Quarterly Letter to Investors:
January 2010

2009 in Review

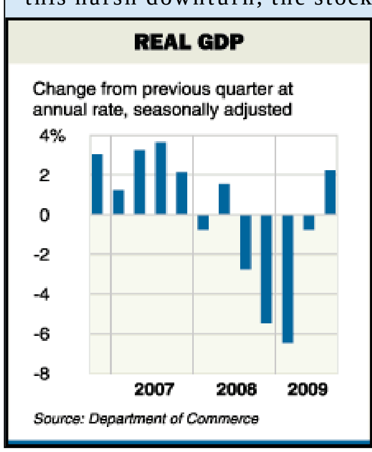
After the disastrous economic and financial collapse in 2008, financial markets began 2009 by tumbling further. By early March, U.S. stock prices had fallen another 25%, on top of the 38% drop in calendar year 2008, as fears of another depression and the possibility of bank nationalization rattled investors. Then as those concerns dissipated and as investors began to comprehend the likely impact on economic activity of the unprecedented global monetary and fiscal stimulus, stocks surged higher from the March 2009 lows. Even as consumers and businesses chose to pay down debt in lieu of spending,

S&P 500

10 Year U.S. Treasury Note

which can be deflationary in nature, the federal government provided some offset with aggressive spending and lending initiatives. By the end of 2009, stock prices, as measured by the S&P 500 Index had risen by 23.5% for the full year and by nearly 65% from the March trough. Most international stock markets performed even better with world indexes outside the U.S. up 37% in 2009. Although interest rates, especially for short maturities, still remain low, yields on ten-year U.S. Treasury Notes actually rose from the historically low rate of 2.5% to 3.85% at year-end 2009. In addition, over the last year, credit spreads between low-grade and AAA rated bonds have collapsed back to normal from record high levels.

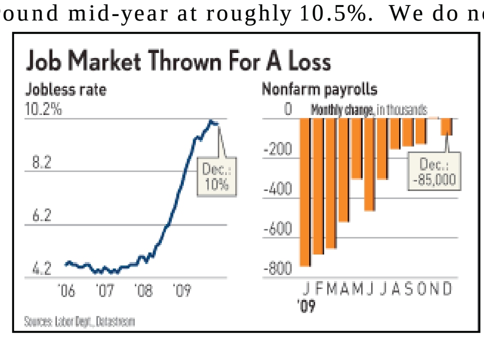
Following three quarters of economic contraction, real GDP growth turned modestly positive in the third quarter of 2009. Even if fourth quarter GDP forecasts of approximately 4% are accurate, the full year will still result in negative real economic growth for the first time in thirty years. For all of 2009, employment declined by 3.7%. Also, corporate profits, as measured by S&P 500 earnings, declined for the second consecutive year, and after peaking at $91/share in June 2007, likely fell by 57% during the subsequent nine quarters, ending September 2009, to approximately $39/share. In the face of this harsh downturn, the stock market once more predicted future economic events as the upturn in market fortunes led the upturn in economic activity by about two quarters and the rebound in corporate profits by nearly three quarters. The collective wisdom of literally millions of investors around the globe once again demonstrates the benefits of free market capitalism despite the intrusions of government.



The technology sector led the way higher by advancing over 60%, with consumer discretionary and basic materials both advancing by better than 40%. Defensive sectors such as consumer staples, utilities and telecom all lagged and many financial stocks enjoyed a volatile year in which they plummeted to multi-decade lows before rebounding sharply and ending the year moderately higher.

2010 Economic Outlook

Economic growth in the U.S. and other developed countries around the world is expected to continue throughout the coming year, though at a pace that is well below normal compared to other recession recoveries. Emerging markets, relative to industrialized countries, are likely to rebound faster as their domestic economies are healthier and less burdened by massive debt accumulated during the downturn relative to the industrialized countries. Job growth is projected to begin sometime in the first quarter of the year in the United States and the unemployment rate should peak around mid-year at roughly 10.5%. We do not



anticipate worrisome inflation for consumers throughout the year as capacity utilization rates are quite low by historic standards and will need to rise considerably before excess slack is eliminated and pricing pressures can be passed along to the consumer. However, the enormous amount of excess liquidity created by near zero short-term interest rates and other central bank monetary stimulus is likely to mean that many asset prices such as commodities, energy, gold and emerging market stocks will continue their upward advance. We see this as an environment where asset price inflation co-exists with modest consumer price inflation.

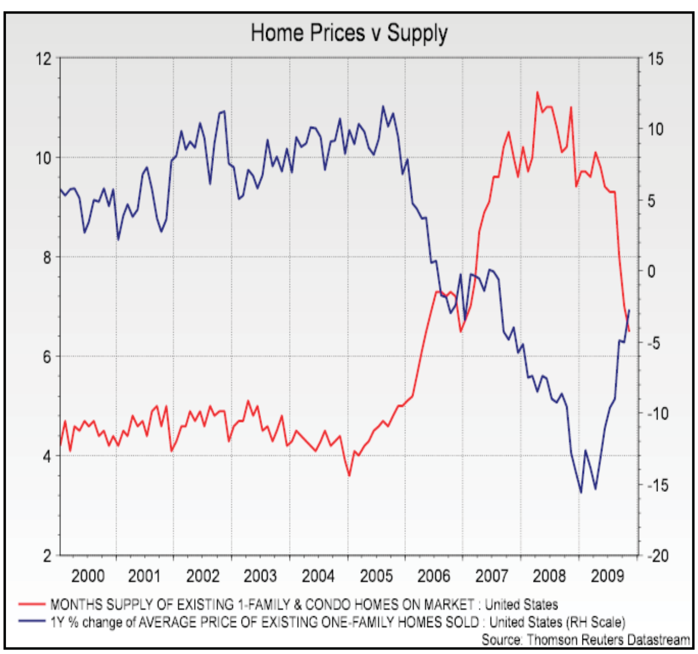
In this gradually improving global economic climate, the U.S. Federal Reserve Bank as well as the central banks of Europe, the UK and Japan are likely to be especially cautious with regard to raising short-term interest rates or exiting from the various forms of monetary stimulus they created during the financial crisis. Monetary authorities will resist the temptation to withdraw stimulus too soon for fear that rising interest rates will choke off economic recovery before it becomes self-sustaining. The U.S. housing and automobile sectors have begun to show signs of moderate recovery as extraordinarily low lending rates combined with federal incentive programs (cash for clunkers and tax credits for home buyers) have encouraged buying. If mortgage rates rise too quickly, it will have a direct affect on housing affordability and may pre-maturely halt the budding recovery. With this in mind, most economists don't believe the Fed will raise interest rates until the second half of 2010, at the earliest.

Expectations are for a more rapid rise in corporate earnings even in a moderately rebounding economy. The sharp and sudden reductions in corporate spending and labor force cuts, plus significant balance sheet deleveraging by corporations have combined to create extremely lean financial structures. Therefore, even a modest uptick in economic activity can trigger enough new demand to create a meaningful improvement in the level of corporate earnings. From an estimated level of approximately $60 per share in 2009, S&P 500 earnings are projected to grow about 30% in 2010 to around $80 per share.

Financial Markets Outlook

In a low inflation, low interest rate environment, stocks have historically commanded high valuations when measured in terms of traditional metrics such as price to earnings ratios, price to cash flow ratios and dividend yield. Currently, given expectations for S&P 500 earnings per share of approximately $80 for 2010 and perhaps $90 per share for 2011, a reasonable price target for the S&P 500 Index at year-end 2010 would be 1,300 to 1,350 or about 15% to 20% higher than the year-end 2009 level of 1,115. This would imply a price/earnings multiple (P/E ratio) of between 14.5 and 15 times earnings. Naturally, many variables could affect stock prices throughout the year. Any factor which could change the outlook for corporate profitability or interest rate expectations needs to be evaluated closely. Issues we are currently watching include the potential for tax reform, legislative incentives for job creation, any move toward more protectionist trade policy and any legislative action that would compromise Federal Reserve independence. Also, any meaningful changes to fiscal policy which could change federal budget deficit expectations and any changes which could impact the political composition of Congress after the November mid-term elections could influence financial market conditions.

Fixed income markets are likely to under-perform equity markets again in 2010 as interest rates remain low in the first half of the year but begin to rise later in the year, putting downward pressure on bond prices. Within the past year, credit spreads between low-grade and high-grade bonds narrowed back to historically normal ranges leaving the high yield bond category fairly valued at present. Residential real estate appears to have bottomed in 2009 as there has been a modest rebound in both sales and prices. We think the housing recovery remains fragile given the significant inventory of foreclosed homes still to be sold and even larger number of homes valued below the mortgage debt owed. Close attention must be paid to housing transactions and prices once government incentive programs end and mortgage rates begin to rise later this year. We see the commercial real estate market beginning to stabilize, although there is a considerable amount of highly leveraged properties with loans maturing in 2010 and 2011. If re-financing efforts on these properties prove difficult, it could create an environment with a lot of forced sales producing depressed prices. Since there does not appear to be a serious oversupply of commercial real estate relative to expected demand, any price declines are likely to be temporary. Most commodities prices, including gold and energy prices are likely to continue their upward trend as long as the developed world maintains near-zero short-term interest rate policies and massively stimulative fiscal policies.



Asset Allocation and Investment Strategy

Nearly a year into a financial market recovery, it is reasonable to expect that future appreciation in most asset classes will become more difficult. Many financial assets have already risen 50% or more from their bottom. Acknowledging this, we are naturally more cautious in our expectations for investment returns this year. We continue to be advocates of broad diversification across U.S. stocks, foreign stocks, short-term high quality bonds, commercial real estate and commodities in the proper proportion which best accommodates your risk/reward profile and investment objectives.

Regarding U.S. equity portfolios we maintain an over-weighted position in technology and basic materials, equal weights in financial services and retail, and are underweighted in defensive sectors (although less so as the cyclical recovery matures) such as consumer staples, utilities and telecom. Recently we have moved to an over-weight in healthcare as reform measures are now widely known and many healthcare stocks appear undervalued. Also, we maintain our view that emerging market equity markets are likely to perform better than most developed markets given their faster economic growth rates and healthier balance sheets. We therefore support the inclusion of U.S. companies with significant overseas exposure and foreign equity exchange traded funds (ETFs) in most client portfolios.

We continue to wait patiently for higher yields on fixed income instruments rather than investing in securities with maturities beyond two or three years in today's historically low interest rate environment.

This overall approach has been rewarding for clients as most portfolios experienced returns far in excess of market benchmarks during 2009. We appreciate the confidence and support you have displayed during this difficult period and always welcome your insights, questions or comments.

If you have not done so already, please register for our 2010 Economic/Market Outlook Webinar on January 20, 2010 at 4:00pm by logging onto our website www.covasset.com and clicking on the registration link.

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