



LOWRY HILL

PRIVATE ASSET MANAGEMENT

ANNUAL CLIENT LETTER JIM STEINER, MANAGING PRINCIPAL

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We have seen a robust market rally since the March stock market low as a result of improved credit conditions and a slow but steady recovery in economic conditions. While this rally has helped to restore investor confidence, the past 24 months—during which the global financial and banking crisis contributed to the worst economic and capital market conditions since the Great Depression—have been some of the most challenging for investors in over 80 years. As importantly, the past decade has seen some of the worst stock market returns in the last 200 years.

We realize that both the last decade and the recent short yet tumultuous period created emotional challenges for all. Our hope is that by focusing our attention on thoughtful and prudent long-term investment and financial decisions, keeping in mind the current macroeconomic environment and your unique long-term goals, we have served you well. Thank you for being a client.

The last few months have also seen an increasing number of individuals inquiring about Lowry Hill and our services. It is clear that many of these potential clients are coming to us as a result of a good word from you or your trusted advisers. Thank you for your support.

In this letter, we will provide an overview of the market and what we are watching for in the coming year. We will also examine certain evolutionary issues that we believe are important considerations for long-term investors over the next decade. Finally, we will provide a brief update on Lowry Hill.

A note must be made regarding the content of this letter. It is challenging to discuss the current economic environment without seeming to have a political perspective. Our goal is not to advocate a political view, but rather to examine facts and then attempt to decipher what they might mean for investors.

MARKET OVERVIEW

Employment Matters

When global financial markets froze up last October and governments throughout the world were forced to intervene in order to provide adequate liquidity to the market, companies aggressively adjusted their costs. One man's cost is another man's income, and the result of this adjustment process has been high unemployment and a deepening recession.

At the peak of the last economic cycle in 2007, over 63 percent of all working-age Americans were employed. Today, only 58 percent of working-age Americans are employed. The important factor to consider is that from World War II until 1974, the employment level in the United States mostly remained between 55 to 58 percent. Employment remained near this level with modest movement during economic expansions and contractions throughout this 30-year period. Beginning in the late 1970s, the employment ratio broke out above that range to a high of almost 65 percent by the end of

the 1990s. One of the core questions going forward is whether or not we have had a structural change in the employment level in the United States. Our consumer-based economy relies heavily on high employment levels to generate sustained growth. Moreover, the federal government relies on individual income taxes, Social Security withholding taxes and Medicare taxes to generate 80 to 85 percent of its revenue. Employment levels, while a lagging economic indicator, matter.

Revenue Growth and Capital Spending Crucial

While the revenue of the S&P 500 companies is projected to decline by over 9 percent in 2009, the operating margin, which bottomed at 10 percent in the first quarter of 2009, is projected to expand to over 16 percent in the last quarter of 2009. This is only slightly below the peak operating margin achieved in 2006. Companies are running lean, which has quickly translated into rapidly improving margins and better-than-expected earnings. In order for the recovery to sustain itself, revenue growth must be layered onto these lean cost structures in the coming year. If this occurs, earnings will increase dramatically. Equally important, with government stimulus nearing an end, capital investment by the private sector must return for the recovery to take hold. We are hopeful that this recovery will be sustained.

John Maynard Keynes recognized that during periods of significant economic uncertainty there is a preference for liquidity. Keynes stated, "Our desire to hold money as a store of wealth is a barometer of the degree of our distrust for our own calculations and conventions concerning the future." This effectively describes the current perspective of both company CEOs, who allocate capital to new projects, and investors, who allocate capital across various securities. Uncertainty remains. This can be seen in the preference of investors to hold low-yield, short-duration, bond-equivalent assets and cash. Cash continues to build on corporate balance sheets as well.

This liquidity preference is understandable. The economy is currently wrestling with the restructuring of the automobile, health care and financial services industries. The resulting structure of these industries remains unclear, as legislative action and government regulation will dictate the ultimate structure of each. These three sectors constitute close to 40 percent of the gross domestic product of the United States. When the rules of an industry are unclear, the preference is to be cautious. However, it does provide opportunity for watchful investors—as change always does.

Pricing and Capital Allocation

One of the great risks is that pricing within certain industries will not be governed by supply and demand, but rather will be established by bureaucratic fiat. While initially benign, such a price structure may lead to perverse incentives and a misallocation of capital within an industry. This is one of the fundamental issues with our current health care system. The pricing within our health care system varies greatly depending upon who is making payment. For executives within this industry, this has created significant challenges to the allocation of human and physical capital. Possibly the best examples are the excessive number of magnetic resonance imaging (MRI) machines in the U.S. relative to other countries and a persistent shortage of general practitioners throughout the health care system. The issue of how price is established within an industry is one in which investors must always be watchful but even more so as each of these industries goes through a fundamental restructuring process.

Building an Ark

The consensus operating earnings for the S&P 500, a proxy for the U.S. equity market, are currently estimated to be \$71 in 2010. We believe that long-term operating earnings for the S&P 500 will grow in the 4- to 8-percent range over the next five years. This rather wide earnings range is based on many of the uncertainties that we discussed earlier. Assuming earnings grow at 6 percent, the mid-point of our range, we estimate \$95 in earnings for the S&P 500 at the end of 2015. If the market trades at its average multiple of 15.5x earnings (the long-term average multiple for the market), the target price for the market in 2015 is approximately 1475, a 6 percent annual return from current levels for this five-year period. The current dividend yield on the S&P 500 is 2 percent. While this slightly less than 8-percent total average annual return appears modest compared to the long-term historical average, it is also important to remember that from December 1999 to December 2009, the average market return was -1 percent per year. This is a simple projection method. Yet, while more sophisticated modeling may be mathematically more profound, the predictive result may be no better.

As Warren Buffett has stated, "Predicting rain doesn't count, but building arks does." While we make long-term market predictions each year, the vast majority of our time throughout the course of the year is spent searching for attractive businesses that we can invest in for the long term. We believe we can identify businesses in domestic and international markets with solid long-term economic models that can be purchased at attractive prices. The pursuit of such companies is a constant for us. We will continue to build the ark.

THINGS TO WATCH

Significant core economic issues are being debated today that will impact investors over the next 10 years. Most of these issues will be resolved through steady evolution. Such matters require attention, as so often we miss change that occurs gradually. We are much more aware of changes that happen suddenly and abruptly, and capture our fear and hope through media headlines.

Monopolistic Power

The first economic issue is monopolistic power. This past year, an excellent biography was written by Melvin Urofsky on Louis Brandeis, the late Supreme Court Justice. Brandeis began his career as a business attorney, first in Kentucky and then, for the majority of his career, in Boston. After living through a number of economic recessions, most notably the financial crisis of 1907 in which J.P. Morgan played the role that the U.S. government played in our recent crisis, his perspective on monopolistic power evolved. He believed that monopolistic power, whether it is business enterprise or government, should be viewed with great caution as it has implications for the proper functioning of an economy. This perspective, held by Brandeis and many others of his era, set the stage for the development of our current regulatory system which evolved after the Great Depression.

In today's global economy and after the significant bailout by governments throughout the world, it is important for investors to pay attention to this same issue. What is appropriate scale for enterprises in a complex and global economic environment? Is "too big to fail" an appropriate measure for restricting the size of an enterprise? What about the overall size of government? What are we to make of the government being not only a regulator, but also an owner and investor in the

capital assets of the economy? The answers to these questions will both evolve and be important to investors over the next 10 years.

Credit Regulation

The second economic issue is that of how credit will be regulated. During Alan Greenspan's Federal Reserve tenure, his guiding principle was that the market would provide the necessary discipline to appropriately regulate credit. The recent financial crisis may lead one to conclude that the market, if left to its own devices, will create an excess level of credit throughout the system and sow the seeds for financial crisis.

Hyman Minsky, a 20th century economist who passed away in 1996, viewed the creation and regulation of credit as the primary challenge of capitalism. Near the end of his life, Minsky was deeply concerned about the development of unregulated derivatives, due to the leverage created by these instruments. He believed that the prosperity of the economy encourages businesses to assume higher and higher levels of debt because it allows for greater profits to flow to the owners (or, as in the last decade, to traders and hedge fund managers). Over time, the accumulation of debt rises at a rate faster than the ability of individuals to make payment. He categorized borrowers as three types: the hedge borrower, the speculative borrower and the Ponzi borrower. The "hedge borrower" is one who can make payment of his debt through cash flow. The "speculative borrower" is one who can make payment only by constantly rolling over the debt in order to meet the original obligation. Finally, the "Ponzi borrower" is one who cannot make payment of the debt or even the interest on the debt because he relies on the appreciation in the value of assets to finance the debt. As the system fills up with the last two types of borrowers, the point of crisis is reached and the system eventually falters.

The reason for this discussion is that Minsky appropriately described the most recent financial crisis. The initial reaction of many is to conclude that the overall system is flawed. If the evolutionary path is to completely overhaul the entire financial system and for the regulators to assume the role of setting market prices, we are suspicious of the ultimate outcome. We believe thoughtful minds will prevail, and a regulatory system that addresses the complexities of a global economy and a sophisticated credit system will evolve. The new system must better manage systemic risk and prevent too many "speculative" and "Ponzi" borrowers from controlling much of the credit in the economy. The long-term positive of all of this is that the process of reducing debt throughout the system has begun. While it will take many years to alter balance sheets, the positive first steps have been taken.

As investors, we worry about the growth of the federal government deficit and that future deficits are being systematically built into budget projections. In time, government debt must grow at a rate less than that of gross domestic product, or the government itself will fall into the category of "Ponzi" borrower. The implications of such an outcome are dire.

More Government

Third, what is the impact on long-term economic growth as the government becomes a larger percentage of the overall gross domestic product? The government needed to step in to avoid a total financial meltdown in 2008 and did so effectively. It must now make the challenging decisions of what to continue to own and control over the long term and what to turn back to the private sector.

In addition, the government commitments to health care and Social Security will continue to grow as the U.S. population ages.

In searching for historical examples, it is difficult to find a developed country that over the last 30 years has deliberately increased government involvement in its economy. The recent trend has been to open markets and reduce government activities. France, however, is an example of a developed country that went against this global trend, as its government increased participation in the domestic economy during this period. Government spending grew from 44 percent of gross domestic product in 1978 to over 55 percent expected for 2009. The employment ratio in France declined from an average of 55 percent in the 1970s to less than 51 percent from 1990 to 2008. Tax revenue rose from 37 percent of gross domestic product in 1978 to over 46 percent in 2008. Finally, the growth in France's per capita gross domestic product was, on average, 30 basis points lower than that of the United States annually. France's per capita gross domestic product has been lower than that of the United States over this entire time period.

The message we take away from the French experience is that as government becomes a larger percentage of the gross domestic product of an economy, there is the risk that the economic growth of the country will slow. This is not to say that economic growth is the most important goal of a democracy. Other critical elements include the rule of law, property rights, civil liberties, distribution of income and wealth, and defense. Yet for investors, the structure and mix of public and private assets is certainly important. While a politically sensitive issue, this must be acknowledged. The appropriate balance will be worked out over the next few years, and it will be important to be watchful of this evolutionary change, as it will impact tax rates, earnings growth and capital formation in the overall economy.

Innovation and Entrepreneurship

Finally, what makes an economy grow? Joe Schumpeter, a Harvard-trained economist and contemporary of John Maynard Keynes, provided an interesting thought experiment on this issue. If an economy had no profit in it, it would, if left to its own devices, create profit. The strong push for a capitalist economy to create profit lies in the belief that eventually an innovator will make a product at lower cost and pass the savings on to the consumer through a lower price than current competition, and subsequently retain some of the cost savings as profit. The profit can then be invested in more innovation, or an entrepreneur will develop a new product (such as the iPhone) that will generate new consumer demand. The profit will be retained and invested in new entrepreneurial projects. Schumpeter's main point is that the natural flow of a capitalist economy is to create profit, and profit is one of the best mechanisms to encourage innovation and entrepreneurship in an economy.

The most hopeful sign of such entrepreneurial activity can be found in a story told to me recently. For those of us who grew up in Minnesota and spent summer evenings enjoying a trip to a Bridgeman's Ice Cream Shoppe®, this story will resonate. In the 1930s, in the midst of the Great Depression, Chester and Roy Bridgeman started their ice cream business in the middle of a cold winter in Duluth, Minnesota. There are few things more hopeful than starting an ice cream business in northern Minnesota in the winter during the Great Depression. Let us hope there are more people like the Bridgeman brothers in the world today for they are the true engines of our economy.

UPDATE ON LOWRY HILL

While the challenges of the last two years have been significant, we continue to search for ways to add value for our clients. Last February, we created our mutual fund (called the Clear Riversm Fund). The fund was created to provide more consistent diversification for accounts with less than \$500,000. The fund trades under the ticker CLRVX and is comprised of our core equity strategies. Tom Gunderson, Tom Hull and I manage the fund, while the stock selection is done by our six equity strategy teams. The companies owned by the fund are well diversified across all economic sectors. In addition, 52 percent of company revenue, on average, comes from outside the United States, so it has strong international diversification. The Clear River Fund performed well in its inaugural year and is serving its original purpose effectively. More information on the fund can be found at www.clearriverfund.com.

Over the last 25 years, we have worked successfully with the Blandin Foundation in Grand Rapids, Minnesota by functioning as their chief investment officer. We also have 60 foundations that are now part of Lowry Hill's client base. Our investment process, one with risk management at its core, has provided significant long-term value for these foundations. In 2010, we intend to make this investment service available to a broader set of foundations and endowments. While our investment services are an important element of what we do for these foundations and endowments, we also provide back-office capabilities that can lower their overall management costs. If you know of a foundation or endowment that may benefit from this service, please let us know.

Our focus this past year has been on deepening relationships with our clients and working to improve the individual skills of everyone at Lowry Hill. We also continue to ask everyone at Lowry Hill to become engaged in their communities. Each of us is encouraged to spend 5 percent of our time in various activities in our communities, and we know that this has made a difference in these challenging economic times.

We also want to say thank you to Dick Kovacevich and John Stumpf. Dick has retired as the chairman of Wells Fargo, effective December 2009. John now assumes the role of chairman, as well as continuing in his roles as president and chief executive officer of Wells Fargo. Both Dick and John have been supportive of Lowry Hill over many years. While we are a small business in the scope of the larger Wells Fargo organization, they have allowed us to carefully and thoughtfully grow our business. They have also allowed us to develop and maintain our strong culture of high-quality client service, which is so important to our long-term success. We also thank them for the important role they have played during this financial crisis. While executives of financial firms have been vilified in the media over these last 12 months, Dick and John have provided steady and consistent leadership under trying circumstances.

We will continue to focus on providing you with financial peace of mind in the coming year. We believe, as John Maynard Keynes did, that investing is about fiduciary duty. Keynes also believed that investors must make investments in companies and strategies that maintain the long-term sustainability of the overall economy. For any one of us to be successful, we must all be attentive to the key principles of a sound economy.

Once again, thank you for your business. Please do not hesitate to call if there is anything we can do for you. We wish you a peaceful and prosperous New Year!