RAPIDAN CAPITAL

FIRST QUARTER 2010 INVESTOR LETTER

April 30, 2010

For the quarter, the ValueAligned® Fund, L.P. (VAF) was up +6.1% gross (+5.8% net) and another +5.0% in April, while the S&P 500 was up +5.4% with dividends (+4.9% without dividends) and up another +1.6% in April.

By the end of April the VAF was up +11.4% for the year. The S&P 500 is up +7.1% with dividends through April.

The US stock market's gain was the best start to a year since 1998 – today's stock market is up about +70% from its lows of a year ago, almost making up the -43% loss. After the market roller coaster of 2008 and 2009, the first quarter of 2010 has been uneventful by comparison. Volatility associated with the financial panic and political policy uncertainty has come way down into a more normal range.

That said, most investors are still extremely nervous – frightened by the -29% drop in house prices and the nearly -60% drop in the stock market from the top in October 2007.

Our indicators tell us to be bullish long-term, but to be a little cautious in the short-term. Therefore, we've been pruning stocks that are closest to our estimate of intrinsic value and transferring the proceeds into stocks that are more deeply discounted with higher expected returns.

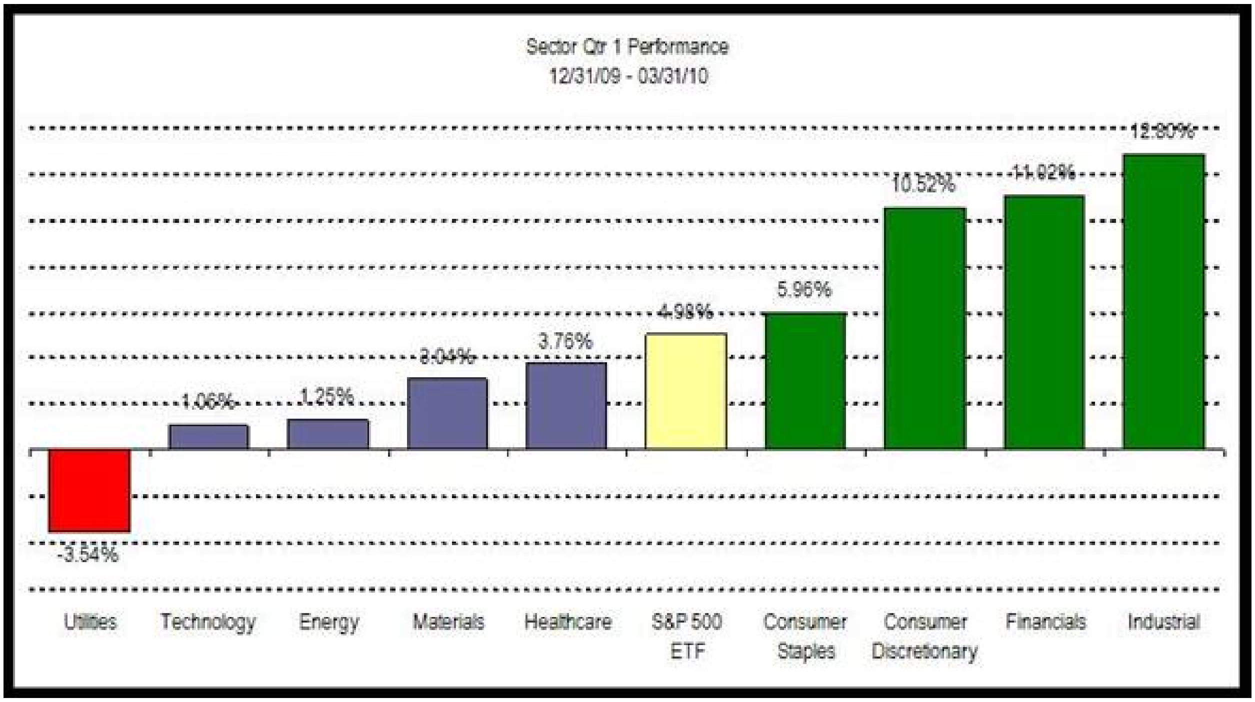
Current invested position

At the end of March we were 55% net invested – 90% long stocks and 35% short a few consumer stocks, the retail sector ETF (XRT) and the S&P 500 index ETF (SPY). The SPY hedges our stock market exposure, letting those special situation stocks – those that are likely to move even when the market does not move - like Borders (BGP), AC Moore (ACMR) and Leap Wireless (LEAP) to increase, while hedging our more traditional stocks that tend to move with the market like Johnson & Johnson (JNJ), WalMart (WMT) and 3M (MMM) during this period of higher near-term stock market risk.

In the middle of February, when the stock market was near its short-term bottom and near-term risk dissipated, we had been 110% long stocks and only 15% short stocks for a 95% invested position. We have been in pruning mode as the stock market went up steadily throughout March and into April.

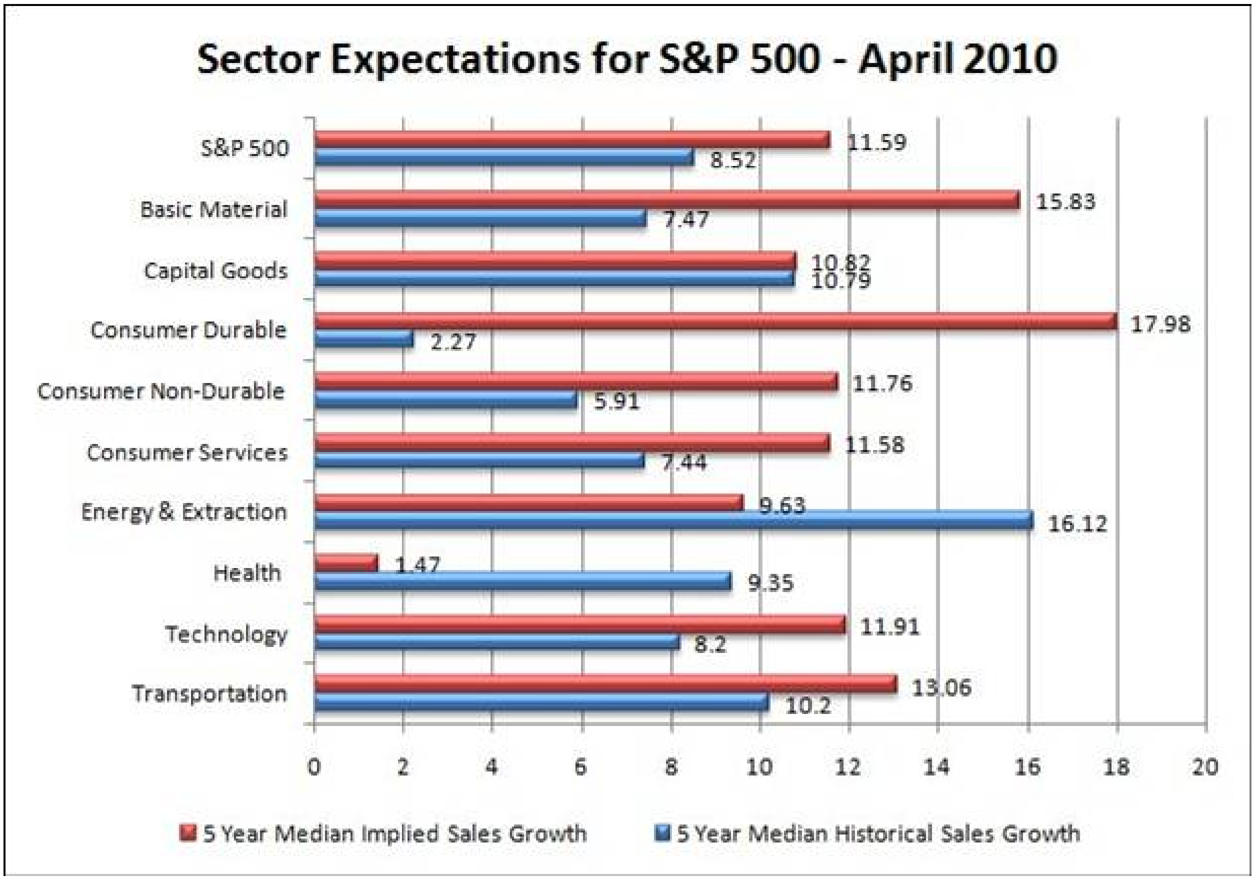
Sector performance and expectations

The **industrial sector** was the best performing sector in the first quarter with a +12% gain. **financials** (+11%) and **consumer discretionary** (+11%) were the next two outperformers. Even the other consumer sector, **staples**, outperformed the index. Industrial and consumer stocks outperformed because they exported a large percentage of their sales or otherwise operated in booming overseas markets.



But for the fourth quarter in a row the riskiest stocks have done the best as confidence in the credit system replaced panic. For instance, the financial sector, which has benefited directly from the government's commitment to preventing large-scale failures at almost any cost, benefited from the renewed confidence. But all highly leveraged companies, like our ValueAligned Manitowoc (MTW, +40.5% through April) have been helped by the Federal Reserve's policy of keeping short-term interest rates near zero for an "extended period." Industrial stocks have benefited not only from low interest rates, but from massive global fiscal stimulus – especially in China. Now, however, the stocks that have done so well over the past year are no longer cheap. **Their expected performance exceeds probable performance.**

We use the Applied Finance Group's (AFG) platform to better understand the economic profitability of our companies, and at the same time measure the *performance drivers, like sales growth or EBITDA margins, a company must deliver to justify its current stock price*.



We reverse engineer the valuation process by understanding the embedded expectations a company must deliver to justify its current trading price. It's not what the analysts or the company *say* will be their performance. It's what the market price *implies* about sales, margins, capital costs and competitive advantage period (CAP) against which we measure reasonableness – another way of checking whether current prices are over or under our estimate of intrinsic value.

AFG did an analysis that measured the embedded expectations for 5 year annualized sales growth of the economic sectors of the stock market. When the red bar in the chart above is longer than the blue bar, current share price expectations are much higher than recent performance. We could say that because the sales growth expectations embedded in the current prices are so high, the sector is overvalued.

The biggest surprise is the huge expectations for sales growth embedded in the prices of consumer stocks. In the durables sector - automobiles, washing machines, flat-screen TVs, etc. - the current share prices imply five years of +18% sales growth *per year* going forward. That means sales for durables will more than double in five years – no way that happens, so they are overvalued.

We think that this exuberance in the discretionary sector is a product of the huge, but fleeting, fiscal stimulus from last year's cash-for-clunkers program, this year's cash-for-energy efficient appliances program, a first-time homebuyers' tax credit and the **$195 billion from a surge in tax refunds and lower final tax liabilities due to the *Making Work Pay* tax credit.**

But this consumer stimulus begins to wind down in the second half of the year, and tax increases loom in 2011. Therefore, as the prices of our shares of consumer companies like Best Buy (BBY), Wal-Mart (WMT), Sears Holdings (SHLD), AutoZone (AZO) and AutoNation (AN) climbed through the quarter, we took profits on some of the positions, sold all of the AN, and in the case of SHLD and AZO, we purchased put options to protect our substantial gains through May. The protection is now in the black as April ended.

Enabling the Technology Build-Out for the Consumer, Best Buy (BBY, $42.64, +7.8%)

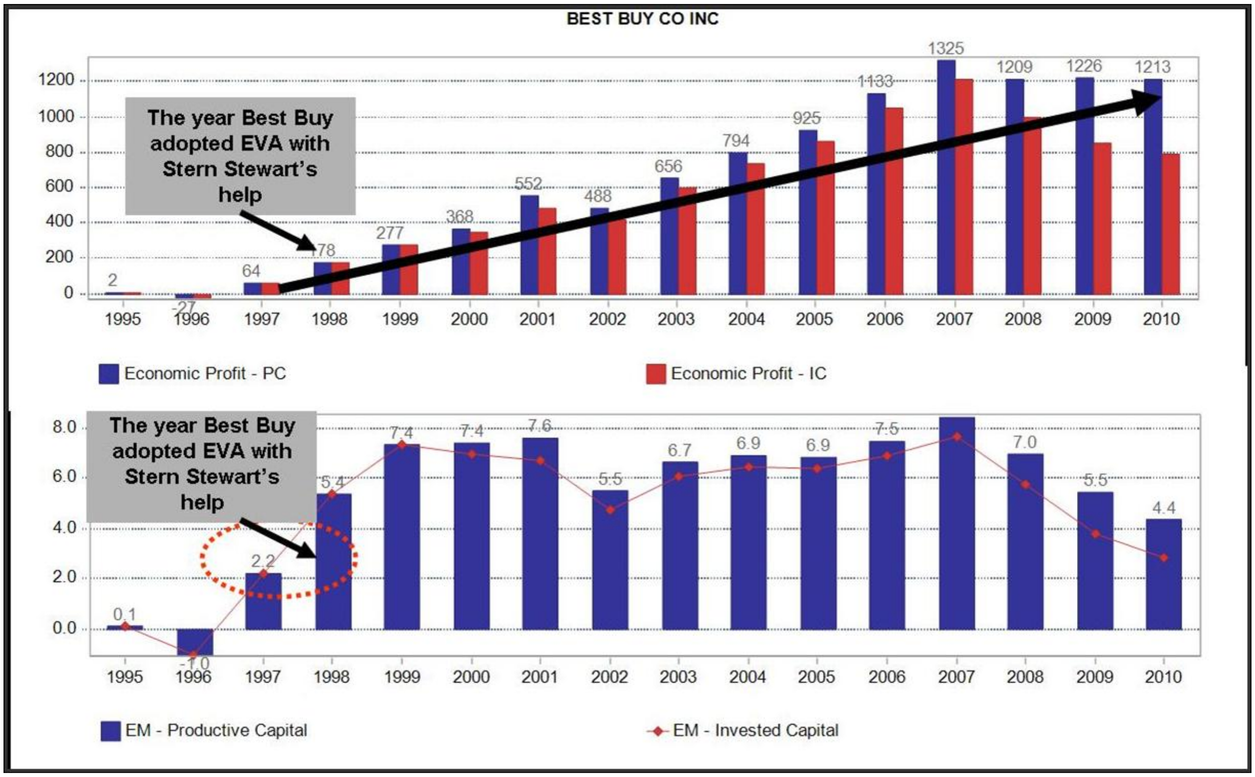
BBY's operating and stock price performance during the downturn demonstrate the U.S. consumer's resilience – seems that when Americans get tax breaks, they buy mobile phones, I-Pods and big screen TVs.

BBY is misunderstood by Wall Street, which suits us just fine. Take a look what the Morningstar analyst said about BBY after its most recent quarterly earnings report.

> *On top of already strong holiday sales, Best Buy BBY capped its fiscal year with solid sales and profitability and provided an upbeat outlook for fiscal 2011. We still have long-term concerns about mass merchant competition and a sales mix shift to lower-margin categories(my emphasis), but plan to raise our fair value estimate by a few dollars on the basis of the firm's current momentum.*

And then this statement later on in the same research report:

> *Although Best Buy's unique shopping environment and service offerings provide a source of differentiation, we are not convinced that the firm has developed an economic moat to fend off its rapidly encroaching rivals.*



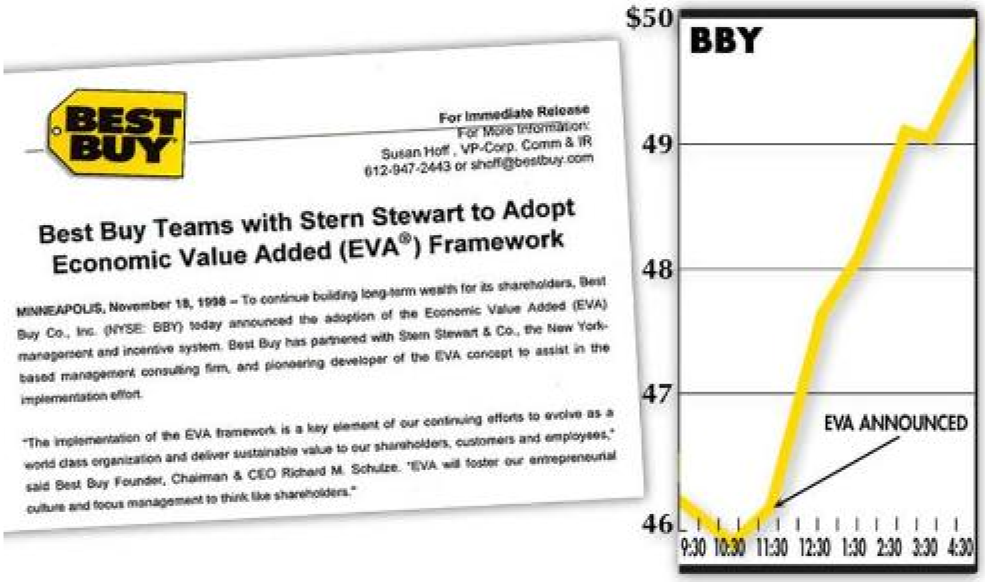
It seems that this analyst, like many on Wall Street, is worried that BBY's gross margin percentage, not dollars mind you, is going to sink because of low cost flat panel TVs and commodity-like price competition from WalMart and other superstores. But if BBY has not built an economic moat, a metaphor created by Warren Buffet to describe whether a company has defensible competitive advantages that allow it to earn positive EVA today and into the future, why does BBY consistently earn many percentage points above its cost of capital – the financial definition of an economic moat?

As you can see from the charts above reproduced from the AfgView.com website, even during 2008 – 2009, BBY's economic margin (EM) – its return on capital above its cost of capital – was between 4% – 7%. During the worst financial panic in a generation, the one that supposedly scared the heck out of consumers everywhere, **BBY remained highly economically profitable**. And as the long arrow shows in the above chart, BBY has added millions of dollars of economic profit – intrinsic value – since it adopted the EVA financial management system back in 1998. EVA works – that's what the analysts are missing.

A little Best Buy history

In 1990 Best Buy operated just 49 stores and by 1998 the company operated 284 stores. During this growth period, return on invested capital (ROIC) averaged only 8.0%, its gross margin declined from 24.5% in 1990 (getting as low as 13.7% in 1996) to 16.8% in 1998. **Store growth consumed invested capital at a 40% rate per year.**

By the spring of 1998 Best Buy's profitless growth halted its stock advance. While institutional investors were interested in BBY's concept and its prospects for growth, many doubted whether the chain could grow without a more structured management platform.



That's when Best Buy chose to implement the EVA financial management system to control its ambitious growth plans. The 1999 annual report explained its commitment to EVA and Value-based Management (VBM):

> *We believe the use of EVA will continue to improve decision-making and help us undertake investments that will maximize shareholder return. By fostering our entrepreneurial culture and guiding our management to think more like shareholders…"*

Source of Best Buy's competitive advantages - amenity

Its EVA decision-making has driven BBY's strategy toward helping consumers adapt to the interconnectedness of the newest technologies. BBY understands that it is today's value of a loyal customer's total relationship that matters – not just the margin at which it makes a discreet purchase of some gadget today.

Its competitive advantages are in those processes and services enabling the *build-out* phase of the technology revolution. As Brian Arthur of the Santa Fe Institute and the author of the new book "The Nature of Technology" explains, **the real gains in any technology revolution come when the new technology adapts to the users.** The idea that a new technology like the flat panel TV, mobile internet, touch screen PC or digital photography needs to adapt to its users seems obvious enough, but Arthur thinks it is heavily underestimated.

People will not use a technology that doesn't work properly. They will shun anything awkward or untrustworthy or just plain difficult to use. Making the technology better, faster, cheaper is only part of what's needed. A new technology is used when it is more convenient, easier and reliable. A technology must provide amenity.

Think about it. Amenity is what makes Apple competitive – it has made beautiful, easy to use interconnected devices. BBY's strategy is similar. It aims to *facilitate* the adaptation of the newest connected technologies for consumers.

Here's how CEO Brian Dunn explained it on the March 25th, 2010 conference call:

> *We are in the midst of transforming this organization, building on what we have been to become something new. It's an ability we have demonstrated time and time again, and I'd like to give you a few examples that illustrate our current transformation. First, we're building upon our foundation as a company that primarily sells hardware and accessories, learning to see that hardware as merely the starting point in a relationship with customers; not an end in itself but the means by which we can connect customers to the people, content and networks they care about. (My emphasis)*
>
> *As an enterprise, we plan to sell tens of millions of connectable devices this year. Each one of those devices is an opportunity to create a longer, more profitable relationship with our customers. Take for example the growing and exciting but potentially intimidating array of entertainment experiences. We can help customers understand which of the various TVs in the market are right for them: Plasma, LCD or LED. And very soon, you'll have to choose between each of those options and whether or not you want it to be 3D capable.*
>
> *But the TV itself is only a part of the equation. The experience really comes to life through a connection to the right type of content. For instance, we can help the customer understand and choose among the various ways to bring movies into his or her home: purchased in a store; rented through the mail; or streamed directly to their PC, TV, Blu-ray player or mobile phone. And then in this case, it could be that the right solution means enhancing a high definition satellite or cable TV package or broadband Internet service for an IP enabled model with the traditional solutions customers have come to expect in this category: a digital surround receiver, speakers, cables and a universal remote control, a Blu-ray player or gaming platform and installation. It could also mean integrating capabilities once only accessible on your PC with other devices in your home. Now, that same television could become the telecommunications hub in your home. Best Buy will help you choose the right broadband connection so you can Skype with family or check a friend status on Facebook, all from your TV.*

BBY sees itself as enabling the consumer build-out of the technology revolution. It aims to allow users to get what they want out of technology – amenity. That's why its ROIC is far above its cost of capital and is likely to remain there.

Macroeconomic shift from consumption to manufacturing & exports

Most private industries have shed jobs in the past two years, but those in the consumer sector have suffered the most. Employment in residential construction and auto manufacturing is down by more than -30%, in retailing and banking by some -8%.

Some of those jobs will come back, but many of them will not, because high home prices, easy credit and cheap oil that drove America's over expansion in construction and retail are not going to return.

We built too many homes, or, at least, remodeled too many with cheap imports from China, purchased at Home Depot (HD). And we have too many restaurants, stores and malls. Cheap imports and easy credit allowed us to live beyond our means – we didn't save anything. In fact, we spent more than we earned. Mark Dodson from Hays Advisory explained how easy credit for middle and lower income Americans allowed them to consume as though they were rich:

> *The problem comes with consumer demand in the US. Basically the saving rate went to zero. In the US, the top 20% of people have 40% of the income and save about 15% of their income. A lot of that is pension plans and paying off principal on mortgages, so it's automatic savings. If you take 15% of 40% you have a savings rate of 6%. This means that the bottom 80% is earning about 60% of the income and is spending* ***110% of their income (my emphasis)****. That is (was) not sustainable. So, finally when housing prices collapsed and the defaults in consumer finance occurred, that whole system fell apart.*[1]

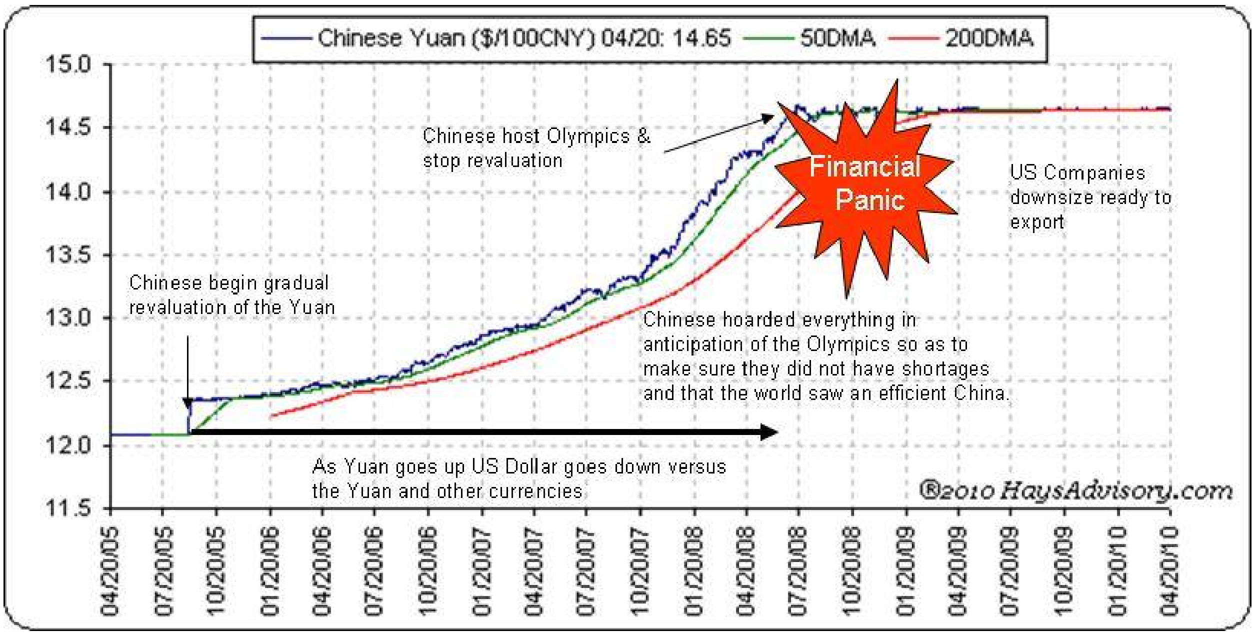
Instead, as the Economist magazine recently put it, "America's economy will undergo one of its biggest transformations in decades. This macroeconomic shift from debt and consumption to saving and exports will bring microeconomic changes too: different lifestyles, and different jobs in different places."[2]

The U.S. bailout of Asian economies is complete: The China/U.S. currency problem?

With the Asian currency crisis in 1997-1998, Asian central bankers basically learned one lesson: avoid having an overvalued exchange rate. They learned to intervene in the currency market so that their currency did not appreciate relative to other important currencies like the US dollar and the Euro. **The 1997-1998 period marks the beginning of the US consumer bail-out of Asian economies.**

The first net result of this "overvaluation" of the U.S. dollar was a net subsidy to consumers – American consumers were able to buy cheaper and cheaper foreign-made goods. Low Asian exchange rates caused a structural decline in prices, even as quality steadily increased (think of how the quality of Hyundai cars have improved). These declines led to a massive increase in the standard of living of American consumers and a rise in **real (adjusted for price inflation) disposable income**. (As prices came down for consumer goods, it was like a tax cut for consumers. As WalMart says, “Save money. Live better.”) The rise in real income then triggered demand for real estate and services.

I believe that this Asian subsidy to consumption contributed to the massive increase in home prices before the bubble exploded in 2007-2008. When the prices of cars, televisions, computers and clothes go down, the money not spent on those items was spent instead on the home or on even more stuff.



This also led to an acceleration of the transformation of U.S. companies. Before the financial panic and great recession, we already had seen an unprecedented rise in corporate profitability, return on capital and margins; coupled to increasing US trade deficits with China, India and the other Asian countries. US corporations in essence said **"you take the jobs and the sales; we will take the profits"**.   And so that is how it went. Economic profit and productivity skyrocketed in the U.S. and investment capital followed. That money from abroad financed our trade deficits.

It is worth noting that in the three years before the recent financial panic, China revalued (or devalued the U.S. dollar, politicians forget that when they call for a higher Yuan they are also calling for a lower U.S. dollar versus that currency.)

What were some of the effects? The rise in the Yuan raised the dollar price of commodities like oil and copper, just as the Chinese were preparing for the world to come to Beijing for the Olympics. The Federal Reserve, in my opinion, was too concerned with the inflation in commodity prices at the time because it was caused by dislocations in China hoarding before the Olympics, by redevelopment after China’s earthquake, panicked oil buying after the Israel-Lebanon war in the Summer of 2006 and the huge disruption in commodity prices caused by the flooding of New Orleans after Katrina.

In effect, one of the forgotten contributors to the financial crisis was *tightening* by the Fed. Notice that the financial panic exploded right after the Olympics were finished.

Global economic recovery of 2009 turning into a "global boom"

If the U.S. consumer is not going to save the world's economy this time – who or what will? Judging by the evidence, the emerging economies led by the BRICs – **B**razil, **R**ussia, **I**ndia and **C**hina – are leading a global expansion whose demand will replace much of the demand lost because of the U.S. consumer's saving more and paying down debt.

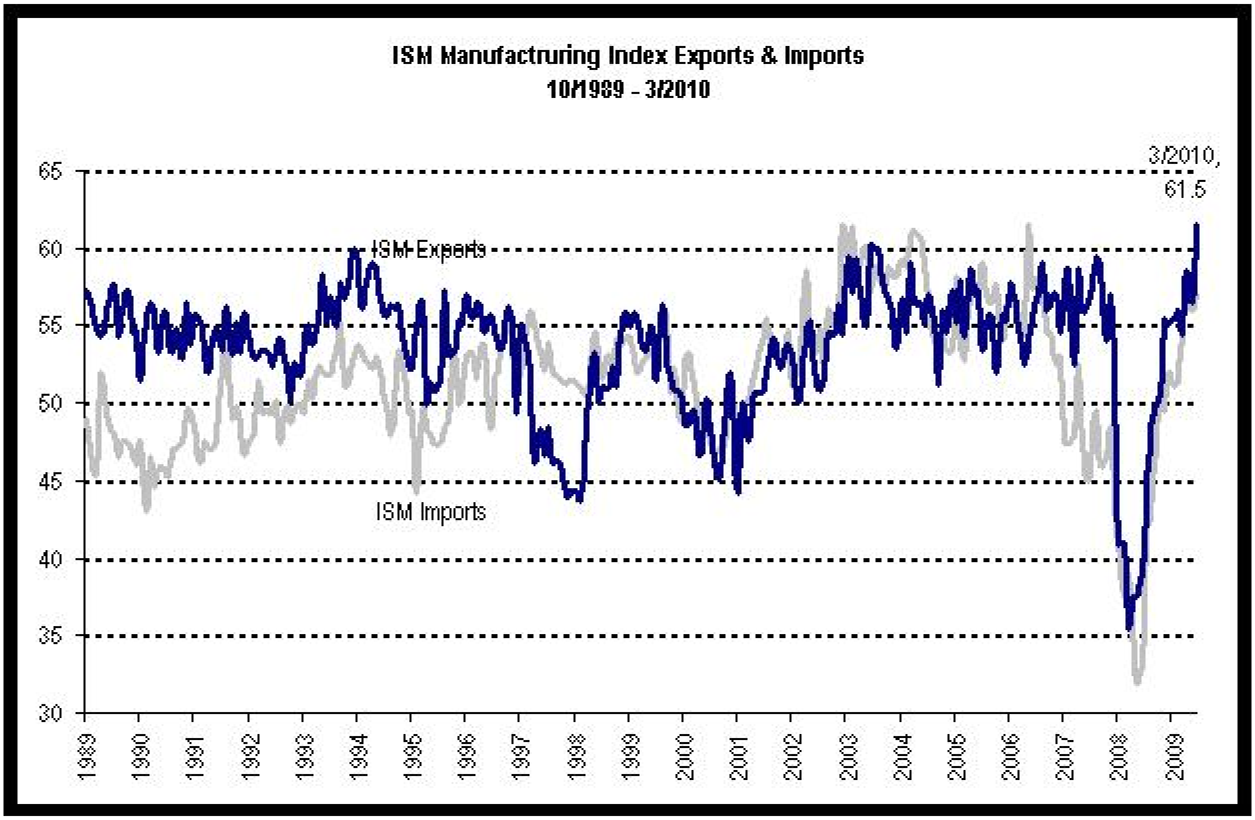
The developing world economies are booming (see chart above).

The JP Morgan Global Purchasing Managers Index shows a 3 1/2 year high was just reached – and this was with the U.S. and Europe lagging, but catching up of late.

Export & manufacturing-led recovery

U. S. exports to China have increased at a stunning **+157%** annual rate over the past three months.[3] Of course, this suggests that Yuan appreciation is unnecessary to get U.S. producers exporting to China. We ought to wave that number in front of Smoot Schumer and Hawley Graham next time they want to devalue our dollar against the Chinese currency.

The manufacturing Purchasing Manager's Index (PMI) for exports surged to 61.5% in March, suggesting that exports, already booming over the past 6 months, accelerate even further (see chart to the right)! And both the manufacturing PMI and U.S. Industrial Production are stronger at this stage of the recovery than they were during the slow recoveries in 1991 & 2002 and the rapid recoveries in 1975 & 1983.



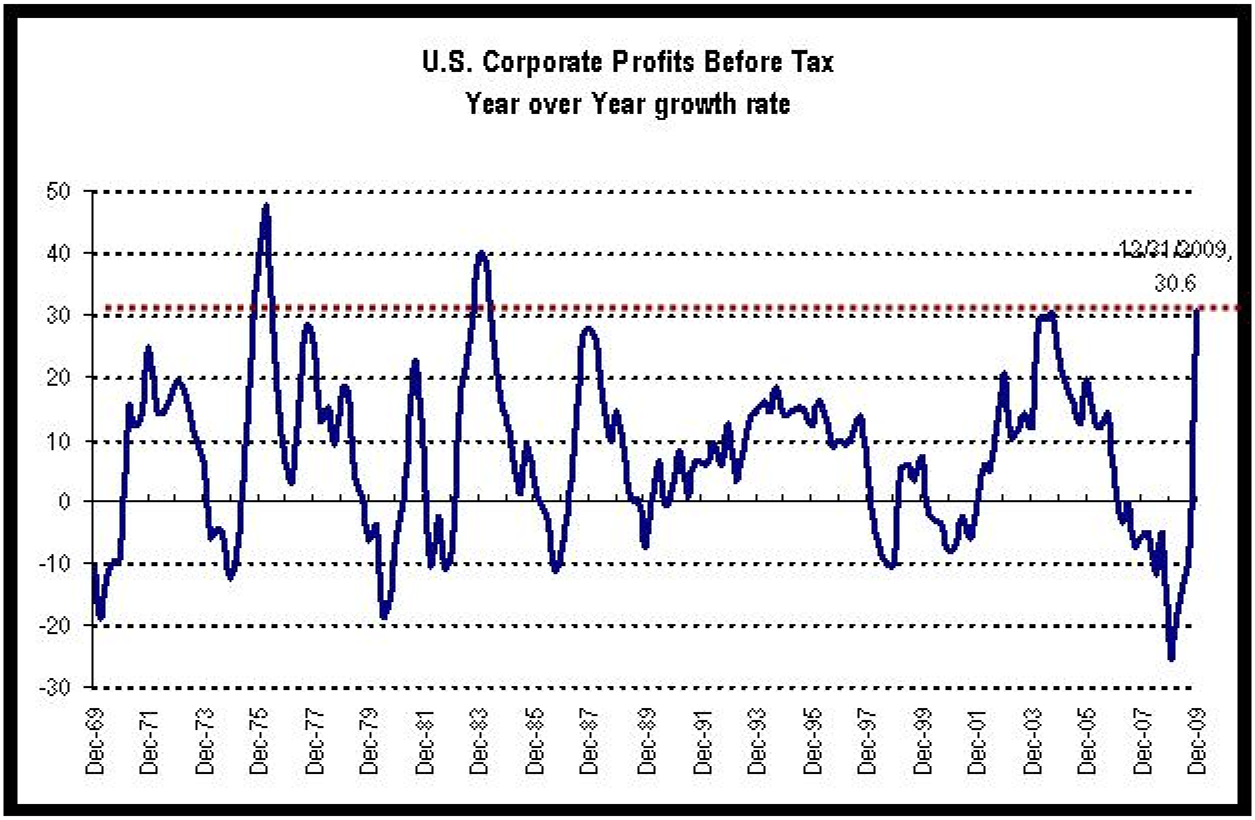
So there is substantial empirical evidence that the economy is recovering. Fourth quarter real GDP grew at a +5.6% annual rate, first quarter real GDP grew more slowly but still a very positive +3.2% annual rate, **the Federal Reserve Industrial Production Index was up in March for the 9th month in a row**, the PMI was up in March to 59.6 and the PMI employment index was at 55.1, the fourth straight month above 50.

According to ISI, the March employment report suggests that industrial production is much stronger than in last two slow recoveries, and about in-line with the 1975 and 1983 strong recoveries. Manufacturing employment has started to increase. The recovery seems to be advancing on all fronts except construction – home building and commercial. We all know there was an artificial boom in housing and in consumer spending causing overcapacity in retail space – both stores and restaurants. As I said above we consumed at a rate way over our heads. And now the areas with too much capacity like home building are still notably weak.

Corporate profits are leading the recovery; Earnings season is outstanding

As of the end of the 4th quarter 2009, corporate profits have increased +30.6% Y/Y. Of course, the increase has been driven by the global boom in trade, declining interest expenses, declining unit labor costs, **huge increases in productivity as permanent employment has not yet come back** and the extremely steep yield curve – which dramatically raises banks' profits by borrowing at next to nothing from the Fed and lending that money to the government earning 1.0% for the 2-year to 3.8% for the 10-year.

Also, banks can lend to corporate credits at a few percentage points above the 10-year yield to earn even fatter spreads. We are starting to see some "junk" deals get done also.



Profit for companies in the S&P 500 surged +176% during the final three months of 2009, the most in Bloomberg data going back to 1998, and analysts estimate a +44% increase for the first quarter of 2010. Earnings estimates for companies in the index rose +9.1% on average so far in April, twice the gain in prices and the largest monthly increase since 2006.

Earnings results for the first three months of this year are beating estimates at nearly the *fastest rate ever for the third time in a year*, with 79.4% of the companies that have reported topping projections. That compares with 79.5% in the third quarter and 72.3% in the period before that.

And second quarter earnings are likely to be even better than the first quarter of 2010, if nominal GDP forecasts hold.

Why is the recovery happening?

Economist Ed Yardeni attributes the earnings boom to the **Greatest Global Boom of All Times (GGBAT)**.

Simply put, there are six billion consumers in the world, and five billion of them in the New World want to achieve the same standard of living as the rest of us enjoy in the Old World. So, for many companies around the world, business is somewhere between good and great. Remarkably, earnings are also very strong among industries that do most of their business in the United States.

The developing world is growing extremely fast. Due to timely and huge fiscal and monetary stimulus in China, India, Brazil and Russia after the panic of 2008, their economies and stock markets started to recover before the old world economies began getting better. Our thesis has been developing world demand for U.S. technology, retail know-how and capital goods would spark an export-led boom in the U.S. – it has. Just imagine that General Motors sells more cars in China than in the U.S. – they do.

GM China: Sales by 2015 may exceed 3M units
SHANGHAI Updated: 2010-04-12 14:15:

General Motors Co. said Monday demand in China is so strong that annual sales may top 2 million vehicles this year -- four years ahead of schedule -- and could exceed 3 million by 2015. GM is counting on robust growth in China, India and other emerging markets to help offset weakness in its home US market as the Detroit automaker struggles to return to health after its near-collapse in 2009.

"We already have an incredible focus on China and we're going to put as much energy as we can on China," said Kevin Wale, president and managing director for GM China Group. GM's China sales jumped 68 percent in March over a year earlier to a monthly record of 230,048 vehicles, propelling a 71 percent surge in first quarter sales to 623,546 units. In the lackluster US market, GM's March sales were 188,546, or 20 percent below China.

China's total vehicle sales jumped 72 percent from a year earlier in the first quarter of this year to 4.6 million units as the economy rebounded from the global crisis. While year-on-year growth will likely slow in months ahead, analysts forecast that China's total auto sales could rise as high as 17 million this year.

The other reason the recovery is happening – capitalism.

Capitalism is the most efficient system for organizing resources. But when big government through rules, laws, regulations and taxes colludes with big businesses, inefficiencies occur – sometimes the misallocation of resources is dramatic like we saw in the housing crisis. But capitalism is so powerful and efficient that it does well, not because of government intervention, but in spite of it.

Huge stimulus packages, 2000 plus pages of healthcare reform, regulatory reform, 1000 plus pages of financial reform, looming tax increases, cap n trade legislation and all the transformations the Obama government can think of, have impeded the recovery – not caused it. The lack of job growth and the length of unemployment are the defining characteristics of this recovery. But we are seeing – like we always do – temporary hiring increasing fast.

Regime uncertainty will slow progress

The amount of jobs lost and the length before a meaningful upturn shown is in fact *scary* (chart below). Also, the failure of strong temporary or part-time employment gains to be converted into full-time jobs is largely due to the "regime uncertainty" I have been talking about for a couple of quarters now.

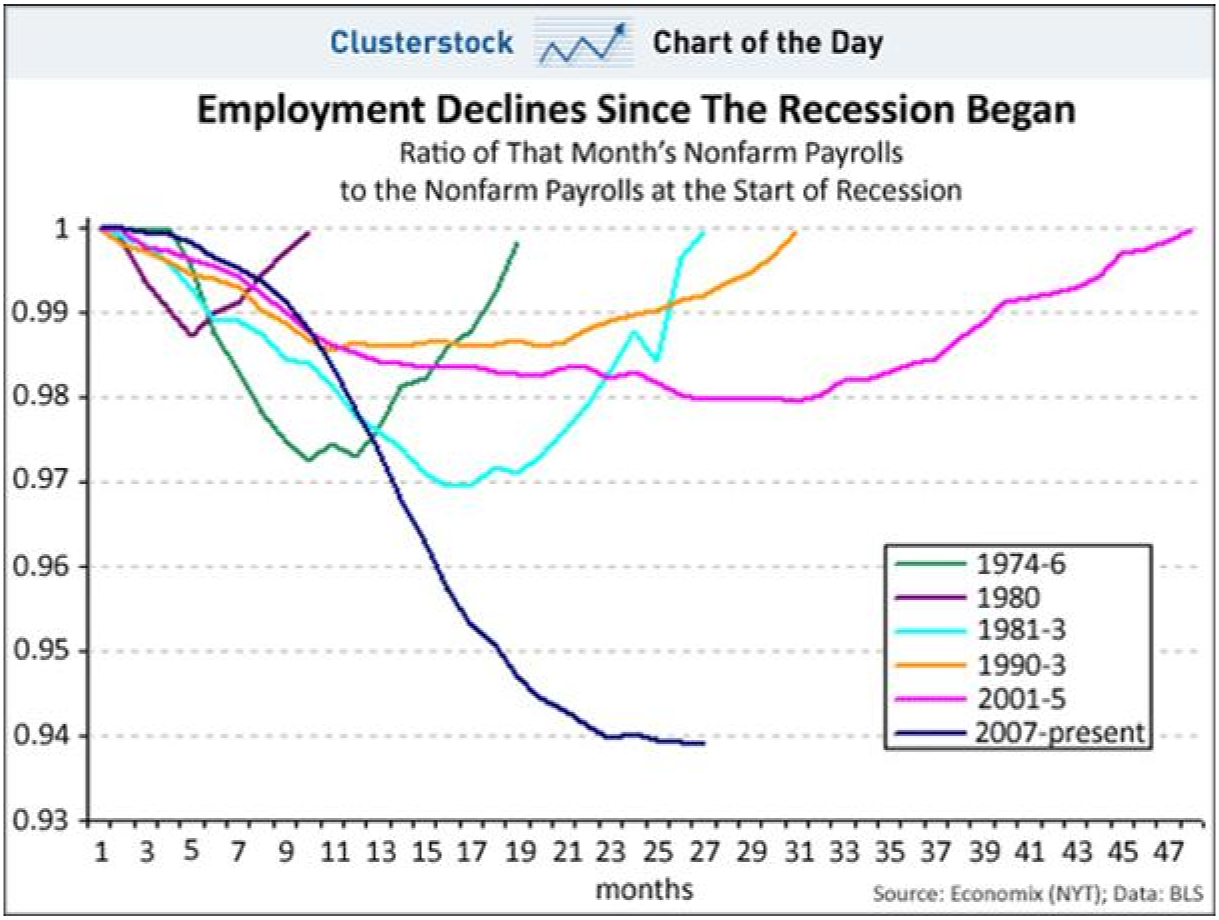
The uncertainties caused by the various interventions by the Obama Administration have deterred private investors – unless they were somehow friendly with the regime – from making investments to expand. Private small and medium-size businesses are simply afraid to invest. There are too many unknowns to make investments sensible. The connected big corporations feel privileged because they seem to be able to affect policy thereby reducing the uncertainty. Small businesses do not have that clout.

The Obama Administration continues to create uncertainty and anxiety. Nonetheless, I believe capitalism is extraordinarily resilient. There are still enormous incentives to work around bad situations. And with all those billions of people yearning to live at our standard – I am confident that they will find a way to draw us in to make it happen.

Finally, there has been a great awakening in the American people. They seem to understand that massive government intervention is not what built hope and opportunity in America. And like only a few other times in our history, limits on the federal government seem to be coming. That is what I think the stock market has started to see. 5 billion new consumers and a new lean and mean private sector in America mean renewal of the government's contract with the its people and higher stock prices.

…but, there is still the "scariest" jobs chart ever to deal with

This graph makes clear that compared to other recessions, the job losses, and lack of job gains, are truly unprecedented. That flattening at the bottom of the blue line above is encouraging but the magnitude and persistence of this job recession demanded attention 14 months ago. Instead, we have had 14 months of uncertainty, confusion and threats to business people and entrepreneurs.



"Jobs saved", used by the administration to claim that their discredited stimulus plan was working, is a stupid metric and its use demonstrates the misplaced objectives of this government. Growth and new businesses create jobs - not government funding increases.

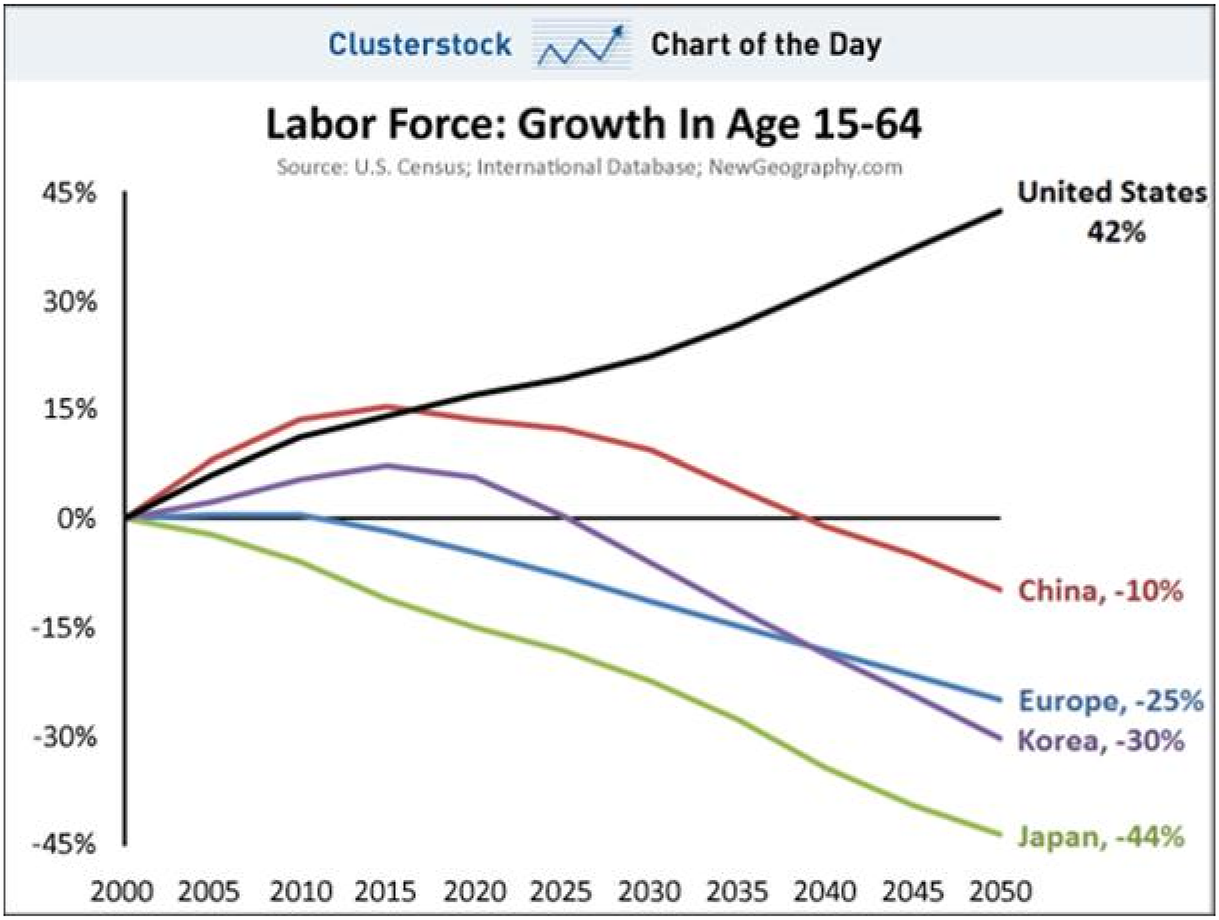
America will remain an extremely powerful nation out to 2050

American values like immigrant opportunity, individual liberty and religious freedom are unique. Even though there is anxiety over the decline of America due to China's emergence and its huge ownership of U.S. public debt, America's working age population is growing faster than our competitors'. And that matters a lot.

We obviously have a problem with entitlements and the baby boomers' retirement, but as long as we maintain a relatively high fertility rate, encourage legal immigration and don't squelch regional and state competition that reveals the best economic policies, we have the drivers to win any global competition.

The key is our working age population. We are set to grow our population by another 100 million people through 2050. Over the next four decades, America will grow its labor force - its productive population - by a whopping 42%, as shown in the nearby graph[4].

Meanwhile, China's labor force will shrink by -10%, Europe's will shrink -25% and Korea's and Japan's will shrink by even more.



In the chart above courtesy of www.businessinsider.com, China's labor force has been growing very fast lately, which has helped it stun the world, but this growth is set to peak and then start falling by the middle of this decade. In contrast, from about 2015 onwards, the U.S. will start showing how what we have always valued since our founding is a key competitive advantage.

China will have to increase worker productivity faster than the fall in its labor force each year just to maintain a level GDP. Put it this way: The U.S. could have zero productivity gains over 40 years and still achieve a 42% larger economy by 2050, all because we believe in families, opportunity for immigrants and limited centralized government.

Many skeptical investors missed the stock rally

After 70%+ gains from the lows in March 2009, we would expect that investors would start putting their huge amount of cash that has been in the bunker to work. As expected, they have moved that cash out of banks and money market funds, but not into stock funds. Instead, money has gone into bond funds, chasing yield thinking that bond funds are "safer". Mark Dodson thinks that this preference for bonds means that long-term sentiment is in tact – investors remain skeptical of the stock market, which is good for intermediate returns and suggests that risk of a new bear market is very low.

Here at the end of April, short-term sentiment is probably too bullish and we expect a correction in the stock market because of it. We expect some weakness over the next couple of weeks, and that is why we are only 50% net exposed to the market.

The stock market is not the market to be afraid of. If there is a bubble today then it is in the very safe part of the bond market – U.S. Treasuries. **Investors have been overpaying for safety since last March.** The penalty for that was a negative return for holding U.S. Treasury bills relative to the returns in corporate bonds and stocks. Investors paid a steep price for the perceived safety of principal by missing out on the fantastic rally in stocks.

We think the thoughtful investor, rather than worrying about how they *missed* the stock rally or remaining afraid of another decade of low stock returns, needs to get back to basics. They ought to think about how much of their savings should be in stocks. We believe that for most investors, no matter the age or income level, stocks need to be the largest part of your investment portfolio to protect income throughout retirement. Even after these gains off the generational low of March 2009, stocks should have long-term returns exceeding bond returns for the next thirty years. Most investors today simply need to invest more of their savings in stocks.

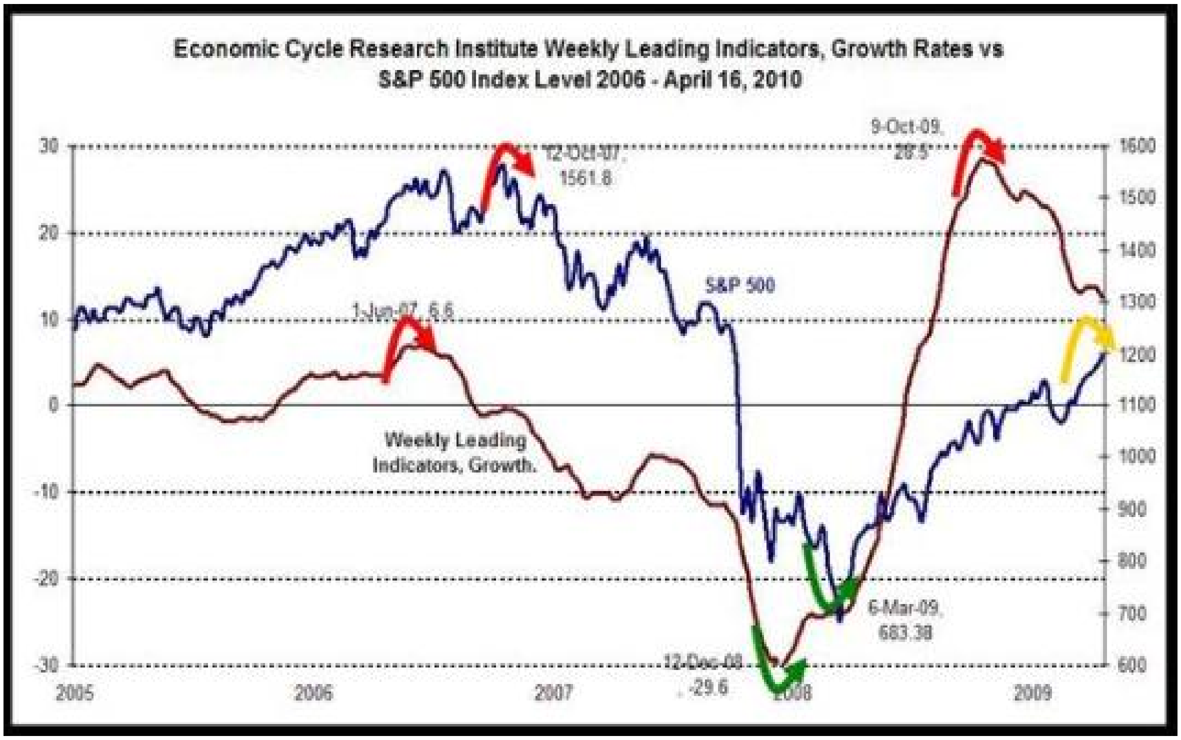
The last 10 years for stocks versus bonds was not good. But the next 10 years promise to be much, much better, because today's starting valuations are more reasonable this time around.

Outlook

When we measure stock market risk, our emphasis is on the business cycle's role in the investment process. The business cycle – expansions and contractions in the macro-economy - explains much of the financial markets' performance.

It's tough to read the economy right now because huge government stimulus everywhere in the world might be distorting coincident and lagging economic indicators. Regardless, we notice the data is pointing to a top in the cycle of leading indicators as investor optimism rises.

As you can see in the graph of Economic Cycle Research Institute (ECRI) Weekly Leading Indicator Index versus the S&P 500 Index (below), the turns, tops and bottoms in the leading indicator growth rate precede tops and bottoms in the stock market by 4 - 6 months we think the top in October 2009 of the Weekly Leading Indicator Growth rate tells us that this earnings season marks the beginning of the next phase of this bull market. We expect near-term weakness of about 5-8% accompanied by a change in leadership.



And as if right on time, the stock market has formed a short-term top even as a spectacular earnings season is under way.

This has been an incredible bull market off the bottom last year. I think that the bull market will be in tact for many more months, but investors need a little break to digest what might happen to earnings after the U.S. elections. Therefore, we probably will spend the spring and summer preparing for the elections with the stock market range-bound until we get some clarity to the regime uncertainty as we get closer to November.

This is not meant to suggest I am bearish – I'm not. Stocks are the place to be over the next couple of years because valuations are reasonable. In your fund, however, we have the ability (since the end of November 2008) to hedge and mitigate market, sector or individual stock risk. We won't make money when stocks go down but we will lose a lot less, without losing the opportunity for the upside.

Have a great spring!

I'll be posting on my *Value Investing with EVA* blog and talking with you throughout the quarter.

Warmest regards,

David

[1] Don Hays in “It’s a Beginning, but Let the Correction Evolve”. Hays Advisory’s Morning Market Comments, Monday April 19, 2010. http://www.haysmarketfocus.com/files/NLPP00003/345.pdf

[2] Greg Ip in “Time to rebalance. A special report on America's economy”. Mar 31st 2010, *The Economist., http://www.economist.com/specialreports/displaystory.cfm?story_id=15793036*

[3] ISI Group, Weekly Economic Report, April 5th, 2010.

[4](http://www.businessinsider.com/chart-of-the-day-why-american-will-in-the-long-run-beat-the-crap-out-of-china-2010-3?utm_source=Triggermail&utm_medium=email&utm_campaign=CS_COTD_033110