Quarterly Letter to Investors: *January 2009*

A Look Back

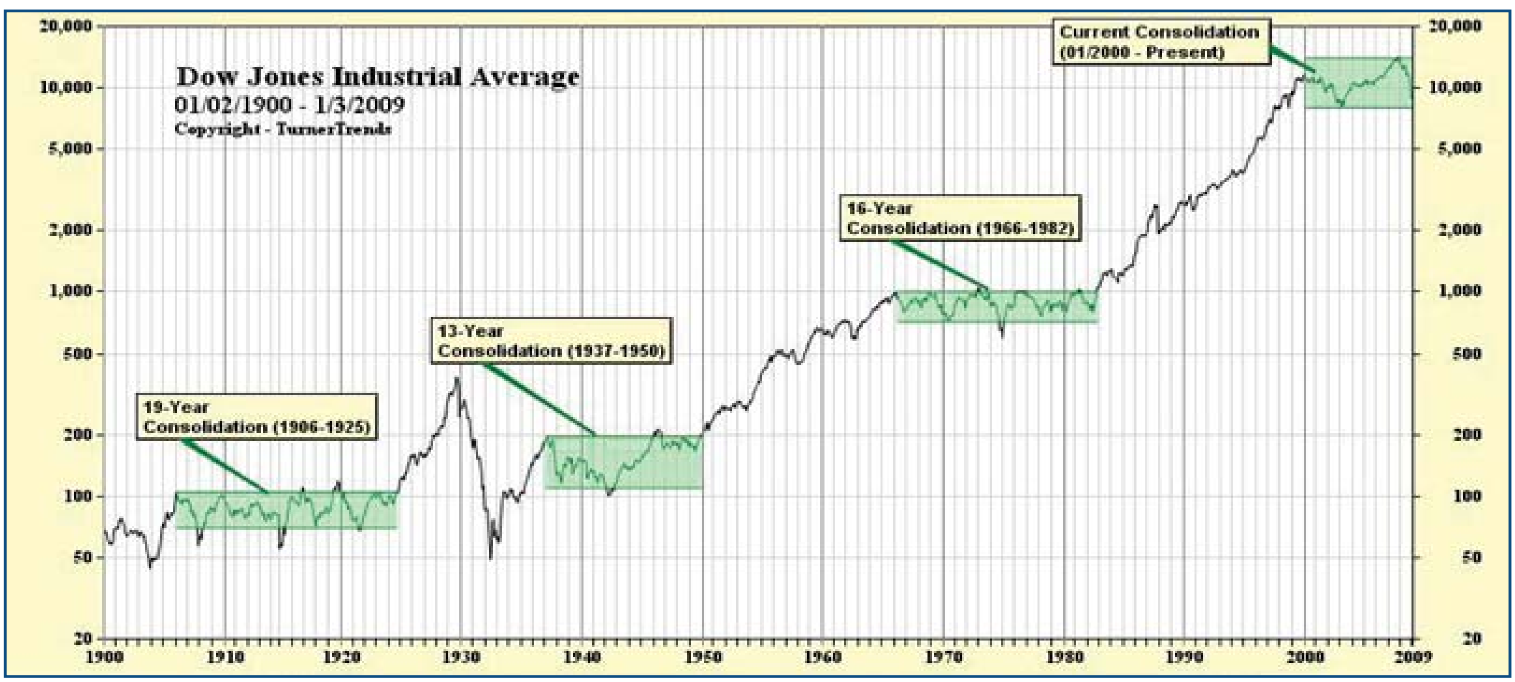
By now, everyone is well aware of the extreme turmoil and distress in the global financial markets and the sudden collapse in economic activity. Given the sharp and abrupt nature of the deterioration in the markets and the economy, a great deal of uncertainty exists. With this perspective, we will do our best to convey our thoughts on what has transpired and what we envision for the future.

While sub-prime mortgages are widely recognized as the initial culprit behind today's difficulties, it is important to place this instrument in its proper context. Sub-prime mortgages only accounted for roughly 10% of all residential mortgages. So if the problem could have been confined to just sub-prime, the economic damages could have been contained long ago. But as we have stated in previous communications, congressional legislation requiring loans to urban dwellers, the failure of lenders to adhere to appropriate lending standards and plentiful stories of unprincipled borrowers who took advantage of the system all share some of the blame for the meltdown. In addition, there is no doubt other perpetrators are complicit - greedy mortgage originators, conflicted credit rating agencies, incompetent bond insurers and others.

Current accounting rules require financial institutions to record losses due to declines in the value of assets or loans on their books. As these losses are recorded, more capital needs to be raised, which typically dilutes earnings and depresses stock prices. Declining stock prices have caused the process of raising capital to be more difficult and expensive.

In early 2008, after the perceptions of the risk of prominent financial institutions began to increase, other entities became hesitant to lend to them or any other financial organizations. Initially, the Federal Reserve Bank and the U.S. Treasury attempted to isolate the companies regarded as "at risk". When Bear Stearns was sold to JP Morgan last spring at a fire sale price, that resolution seemed to temporarily calm the markets. However, within a few months, it had become apparent that systemic financial problems were still embedded within our economy. After forcing Fannie Mae and Freddie Mac into federal conservatorship, injecting tens of billions of dollars into AIG (resulting in an 80% government ownership stake) and engineering the takeover of Merrill Lynch by Bank of America, Lehman Brothers was allowed to fail and the financial markets were badly disrupted leading to a plunge in asset values worldwide. When the Reserve Fund, a large money market mutual fund complex which invested in Lehman commercial paper couldn't convert depositors redemption requests at the promised $1 per unit, fear immediately gripped the credit markets and cascaded into virtually every other asset class (save U.S. Treasury Securities) and every market region throughout the world.

The resulting chaos in the credit markets had a dramatic effect on both consumers and businesses. Understandably, consumer spending suffered abruptly and harshly, especially for big ticket items such as automobiles and vacation travel. Purchase decisions were deferred until



it became clearer how the market and ensuing economic turmoil unfolded.

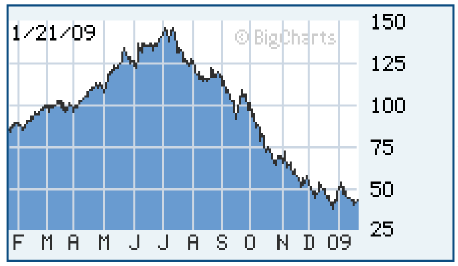
In retrospect, the failure of Lehman was the seminal event that tipped markets over the edge and set the stage for a rapid plunge in economic activity. By their actions since the decision to let Lehman fail, U.S. Treasury officials would clearly have elected a different path had they had the opportunity for a "do-over". Desperately afraid of systemic risk, the administration and the Fed have provided massive capital infusions into AIG, Citigroup, General Motors, Chrysler and most recently Bank of America. None of the moves by the Treasury, the Fed or Congress have prevented a severe economic contraction to grip the United States and most of the rest of the world. The only question now is how long and how deep will the recession be?

A Look Ahead

In an environment as difficult as now, many people are pinning all of their hopes on government stimulus to re-energize the economy. Policy officials have been highly engaged in the problems within the financial sector, the turbulence in the credit markets, and the severe downturn in the economy. An abundance of new policy initiatives have been implemented to deal with these issues. In order to bolster capital and attempt to elevate confidence, the U.S. Treasury injected significant capital infusions into the nation's largest banks from the $700 billion Troubled Asset Relief Program (TARP). Other financial institutions, including insurance companies, finance companies, and credit card companies are also eligible for TARP funds should they acquire bank charters or buy a bank. The Fed also announced a program to buy a variety of troubled, illiquid assets as well as up to $500 billion of private mortgages. FDIC insurance on bank deposits was increased to $250,000 and some bank borrowings and commercial paper fundings are being guaranteed. These and other programs have been introduced to help thaw the frozen credit markets. By most measures, credit markets have responded favorably to the various government programs. Bank borrowing costs have declined noticeably, mortgage rates have dropped and should subside further as the Fed purchases more mortgage securities, and commercial paper issuance has increased markedly since September. Significant obstacles to recovery remain as noted by the plunge in financial companies. Therefore, the pervasive expectations are that any additional funding must come from government and will be increasingly dilutive to existing shareholders. So while some progress has been made, considerable work still needs to be done. Because the risks and uncertainties remain high, it is unsettling to investors who are struggling to see the light at the end of the tunnel.

All is not doom and gloom however as there are building blocks falling into place that may form the foundation for an eventual economic recovery. Oil prices have plummeted to $40 per barrel from $147 last summer. The significance of this decline cannot be underappreciated as each $1 decline in crude oil prices reduces U.S. household spending on energy by approximately $5 billion. Given the magnitude of the decline we've experienced, the after-tax discretionary income benefit now exceeds $500 billion from last year's peak. The free cash flow benefits to household pocketbooks are orders of magnitude greater than last spring's $125 billion fiscal tax rebate stimulus and likely more effective and timely than whatever fiscal stimulus legislation the federal government enacts over the next few weeks. In addition, energy price declines are global which will help consumers throughout the world.

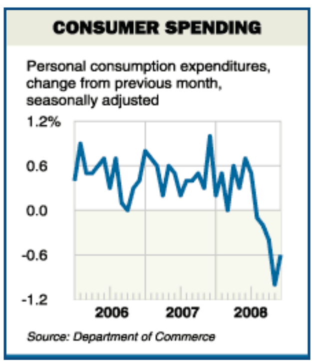
Crude Oil



Additionally, while the housing market is still weak, new home construction has been reduced to well below levels necessary to keep pace with population growth. Rising foreclosures will hamper the drawdown in unsold home inventories in the near-term, but once the foreclosure rate slows, unsold homes could rapidly be reduced, leading to an upturn in home building. The seeds for a new cycle have already been planted with homes now dramatically more affordable than they have been in many years. Lower housing prices combined with extraordinarily low mortgage rates have set the stage for an impressive rebound in home buying activity at some point in the future. The hurdle that remains is credit availability. Banks have quickly turned back the clock several decades in their lending practices, now requiring substantial down payments, full income documentation and sufficient credit scores before extending mortgage credit. While this will ultimately lead to a healthier financial sector, it will hinder a rapid recovery.

Observations and Policy Advice

Constructive policy initiative by the new Obama administration could lift confidence and hasten economic recovery. In addition to cutting taxes on the large majority of Americans as promised in the campaign, an announcement delaying any tax increases, including those on capital gains and dividends would be cheered by investors and businessmen. A reduction in the corporate tax rate would also be welcome, as it would make our corporations more competitive internationally. Infrastructure spending, while appealing on it's face value of promoting domestic spending, will almost certainly take too long to work it's way through bureaucratic government processes to produce any timely economic benefits and spur recovery. Some SEC regulatory changes may be the easiest to enact and could very well hasten recovery in the financial sector. Simply reversing FASB 157, implemented in December 2007, which requires banks to mark their assets to market could expedite financial sector healing faster than many other more costly measures. This requirement has created a vicious cycle of banks marking illiquid assets at lower and lower prices each quarter requiring more and more dilutive capital infusions. Another alternative is for the federal government through one of its agencies to purchase the troubled assets from our banks, and in effect, magically rehabilitating the balance sheets of these institutions. This proposal would be similar to the highly successful Resolution Trust Company (RTC) which was set up in the early 1990s to buy troubled commercial real estate from U.S. savings and loan companies. Once President Obama's economic team is confirmed, we are hopeful that a swift response to the growing crisis will be introduced with at least some elements of the ideas presented above included in their plans. ***The most important single task they must focus on is restoring confidence in the integrity of our financial system and institutions.*** Hopefully the restoration of consumer and business confidence will translate into improved consumption and investment.



Investment Strategy

With this backdrop, it is as important as ever to maintain the appropriate asset allocation and diversification in order to achieve your long-term investment objectives. And because of the severity of this economic decline, it may take longer than normal to enter a sustained economic and market recovery. Any financial market rebound is likely to be volatile and choppy in nature, based upon past experiences which bear some correlation to the present state of affairs. However, unless the global economy totally collapses, the time to sell securities to avoid depreciation has already passed. The liquidation phase of the global mass de-leveraging process is well advanced and tremendous investment flows have sought safe haven in U.S. Treasury Securities, depressing yields to unprecedented levels. Stock prices are now cheap by historic standards given the panic selling that has occurred since September. Just as investors bought record values of stocks, regardless of valuation in the late 1990s, many investors are presently fleeing just to preserve whatever value remains in their portfolios, apart from of any reasoned analysis of value or prospects for future recovery. This behavior is typically seen near market tops and bottoms.

We have embarked on an effort to improve our equity portfolio construction by swapping stocks into companies that offer greater growth potential with equal or lower risk, or similar growth expectations with lower risk. In keeping with our style preference, we prefer companies with low leverage ratios which are considered leaders in their industries. In this market environment where all companies have fallen in value, we have a rare opportunity to invest in the "best of breed" companies which will not only survive but thrive when business conditions improve at valuation levels not seen in many decades. We have also begun to evaluate the potential opportunities some analysts suggest exist in other parts of a company's capital structure such as bonds and preferred stocks, given the dislocations that have occurred in these market segments. We also expect to increase the use of covered call writing, when appropriate, in order to generate additional income and to take advantage of presently high option premiums due to elevated risk and volatility levels. And, while it may be pre-mature in light of the current deflationary environment, we are becoming more and more convinced that when economic conditions do begin to improve, perhaps a year or two from now, rising inflation will be difficult to contain. Especially as we consider the massive amounts of capital virtually every government in the world is injecting into their economy in an attempt to stem the financial crisis. With this in mind, we will be gradually introducing traditional inflation hedges into our client portfolios such as inflation protected securities and gold and other commodity ETFs (Exchange Traded Funds).

In order to make room for additional commentary in this investment outlook, we have separated many of the charts we would typically embed in this report onto our website. We advise you to view these graphs at the following URL: www.covasset.com and feel free to peruse the rest of our recently updated site.

As always, and particularly in view of the current challenging economic and market environment, we are available to meet or discuss your specific needs and circumstances whenever you wish. We appreciate the relationship we have with you and will work diligently on your behalf to guide you through this difficult time. **Please accept our best wishes for a healthy, happy and hopefully prosperous New Year!**

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