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Farming at the base of a Volcano
-LLN

Volcanoes are an awesome force of nature. A looming presence on the landscape, they occupy the back of one's mind until conditions dictate otherwise. My daughter recently completed an assignment listing the positive attributes of living near a volcano. She told me "the soil is rich, the farming is excellent, but one must be willing to tolerate the potentially catastrophic consequences." This sounds like the current investment environment, doesn't it? A financial explosion occurred, it's now settling into the back of people's minds, and investors are eagerly seeking to reap the harvest as business conditions recover. During this update we will review the sustainability of the recovery, how your portfolios are positioned to benefit, and what we believe to be the most significant risks that could lead to the next "volcanic eruption."

Since our last quarterly letter, the economic data has continued to signal an upturn and the probability of a double dip recession is becoming more remote. Consumers are hesitant to take on new debt and consumer credit continues to decline, something we think of as rational behavior. Importantly, there appear to be signs that the employment picture is stabilizing and even improving modestly. Weekly jobless claims are falling and the change in non-farm payrolls is now positive. While employment is typically a lagging indicator, we consider the improvement in the employment picture to be crucial to both the sustainability and strength of the rebound. Few expect a strong recovery in employment so any strength should result in higher GDP projections.

We believe that the Federal Reserve is becoming more comfortable with the sustainability of the recovery. According to the minutes of the March Federal Open Market Committee meeting "financial conditions had become modestly more supportive of economic growth" and "No market strains emerged in conjunction with the Federal Reserve's closing of nearly all of its remaining special liquidity facilities over the intermeeting period." The removal of quantitative easing began several months ago and TALF (Term Asset-Backed Securities Loan Facility) is on schedule to close on June 30th. Bond yields are drifting higher with the 10 yr treasury yielding around 4%. Oil prices are back to $86/barrel as traders bet on the continued strengthening of the economy and improving demand.

The companies in which we are invested are reporting stronger results. Health care related investments contributed the most to results in the quarter. The recently passed healthcare bill provides greater access to care and services without, as of yet, identified controls on cost. While one may reasonably argue that our country cannot afford such a program, the immediate impact on healthcare companies is generally positive. Financials contributed the second most to results as the businesses we own are well positioned to flourish as market conditions return to more normal activity. Our long-term theme of investing in industrial companies with significant exposure to emerging regions of the world resulted in mixed performance. Our investment in the energy sector was the greatest detractor from results. We remain positive longer term because depletion rates exceed discovery rates and greater wealth in emerging regions of the world will accelerate energy consumption.

The greatest concern we have with the current environment (to push the metaphor a bit more) is that we are investing in the shadow of a volcano, one based on political and fiscal mismanagement. The Federal Reserve's balance sheet is stretched and state and local governments are struggling to balance budgets. This is not the result of the recent crisis as much as it is a reflection on decades of poor political leadership and weak financial controls. The European Union is showing its own fallibility as Portugal, Ireland, Italy, Greece, and Spain struggle to restructure their fiscal policies and maintain the viability of a common European currency.

To paraphrase Warren Buffet, it is when the tide goes out that you realize who was swimming without a suit. Since 1970 total federal spending has increased 221% from $870 billion to $2.79 trillion while the median household

income has risen 32% to $53,355 (all figures adjusted for inflation). The Pew Center conducted a study, published in February, of state retirement benefits that revealed a $1 trillion gap in funding for state worker benefits. The authors point out that the underfunding began long before the recession as states skipped pension funding payments even in good times, leaving a larger hole. State legislatures were also guilty of expanding benefits to public workers without setting aside funding to cover the larger obligation. Signs of concern over government fiscal policy are evident in the markets. California, to name one, is paying much higher yields to borrow in the market. More striking is that in late March the corporate bond yields of some high quality businesses like Procter & Gamble and Berkshire Hathaway were lower than the corresponding US Treasury maturities. It is a rare event when a corporate bond yields less than the Treasury's "risk free" rate! Clearly the factors listed above illustrate an unsustainable situation.

Will Rogers said, "The more you observe politics, the more you've got to admit that each party is worse than the other." We think that the fiscal mismanagement pendulum has reached its apex and will begin to swing back toward more reasonable policy. Corporate bonds yielding less than US Treasuries could be interpreted as investors viewing the private sector as more credit worthy than the government. We think the market is telling us that taxes are going higher and that any politician willing to step up and campaign against conventional thinking (Tea Party anyone?) may actually get elected. Given the electorate's taste for "freebies" it will be difficult to meaningfully cut government programs without the support of a full blown rebellion from voters. The midterm elections should be interesting.

Worries over political parties extend back to George Washington's Farewell Letter to the Country, yet our system has survived. Corporate balance sheets are stronger today than they were three years ago. The investments we've made in financial companies are well positioned to gain market share at the expense of those businesses that met their demise in the crisis. Many of our best investments are generating the bulk of their growth from international markets. For these reasons, we are approaching this part of the investment cycle constructively.

One year ago the leading economic indicators began to show some strength following the collapse in business activity. We're now entering a period where the comparisons will be tougher which could lead to a period in which recent gains are digested by the market. We'll remain focused on purchasing quality companies generating solid excess cash flow that have the ability to generate superior returns on capital. We've become more cognizant of the need to identify potential risks following the crisis of 2007-2009, and will keep an eye on the horizon while tilling the soil.

Thank you for entrusting us with the management of your money. Please feel free to call us at any time to share your thoughts, questions, or concerns.

Sincerely,

John A. Zaro III Managing Partner	JM Sam Nevin, Jr. Partner	Laura K. Drynan Managing Director