

Founders Capital Management, LLC

2009 Annual Report:

“Sinking the Three-Foot Putt”

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PRINCIPALS' LETTER

From: Founders Capital Management

2009: Sinking the Three-Foot Putt

2009 was another year of incredible volatility for the stock and fixed-income markets. Once the dust settled, the S&P 500 rebounded 26.5% after 2008's sickly roller coaster ride—during which the S&P 500 lost 37%. At the beginning of the year, the housing mortgage meltdown and pressure on securities associated with high-risk loans precipitated further investor panic. By the end of the first quarter, investors had had enough and were screaming, “*SELL EVERYTHING!*” The S&P 500 bottomed out on March 6 at 666 (approximately where it had finished 13 years earlier), and many pundits at the time were predicting further declines, to 400 and lower. We now know that this did not happen, and investors who had opted out of the market ended up regretting their action to sell.

Founders Capital Management is pleased to report that the underlying business value of our aggregate equity holdings grew again in 2009, although the pace of this growth remained slower than normal. The cumulative companies we own are very profitable and continue to exploit attributes that give them a long-term competitive advantage. In this difficult environment, many of our companies are actually growing stronger as competitors fall by the wayside or go out of business.

We stated in last year's letter that we had experienced a once-in-a-generation financial earthquake—and that tremors were likely to follow. Indeed, they did—and similar to 2008, 2009 was a year to avoid losing money permanently by shying away from various types of financial investments that continued to suffer interminable losses. Many of 2009's best-performing equities were financial stocks, and we were not participants in these rebounding securities. We will explain our rationale for avoiding these companies in this letter.

A point to remember: Although the market was successful in driving a “momentous rally” over the past nine months, a sustainable increase remains suspect due to lingering risks in the financial arena. We think today's bankers have a lot in common with certain golfers—they seem to be driving hard for the green, only to end up deep in the bunker. Given this dynamic, we will most likely continue to see random price movements in both stock and fixed-income markets during 2010—along with a high degree of volatility.

This leads us to our usual statement, which we continue to evolve as market conditions change:

With today's uncertain environment of prolonged low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues —investors (including professional) *remain extremely cautious*. At current prices, we expect our *equity holdings* to perform fairly well into the future.

This is not a general statement on the short-term direction of the stock and fixed-income markets. You should note, however, that we *omitted* fixed-income securities from our positive statement. Most fixed-income securities have risen considerably in the past nine months, and the current longer-term yields between 2% and 4% will not offer outsize returns going forward. We believe that our equity stakes in great companies remain “fairly priced” at their current quotations, however. We also believe that these excellent businesses will continue to gain value over the next 10 years, despite short-term gyrations in the markets.

In the past, we have stated that investors wishing to grow their wealth should concentrate on the pace at which their investments grow in intrinsic value. Unfortunately, this is not the norm—most individuals are only ecstatic with high growth in paper wealth, regardless of whether that wealth is grounded in the growth of actual *business value*. In fact, individuals that have experienced a large rebound in their paper wealth due to a recovery in financial equities should beware: *The actual business value of many entities has deteriorated as a result of the economic downturn*, making these companies less valuable.

The Three-Foot Putt

“I don’t fear death, but I sure don’t like those three-footers for par.”

—Chi Chi Rodriguez

The theme of this year’s letter is the “three-foot putt.” For any golf enthusiast, the most intimidating stroke on the golf course is attempting to sink a putt that is 36 inches from the hole. For some unknown reason, every golfer agonizes over this three-foot monster as if it were the nastiest stroke of the round. And it is—who likes to miss an easy putt?! It is far more gratifying to hit a ball 250 yards off a tee, even though it may fade or hook a little. The three-foot putt is something to avoid.

Over the past 18 months, many investors have acted like duffers, hacking away at their portfolio. Fear overwhelmed these individuals, who would wake up queasy each morning, worried that by the end of the day their wealth would be gone. Their emotional response was to avoid put(t)ing their money in the market. Unable to endure a continuous falling portfolio, these investors sold everything, sidelining their money in U.S. Treasury securities—earning negative interest as they waited for the storm to pass. They had visions of driving a long ball in the future after the market plummeted further, versus put(t)ing their money on a stable course that few investors dared to walk.

True investment involves the rational comparison of capital allocation alternatives. Like executing a three-foot putt, the task can require steady nerves and focus. Let’s look at an example: If we were offered an opportunity to invest \$10,000 in a five-year U.S. Government bond (A) that has a coupon or payout rate of 2.5% per year over the next five years with zero growth (and a guaranteed return of principal), or to invest in a series of fluctuating securities (B) that has the following attributes on initial investment—which should we choose?

Investment	Total Earnings	Annual Yield	Projected Annual Growth	Annual Payout
(A) \$10,000	\$250	2.5%	—	2.5%
(B) \$10,000	\$763	7.6%	8%	3.3%

The rational investor would choose to place a \$10,000 investment in (B), given the more favorable investment figures. That same individual might reconsider, however, after learning that (B) represents \$1,000 investments in each of 10 equities—Chevron, Coca-Cola, PepsiCo, Johnson & Johnson, Home Depot, Microsoft, Diageo, Procter & Gamble, Conoco Philips, and Kraft (all of which we own). In this volatile market environment, the thought of “roller-coaster prices” associated with an investment in (B) might make the individual’s stomach turn.

Despite the certainty that an allocation of capital to these equities provides an individual a higher initial dividend payout rate of 3.3% (along with an average growth rate of ~ 8%), most people are still “waiting” for a further rebound in prices before put(t)ing their money into the stock market—when the annual dividend payout rate for these combined stocks declines and returns become lower! Of course, a rebound continues to occur—and many investors are missing out on the significant stock market rise. To be fair, these same investors are now waiting for a market setback, and looking for a time to go “all in” to ensure they don’t miss out on the next “rise.” As always, we believe this type of schizophrenic investment behavior makes little sense.

Rationally speaking, our table shows that an allocation today to the named stocks continues to provide an investor a better deal than mid-term government securities. (For more interested investors—the dividend payout from the 10 stocks mentioned above is more favorable than it appears. The actual *earnings available to owners* of these combined securities rises from the 3.3% dividend yield to an *owner cash yield* of ~ 6.5%, because many of these companies return additional money to shareholders through stock buybacks, in addition to dividend payouts.)

Perpetual Questions

Where is the market going? Has the market bottomed out? Will the market continue to go up?

“Focus not on the commotion around you, but on the opportunity ahead of you.”

—Arnold Palmer

As we have stated many times previously, there are no clear answers to any questions about the market’s near-term direction. Rather than futilely attempt to predict the market’s short-term movements, we are opting to keep our eyes open for opportunities that emerge in a volatile environment—and *opportunities always do surface*. In the meantime, we remain confident in the knowledge that we own securities at prices that will provide us a fair return over time, despite gyrating markets. This includes fixed-income instruments that offer a risk/reward relationship that is commensurate with our expected returns, as well as ownership of individual companies through the equity market that offer us a long-term **margin-of-safety**:

“We will continue to price, rather than time, our purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?”

—Warren Buffett

We would like to share some thoughts and opinions about the current *economic condition* (vs. stock market condition) as these beliefs drive how we are invested over both the short and long term. But before begin, we need to qualify that our thoughts may change as the economic environment transforms.

Our Thoughts About Short- and Long-Term Recovery

We were surprised at the end of 2009 that the recession seemed to be coming to an end, sooner than we had anticipated. We do not expect a robust recovery, however—in fact, we are expecting a slow recovery, owing to the fact that the highly leveraged consumer and the financial community have a long way to go in the deleveraging process. As everyone reduces their debts and the credit market remains challenging, the extension of credit that normally drives robust, long-term economic growth is substantially compromised.

Our assumptions regarding a continued credit contraction and slow long-term economic recovery in the U.S. are based on four realities:

- 1) **The banking sector remains impaired, and financial entities are not lending or being managed in a way that leads to robust economic recovery.** The leaders of the financial community remind us of the banker who came home after a round of Sunday golf, and his wife asked why he can't get a partner like Mike Jones to play with him. The banker replied, "Would you want to play a round of golf with a guy who regularly cheats, lies about his score, and has nothing good to say about anyone on the course?" "Of course I wouldn't," replied his wife. "Well, neither would Mike Jones," said the banker. Despite the government's successful intervention to partner with banks (when no one else would) and to provide them necessary investment and insurance, we remain skeptical of a long-term financial recovery. Why? The credit crisis that largely impacted major financial institutions may be just the beginning of an unwinding that will impact the heart of American business—regional and community banks, and small businesses.

The domino impact of the credit crisis is working its way to regional and community banks, contributing to large aftershocks in the banking industry. Many of the 8,000+ regional and community banks in the U.S. engaged in "lazy banking" over the years by opting to invest in low-quality, higher-than-normal-yielding securities with customer deposits instead of loaning money in the traditional way. They purchased securities, such as preferred stock of large financial institutions like Fannie Mae and Freddie Mac, along with lower-quality Collateralized Mortgage Obligations (CMOs) and Collateralized Debt Obligations (CDOs). These lower-quality securities have deteriorated in value—severely, in many cases.

In addition to this questionable allocation of capital, the \$3.1 trillion of outstanding commercial real estate loans, of which \$1.7 trillion is held by 3,000 banks and thrifts, are faltering as businesses dissipate, leaving real estate owners little or no revenue to support their large real estate debt. Naturally, this large real estate debt was supplied by banks that supported aggressive refinancing that removed equity from existing properties. As 80% of this commercial real estate debt matures within the next four years, the compounding financial issues will require many regional and community banks to recognize permanently impaired securities and force them to write off bad loans, impacting their capital base—and their ability to extend credit. (We expect to see many regional and community banks go out of business or be absorbed by larger banking institutions over the next five years.)

The U.S. economy may be consumer-driven, but a large share of our country's economic success pivots on the entrepreneurial opportunities our capital system provides individual business owners. Small business drives the U.S. economy by providing jobs for more than half of the private work force. "Recession Spells End for Many Family Businesses"—an article about small family businesses that appeared in the *Wall Street Journal* in October 2009, stated that 90% of U.S. businesses are family-owned or -controlled, from traditional small businesses to a third of *Fortune* 500 firms. Although the data are hard to come by, an estimated 4.3 million businesses employing 19 or fewer people closed in a one-year period during this downturn. These families would hardly call this a recession—most likely they would describe their circumstances as a depression. The article goes on to state that small businesses are now having problems securing the credit they need to grow and survive. Most small and family-owned businesses obtain their credit from regional and community banks. As regional and community banks begin to follow the lead of their larger counterparts and aggressively hoard cash to protect capital, the restriction of credit is placing a tremendous strain on thousands of small U.S. businesses that make up a major portion of our employment base. The trickle-down effect—layoffs, wage cuts, and small business bankruptcies—could continue, leading to even higher unemployment (>10%) and lower consumer spending.

To curtail this trend, in December 2009 President Obama met with executives of smaller banks to push them to do more lending to small businesses. He stated to the bankers, "The pendulum may have swung too far in the direction of not lending." Unfortunately, the local and regional banks

are not sound enough structurally to lend, and there is no comprehensive plan by the Obama administration to back the smaller banks and family businesses.

(We are concerned enough with this issue, given the fact that many of our clients own small businesses and rely on local banks for liquidity and loans, that we sent President Obama a letter in early 2009 suggesting various remedies—that letter is included as an attachment to this annual report.)

- 2) **We believe the downturn in housing, which constitutes a large portion of U.S. wealth, has not bottomed out.** Why? There are currently some 75 million homeowners in the U.S.; 50 million of these have mortgages attached to their homes. (It is interesting to note that one-third of U.S. homeowners own their homes outright.) We currently have a surfeit of about 2.5 million houses on the market today. Under normal circumstances, with approximately 1.3 million new U.S. households created each year, it would take around two years to absorb this excess housing inventory. We are not in “ordinary times,” however. It is quite possible that the oversupply of housing stock will take longer to absorb—perhaps up to three years. The bottom line? With lingering excess housing inventory, it is likely that housing prices will continue to decline until further absorption can take place. A slow absorption rate coupled with declining home values leads to another spiraling problem—ongoing mortgage delinquency.

With housing declining 30% from its peak over the past couple of years, the average homeowner has watched the equity in his or her American dream fall to around 20% today—from 50% in the early 1980s. Unfortunately, we need to focus on the portion of average homeowners that have less-than-zero equity in their homes—that’s a staggering 24 million homeowners, if housing declines an additional 10%. Put another way: Almost half of all U.S. households with mortgages may have negative equity in their homes. Many of these homeowners that cannot afford their monthly payments may opt to “walk away” from their homes and leave the keys in the mailbox. In fact, there is an industry term for this—“strategic defaults.” In non-recourse states such as California, homeowners in this category can walk away without any consequence to their remaining assets. The result? Many “paying homeowners” with negative equity actually have a perverse incentive to hand their loss to the bank (or mortgage investor) without suffering any repercussion—an obvious looming menace for the financial institutions and investors that hold these mortgages.

- 3) **We believe there could be a significant increase in the savings rate as Americans strive to pay down their automobile loans and credit card obligations—contributing to an ongoing credit contraction.** Last year, Visa reported that for the first time in history, the total dollar volume of purchases on their debit cards exceeded total dollar volume purchased on their credit cards.

Despite the positive trend of U.S. consumers working to reduce their debt, credit card delinquency and charge-off rates are rising exponentially—reaching 10% of outstanding balances in 2009. We think the delinquency and charge-off rates may continue to rise as the average American is unable to support \$9,000 of credit card debt. The industry response to mounting losses—credit card issuers are aggressively cutting or eliminating credit lines for the less credit-worthy, reducing credit availability to Americans by up to an estimated \$3 trillion by the end of 2010. Washington is not happy with this antagonistic industry response and is attempting to force financial institutions to extend credit to higher-risk customers. This creates a catch-22 situation—either credit is extended to unworthy individuals to increase consumer consumption (pushing future write-offs even higher), or a contraction of credit will stifle economic growth. Regrettably, we think a little of both will result—leading to increased write-offs and a slower-than-normal recovery in consumer consumption.

- 4) **We believe reduced tax revenues in many states will have a large economic impact on various regions of America.** The 12.5% average reduction in state revenues is due largely to increased unemployment, a lack of taxes from corporate profits, and lower sales tax revenues as consumers pull back on spending. New Jersey, which has the highest state and local taxes, will see its deficit

balloon to \$9 billion in 2010, from \$1.2 billion today. California is more than a microcosm of the U.S. By itself, this state's \$1.5 trillion GDP represents the equivalent of the eighth-largest country in the world. Many say, "Where California goes, so goes the rest of the U.S." California is facing a \$26 billion deficit.

Many states are currently responding to lower revenues and higher deficits with pay reductions and job eliminations. We don't have an opinion on these state actions to control expenses; however, we see trouble brewing in the state and municipal debt market. Defaults in this area could rise due to a greater reduction in state and municipal tax revenues. We remain extremely cautious about the municipal debt market in various states, including California. Despite Washington's refusal to assist California, it is highly probable that there will be no choice but to back failing states, as these entities do not have the power to "print money" like the federal government. In the end, failing states that take federal money to cover budget shortfalls, and vast sums of money borrowed by the federal government to shore up the economic system, could eventually lead to increased federal and state taxes—further hampering long-term economic growth.

Inflation and Deflation

An astute member of our group (we pride ourselves on having interested and smart clients) recently asked us this following question:

With continued trouble with mortgage-backed securities and a huge mess developing with commercial mortgaged-backed securities, faltering mid-size banks, an FDIC in need of its own TARP, and a deficit of trillions of dollars (before healthcare reform), why would we not be loading up on commodities like there is no tomorrow as a hedge against what will no doubt be hyperinflation in the future?

This question just about covers it all, and it takes a somewhat lengthy explanation—so here we go!

Let's rephrase this question before we explain our investment approach: What are the consequences of a massive government intervention into the markets (to prop up the banking system and falling mortgage-backed and asset-backed securities of all types), along with growing government budget deficits, long-term healthcare reform, and future pension obligations from Social Security promises made in the past?

The debate on this question will eventually center on how the government plans to fund massive amounts of growing debt, and whether its monetary actions will eventually lead to *inflation* or *deflation*. It is important to understand the definitions of inflation and deflation to properly address this question. It is our opinion that the *result* of inflation is rising prices, and the *result* of deflation is falling values—however, neither of these are the *cause* of inflation and/or deflation. First, there are various types of inflation/deflation to consider—such as commodity inflation/deflation (i.e. rising or falling oil prices), wage-price inflation/deflation, financial asset inflation/deflation (stocks), tangible asset inflation/deflation (real estate), and monetary inflation/deflation. Positive or negative activity in these areas, individually or systemically, can lead to a rise or fall in prices or values, and have different effects on the economy.

Ultimately, inflation or deflation is usually caused by an *imbalance of supply and demand*. The greater the imbalance, the greater the inflation or deflation effects. As an example, let's look at a commodity like oil. If the supply of oil contracts and demand stays constant and/or rises, then it is highly probable that oil prices will increase. Since a vast amount of goods in the world are based on or contain petroleum, it would make sense that most goods would rise in cost as oil prices increase. Thus, manufacturers would likely increase the price of goods to offset their rising costs. This is common sense—let's move on to something a little more complex.

In commodity inflation, predominantly (but not only) a *contraction of supply*, coupled with steady or rising demand, usually leads to rising prices. With monetary inflation, however, the opposite occurs. An *increase in the supply of money* can lead to rising prices due to *added liquidity* within the financial system. With higher liquidity, asset prices rise due to the need to find a home for additional money injected into the system that will provide greater returns. Eventually, rising wages and prices for goods can also occur if extra money permanently finds a way into the financial system. In the long run, the endless printing of money will make currency less valuable, and it literally becomes “*worth less*” than the paper it is printed on.

In monetary inflation, pundits quickly point to central banks and governments as the main culprits for exponentially increasing the supply of money—through *quantitative easing*. Quantitative easing describes an extreme form of monetary policy used to kindle an economy. Normally, the central bank stimulates the economy indirectly by lowering interest rates. This action allows banks to increase profitability through a process of raising money at low rates of interest and lending money out at higher rates. But when interest rates are near zero (where they are today), the central bank obviously cannot lower them any further. They then attempt to fuel the financial system with new money through *open market operations*. In this process, the central bank purchases primarily short-term financial assets from financial institutions (i.e., banks). To accomplish this, the central bank uses money it borrows or creates out of thin air, usually in conjunction with the U.S. Treasury. The creation of more money is supposed to underpin a further increase in the overall money supply through deposit multiplication, which encourages lending by financial institutions and reduces the cost of borrowing—thereby stimulating the economy.

Today, however, we need to somewhat revise this view on increasing the supply of money. As our financial system has evolved, the extension of credit and so-called dispersion of risk (through securitization and derivatives) has incentivized financial institutions to further add tremendous amounts of liquidity, which facilitated an environment for rising prices in areas such as stocks (tech stocks in the late 90s), or real estate (housing the past five years). In other words, it can be argued that the market is quickly emboldened by any actions taken by the central bank and U.S. Treasury to bolster the economy, which indirectly could have greater influence over the ultimate money supply than pundits realize.

At this point, it is important to understand that currently, approximately 75% of total credit is extended through non-bank institutions, which—unlike banks—are largely unregulated. This outsized segment has recently been referred to as the “shadow banking system.”

Added liquidity stimulated through unregulated shadow banks can lead to inflation in asset prices, and eventually to overinflation as asset prices are bid up to so-called bubble levels. For example, let’s say a hedge fund that has \$1 million of equity decides to borrow \$19 million of U.S. Treasury bonds at the low interest rates offered today, and then sell the bonds in the open market (“selling Treasuries short”)—thus ending up with \$20 million to invest. This hedge fund can turn around and purchase any asset (stocks, corporate bonds, mortgage bonds, real estate, etc.) that will offer a higher return than the ultimate cost of borrowing \$19 million—and pocket the difference. In theory, taking advantage of the “spread” between borrowing and investing money sounds logical. But this activity becomes a problem when the hedge fund needs to “lock in” its profit on the rising asset by selling it, and then pay back the \$19 million of borrowed money. Essentially, when all hedge funds sell at the same time, asset prices fall—leading to uncontrolled asset deflation if sales take place precipitously.

As every hedge fund “heads for the exits,” the only one left to add liquidity to prop up the financial system is the central bank and/or government, which must *react* to stem the possibility of severe deflation brought about by continued asset destruction. We end up with a vicious cycle, whereby the central bank and government are forced by the market to increase the supply of money to support ever-rising prices. The consequence of not responding—by backstopping the added liquidity stimulated by the unregulated private market—is persistent financial and economic deflation of assets. We already experienced this in the 1930s, and it wasn’t pleasant.

Today's potential problem—whereby central banks and governments stimulate the market through methods such as maintaining low interest rates or by issuing and monetizing additional debt—invites further market response. What begins as actions by the central banks and governments to support the economy and the market against deflation ends as a market further inflating assets through leveraged activity. For example, today's low interest rates in U.S. Treasury securities invites many hedge funds, which are receiving investment funds from countries such as China that are flush with dollars, to borrow U.S. Treasuries at near 0% interest rates, sell these Treasuries in the open market for dollars, and then exchange dollars for other currencies to invest this money in rising overseas assets—perhaps in commodities to protect against the falling value of the dollar. If we follow this transaction closely, we can see that the action of selling dollars—initially realized through a short-sale of U.S. Treasuries—further devalues the dollar. This market deed, over which the central bank has little to no initial control, exacerbates a falling dollar and rising commodity prices. Essentially, the U.S. dollar is being “pushed down” by the market and is being added to the Japanese yen in the “carry trade”—borrowing money at near-zero levels and placing this borrowed money in other investments that are expected to rise in value. (Clearly, the devaluation of the dollar may be resulting not just from central banks around the world diversifying their reserves from the U.S. dollar and the U.S. government's quantitative easing—hedge funds may also be contributing to the dollar's decline in a big way.) This “free lunch” borrowing activity always comes home to roost when the leveraged trades need to be reversed as investors attempt to “lock in” their profits—or, worse yet, run for the exits en masse. All it would take to trigger a reversal of this trade would be an unexpected rate hike by the Federal Reserve that would raise the cost of borrowing money for these leveraged investors—a scenario that is not beyond possibility.

The above example paints a more complex picture of the market as well as the inflation versus deflation debate. A struggle currently exists between inflationary and deflationary forces that are exacerbated by the temporary actions of central banks and governments to manage the economy and financial system (to avoid deflation), versus the market's actions to take quick advantage of “temporary free money” and further inflate assets. This ongoing cycle could lead to further bouts between inflation and deflation, as well as the devaluation of all fiat currencies as central banks and governments throughout the world are continually forced to “prop up” the global financial system.

This leads us, finally, to hyperinflation. Hyperinflation is the result of a massive destruction of currency(ies)—usually brought about by the excessive printing of money. Confidence is lost in fiat currency as its value is exponentially destroyed by the central bank(s), government(s), and the market(s). The destruction of fiat currencies can spread beyond the U.S. dollar, since countries expand their money supply to maintain targeted exchange rates to the world reserve currency (the U.S. dollar), to protect their ability to trade. (This is now happening—China recently reported a 30% increase in its money supply.)

Many of our readers will now ask; “How can we let this happen? Why can't we introduce regulation to stem this unhealthy leverage activity produced by the market, and allow the central banks and governments to slowly ‘mop up’ the excess liquidity to stem future inflation?” This is a valid point. Because the global markets are now so interconnected, however, the required regulation would have to be global, and agreed upon by major central banks and governments throughout the world. Common agreement requires give and take, which can be a very slow process.

In summary, we don't know the answer to the question. But we believe it will remain a very difficult investment environment, and we are uncertain if we will end up facing extremes, such as hyperinflation or severe deflation. Why? Because before a crisis occurs, these extremes can be “manipulated” and/or managed through central bank and government intervention or regulation, or through market “self-regulation.” Since we all realize the consequences of these extremes, it is in our collective best interest to avoid them. We believe they can be avoided. The most plausible outcome would be “controlled inflation” and a “managed devaluation” of the U.S. dollar.

A Word About Capitalism (and our prediction of a very long recovery)

During the past year, the concept of capitalism has come frequently into question—whether or not it is a viable economic and social system. You will not be surprised to hear that we are optimistic and “all in” for capitalism as a base for our economic and social structure. We feel it is important to discuss capitalism’s inherent problems today, however, and to recommend some broad adjustments.

First, we need to understand the difference between the “symptoms” of capitalism versus the “problems” of capitalism. Our current problems owe more to “capitalists” that abused a system rather than capitalism as an economic and social structure. In concept, abuse can happen (and does) in any economic and social system—this we have witnessed over the centuries.

The core issue with the capitalists that led to this dilemma is what can be referred to as “animal spirits.” Humankind has a propensity to bring things to the extreme, and the capital markets are not exempt. Over the past decade, we have seen investor animal spirits produce bubbles in Internet stocks, the general stock and debt markets, real estate—and possibly commodities in the near future. Bankers may have paved an easy road to these bubbles through loose lending policies; however, investors of all types need to look in the mirror and recognize their contribution to the current situation. At every level—federal government to individual—our society has borrowed too much money and now possesses too much debt. The debt binge of the past 20+ years needs to be managed down, and as we go through a 10+ year “payback period,” economic growth will likely slow.

In the meantime, through quantitative easing, the U.S. government and U.S. Treasury helped to avert a meltdown of our financial system. We face a number of risks now, however. Banks, which need to conserve capital as losses continue, may refuse to lend despite an increase in their deposits. In addition, accommodative government policies could end up being too effective, precipitating a worst-case scenario of more investor speculation, further bail-outs, added currency destruction, and eventual hyperinflation.

New regulation is required if we are to avoid a repeat of the recent financial debacle. Over the long term, lax monetary policy will only invite a retriggering of extreme animal spirits and encourage financial risks whose consequences will ultimately be borne by society. The idea of privatizing profits for successful ventures but socializing risk for failed financial dealings is unsupportable.

A few broad policies are needed to manage today’s capitalist structure:

- 1) **Our financial authorities need to manage the “animal spirits” of the market when they get out of control.** It is not good enough to “jawbone” about frothy markets. Some action should be taken, and intervention is necessary to manage the situation before it gets out of control.
- 2) **Controlling the money supply is not the only thing the financial authorities can do—they must also control the extension of credit throughout the whole financial system, encompassing both banking and non-banking entities.** Regulation can be introduced that sets stringent capital requirements for various financial entities. Banks can be forced to account for securitized activities by requiring “skin in the game”—if a bank purchases mortgages, only to package them and eventually sell them to investors, a fair portion of the packaged mortgages should reside with the bank. And shortly, financial organizations will be required to account for any short-term off-balance sheet financing vehicles that are designed to securitize assets, and include them on-balance sheet. Non-bank entities such as hedge funds should also be regulated, and leverage activity should be managed and fully monitored—including derivative liability exposure.
- 3) **Transparency should exist to enable authorities to measure aggregation risk—when institutions end up on the same side of a trade, all carrying out a similar strategy.** A problem presents itself when everyone tries to “run for the exit door” at the same time.
- 4) **An implicit government guarantee should not exist for financial institutions that feel they are “too big to fail.”** This implicit guarantee has made banks think it is okay to use depositor money to take

excessive risk. Banking institutions should not be allowed to use depositor money for proprietary trading—banking executives wishing to trade for their own gain should do so using their own capital.

- 5) **Compensation, which is currently out of control, needs to be controlled.** Bankers should not be compensated through large bonuses (stock or cash) for figuring out how to abuse a system by using other people's money to take excessive risk, and making exorbitant profits for themselves.

It is going to take a long time to recover from this financial debacle. Unfortunately, much of what we need to do to save the system today is the opposite of the actions needed to better control our financial system in the future. Today, we need:

- the return of “animal spirits” for individuals to feel comfortable to invest in the markets
- to provide excessive liquidity to extend desirable credit, and to stem a permanent downturn through deflation
- low interest rates to allow banks and individuals to produce money and replace lost equity
- a friendly valuation of bank assets to keep them “well capitalized”
- a lack of transparency—if banks recognized all on- and off-balance sheet assets at their true value and recognized fully deteriorated assets, many would be deemed insolvent
- a government guarantee on bank assets and deposits to forestall any “run on the banks”

Given the conflict between short- versus long-term needs, we will likely go through a very long and slow process of monetary exiting and introducing the necessary changes to financial regulation. We can only accomplish this as the financial system heals. Congress has its work cut out for itself in 2010.

So, what do we anticipate?

In consideration of these looming issues, we expect the following over the next few years:

- A slow rebound of economic activity in the U.S. and Europe, along with continued robust economic growth in countries such as China and India
- Continued backing of the financial system by the U.S. government—banks, homeowners, defaulting states/municipalities, etc; we also expect foreign governments to back their financial systems
- The financial system will undergo a “healing process” that will result in long-term restrictive consumer lending practices and capital conservation by banks, increased equity requirements for homeowners, and cutbacks in state spending
- The emergence of financial conservatism in the U.S. as individuals increase their savings rate and shy away from excessive borrowing
- Persistently high U.S. unemployment levels as companies strive to be more productive in an increasing global competitive environment; in addition, we expect future wage increases to remain low
- Ongoing U.S. government stimulus programs to maintain positive economic activity and offset higher unemployment levels—the stimulus programs will increasingly be aimed at putting citizens back to work by rebuilding U.S. infrastructure (highways, water, energy, etc.)

- **Increased federal and state taxes for U. S. corporations and wealthy individuals** (i.e. healthcare), as well as consumption taxes on energy, luxury goods, and “sin items” such as cigarettes and liquor
- **Borderline deflation during most of 2009 and early 2010** as financial deleveraging and credit contraction continue—in response, the U.S. government (and world governments) will pump trillions of dollars into the financial system to avoid deflation and a repeat of the Great Depression of the 1930s
- **The Federal Reserve and U.S. Treasury may find it difficult to quickly remove the vast amount of injected money from the financial system**—it is quite probable the necessary stimulus and liquidity actions by the U.S. government will be followed by inflation in the future (perhaps quite high)
- **A possible re-leveraging of the markets** as large investors (such as hedge funds) take advantage of a lack of regulation and loose monetary policies by borrowing vast amounts of money at low interest rates—reinvesting borrowed money and pushing up asset prices throughout the global financial system

Considering these factors, it is possible we will end up with a stagnant U.S. economy but experience inflation (prices, assets, and monetary) as the financial system readjusts and large countries such as China and India continue to grow, increasing demand for energy and other commodities.

How will we invest in this climate?

“Placing the ball in the right position for the next shot is 80% of winning golf.”

—Ben Hogan

With every crisis, there is an opportunity. We believe that a rational and pragmatic investment approach will produce satisfactory results over the long term. *In essence, we are positioning our capital in the middle of the fairway.* With an eye on results over the next decade, our investment approach is based on our current beliefs and assumptions summarized throughout this letter. We may see higher-than-normal volatility as the market struggles between inflationary and deflationary forces. Nevertheless, we are confident that an allocation of capital to specific securities will outpace risk-free returns on 10-year U.S. government bonds—currently at 3.7%. Generally, we have positioned our capital as follows during this challenging period:

- **We are currently avoiding any allocation of capital to banks and other financial institutions at their current prices** (despite the significant run-up). Recent bank paybacks notwithstanding, the U.S. government remains a significant backer to many of these enterprises and has an obligation to the taxpayer—not to bank owners and managers. We do not have an interest in being second in line, behind the U.S. government. In addition, the fundamental business of financial institutions remains suspect—financial institutions will face many more write-offs in upcoming years as bad loans continue to surface. We do not have the ability to prognosticate the extent of these looming losses.
- **We are sticking with investments that offer a “current short-term return” that is approximately equal to or better than a long-term 10-year U.S. government bond**—including higher dividend-paying stocks as well as higher-paying fixed-income investments that have a lower chance of default. Zero default is not predicted—however, we do anticipate our aggregate returns in this area to exceed the U.S. 10-year government bond benchmark.

- We are erring on the side of investing in companies that are positioned to do well during depressed, deflationary, or inflationary times. This includes consistent, low capital-intensive businesses with recognizable consumer brands such as Coca-Cola, PepsiCo, and Procter & Gamble.
- We have a larger-than-normal allocation of capital to companies that are exposed to international markets. These global companies will continue to take advantage of growing markets and provide investors greater long-term returns compared with businesses that participate exclusively in the U.S. domestic market. These businesses are also exposed to non-dollar-denominated currencies and report higher earnings if the U.S. dollar declines faster than other world currencies.
- We have a larger-than-normal allocation of capital to commodities that would benefit from declining currencies—especially the U.S. dollar. This exposure is both direct and indirect through investments in oil companies, gold and silver mines, or directly in gold and silver bullion.
- We are consistently reallocating capital that matures in the fixed-income area to short-term investments (on average, less than 5 years) with the anticipated possibility of reallocating this capital to higher-earning securities if inflation resumes.

At Founders Capital Management, our activity will remain deeply rooted in the time-tested principles of investment simplicity. We will seek investments in securities that we know and understand, and in assets whose intrinsic value we can fairly estimate. We will also continue to:

- Manage our portfolio in a way that avoids excessive trading
- Strive to identify developing risks—even in areas that have not yet erupted
- Invest for the long term, and concentrate on the distinction between what is knowable and important as opposed to what is either knowable and unimportant, or important and unknowable
- Hold to the conviction that emotional stability and thinking independently from the crowd eventually lead to success, despite random price fluctuations in the market.

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2009 Highlights

"Never have a club in your bag that you are afraid to hit."

—Tom Kite

Our current portfolio represents a collection of great businesses that we believe are trading at better-than-fair prices and that continue to gain value every day. To paraphrase Tom Kite: We don't have a business in our portfolio that we are afraid to hold. Berkshire Hathaway, Coca-Cola, PepsiCo, Procter & Gamble, Microsoft, Burlington Northern, Johnson & Johnson, Medtronic, Disney, Comcast, and our other holdings continue to grow their aggregate earnings and strengthen their businesses independent of any short-term gyrations in their stock quotations.

Following is a summary of business highlights from our portfolio companies during 2009, along with our expectations for 2010.

Consumer Group

Our primary consumer holdings—Coca-Cola, PepsiCo, and Procter & Gamble—continue to drive the ball down the center of the fairway. These companies had an excellent 2009 despite economic headwinds, and we expect our consumer group to produce very good results in 2010 as the recession cloud dissipates.

How will our consumer group perform during deflationary or inflationary times?

We have mentioned in the past how a consistent purchase pattern among product categories creates an efficient revenue and profit stream. The daily worldwide consumption of Coca-Cola, PepsiCo, and Procter & Gamble products enables these businesses to perform better than average in both deflationary and inflationary times. Consistent purchase patterns and high product turnover also allow these companies to use assets effectively. If a business needs to invest vast sums of money into property, physical plant, and equipment to produce consumer goods, a steady unit sales pattern leads to consistent production efficiency—maximizing the return on each dollar invested in the business. The art of making Tide, Crest, or concentration syrup for Coca-Cola and PepsiCo products has not changed in decades—which means associated property, plant, and equipment last for years. During deflationary and inflationary times, these companies can “delay” large capital expenditures. This is very important, as these businesses can lower prices in a period of deflation, or raise prices with inflation—remaining highly profitable in either circumstance. A final, highly significant point: Each of these companies produces products that have a tremendous share of the consumer's mind. Their brands are highly sought-after and consumers pay more for their products versus a generic counterpart.

Businesses that do not share such attributes—large appliances, automobiles, or heavy tool makers, for example—suffer under deflationary or inflationary times due to inconsistent purchase patterns, high capital requirements, and consumer sensitivity to price and insensitivity to brands. (Imagine buying steel in advance to make a car or washing machine, and then having the price of steel rise or decline 30% while you are in the middle of production—savvy retailers and consumers are not going to expect a rise in steel prices to be passed on to them, but they will expect any reduction of input prices to be passed on.) Coca-Cola, PepsiCo, and Procter & Gamble are not subject to these negative forces, whether in a deflationary or inflationary economy. Let's review each of them.

Coca-Cola

During 2009, Coca-Cola grew its overall volume between 3% and 4% and improved profits by 23%. Along with impressive growth through the recession, Coke improved its balance sheet and increased its cash position during the year. The company will end 2009 with approximately \$9 billion cash on hand, up from \$4.9 billion at the end of 2008. These data illustrate the “business strength” of Coca-Cola, as opposed to the market strength of Coke’s stock price—if the business does well, the stock price will eventually follow. We believe Coke has a tremendous future and is positioned to deliver promising results over the next decade for several reasons:

- **Coke has a unique opportunity to increase its penetration of fast-growing economies outside the United States.** More than one billion people are expected to enter the global middle class by 2020, bringing more discretionary wealth and spending on products such as beverages. Based on this projection, Coke anticipates approximately 6% annual revenue growth, due largely to a forecast of explosive demand in high-growth regions such as India and China—these two areas are expected to drive 70% of incremental volume growth over the next 10 years. Coke is responding to this forecast with plans to double the number of bottling plants in China over the next decade and to triple its sales penetration to reach 4.7 million outlets in the country. China’s average annual per capita consumption of Coke products is 28 per person, compared with an average of 199 in Brazil and more than 400 in North America.
- **Coca-Cola has been focusing on innovation in the “all beverage” category the past few years.** We think innovation is a key to long-term business success. From the purchase of Glacéau (makers of Vitaminwater and Smartwater) to the company’s launch of a dairy-based pulp drink with a coconut and fruit taste in China, the company is extending its reach well beyond a basic carbonated beverage company. Continuing the innovation theme, Coke is launching Vitaminwater Zero in 2010 and has plans to continue introducing low-calorie products throughout the world in the upcoming years.

In summary, we think Coke is the “Real Thing” in any economic environment. Coke is a cash machine—the company will produce approximately \$6 billion for shareholders in 2009, up some 10% from last year. In light of its strong cash flow, the company recently decided to reinstate its share repurchase program and may buy back something around \$1 billion in the second half of 2009—this is on top of the company’s ongoing dividend program. Coke continues to pay an annual dividend of \$1.64 per share, which currently yields almost 3%, and we think this will increase in 2010—to around \$1.75. In 2010, we believe Coca-Cola will earn more than \$3.40 per share and will return a large portion of its earnings to shareholders through dividends and share repurchases.

PepsiCo

As a result of the U.S. economic downturn, PepsiCo’s growth was lower than anticipated. The company’s annual earnings came in 25 cents per share lower than predicted, at \$3.70 per share. In 2009, worldwide volume increased slightly, with sales growth remaining flat, a performance that reflects the fact that PepsiCo derives a much larger percentage of its business in the domestic market compared with Coca-Cola and thus was more negatively affected by the U.S. recession. Nevertheless, PepsiCo remains committed to pursuing aggressive international growth in both drink and snack products. PepsiCo’s global business now accounts for more than 50% of the company’s sales, and we believe this proportion will greatly change over the next 10 years—especially as the company addresses opportunities in China.

In the past 12 months, PepsiCo opened a new factory in China in the southwestern city of Chongqing that will manufacture up to 80 million cases of various beverage products—from Pepsi and Mountain Dew to Gatorade and Tropicana juices. The company has also earmarked five more plants to be opened in the next 24 months, to be located in lesser-developed Chinese provinces. This is part of PepsiCo’s effort to reach deep into China’s vast market. In all, PepsiCo will invest \$1 billion in China

over the next 36 months to build the company's sales force to expand product distribution, and to expand local research facilities to develop new products that are tailored to Chinese consumer tastes.

During the second half of the year, PepsiCo announced that it will acquire Pepsi Bottling Group and PepsiAmericas for \$7.8 billion in a 50% stock–50% cash deal. Once this transaction is completed in early 2010, PepsiCo will directly control 80% of its distribution. The company expects to generate pretax synergies from the acquisitions of \$150 million in the next 18 months, and \$300 million by 2012. The question is: Why has PepsiCo decided to consolidate its capital-intensive distribution system with the parent company, compared with Coke, which controls its distribution system through minority ownership positions? PepsiCo occupies different business segments than Coke, such that it makes some sense for the company to effectively place all distribution under one umbrella. For example, a large part of the company is in the snack food business and a more integrated beverage and food business distribution system could help the company leverage its vast stable of brands in the retail market. Over time, we will see how this strategy works for the company and if it leads to incremental business.

In 2009, PepsiCo again increased its return to shareholders and raised the annual dividend by almost 6%, from \$1.70 per share to \$1.80 per share. We expect PepsiCo to raise its dividend to approximately \$1.90 per share in 2010, which implies a yield of about 3% at the current stock price. Given the acquisition of PepsiCo's key distribution partners, we think the company will suspend its stock buyback program temporarily in 2010, a prudent move designed to pay down debt. Looking ahead to the company's distribution strategy creating long-term value for shareholders, we regard this as good management of capital. In 2010, we expect PepsiCo to grow earnings between 11% and 12%, and we remain excited to own this quality company as the worldwide market potential for non-carbonated soft drinks and snack foods continues to expand in the next decade.

Procter & Gamble

Over the past few years, we added Procter & Gamble to our consumer products portfolio, and we accumulated additional shares of this company during 2009.

At the right price, we continue to add this consumer juggernaut that sells more than three billion products to more than four billion customers every day. P&G brands touch the lives of people around the world. The company has one of the strongest portfolios of trusted leading brands, including Pampers, Tide, Ariel, Always, Whisper, Pantene, Gillette, Bounty, Dawn, Gain, Charmin, Downy, Lenor, Iams, Crest, Oral-B, Duracell, Olay, Head & Shoulders, Wella, Vicks, and Braun—to name just a few.

P&G's worldwide sales volume has stagnated due to the recession— and so has the stock price— presenting us a unique opportunity to build a large position in this company. P&G is addressing the lackluster volume growth and repositioning the company to market to a more “value-conscious” consumer in a difficult economic environment. (In the past, we discussed P&G's strategy of “tiering” product offerings: For example, the company offers Basic Crest toothpaste for the budget-minded consumer, and Crest Whitening Expressions and Crest Pro Health for less price-sensitive consumers.) When volume tapered off at the beginning of the recession, P&G was in the midst of introducing the more expensive versions of a variety of products and initially responded to the slowdown by increasing prices to offset lower sales. As the slowdown accelerated, the company found itself with a product portfolio of higher-end products, along with higher price points. Six months ago, P&G began to transform its product selection by offering a “value-tiered” approach and effectively recalling many of the price increases it had instituted on its product lines. For example, the company is now offering larger packages of certain middle-tiered products for the same price as the regular-size packages, and providing customers an opportunity to buy certain products in bulk. Targeting customers that wish to buy products in limited quantities, the company is also offering smaller packages at a lower price. We expect this effort to improve targeting of the company's product and volume mix—giving different

customer populations what they want in the quantities and prices they desire—to lead to renewed volume growth.

We expect P&G to produce approximately \$4.10 per share in earnings during 2010 and to return a large portion of its \$12 billion in profits to shareholders in the form of share repurchases and dividends (expected to be \$5.5 billion or \$1.85 per share—equaling a dividend yield of 3% at the current stock price). We remain excited about P&G’s tremendous global opportunity and will continue to make a long-term allocation of capital to this company.

Industrial and Transportation Group

Our primary industrial and transportation holdings—Burlington Northern Santa Fe Railroad and United Technologies Corporation—were profitable in 2009, and we expect these businesses to produce good results in 2010.

How can infrastructure businesses such as Burlington Northern and UTC perform well during an inflationary or deflationary environment? Although most infrastructure businesses struggle under such circumstances due to their capital-intensive nature, each of our invested businesses has infrastructure that has been established over many years. For example, it has taken more than a century to build the U.S. railroad infrastructure, and it would take an extraordinary amount of time and capital to create a business transportation system that competes with a railroad such as Burlington Northern. Although the railroad business is also capital-intensive compared with most consumer-product businesses, certain attributes make this type of investment attractive in either an inflationary or deflationary environment. When facing challenging economic times, companies will attempt to run more efficiently, either due to lower sales and decreasing prices in deflationary circumstances, or due to exponentially increasing costs in an inflationary environment. Moving shipments of goods using rail instead of higher-cost trucking can achieve large productivity increases. Thus, we expect that many companies will seek to curtail shipping costs by significantly increasing their use of rail instead of trucking in any environment. An increase in volume (and revenue) over an established infrastructure that is difficult to duplicate spells higher profits for a company like Burlington Northern.

United Technologies

UTC’s business model provides a unique competitive advantage: The company concentrates on infrastructure businesses that have a slow replacement rate—think of how often you need to replace an elevator, air-conditioner, or airplane engine. Yet these products have a high servicing component. Once UTC has won a contract for supplying elevators or air-conditioners for a building, the associated servicing contract can continue for years, providing a predictable and long-term revenue annuity. In addition, once these products are installed, it is highly unlikely that they will be replaced anytime soon, since removing banks of elevators or large air-conditioning systems from buildings takes considerable time, effort, and money.

UTC continued to expand its infrastructure-based business with two significant investments in 2009:

- **UTC agreed to acquire a 49.5% stake in Clipper Windpower.** Clipper utilizes gearless generators, the next-generation design for the industry, and currently produces the largest commercially available wind turbine in the world. UTC’s initial investment in a renewable energy company demonstrates the company’s belief that wind technology projects (especially off-shore) represent a significant growth opportunity in the future. The agreement with Clipper will allow UTC to combine its significant knowledge in turbine manufacturing (through Pratt & Whitney) with Clipper’s wind expertise. This investment could also be a prelude to further acquisitions in the wind sector as UTC moves to consolidate regional players.

- During the 4th quarter of 2009, UTC acquired GE Security for \$1.82 billion. General Electric's global security business represents a \$100 billion fragmented market, and with less than 2% share, it was not a big player in the field. UTC is a leader in global security, and this \$1.8 billion bolt-on acquisition enables the company to increase its global security market share to approximately 25%. In addition, this acquisition will give UTC a greater ability to cross-sell its security business packaged with HVAC, elevators, and building controls.

We expect UTC to produce approximately \$4.11 per share in earnings during 2009, and to increase earnings to \$4.60 per share in 2010. We also expect the company to distribute a large portion of its \$4.3 billion in profits to shareholders through dividends and share buybacks.

Burlington Northern Santa Fe Railroad

A significant development occurred with Burlington Northern in November 2009: Berkshire Hathaway decided to purchase the 77% of BNSF's stock it did not own—taking full ownership of the second-largest rail network in the U.S. As such, we will be tendering our shares of BNSF to Berkshire Hathaway for \$100 per share during the first quarter of 2010. While this quick gain in BNSF's stock price makes us all feel good, Mr. Buffett rarely pays “full price” for anything—and we believe this is the case with BNSF. Nevertheless, we maintain a very large position in Berkshire Hathaway that will enable us to participate indirectly in BNSF's increasing value.

Mr. Buffett's interest in BNSF was spurred by a long-term increase in worldwide energy demand that is driving businesses to seek more cost-effective ways to ship their goods to end-users. Although energy demand has slowed during 2008 and 2009, we do not see an end to companies' desire to curtail operating costs and to increase productivity in upcoming years. We also believe that energy prices will remain higher than most expect over the next decade. An analysis of the movement of goods has not changed much over the past few years—around 70% of the transportation of merchandise revenue is accomplished via trucking. Since rail transportation is three to five times more fuel-efficient than truck transportation, we are likely to see the percentage of goods transported via rail vs. truck increase over the next decade—perhaps significantly. We expect the growing use of rail, along with the expansion of railroad services via “double track” (vs. single track) and “double stacking” of containers, to drive a large expansion in railroad use, revenues, and profits.

Healthcare Group

Our primary healthcare holdings, Johnson & Johnson and Medtronic, achieved profitable growth during 2009, and we expect these medical businesses to grow their earnings throughout 2010.

Despite recent legislation to reform healthcare and the difficulty in predicting the future of drug development, we believe that investing—at the right price—in a diversified portfolio of healthcare companies that do not carry many of the typical risks associated with this sector can be rewarding. We remain convinced that Johnson & Johnson and Medtronic are two companies that fit our investment criteria: Each company occupies product segments that are resilient under any economic condition or social reform, and each displays consistent purchasing patterns and strong loyalty from a growing customer base. Both companies are positioned to do well as the global population increases and ages in the coming decades—and we believe both are currently selling at a “fair price.”

Johnson & Johnson

J&J is extremely diversified, with more than 250 companies selling to every country throughout the world. The company competes in three healthcare segments—Consumer, Pharmaceutical, and Medical Devices and Diagnostics—which constitute approximately 30% of the \$4 trillion global healthcare market. Although J&J is a very large company, its sales represent only about 5% of total sales in the sectors in which it competes—the other 95% represents future opportunity.

With its entrepreneurial culture and decentralized management style, J&J's business model is unique within the healthcare industry. The company's approach has enabled it to thrive in an ever-changing healthcare market, allowing it to adapt and take advantage of growth opportunities. When one area of the company faces challenges, other divisions can make up the difference. For example: In the past few years, J&J's pharmaceutical segment has been challenged by patent expirations and slower sales growth. During the same time frame, the company's Medical Device and Diagnostic segment picked up the slack and continued to grow. Over the next five years, as growth in the Medical Device segment wanes, we expect the pharmaceutical division to escalate as new drugs in the pipeline come to market, leading to approximately \$7 billion in new sales. We also expect emerging markets to contribute to the company's expansion in coming years. The most significant opportunities will come from the BRIC countries—Brazil, Russia, India, and China. J&J's decentralized and diversified approach are key reasons the company has been able to deliver an exceptionally consistent performance for decades, racking up more than 75 consecutive years of sales increases—and we imagine this will continue.

We expect J&J to earn approximately \$4.60 per share in 2009, and to grow earnings at 7.5% in 2010, to \$4.95 per share. The company generates more than \$11 billion of owner earnings and will return this cash to stockholders through \$5.5 billion of dividends (a 3% dividend yield at the current stock price) and \$5.5 billion in share repurchases. This equates to a 6% yield for shareholders, which is difficult to find in today's investment environment. Given the current return to owners of this company, along with its optimistic future, J&J is a very attractive position in our portfolio.

Medtronic

During the current recession, we have accumulated a large position in Medtronic, the leader in implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. The company continues to be a growth leader in devices that manage chronic diseases of the spine, pancreas, and brain. In 2009, the company grew its sales at approximately 8% and is expected to grow revenues at approximately 5% in 2010. This is exceptional growth during a recession, and we anticipate the company's expansion to continue despite healthcare legislation that will place certain price controls on medical device manufacturers. Medtronic maintains a strong commitment to investing more than 9% of sales into R&D and has an innovative pipeline of products in development that target many underpenetrated markets. Products that will propel the company forward include drug-eluting stents, artificial discs, neurostimulation, and continuous glucose monitoring devices for patients suffering from diabetes.

In addition, Medtronic is placing greater emphasis on growing international revenues. We anticipate the company to increase its share in many product areas as international markets expand. Medtronic still expects tremendous growth in Russia, China, Brazil, India, and Asia/Korea. The company is aggressively adding sales representatives to address opportunities in these emerging markets. These factors will more than offset the price controls introduced for medical device makers in the new healthcare reform bill.

We expect Medtronic to earn approximately \$3.20 per share in 2009 and to grow its earnings 9% in 2010, to approximately \$3.50 per share. Even though the company's stock price has rebounded markedly this past year, we believe it remains undervalued. We plan on holding this healthcare company in our portfolio over the long term.

Technology Group

Microsoft

Our technology holding, Microsoft, had very good results in 2009, and we expect the company's growth to accelerate during 2010. Although a weak global economy temporarily hobbled demand for

software, Microsoft positioned itself to weather the storm more successfully than most technology firms. Microsoft's success over the past year owes to:

- **Windows 7**—Microsoft released Windows 7, the next generation of its Windows Operating System line, in October 2009. Windows 7 has received a far better reception than its predecessor Vista, with initial retail sales more than 200% higher than Vista on a unit basis since its release. With an expected PC volume growth of 9%+ in 2010, we believe the release of Windows 7 is timely and that Microsoft will see improved financial results in the coming year.
- **Office 2010**—Microsoft issued a beta release of Office 2010 in November 2009, with final release slated for early 2010. In addition, in response to Google Docs—a free web-based word processor, spreadsheet, presentation, and form application offered by Google—Microsoft plans to introduce “Office Web,” a free web-based version of Office 2010 that will include the Office word processing application, the Excel spreadsheet, PowerPoint presentation software, and OneNote message pad. The programs will be available directly through Microsoft's Windows Live portal and will launch directly within a user's browser. It is likely that Office 2010 will gain considerable traction as consumers upgrade their desktop productivity software by purchasing new computers that feature the Windows 7 operating system.
- **Bing Search Engine**—Microsoft introduced its own web search engine, Bing, in the third quarter of 2009. Bing has been gaining ground, increasing the company's share of the U.S. search market from 8.4% at launch in June to 10.3% in November, according to internet marketing research company comScore. Microsoft has grabbed the largest share of search traffic from Yahoo! over this time period—ironic, given Yahoo!'s rebuff of Microsoft's bid for the entire company in 2008. (We are pleased this acquisition did not go through.) In lieu of a merger, Microsoft and Yahoo! signed a search deal whereby Microsoft will supply the Bing search engine to Yahoo!'s sites in return for a small portion of advertising revenues.

Last year, we cited Microsoft as a perfect example of a company that exhibits a disparity between its market price and intrinsic business value. We estimate that Microsoft's intrinsic business value had almost doubled over the past five years, and during this same time frame, the company's stock price had declined approximately 28%. As with any large disparity in the stock market, this convergence closed somewhat in 2009—Microsoft's stock price rose around 60% during the past 12 months.

What do we think of Microsoft now? The company's current market capitalization is approximately \$275 billion, including approximately \$40 billion of cash on the company's balance sheet. Microsoft will likely generate around \$18 billion of cash in 2010, and this will grow at 8% to 10% per year. Under this scenario, Microsoft would still be able to buy back most of the company from shareholders in 10 years. We think Microsoft is undervalued, and we will remain invested in this company.

Financial Services Group

Berkshire Hathaway

Berkshire Hathaway should show an increase in shareholder equity of approximately 20% in 2009, from \$109 billion to \$131 billion. Even though book value (a measure of a company's worth if all its assets were liquidated) has now grown at more than 8% since the end of 2007, Berkshire's stock price is down more than 30%. This represents another instance of a disparity between a company's stock price and its intrinsic value—Berkshire is worth more than its current stock quotation.

As we stated previously, toward the end of 2007, Mr. Buffett significantly scaled back the company's coverage of catastrophic events such as hurricanes, which led to stagnant growth in premiums and

float. As such, Berkshire's catastrophic insurance results were not as strong in 2009 compared with the past few years. We remain unconcerned with Berkshire's decision to temporarily pull back on its catastrophic insurance coverage throttle. In the insurance business, discipline is not only a requirement for profitability—it's a necessity for long-term survival. Mr. Buffett runs Berkshire the same way Patty Berg plays golf: *"It's not how fast you get there, but how long you stay."* And Berkshire has staying power.

Competitive insurance companies that aggressively priced catastrophic insurance coverage and invested premium money in esoteric securities got clobbered during the downturn. In contrast, Berkshire's conservative approach allowed the company to emerge on top. Although Berkshire's relative success is important to note, what we're most focused on is the weakened competition in the overall industry. We believe this climate will lead to a "hardening" of insurance prices during 2010, at which point we expect Berkshire to open up the underwriting throttle a bit—providing catastrophic insurance coverage to various industries at increased prices.

Warren Buffett continues to maintain a passionate desire to grow Berkshire Hathaway's intrinsic value. Mr. Buffett cut a slew of large deals during the recent market downturn:

- **Berkshire invested \$6.5 billion with the Mars family to purchase the Wm. Wrigley Jr. Company.** In exchange for this investment, Berkshire received \$2.1 billion of preferred stock and \$4.4 billion of "subordinated notes," due 2018. The notes will be held to maturity and are currently collecting annual interest at 11.45%.
- **Goldman Sachs Group, Inc. agreed to sell \$5 billion of perpetual preferred stock to Berkshire Hathaway in a private offering.** The preferred stock has a dividend of 10% and is callable at any time at a 10% premium. In conjunction with this offering, Berkshire Hathaway received warrants to purchase \$5 billion of Goldman Sachs common stock with a strike price of \$115 per share, exercisable at any time for a five-year term. (These warrants are now very profitable, given Goldman Sachs' share price exceeding \$165 at the end of 2009).
- **General Electric sold \$3 billion of perpetual preferred stock to Berkshire Hathaway.** The preferred stock has a perpetual dividend of 10% and is callable after three years at a 10% premium. Berkshire Hathaway also received warrants to purchase \$3 billion of GE common stock with a strike price of \$22.25 per share, exercisable at any time for five years.
- **Berkshire acquired a 12% convertible perpetual capital instrument issued by Swiss Re at a cost of three billion Swiss Francs.**
- **Berkshire acquired three million shares of Series A Cumulative Convertible Perpetual Preferred Stock of The Dow Chemical Company ("Dow Preferred") for a cost of \$3 billion.** The Dow Preferred was issued in connection with Dow's acquisition of Rohm and Haas.
- **And finally, the big one—BNSF:** As noted previously, in early November, 2009 Berkshire announced the acquisition, for \$26 billion, of the remaining 77% of BNSF Railroad that it did not already own—valuing the entity at \$44 billion, including the assumption of \$10 billion in debt. Mr. Buffett's investment is a bet that railroads will increase their relative share of the transportation market as fuel prices increase, and that the U.S. economy will grow in the future (increasing the amount of goods being transported).

After the BNSF transaction is completed in early 2010, Berkshire will have committed more than \$50 billion of capital to new investments during the past 24 months. At that point, we expect Berkshire to have roughly \$20 billion of cash remaining on its balance sheet, a level we believe is on the lower end of Mr. Buffett's targeted "buffer." This likely indicates little potential for large deals during the upcoming year.

An update on Berkshire's derivative contracts: Over the past few years, Berkshire Hathaway had entered into several derivative contracts. In the first series of contracts, Mr. Buffett provided insurance protection if the U.S. and various foreign stock indices closed below a certain level in the future. These "put contracts" had original terms of either 15 or 20 years and were struck at the market. For providing this insurance coverage, Berkshire received premiums of \$4.5 billion, which may be invested between now and the expiration dates of the contracts. In 2009, Berkshire agreed with certain counterparties to amend six equity index put option contracts. The amendments reduced the related contract expiration dates between 3.5 and 9.5 years. In addition, the amendments reduced the strike prices of those contracts between 29% and 39%. Essentially, these derivative contracts now have a shorter duration period, along with a reduced exposure to Berkshire.

In summary, we are pleased with Berkshire's progress and Mr. Buffett's excellent capital allocation talents. We will remain enthusiastic holders of Berkshire Hathaway, and we look forward to watching the intrinsic value of this holding continue to grow in the future.

Retail Group

Our major retail holdings, Home Depot and Walgreens, had another challenging year in 2009 as consumers continued to cut back on retail purchases. Nevertheless, we remain strongly interested in large industry-specific retailers that can gain economic value through a recession. During economic setbacks, natural consolidation occurs in the retail sector as smaller competitors are pressured out of business. This is especially true in specialized areas such as home improvement and pharmacy retailing. We stated previously that the retail areas in which we are invested involve a couple of two-horse races—between Lowe's and Home Depot in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. In our view, it is nearly impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate. For example, a new competitor would find it very difficult to penetrate Home Depot, which owns about 87% of its stores and has listed property and equipment valued at about \$27 billion. (Walgreens owns 19% of its stores.)

Home Depot

Home repair and remodeling has slowed significantly during the past few years as a result of the housing downturn, and Home Depot's business performance has suffered in kind. The good news: The housing slump is showing signs of improvement. Residential construction jumped at an 18.9% pace in the last quarter of 2009—the highest increase in six years, adding 0.4 percentage point to growth. Home sales have been supported in part by tax credits for homebuyers and the Federal Reserve's purchases of mortgage-backed securities to help lower borrowing costs.

We believe residential investment bottomed out in 2009 and will begin a slow resurgence. Nevertheless, we also believe there will be continued pressure on housing prices in 2010 as record foreclosures, an inventory glut, and rising delinquencies weigh on a U.S. economy recovery. In addition, tighter lending standards will slow the extension of consumer credit, and retailers such as Home Depot will continue to be negatively impacted as many individuals focus on paying down high-interest debt.

Meanwhile, Home Depot is making great strides in improving the company during this difficult period. The company is rolling out a new distribution system along with innovative information technology tools to exploit efficiencies in merchandising, store operations, and transportation.

Home Depot's Rapid Deployment Centers (RDCs) are the epicenter of the company's plan to reduce its cost structure and improve sales. The RDCs are providing Home Depot with a more flexible flow of inventory throughout its extensive store network, along with better insight into inventory levels at the stores and within their supply chain. The RDCs represent a move away from Home Depot's

traditional direct-to-store delivery model and streamlines inventory management. For example, Home Depot now orders 75% of its inventory through a centrally managed auto replenishment system, compared with 25% in the past. Why is this technically important? If Home Depot's RDCs increase inventory productivity by one turn, this would translate to an additional \$1 billion in cash flow to shareholders—a 25% increase!

Home Depot keeps building its competitive advantage and widening the moat around its home improvement fortress. We expect the company to earn approximately \$1.55 per share in 2009 and to increase its earnings 10% in 2010—to \$1.70 per share. This is tremendous performance under recessionary conditions, and with a solid dividend yield of 3%, investors essentially are being paid to wait until the economic cycle turns around. When the full recovery approaches, Home Depot's consistent focus on improving operating performance and asset productivity should pay big rewards. Overall, we feel confident the company is doing the right things and will remain committed owners of Home Depot.

Walgreen Company

Walgreens grew sales at a 7% clip over the past 12 months despite a difficult retail environment. We are pleased with this terrific achievement in 2009, given the challenging economy. The company's growth is slower than in previous periods, however, with the annual pace of new store openings decreasing from 8%–9% the past few years to a current rate of 3%. As the pace of store openings has slowed, Walgreens management has placed greater emphasis on making stores more productive, enticing shoppers to buy one more item during each visit. More important, the company has continued to evolve its business model in response to a changing healthcare system.

Just as Walgreens evolved its business during the Great Depression by innovating the lunch counter—with Myrtle Walgreen preparing the sandwiches, soups, and desserts in her cramped apartment kitchen and Chuck, Jr., delivering them—the company today is evolving to meet customer's needs in a rapidly shifting healthcare environment. Healthcare reform legislation is expected to levy a higher tax on corporations and their employees to compensate for the cost of universal healthcare. Walgreens is currently executing a plan to expand its "Take Care Clinics" (part of Take Care Health Systems, a wholly owned subsidiary of Walgreens) at worksites nationwide to help businesses better manage rising employee healthcare costs. Take Care Employer Solutions manages primary care, health and wellness, and occupational health centers at nearly 370 employer campuses across the country, with an emphasis on cost-effective preventive healthcare. For example, beginning January 1, 2010, Caterpillar, the U.S. heavy equipment manufacturer, will execute a new employee healthcare plan that favors Walgreens: Instead of employing a prescription benefit manager (PBM) such as Medco to negotiate prescription drug discounts from manufacturers, Caterpillar and Walgreens will jointly negotiate prescription drug prices directly with manufacturers, creating greater transparency and savings for the corporation and its employees. This type of agreement will allow Walgreens to get closer to the customer, increasing loyalty that will lead to greater sales and profitability.

In addition, healthcare reform and the aging of the baby-boom generation will introduce greater complexity into the prescription drug sector. Prescription drug retailers and wholesalers may evolve into patient data warehouses that become a focal point for managing healthcare across the nation. We believe Walgreens is well positioned to be an integral part of the future healthcare system. Our expectation is that Walgreens will also remain a leader in the retail drug business and will continue to grow its franchise from 7,500 to 8,000 stores by 2012. In the meantime, we believe Walgreens will earn around \$2.15 in 2009 and increase earnings over 18% in 2010—to \$2.55 per share.

Media Group

Our media division continues to supply and distribute "great content" to customers. We strongly believe that a concentrated investment in quality content providers that can continually expand their

audience reach will pay handsomely in the future. Disney and Comcast, our largest media holdings, continue to grow and deliver the news, stories, and shows that America receives every day.

Companies across the media landscape continue to retrench to survive the toughest economic environment since the Great Depression—and Disney and Comcast are no exception. While the ongoing cutback in advertising has impacted the profitability of media companies in the short-term, Disney and Comcast are faring better than most, since they are less dependent on this source of revenue compared with other media companies. In fact, we feel Disney and Comcast are gaining competitive strength during the economic downturn due to their solid foundation in family entertainment and in cable and Internet.

Walt Disney Company

During 2009, Disney's revenues and profits declined as a result of falling advertising revenues. Under difficult business conditions, Disney remained very profitable and produced \$3.2 billion of earnings in a depression-like media environment. We still believe that Disney has stronger long-term growth prospects than most investors realize, due to the company's highly competitive position within the entertainment industry. Disney has a broad range of content with significant international exposure and continues to extend its reach by localizing animation and other media content for individual countries. For example, China's planning agency, National Development and Reform Commission, recently approved the plan for a Disney theme park in Shanghai. The amusement park will be located in the city's eastern Pudong district; the initial phase would include a Magic Kingdom-style theme park with characteristics tailored to the Shanghai region.

Disney is also taking advantage of opportunities to grow its franchise during this recession. In late August 2009, Disney reached an agreement to acquire Marvel Entertainment, Inc. in a stock and cash deal valued at approximately \$4 billion. Marvel Entertainment, originally founded in 1939, is a global entertainment licensing company with a library of more than 5,000 characters, including Wolverine, the X-Men, Spider-Man, Captain America, the Fantastic Four, Iron Man, and the Incredible Hulk. Marvel's strategy has been to leverage its character franchises across a variety of entertainment mediums including film, consumer products, toys, video games, animated television, direct-to-DVD, and online. We believe this transaction boosts Marvel's opportunities to extend its vast collection of characters through Disney's strong global franchise.

We expect challenging conditions to continue for Disney in 2010, with improvement beginning in the second half of the year. The advertising market seems to be stabilizing, which could help the company's numerous media network businesses, including ESPN, which remains on a strong growth track. The studio entertainment segment continues to struggle in this downturn, but we see some encouraging signs in new content slated to debut in 2010—*Alice in Wonderland*, *Prince of Persia*, and the much-anticipated *Toy Story 3* highlight upcoming releases.

We expect Disney to earn \$2.00 per share in 2010 and to use most of the \$3.5 billion of produced cash for debt reduction and shareholder dividends. We remain excited long-term holders of Disney and believe that this global media company will be significantly more valuable 10 years from now.

Comcast

We hold a major position in Comcast, the largest cable provider in the U.S. Comcast also owns cable networks and sports and programming assets, including E! Entertainment Television, The Golf Channel, the Philadelphia Flyers NHL hockey team, and the Philadelphia 76ers NBA basketball team.

As with other media-related companies, Comcast had a challenging year weathering a weak advertising environment and softening product demand. On the other hand, Comcast continued to perform relatively well during this recession given that the cable business is somewhat recession-resistant—consumers tend not to cancel their cable services during an economic downturn.

Comcast has taken advantage during the downturn to grow its franchise. In December 2009, the company announced an agreement to form a joint venture with General Electric, which will hold GE's NBC Universal assets and Comcast's cable networks assets (including E!, Style, E! Entertainment Television, the Style Network, Versus, Golf Channel, G4, and a collection of regional sports networks). This new company, of which Comcast will initially own and control 51%, combines Comcast's cable franchise with NBC Universal, the fourth-largest media and entertainment company in the United States, with assets spanning cable and broadcast television, TV production, digital media, filmed entertainment and theme parks and resorts. Over time, Comcast would like to leverage its strong cable distribution network with NBC Universal's content to increase profitability. For example, this distribution/content combination could alter the movie industry—when Universal Studios comes out with a new movie release, it is highly likely that the film will be given priority to be shown through Comcast's On Demand service versus after-theater distributors such as Blockbuster and Netflix. In the relatively near future, we may be ordering most movies soon after release through cable television. This change may also hold true for television viewing, as NBC content could be shown anywhere, at any time, through Comcast.

Comcast will have the opportunity to increase its ownership of this joint venture over a seven-year period. GE will have the right to redeem 50% of its interest at year 3.5 and its remaining interest at year 7. The arrangement for NBC Universal was made in such a way that Comcast could absorb NBC Universal in due course without negatively impacting Comcast shareholders. GE would also not have to sell its complete interest in NBC Universal at a discount during the recession. In the meantime, since both parties are near-equal owners, they have an incentive to grow the joint venture's value over the next seven years.

Comcast continues to leverage its cable assets and should grow free cash flow at approximately 15% per year over the next five years—from \$4 to \$8 billion. This has a positive impact on the amount of money Comcast can distribute to shareholders, and the company recently announced that it is increasing its dividend by 40%, to \$0.378 per share. The company also intends to complete the \$3.6 billion remaining on its current share repurchase authorization over the next 36 months. Our view of Comcast's future has not changed, and we plan to keep this company in our portfolio for the long run.

Commodities Group

Our Commodity Holdings include Barrick Gold, Central Funds of Canada, Chevron, and several other oil companies. In the latter part of 2004, we invested broadly in commodities such as gold, silver, and oil for two core reasons:

- Given the growing U.S. debt, we believed that the value of the U.S. dollar would deteriorate over the long term—and that the country would have no choice but to eventually inflate away its rising debt. This assumption has proven correct, and thus we have not changed our view. We believe our country's ongoing lax monetary policies will result in a continuing deterioration of the U.S. currency. Over a long-term period in which the dollar has continued to lose relative strength against other world currencies, gold has now risen to around \$1,100/oz.

While changes in the dollar's value will continue to be an important factor in determining the price of certain commodities, in the future it will not be the only driving issue. We still have concerns regarding the geopolitical and global financial landscape as the world money supply increases rapidly—the U.S. is not the only country printing money. This fact further supports an argument for higher long-term commodity prices, as a growing world money supply can ultimately lead to worldwide inflation and a deterioration of all fiat currencies.

- There continues to be a long-term growing imbalance between commodity supply and demand. For example, during the tail end of 2008, daily worldwide oil consumption reached approximately 87 million barrels of oil per day, while production leveled off at 86 million

barrels per day. While the current recession has now dampened demand, the long-term widening gap between consumption and production will most likely lead to higher oil prices, despite any short-term downturn in oil prices. Although we do not have a specific price in mind, we continue to believe that the price of oil will plateau at a higher level in the future than it has in the past, driven by increased energy demand by rapid-growing economies in countries such as China and India.

Barrick Gold Corporation

Barrick Gold Corporation has mines that span the globe and is the world's largest gold producer. 2009 was an eventful year for Barrick. The company raised \$5.1 billion in September and announced its plan to eliminate all its gold hedges within a 12-month period. By December, the company had completed the elimination of all its gold hedges—nine months ahead of schedule—and now has full leverage to the gold price on the industry's largest gold production and reserves. This is a noteworthy development, since our initial interest in Barrick five years ago pivoted on the company's significant gold hedge program, which at that point caused a drag on the company's value and stock price. Barrick instituted this hedge position, whereby the company presold almost 20% of its gold reserves at a low set price, to protect the company's profits in the event that the price of gold continued to decline. (The price of gold declined from more than \$800 per ounce in 1980 to less than \$265 per ounce in a 20-year period.) However, like Newton's third law of motion—"for every action, there is an equal and opposite reaction"—Barrick's so-called protection against a declining gold price could become a problem if the price of gold rose well beyond its presale price. And that is what happened—when gold prices began to rise, Barrick's gold hedge became an ever-increasing liability; the company had difficulty selling the bulk of its current gold production at higher prices. Our opinion at the time was that the rise in gold prices would be a longer-term event and that in the short-term Barrick's value was being unfairly punished due to its large hedge position. We believed it was highly likely that the U.S. government would have little option but to print money and inflate its way out of an alarming credit expansion that had taken place over a long period of time. Money-printing is now a phenomenon associated with curing the credit crisis, just as Barrick completed a five-year plan to eliminate 100% of its gold hedge. Going forward, the company is now positioned to take advantage of selling gold production at higher prices.

Barrick will continue to focus on earnings and returning cash to shareholders. This strategy is unusual for a mining company—most competitors attempt to spend profits on finding the next "gold strike." As a result of the company's actions, we believe Barrick's value will continue to increase over time.

Central Fund of Canada

We continue to maintain a sizeable investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately \$2.7 billion, represented by 52% gold bullion and certificates, 45% silver bullion and certificates, and 3% cash, marketable securities, and other working capital amounts.

Chevron

Our largest oil investment is in Chevron, a leading international integrated oil and gas company with operations worldwide in a variety of energy segments. Our continued interest in Chevron is based on the expectation that the company will grow volumes at an annualized 3% rate through the end of the decade. The company continues to make strides in developing its tremendous asset profile and adding to reserves. In September 2009, Chevron announced that it had made the official decision to proceed with the Gorgon natural gas project offshore of Western Australia, which has estimated recoverable reserve of 40 trillion cubic feet—*big*. Chevron is the largest operator in the project, with a 50% interest; ExxonMobil and Royal Dutch Shell each hold a 25% interest. The \$35+ billion project

includes a three-train Liquefied Natural Gas (LNG) facility, a carbon dioxide injection facility, and a domestic gas plant. Also in September, Chevron announced that several industrial customers had entered into long-term contracts for LNG supply from the Gorgon project. The early clients include Osaka Gas and Tokyo Gas. First gas from the Gorgon project is planned for 2014. Approximately 35% of Chevron's current production is natural gas, and the company expects this figure to reach 45% by 2015. Natural gas prices are currently low, and any future price increase in this energy source will provide an additional boost to Chevron's earnings.

Chevron continues to be one of the leading oil producers in the deepwater Gulf of Mexico. The Tahiti Field, one of the largest in the Gulf, went into production during 2009, while the Jack-St. Malo and Big Foot developments entered separately into the front-end engineering design phase. Chevron believes the Jack-St. Malo field can produce 120 million to 150 million barrels oil equivalent per day (MBOED), with total estimated recoverables in excess of 500 million barrels of oil equivalent (MMBOE). Chevron's Tahiti Field, the deepest-producing well in the Gulf, achieved first oil in May 2009 and reached capacity of 135 MBOED in July 2009.

Chevron is clearly shifting its oil production to deepwater sites, which allows the company to increase the cash received per barrel of oil since development expenses for these locations have already been completed. Deepwater oil also fetches higher prices on the open market. Although oil prices have dropped substantially over the past 18 months, we believe the current valuation of Chevron (and other oil companies) still does not reflect higher long-term energy prices.

Fixed-Income Investments

The Morningstar taxable bond index was up 14% in 2009. This positive result follows a (6.8%) decline in 2008. We can say with confidence that the credit market achieved a full recovery, with fixed-income investors once again aggressively buying and selling their bonds. Investors remain spooked, however, as they choose to receive virtually 0% interest on the purchase of short-term U.S. government debt.

Corporate bond prices—which represent a large percentage of our fixed-income holdings—recovered considerably during the past year. We need to remind ourselves, however, that the “deterioration” in credit quality remains among most non-government fixed-income instruments, and the “real risk” still resides in the credit market, not the stock market.

We continue to emphasize several points about fixed-income instruments that concern us. Several risks associated with this “secure investment vehicle” loom, including issues surrounding bonds such as the possibility of future rising interest rates and even greater chances of default. We believe that long-term market interest rates may move upward in the future as the Federal Reserve continues to maintain low interest rates and aggressively creates liquidity in the market, all with the goal of assisting banks to recover losses and allow leveraged borrowers to refinance their debts. As incoming data such as a continued housing slowdown and rising mortgage default rates lead to a further loosening of monetary policy, the resulting increased money supply can lead to an increase in long-term interest rates as inflation takes hold of the economy.

Regrettably, we also believe that bond defaults in the financial area are still in the middle stage and that bank write-downs will increase in 2010. During the next few years, it is possible that the U.S. banking system will require additional equity to offset its loan write-offs due to bad mortgage loans, defaulting auto loans, and unpaid credit cards. This monetary sum is so vast that “equitizing” the banking system could require not only bank preferred shareholders to convert their preferred stock to common equity, but some bank bondholders as well may be forced to convert their bonds to common equity. Not a pleasant thought. In fact, the most popular bonds currently available for purchase are bank fixed-income instruments. Many investors “think” these bank bonds are quasi-government-backed since they witnessed the U.S. Treasury back banks to protect the financial system from complete failure. As many banks return money to the government, we are not so certain that Congress

and the U.S. Treasury will be so forthcoming with money to banks again (if trouble deepens) without requiring other participants within the bank capital structure to contribute—including bank bondholders. Unfortunately, there is nowhere to invest to obtain “easy returns,” and we will continue to be mindful of the ripple effect as loan defaults rise within the financial system.

During 2009, we have had several tranches of municipal and corporate bonds come due. We continued with our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and are carefully allocating money to short-duration, fixed-income securities (one to five years) as interest rates and default rates could rise in the future—perhaps significantly. We will continue to avoid any speculative investment activity and to maintain our attitude of finding the best-yielding securities, understanding the risks we are taking with each individual fixed-income allocation.

In summary, we remain concerned about:

- long-term, unresolved issues related to lax lending practices by major banking institutions that have not yet worked through the system
- the possibility of higher inflation in the future due to an expanding money supply
- long-term rising commodity prices

In this volatile environment, we will stay committed to short- to mid-term fixed-income opportunities that offer a fair risk and reward profile.

WHAT'S NEW AT FOUNDERS?

In 2009, we continued to invest heavily in our business. We are up and running with Bloomberg, a computer system that enabled us to better monitor and trade fixed-income instruments. We previously mentioned that bonds are priced (and traded) very differently than stocks. Bonds are more akin to a private transaction that takes place between a buyer and a seller—in other words, a negotiation takes place. As a result of our investment in Bloomberg, which became necessary in a credit-sensitive environment, we have seen a significant improvement in our ability to recognize and respond quickly to opportunities within the fixed-income area. This development has positively affected our fixed-income results in 2009.

At Founders Capital Management, we believe the best way to learn golf is to caddy for great golfers, and the best way to learn investing is to walk in the shadow of great investors – past and present. We are striving to make sure we stick with the sport we know—value investing. We don't have a desire to switch from one sport to another and end up like Babe Ruth:

“It took me seventeen years to get 3,000 hits in baseball. I did it in one afternoon on the golf course.”

—George Herman “Babe” Ruth

Although there were (and will continue to be) challenges, we will keep our focus on the “three-foot putt.” We want to see exactly where we are placing our money and to maintain a view on the intrinsic value of things. As such, we continue to invest in high dividend-paying stocks and bonds—and then watch our investment “grass” grow under our feet.

In this age of continuing high uncertainty, it is our opinion that to be successful at the investment game, it is important to highlight long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid making irrational decisions based on emotions—including fear of failing to meet desired returns for clients, fear of lacking intelligence and overanalyzing a situation, and being greedy when prudence should prevail.

We are comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and believe the returns are fair for the risks we are taking. We want to assure you that we continue to be mindful of the risks in today's markets and will strive to allocate capital in a way that minimizes any long-term effects on the value of our holdings.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2010.

February 8, 2009

President Barack H. Obama
The White House
1600 Pennsylvania Avenue NW
Washington, DC 20500

Dear Mr. President:

We are writing to express concern about the spreading financial crisis, and to make sure you are fully aware of the deepening trouble our economy may face. If a comprehensive plan of action is not quickly developed and executed within the current year, our nation will likely face a recession that is extremely deep, and one that might possibly extend into a depression.

The proposed actions of providing investment and insurance, along with an aggregator bank to purchase bad loans and dented securities, will most likely relieve the largest financial institutions from their toxic assets and ultimately get credit flowing again. However, we may be at the beginning of the unwinding that will likely impact the heart of American business—regional and community banks, and small businesses.

The domino impact of the credit crisis will make its way to regional and community banks, contributing to large aftershocks in the banking industry throughout 2009. Many of the 8,000+ regional and community banks within the U.S. engaged in “lazy banking” over the years by purchasing securities such as preferred stock, Collateralized Mortgage Obligations (CMOs), and Collateralized Debt Obligations (CDOs) with customer deposits in lieu of going through the procedure of loaning out money in the traditional way. These securities have deteriorated in value. In addition, commercial real estate loans extended by regional and community banks are beginning to falter as businesses dissipate, leaving real estate owners little or no revenue to support their real estate debt. These compounding issues will necessitate many regional and community banks to recognize permanently impaired securities and to write off bad loans, impacting their capital base—and their ability to extend credit.

The American economy may be consumer-driven, but a large portion of our success is due to the entrepreneurial opportunities that our capital system provides individual business owners. Small business drives the U.S. economy by providing jobs for more than half of the private workforce. It is our experience that most of these small businesses—many family-owned—obtain their credit from regional and community banks. Strong relationships have been established between local banks and small businesses over the years. If regional and community banks aggressively begin to hoard cash like their larger counterparts, the restriction of credit will place a tremendous strain on thousands of small American businesses that make up a major portion of our employment base.

Small businesses are becoming banks as they see accounts receivable increase exponentially as customers are unable to obtain credit from reluctant larger banks. Many small business owners are now faced with a dilemma—to increase their credit line with their local bank, or begin to restrict business activity with large, demanding customers. We all know what the decision will be—small business owners will turn to their local bank for an increased line of credit. Unfortunately, regional and community banks are beginning to restrict credit to small businesses due to their impending financial problems. Within the next 12 months we may begin to see many small businesses, which make up the heart of American employment, fall into bankruptcy as they lose their ability to access credit.

Proposed remedies for a deepening crisis

To paraphrase Wayne Gretzky (and Warren Buffett): We need to “skate to where the puck is going to be, not where it has been.”

It is our opinion that the developing financial plan requires greater depth to manage the deepening crisis—we need to get ahead of the curve. Concurrent with the plan being developed for larger financial institutions, a combination of actions will be required to address the impending regional and community bank crisis. Similar to the developing “higher level” plan, the regional bank program should allow for investment in regional and community banks to shore up their capital base, while at the same time providing relief to local financial institutions through a coordinated purchase of bad loans and permanently impaired securities. We may also need to evaluate providing insurance, for a period of time, to regional and community banks that small businesses will payback their loans. This temporary backstop will give regional and community banks confidence to lend as their small business customers request additional credit to support their enterprises.

Some may say to you—“Let the small banks fail. We have too many banks within our financial system.” This may be a convincing point. However, a rapid consolidation of our financial system during a tender economic time would not occur without consequences—perhaps significant. It is far better to construct a comprehensive plan that will allow natural consolidation to take place over time versus further shocking the financial system, creating panic among depositors and those that rely on regional and community banks for credit.

A considerable aspect of our current financial crisis, in addition to the deterioration in value of financial assets, is a great loss of confidence. This is the keystone of the current credit crisis that has now lasted over one year, and will assuredly role downhill. J.P. Morgan summed up our current situation decades ago, when he was asked if commercial credit was based primarily on money or property. Said Morgan: *“No sir, the first thing is character. Before money or anything else. Money can’t buy it.”* Our financial system is built on trust, and when trust wanes, the financial system is vulnerable to collapse. Until we gain faith in the character of our financial system, the markets will continue to falter.

It is in our nation’s best interest to develop a comprehensive plan to provide confidence in the U.S. financial community that serves all American businesses. Otherwise, we will continue to “react” to each rising crisis. As you know, the crisis is upon us—let us all act to ensure we don’t fail to plan while we have the chance. The alternative is a plan to fail.

Thank you for creating an effective environment for citizens to communicate their thoughts. We wish you all the best in your endeavor to make America an even better place to live—we have confidence that you and your team will be successful.