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4th Quarter 2009

**CAZ CORNERSTONE PORTFOLIO**  
**Quarterly Update**

Wow! What a year this turned out to be. When future generations look at the historical record for 2009, they will assume it was a glorious year with solid returns, a typical result after a massive down year. But simply looking at the return for the year will miss the real story. If one looks at the true timeline of 2009, they see one of the worst 60-day periods in stock market history to start the year. Remember, the U.S. market was down by more than 20% for the year, AFTER it had declined by nearly 40% the year before! Then they see one of the largest 60-day rallies in history, followed by a steady climb of the “wall of worry” for the remainder of the year with nary a meaningful pullback. While all of this was occurring, the economy continued to “stabilize” while the unemployment rate continued to go up and the U.S. government pumped more stimulus into the economy than had ever been done in the history of our country! We now have 10% unemployment, the largest deficit in history, and the total amount of debt owed by our government is measured in numbers that heretofore were nearly impossible to fathom (to some of us the concept of trillion is still hard to wrap our brains around)! Who would have thought on March 9 when the S&P 500 was at 667 that the market would have its best year since 2003?

**How Accurate Were We in 2009?**

With the perspective of what an unusual year it has been, let’s look back at our thoughts from last year to see what we forecasted correctly and what we missed. Here are the summary points from our year-end 2008 letter in *italics* and below each point is our comment on the accuracy of each forecast:

*Here we go again! We don’t like going out on a limb with what we see for 2009, but people ask us to, so we are obliged to try our best to see the future. Here is what we think is possible for 2009:*

- *The Federal Reserve and Central Banks around the world will use every tool in the tool chest to try and rescue the banking system. Rates are already near zero in many countries, so those efforts will include the expansion of the Central Banks’ balance sheets, reduced capital requirements, direct purchase of securities and anything else they can think of. Then toward the end of the year, as things begin to stabilize, the Central Banks will have to think about the future inflationary ramifications of the massive increase in money supply. They will just think about it, though. We do not think they will begin to tighten credit in 2009.*



- Money was pumped into the banking system at a level never seen in history. At this point the easy money “spicket” is still wide open in all but one or two countries, but most governments are starting to seriously evaluate how they are going to remove the massive stimulus from the economy.
- *The housing market in the US will bottom. Yes, that is what we said. There is a bottom, and it is likely to be reached in the summer/early fall of 2009. That does not mean that prices will go up, but it means that they will most likely stop going down.*
  - Home prices in parts of the country have bottomed, but the overall trend is still down. The rate of deceleration has slowed dramatically but prices are still dropping in most of the country under the weight of record foreclosures.
- *The US government will announce one of the largest fiscal stimulus programs in history. While that is a given based on what we are hearing from Washington, the surprise may very well be the sheer magnitude of the programs.*
  - This was fairly easy to predict, but the creativity of the governments surprised us. “Cash for clunkers” served as an extreme example of using all the tools in the tool chest! The magnitude of the stimulus truly blows the mind if one starts to think about it. The amount of government debt incurred is staggering.
- *The result of the stimulus effort will be one of the largest deficits, as a percentage of GDP, that has ever been seen.*
  - Easy one to predict and while very accurate, it is disturbing how large the deficit has become.
- *Long-term interest rates will begin to climb by the end of the year. As the world begins to recognize that the economy will indeed recover at some point in the future, the flight to safety will begin to reverse and investors will realize that the true price of the bailouts will be substantial future inflation. When this happens, government bonds will begin to sell off and rates will go much higher.*
  - While many people may not have noticed, long-term rates have gone up quite sharply. The move from 2.46% to 3.85% on the 10-year U.S. Treasury may not seem like much, but a 50%+ increase in long-term interest rates definitely gets our attention. While a 1% or 2% increase in rates may not seem like much, start doing the math of what the extra interest cost is on \$1,000,000,000,000! (Yes, that is 12 zeroes.)
- *At least one state or large municipality will require federal assistance to stay solvent. Clearly the government will oblige, as it would be impossible to justify using taxpayer money to save AIG and not use it to save a STATE!*



- This prediction has not happened...yet, but several states have experienced substantial difficulties. The most high profile example is the IOU's issued by the State of California who was unable to pay its bills.
- *Unemployment rates will continue to increase in the first half of the year and may approach 9% before stabilizing and improving toward year end.*
  - Unemployment is now more than 10%. The “real unemployment rate,” which includes those who have given up looking for a job, those who are underemployed (the businessman waiting tables to try to pay the bills), etc., is now above 15%. Things are stabilizing, and you would hope after spending several trillion dollars we would get some improvement. However, the lack of traction in the job market is disturbing.
- *Corporate bond spreads will stay very high as defaults begin to accelerate and then will begin to improve toward the end of the year as defaults begin to peak.*
  - Defaults have stayed high but the stability in the credit markets has allowed credit spreads to tighten substantially and corporate bonds were strong performers in 2009.
- *Stock prices will continue to bottom in the spring/summer and volatility will begin to drop as investors enter the “waiting mode.” As investors are waiting for a “sign” that all is clear and it is safe to buy stocks, we expect stocks to stay choppy. We do expect stocks to have an upward bias during this time frame and that company guidance will begin to be better by the time we hear third quarter earnings reports.*
  - Very accurate on direction as stocks bottomed in March and rallied. Volatility dropped by more than 60% and company guidance has been better for most of the second half of the year. We certainly underestimated the incredible buying demand caused by all the money sloshing around in the system and the resulting magnitude of the rally. On March 2, 2009, we sent out our “just hold your nose and buy anything” email to all clients. We told clients that we expected the market to rally at least 50% from that level in the next three years. As it turns out, we were given 50% in six months!

Our projections for 2009 were pretty accurate, and we got the overall direction of the market right, which was for a positive year. This is what we stated for an objective:

*It is quite possible that our forecasts for 2009 could be wrong, but **we emphatically believe that investors need to be buying stocks NOW!** How can we be so sure about that? We feel cash flow generation by the companies in our portfolio will be at least 8% per year for the next five years, and the number could be much closer to a 10% annual growth rate. Therefore, if valuations just STAY at the same levels they are today, which we would argue are a bit low, then we expect to make 8–10% on our portfolio over the next five years. Compared to the alternatives of CDs, money markets and T-bills, that return is extremely attractive. In our opinion, investors have the best opportunity to own the best companies worldwide that we have had since November 2002.*



We obviously did not forecast the magnitude of the rally, especially after the incredible sell-off in the first two months, but we were very bullish. We are pleased with the accuracy of our projections, and certainly like the impact on our portfolios. We wish that we could have a rosy outlook for the future and could be just as accurate, although from this point we think we would be a lot happier if our projections for the future were wrong. More on that shortly.

### **The Status of the Patient**

So with that, let's look forward. The analogy that kept coming to the forefront of discussions was that of a patient with a serious illness. Last year at this time, the U.S. economy/market (the "patient") was on "life support," with many questioning whether or not it would ever recover. As the year progressed and we reached March 9, the outlook for the patient looked dire. By May, the patient had stabilized and in September, the patient was walking around and resuming some aspects of regular life. Now, at the end of the year, if one looks at the stock market, the patient appears to be back to normal—running around and exercising daily, pumping its muscles and is as fit as can be. After a rally of this magnitude, surely the outlook for the patient must be bright!

As any doctor will tell you, it is very dangerous for a patient who is recovering from a serious illness or surgery to push oneself too fast. They run a high risk of a relapse! While certainly the stock market is different than a human patient, similarities do exist. If the stock market extrapolates current stability and "less bad news" into expectations for the future, stock prices and valuations rise quickly. If the actual recovery turns out to be less than expectations, then stock prices and valuations will fall. We believe this is where we are today. This market has now built into its valuations what we consider to be very optimistic scenarios into the current prices, and markets have rallied from an S&P 500 level of 667 to more than 1150. At this level, we believe the probability of being disappointed is very high, and the risk/reward scenario is skewed heavily to the risk side of the equation.

So with that unpleasant bit of news, let's look at our projections for 2010:

### **2010 – Tug of War**

- The U.S. government will pass sweeping reforms that will not be as onerous as was originally thought by many, but will still be very expensive to implement and unpopular with a large majority of the public. This is a bit of a softball, as we more or less know it will happen, but the impact on several of the points below will be substantial, so it needs to be stated.
- The Federal Reserve and Central Banks around the world will begin tightening monetary policy. This will occur initially with "soft" measures such as ceasing the purchase of securities and then become more direct with the increase in short-term interest rates and possibly capital requirements.
- Unemployment will initially drop as the full impact of the fiscal stimulus reaches the economy but then, much to the dismay of politicians and the rest of the world, unemployment will stop improving and possibly start increasing again.
- The 2010 elections will reverse much of the power shift that occurred in the 2008 elections, but not enough to change the control of the House or Senate.



- After the 2010 elections are over, the push for tax reform will pick up steam. We will subsequently hear proposals for significant tax increases on high wage earners and corporations.
- The Federal Reserve will increase short-term interest rates at a “measured pace” and liquidity will begin to leave the system.
- Substantial bank failures will continue to occur, and a large number of regional banks will be seized by the government. The FDIC insurance pool will have to be replenished through contributions by member banks.
- Commercial Real Estate will become the hot topic, and an alarming number of projects comprised of buildings, shopping centers, etc., will be unable to refinance maturing debt without an equity infusion. As a result, a record number of properties will be foreclosed upon, and there will be significant pressure on the banks that carry the loans on their balance sheets.
- Long-term interest rates will continue to rise and could reach as high as 4.5% on the 10-year U.S. Treasury as investor appetite wanes and concerns about future inflation accelerates.
- Municipal finances will continue to deteriorate significantly. As these entities are forced to adjust property tax appraisals down to be more in line with current market conditions, they will be unable to increase tax rates. This domino effect will lead to lower revenues which will, in turn, lead to reduction of services and potential debt service issues which could impact bondholders.
- Corporate profits will continue to improve during the first half of the year, and then incremental improvements will become harder to achieve. Much of the gains from cost cutting and efficiency would have been realized, and real revenue growth will be required to sustain reasonable growth rates. As real revenue growth begins to come in below plan, expectations for growth will come down, leading to a reduction in equity market valuations.

It should be fairly obvious that we do not see the world in a particularly positive light as we look forward. Let us be totally clear on this point: things ARE getting better, and we are not going to have a complete meltdown of the financial system like was feared earlier this year. We were extremely bullish earlier this year, and we forecasted the stability and improvement in the economy that we are currently experiencing. That said, we will do what we have always done as prices rise dramatically. We will become more cautious. It is almost impossible for us to build a scenario where this market continues to rise at a steady pace without much of a pullback. Does that mean it cannot happen? Of course not, and we would be much happier if the market continued to go up! But, we have to tell our clients what we see. Today we see the risk/reward scenario skewed dramatically by a move in the markets that we feel has discounted the truly best case result for the U.S. economy. As a result of all of the factors we listed above, we believe that equity markets around the world will suffer a significant correction from current levels. We stated on TV last week that “we would be shocked if we did not see a decline of more than 20-30% from current levels.” As already stated, we would love it if the market would avoid that kind of decline, but we are not sure how the market evades a major drop in the face of the news flow we see coming.

At this time, we are maintaining a rating of a “2” on the CAZ Scale (with 1 being the most bearish and 5 representing the most bullish). How far are we from downgrading our position to a “1”? There is no way to know, as it is a combination of equity valuations and current economic and corporate news. Suffice it to say, if markets continue to rise sharply from



current levels without a meaningful improvement in our outlook for economic expansion and corporate cash flow growth rates, the scale will go down to its most bearish metric.

Does this mean that a client should flee the stock market? NO! What it means is that every client needs to review their current allocation and determine what their risk profile is going forward. Many clients listened to our counsel and added significantly to their equity holdings in the first quarter. As a result of the changes in their asset allocation, and the subsequent increase in the stock market, they are now very overweight in equities compared to their target levels. Those clients are scaling out of the excessive position, and following our counsel to go to an underweight position at this time. **If you have not reviewed your allocation and “stress tested” your exposure to see how it would fair in a major pullback, it is critical that you do so as soon as possible.** Your current allocation may be just right for you, and if so, this is a lot of noise that you can chalk up as interesting, but change is unnecessary. However, if your allocation is not where your comfort level is, then action must be taken.

Clients are aware of the exciting news on the business front for CAZ Investments. We are extremely excited about the efforts we are making to improve our ability to serve our clients and deliver excellent investment results. While we would love to have a rosy outlook to deliver, we are always going to deliver the honest, straightforward and blunt evaluation of the world as we see it. Your comfort and ability to make good decisions is our highest priority. As such, we want to give you all the information we have to offer. The trust you place in us is appreciated, and we value our relationship with you. Please don't hesitate to contact us if you have any questions about anything related to your assets. We wish everyone a wonderful New Year, and may we all make a difference in the lives of those around us in 2010.

Regards,

Christopher Alan Zook  
Chairman and Chief Investment Officer