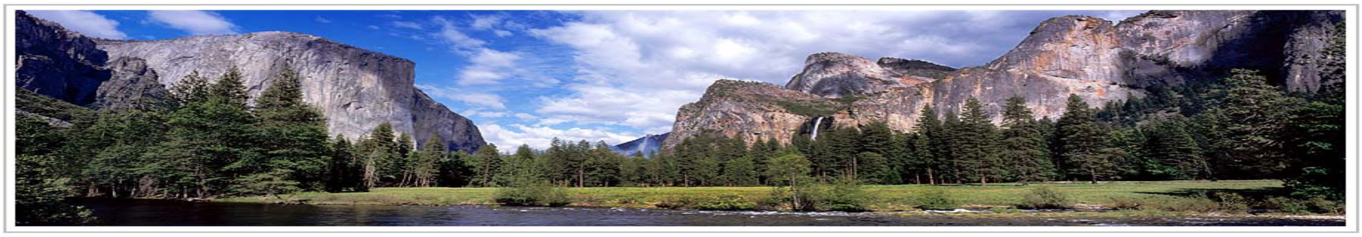

YOSEMITE CAPITAL MANAGEMENT

Fourth Quarter 2010 – COMMENTARY

We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie [Munger] and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children. -- Warren Buffett, 1992 Letter to Shareholders

Isn't it strange? The same people who laugh at gypsy fortune tellers take economists seriously. -- Anonymous

The end of a year is a common time for many to make predictions for the next year. However, making annual guesses about the financial markets should only be made for fun because, as history demonstrates, anything can happen in one year. Furthermore, investing should never be done based on specific forecasts nor be considered in the context of a very short time frame of only one year. Investors need to act on a plan that is meant for the long term, such as ten years. So given that we are about to conclude the first decade of the 21st century, we thought it appropriate to turn our minds to the next decade.

But let's start with what is happening in the world right now:

North Korea recently shelled an island in South Korea and is threatening military action

Iran is working to obtain nuclear weapons

Pakistan is a potential powder keg

American troops are still fighting insurgents in Afghanistan and Iraq

Terrorism remains a huge threat

Ireland was just given a bailout by the European Union and the International Monetary Fund (following Greece last spring)

Portugal is experiencing a financial crisis

Spain's economy (larger than Portugal, Ireland and Greece combined) is in dire straits and may be next on the bailout parade

Even Belgium is not immune from needing assistance

The American economy is struggling to gain traction

Some of the largest American banks are zombies that remain too large and unstable with incompetent and unprosecuted executives still in place as their companies owe billions of dollars from bailouts to the U.S. government

High numbers of foreclosures in many parts of the United States are among several reasons why prices of residential real estate remain at risk of continuing to fall

Unemployment rates are stuck at unacceptably high levels and there is no apparent catalyst to increase employment rates any time soon

The Federal Reserve is feverishly trying to reflate the economy and prevent a deflationary spiral

Many believe high inflation will eventually be a severe after-effect of all the bailouts and central bank actions

Given that list (which is by no means a complete set of woes), consider the following sets of predictions for the next ten years.

A. There will be global warfare and tens of millions of people will die (millions under horrific circumstances), a major American military installation will be attacked without warning and practically destroyed, the American way of life will seem in jeopardy of being lost, the U.S. government will ration many common household items, inflation will increase noticeably and will peak at 18%, the economies of other major economic powers will be decimated as a result of the war, China will fall into several years of civil war and ultimately officially declare the United States as the biggest threat to its national security

B. The world will face a constant threat of nuclear war as development of such weapons occurs around the world, the U.S. will be at war against a Chinese ally, there will be two economic recessions, other countries will be dependent on large amounts of American aid to rebuild their economies that were ruined from events in the prior decade

C. The world will have at least one episode of being on the very brink of nuclear war, inflation will increase dramatically in the second half of the decade and will stay elevated for years to come, the U.S. President and at least two other major political figures will be assassinated, the U.S. will engage in a major war in a foreign land, there will be domestic civil unrest and riots related to this war and other government policies that will have some Americans calling for nothing less than revolution, at least one radical group advocating revolution against the U.S. government will begin a multi-year campaign of bombing government buildings (including the U.S. Capitol, the Pentagon, and the State Department) and banks

D. Inflation will run rampant (including three years of double digit increases), interest rates will soar, unemployment rates will stagnate in the high single digits for almost three years, there will be two recessions (one of which will eclipse previous post-WWII recessions and be considered the worst since the Great Depression), at one point the S&P 500 will lose almost half its market value, the U.S. government will bail out at least two major American industrial companies, a revolution will lead to the overthrow of the government of a major political ally in the middle east by a radical fundamental religious group, energy prices will soar and there will be gasoline shortages in the U.S., the president will be engulfed in scandal and congress will draw up articles of impeachment, another U.S. president will have his presidency considered a failure by many in his own party

E. There will be a double-dip recession and unemployment will rise to the highest rate since the Great Depression, stock markets around the world will crash and the S&P 500 will plummet by more than 20% in just one day on its way to ultimately losing more than 1/3 of its market value, the largest bank failure in the history of the United States will occur, the U.S. government will sign an agreement with other world economic powers to purposely devalue the dollar by more than 40% against other major currencies in an attempt to stimulate the economy, budget deficits will soar to record highs, trade deficits will soar to record highs, a series of terrorist bombings of US embassies and kidnappings will take place, the president will be engulfed in scandal

F. The dictator of a major oil-producing country will amass a huge army and invade its neighbor for more oil resources, the United States will go to war against one of the world's largest standing military forces, a major terrorist attack will occur on American soil, another terrorist attack in a major American city will occur, there will be several terrorist bombings at foreign U.S. military installations, the Fed will raise rates over the course of a year to prevent inflation and in the process will cause what some financial publications will report as "the worst bond market loss in history", high foreign debt levels will cause one country's currency to collapse which will in turn trigger a domino effect on other countries in the region and raise fears of a global meltdown due to financial contagion, derivatives will cause at least one local government to declare bankruptcy, the president will attempt to nationalize the American health care system, the president will be engulfed in scandal and congress will draw up articles of impeachment

G. Technology will advance rapidly to facilitate better home entertainment and easier/safer/cleaner jobs, residential real estate prices will recover and advance well beyond the prior recession lows, more Americans will own their own homes than ever before, inflation and interest rates will approach record lows, unemployment will be mostly below 6% and at one point will fall below 5%, the S&P 500 will have at least two years of annual returns greater than 26%

Wow! Very gruesome, except for Example G (we had to throw in at least one positive possibility).

But if we believe that any one of Examples A through F would occur with reasonable certainty, wouldn't these lead to investment losses and make a mockery of investing in financial securities? Wouldn't it be better to let at least some of today's problems resolve themselves and wait for a good news situation as described by Example G?

Regardless, which set of predictions do we believe is most likely to happen? And given that, how should investment portfolios be positioned and why?

Perhaps you know by now that ***these are not predictions at all, but instead are reviews of actual events during decades since the 1940's***.

Here are the following average annual returns for each of those examples:

Example	Decade	Lg. Co. Stocks	Intermed. Term Gov't Bonds
A	1941-1950	13.4%	1.6%
B	1951-1960	16.2%	2.4%
C	1961-1970	8.2%	3.9%
D	1971-1980	8.4%	5.7%
E	1981-1990	13.9%	12.5%
F	1991-2000	17.5%	7.5%
G	2001-2010	1.2% (est.)	5% (est.)

(Sources: Ibbotson Stocks, Bonds, Bills, and Inflation Yearbook, Tables C-1 and C-5 for Examples A through F; YCM Estimate through mid-December for Example G)

Anyone who chose to hide and avoid investing in order to prevent definite bad events (Examples A through F) from impacting their assets would have missed out on mostly good returns. And waiting for only good news before investing (Example G) would have caused a lot of grief.

There are many lessons for investors from this exercise, among them:

ANYTHING CAN HAPPEN. Uncertainty is ever-present and even terrible things can occur. It's a risky world -- always has been, always will be – and many things simply cannot be forecast with a high degree of certainty. Bad news, circumstances, possibilities are ALWAYS present (and frequently reported by the news media). But good things can occur too. Good news, circumstances, and possibilities are ALWAYS present (though frequently ignored by the news media).

BEING HOPEFUL HAS HISTORICALLY PAID OFF FOR AMERICANS. Living in constant fear has proven costly. We are so fortunate to be living in this time and place because the history of the United States is one of improving fortunes over the course of time in spite of severe disruptions. We have been through wars, terrorist attacks, assassinations, riots and other social upheaval, recessions, high inflation, high unemployment, stagflation, deprivations, financial crises, scandals, political turmoil, Republicans, Democrats, and disco, yet we grew stronger and better (though still far from perfect). This does not suggest being blindly optimistic (remember "Irrational Exuberance") nor ignore the need to address some serious problems, and it remains wise to prepare for negative possibilities. But one should not focus solely on the negative or let the emotions of fear distract us from living our lives to the fullest.

CYCLES HAPPEN. Good times and bad times don't go on forever. Human beings have a natural tendency to expect that recent events will continue into the future for a very long time. In behavioral finance these are called "extrapolation errors". But excesses either way eventually lead to a turn. Markets will go down. Markets will go up. That is simply the nature of the beast.

"BAD NEWS" DOES NOT NECESSARILY LEAD TO MARKET DECLINES, NOR DOES "GOOD NEWS" NECESSARILY LEAD TO MARKET ADVANCES. Our list of examples above was cherry-picked to demonstrate this point specifically, especially given the plethora of today's "bad news" and incessant screams of imminent economic calamity from some quarters. The financial markets have a way of factoring in at least some future events before they become apparent. When the worst outcome is fully reflected in the markets, by definition things get better. Thus the best returns come out of the depths of crises. One of the best examples may be from the very bleak days of 1942, when unemployment from the Great Depression was still high, the attack on Pearl Harbor had pushed the United States into World War II, both the Empire of Japan and Nazi Germany were easily conquering their neighbors, and hope was difficult to come by. Once the nadir of pessimism was reached that year, the American stock market began a mega-bull that lasted until 1966. Similarly, when the best outcome is fully reflected in the markets, by definition things get worse. An excellent example is from 1999 when good feelings about technology changing the world for the better were rampant, unemployment was low, and inflation was very low. Once the zenith of optimism was reached, what followed became the worst stock market returns of our examples.

So what about the next ten years? There is always the possibility that terrible times are ahead, mainly because these could result from a geo-political event that is simply not predictable. But we prefer to remain optimistic about the United States and the world, in part because periods of sub-par market returns have been followed by at least better returns. Statisticians refer to this as "reversion to the mean". There is also plenty of bad news that is causing much anxiety and leading many people to expect poor returns.

Of course, there is no rule that says the reversion to the mean of longer term returns must start now. But at least for the near term there is plenty of evidence to suggest a continuing, if sluggish, economic recovery based on numerous indicators that are positive and well off the recession lows, among them:

Real GDP *(source: U.S. Department of Commerce)*

Disposable Personal Income *(source: U.S. Department of Commerce)*

Monthly Retail Sales *(source: U.S. Department of Commerce)*

Industrial Production *(source: Federal Reserve Board)*

Employment *(source: U.S. Department of Labor)*

For investment portfolios, we continue to preach they should be strategically structured based on investment objectives, risk tolerance, age, assets, etc., and not based on predictions or forecasts or emotional responses to what occurs in the economy, markets, political stage, or the news media. In addition, investors today have easy access to other asset classes that were not so readily available twenty years ago, such as commercial real estate, foreign stocks, foreign debt, commodities, etc., that can help achieve investment goals and/or reduce portfolio volatility. This is why we recommend diversification across asset classes for most investors (though not all asset classes are worth holding all the time). Finally, we suggest that the events of the past decade have made many Americans realize they would do better for themselves by saving more and spending less.

We finish with a thought paraphrasing Peter Lynch: *We don't know whether the next 120 points on the S&P 500 will be up or down, but we do know where the next 1200 points will be: Up!*

All of us at Yosemite Capital Management wish you joyful holidays and a pleasant year in 2011.

John Kleponis, CFA
Senior Portfolio Manager

Paul Heckler
Managing Director

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The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), is a free-float market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market. This index is calculated on a total return basis with dividends reinvested and is not available for direct investment.