EAST COAST
ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher Begg, CFA and Benjamin Favazza, CFP®

Date: October 29, 2009

Re: Third Quarter 2009 Update

Market Summary[1]:

	S&P 500	**MSCI AC World Index**	**MSCI Emerging Markets**	**Barclays Aggregate Bond Index**	**Gold – $/Troy Oz.**	**Crude Oil**
Price 09-30-09	1,057.08	287.23	338.67	1537.21	$1,007.70	$70.61
3rd Quarter	15.61%	18.00%	20.73%	4.01%	8.75%	1.03%
Year-to-date	19.26%	29.04%	57.09%	6.14%	14.25%	58.32%
From March 6th Lows	56.68%	67.31%	85.90%	7.19%	7.28%	55.12%

All asset classes registered strong total returns in the third quarter. A tactical decision to increase equity exposure throughout the year, coupled with satisfactory excess returns attributed to security selection, have produced favorable total returns for our model portfolios. In this update, we will delve into the rationale for our portfolio positioning over the preceding six months and discuss some broad views that continue to shape many of our portfolio construction decisions.

Organizational Updates – Part 1:

We normally conclude with a section on East Coast organizational updates in our quarterly letter. However, given the fact that some of you might find our discussion of inflation a bit tedious, we wanted to make sure you were still awake to read a very exciting company announcement.

- *Two New Partners:* As we highlighted in our second quarter letter, we have been actively engaged in a search for quality investment professionals to join our team. Over the last six months we have worked with an executive recruiter as well as networking with professionals we have worked with throughout our careers. We have had the good fortune of meeting many quality candidates. That being said, a decision to bring on a partner is pivotal, and all the stars have to align for us to be comfortable extending an invitation. We feel quite fortunate to announce two new partners who could not be more complementary to our culture and who round out the professional needs of our organization. We are pleased to announce the addition of Gina Koprowski, CFP® and Robert Murphy, CPA to East Coast Asset Management, Inc.

[1] The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. No East Coast strategy will seek to replicate the performance of these or any other indices.

- Gina Koprowski, CFP®: Gina joins us as a Managing Director and Principal of East Coast Asset Management. Her primary responsibilities are managing client relationships and overseeing the firm's operations and compliance. Gina brings 20 years of financial services experience to the firm. Her most recent position was with Fidelity Investments Private Client Group as a Vice President/Senior Account Executive where she worked with her clients to develop customized investment and financial planning solutions. In addition to client management, Gina has also held roles in operations, systems and marketing at Fidelity in Boston, Fidelity Brokerage Services in the UK, Chase Manhattan Bank's Global Private Bank and Rockefeller Financial Services in New York. She earned her BA from McGill University in Montreal, her MBA in Logistics and Finance from the University of Maryland, College Park, and holds a Certified Financial Planner (CFP**®)** designation. Gina is a member of the Financial Planning Association where she is a volunteer in the pro bono Military Outreach Program. Additionally, she is a member of the Boston Estate Planning Council and serves as Chairman of the Board of the 501-3(c) organization, Outdoor Explorations. Gina and her husband were married this past summer and live in Charlestown, MA.

- Robert Murphy, CPA, MST: Bob joins us as a Managing Director and Principal of East Coast Asset Management. Bob brings 23 years of wealth management experience and an expertise in estate and income tax planning to the firm. Before joining East Coast Bob was with Eastern Wealth Management as Senior Vice President/Relationship Manager providing wealth management solutions for clients. Previously, he was a Vice President with Atlantic Trust Pell Rudman. Prior to that, Bob spent 10 years at Cambridge Trust Company as Tax Officer. Bob is a CPA and holds a Bachelor of Science degree in Accounting from Merrimack College and a Master of Science degree in Taxation from Northeastern University. He is a graduate of the National Graduate Trust School at Northwestern University. He has received a Certificate in Financial Planning from Boston University's Center for Professional Education. Bob is a member of the AICPA and the Mass Society of CPAs. Bob lives with his wife and four children in Woburn, MA.

The Deflation-Reflation Continuum:

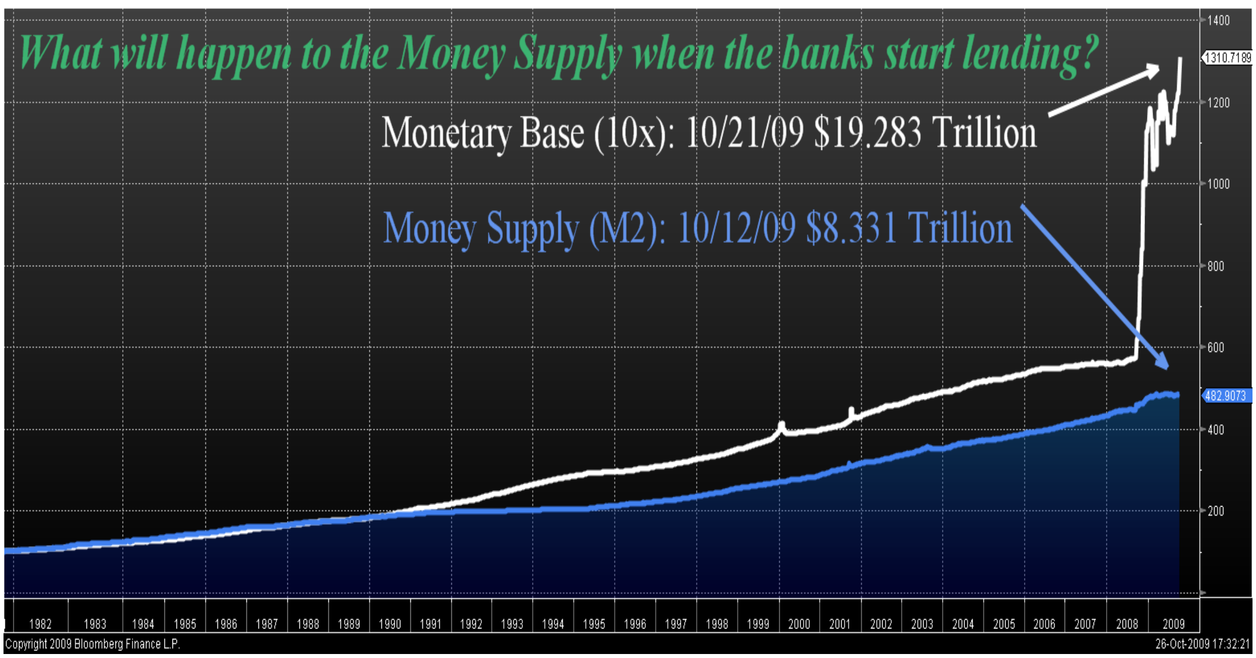
Over the last year we have devoted a good deal of space in our quarterly letters and time in our investment/client meetings to discussions of deflation and subsequent reflation. While we consider our investment philosophy firmly rooted in the value investing school, where we look for mispriced investments on an individual basis, we feel it is critical to have a "global macro" perspective. With this objective in mind we organize our investment process to look at *themes*, *asset class* expected returns, and *global sector* expected returns to complement and inform our bottom up investment analysis.

Our themes, often times, present the team with a list of major headwinds and tailwinds for industries and companies that can be a source of idea flow. This work is also an overlay on the due-diligence work we do on our portfolio companies and the investment universe. From time to time, this aspect of our core research process produces what we call an "elephant in the room" theme. That is, a theme that is relevant to many of our investments. Investment bubbles fall into this category. Since historically all bubbles have reverted, at least to their normalized trends, they can be looked at as near certainties. Over the last decade we have had a couple memorable "mean reversions"; the Tech Bubble of 2000, the US Housing Bubble of 2006, and the corresponding Global Credit Bubble of 2007.

For over a year the "elephant in the room" has been the "continuum" from deflation to reflation. When the credit bubble burst in the fall of 2007, the world went into a painful negative-feedback loop of asset price deflation. Credit markets froze as participants lost trust in both borrowers and lenders. This brought on a vicious deleveraging process as investors were forced, by creditors, government regulation (short-sale rules changed) and by their own emotions of fear and uncertainty to seek liquidity. As selling begat selling and debt coverage ratios plummeted, uncertainty rose and asset prices declined. During a deflationary spiral, the best place to take cover is in the safest and most liquid investment which at that time was US Treasuries. The crisis hit a tipping point in the first quarter of this year when it became clear that policy makers (Fed Chair Bernanke, Treasury Secretaries Paulson–Geithner), would err on the side of bailing out too much rather than too little. In March of this year, we finally began to see the reflationary response to the extraordinary stimulus and bailouts that had been administered to the flailing economy. It was at that point that asset prices started to rise and they have since continued on their upward trajectory.

Jeremy Grantham of GMO, in his May 2009 letter, quantified the situation that the deflationary spiral presented policy makers here in the US. He calculated that the total US market value of housing, commercial real estate, and stocks was about $50 trillion at the peak and fell below $30 trillion at the low. Grantham believed that this drop in perceived wealth would not only have a sustained effect on consumer behavior, but more importantly these assets supported $25 trillion of debt. Late in the first quarter of this year, we at East Coast believed we would have a combination of three outcomes. 1) We would expect to see a systemic write down of debts (debt forgiveness, bankruptcies, foreclosures, etc). 2) We would have several years of accelerated inflation to erode the value of debt. 3) We thought policy makers would attempt to "reflate" assets by increasing the supply of money. We believed that the latter of all outcomes was not only the easiest one for our modern "fiat money" governments to employ but it also has the benefit of having the most immediate effect. Fast forward to today, all three outcomes have materialized with the third remaining our greatest concern.

A useful analogy is the Free Parking jackpot in the game of Monopoly. A popular Monopoly "house rule" adaptation is to put $500 in the middle of the board and the player that lands on Free Parking is awarded these funds. This has the effect of increasing the money supply that is available to players. This is the Federal Reserve equivalent of starting up the printing presses. The net result is there are more funds in circulation to bid for property, build houses, upgrade to hotels, or negotiate direct purchases of property from players, often above market value, to create a monopoly. It also has the effect of indirectly bailing out the player on the verge of bankruptcy, who overbuilt too quickly and has not had the good fortune of anyone landing on his newly constructed property (perhaps the equivalent of the developer who built the n^{th} Miami high rise that now sits vacant). The marginal player now has new funds available to keep him in the game with no consequences for his poor economic behavior. It is ironic that the purportedly capitalist game of Monopoly in fact teaches lessons of socialism.



Milton Friedman put it very succinctly: "Inflation is always and everywhere a monetary phenomenon." The chart above highlights a couple of observations that concern us. Money Supply, often referred to as M2, is the total amount of money available for spending (currency in circulation plus bank deposits). The Monetary Base is a combination of currency and the Reserves available for banks to lend. The normal relationship between the growth of M2 and Monetary Base has been on the order of one to one. You can see from the beginning of the credit crisis there has been a frightening increase in the Monetary Base but it has not yet materialized in a growth of the Money Supply. The Money Supply has not increased because banks have been wary of lending as they continue to incur and fear further losses. We believe as the economy picks up the banks will feel better about lending and we will see an increase in the *velocity* of money which will be a key catalyst for fueling inflation. Our sources tell us that banks are getting more comfortable with lending and there is a healthy appetite for credit. We remain En Garde!

Investors who are keen to the risks of inflation have been voicing their concerns. Warren Buffett penned an op-ed piece in the New York Times on August 19th titled "Slow Growth and the Greenback Effect." Below we have quoted a paragraph from this article which highlights how unlikely it would be for an elected government official to heed these warnings.

> *"Legislators will correctly perceive that either raising taxes or cutting expenditures will threaten their re-election. To avoid this fate, they can opt for high rates of inflation, which never require a recorded vote and cannot be attributed to a specific action that any elected official takes. In fact, John Maynard Keynes long ago laid out a road map for political survival amid an economic disaster of just this sort: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.... The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*
>
> And a quote on CNBC on June 24, 2009:
> ***"Well, I don't worry about deflation at all.*** *We won't see deflation in any significant amount in your lifetime, which is more relevant than my lifetime. . . We have done things that raise the probability of really high rates of inflation at some point."*

We are hopeful that enough warnings from informed citizens such as Warren Buffett and Paul Volker will help build an appropriate exit strategy for the extraordinary intervention we have seen. However, we never make investments on hope and are rightly skeptical, so we have a heightened focus on protecting not only the principal but the purchasing power of our clients' accumulated net worth. Even if the government heeds these warnings, we conclude that they will be late in removing the excess money from the system. Policy makers will be taking their cues from the economy in the form of the unemployment rate, GDP growth, housing prices, retail sales and how much our factories are being utilized. All of these numbers will be anemic for a prolonged period of time. Their constituents and voters will be feeling the pain, and with re-election a necessary objective, they will be loathe to pull money out of the system or raise interest rates. We believe the white knight will arrive too late and after inflation consequences are in the system. Paul Volker was a very unpopular Fed Chairman when he had to reign in the ravages of the stagflation crisis of the 1970's.

Portfolio Positioning – Then and Now – Our Broad Views:

The inflation situation we describe above is a risk that we need to position against. Our clients that are in retirement or approaching retirement have accumulated assets to last them a lifetime. We are not pessimists or doom and gloom investors - but we are realists. Given the heightened risk of purchasing power erosion, we have been implementing a decisive, prudent, and disciplined strategy to protect against it.

- *Then and Now:* As we mentioned earlier in the letter, the first quarter marked an inflection point where we moved from the low-end of our asset allocation ranges in Equities and have gravitated toward the higher-end of our clients' customized ranges. We will always first and foremost allocate capital based on valuation. As value investors, our view of the quality of the investment drills right down to what we expect to extract from that opportunity in cash – all income plus return of our principal. We compare this expectation of return (IRR) to all investment alternatives across all asset classes. This said, high quality global equities have represented the best expected total return from a valuation perspective. They also share the important attribute of being an effective inflation hedge for those companies that have the ability to raise prices with inflation or have tangible assets that are being reflated. We had been making investments during the periods of dislocation in the 4th quarter of 2008 and 1st quarter of 2009 that have paid off handsomely to date. Below we will highlight some broad views that continue to shape the composition of our portfolio.

- *Broad Views:*

  - Equities – "the "Q" component: We perceive a valuation anomaly globally between companies that we define as high quality (Q) when compared to many lower quality cyclical companies. Since the lows in March, when "Armageddon" was taken off the table, there has been a strong outperformance of lesser quality businesses that appear to be priced for a return to bubble-era profitability. Conversely, companies we always tend to favor that have a durable global franchise (example; Nestle, Colgate, Coca Cola, Novartis, Pepsi) trade at the low-end of their 20 year range of valuation multiples and pay well above-market dividend yields. Businesses that have scale advantages, and who are the price-setter in the industry, have the very important characteristic of being an inflation hedge for us. Many of our portfolio positions fit into this category and we have been doing further due diligence on new potential holdings. We fully expect this area to be a relative and absolute bright spot in our portfolio for the foreseeable future.

  - Tangible Assets and Natural Resources: As discussed above, we have a global reflationary environment where central banks are increasing the money supply to levels we have not seen. At the same time, we are in a period of contracted global growth as the world deleverages from the credit bubble. Thus, we have a lot of capacity that will remain underutilized. Where will all the excess money flow? It will flow into assets and more specifically into real assets. While we do not view real-estate as an attractive asset class as it works off its own excesses, we are favoring countries that are resource rich and companies that have tangible assets. Investments we have made with this view in mind are; country/sector specific ETFs such as Australia, Canada, Brazil, and the Global Materials Sector, and company specific investments such as Petrobras.

  - Gold: With cash and near-cash investments earning very low interest rates, our opportunity cost is low to shield some of our fixed-income allocation from inflation. We have and will continue to look at gold in this way. We do not like many of its characteristics as it pays us nothing in income, it indirectly costs us to store it, and very little gold has ever been used up. John Paulson summed up two reasons an investor would want to own gold when he spoke at the Grant's conference in New York a few weeks ago. He said one was the "fear factor" which is a hedge against Armageddon. The second factor and principal source of gold demand is that for a protection against currency debasement. Paulson explains: "Demand for gold as an inflation hedge is, for me, 100 – 1000 times more than the demand for the 'fear factor.'" There are many people, institutions, and countries that are holding major reserves in "fiat" paper currencies that are being debased. We expect a sustained rally in the price of gold and we find it an effective parking spot for money we have that is not earning an adequate interest rate and that is not shielded from inflation risk. We look forward to the day that we will not have a gold allocation in our portfolio again.

- Emerging Markets: We feel the countries of Brazil, China and India represent a vast opportunity for investment over the coming decades. While many of these countries face serious headwinds as their export markets may be weak for the foreseeable future, there exists an emerging consumer economy which will reward many of our investments that may be domiciled in these countries or are global franchises that sell their goods and services into these countries. We will not overpay for growth, but we will challenge ourselves to devote resources to uncover great opportunities, based upon sound investment principles, in these markets for our clients.

- Fixed-Income: We have been telling you that interest rates will rise to reflect the risk to a bond holder of getting dollars back that are worth less. An interest rate of 3.52% for a 10 year Treasury bond and 4.35% for a 30 year Treasury bond is not nearly a sufficient return for a bond holder. Rates are being kept artificially low as the Fed has been buying Treasuries. They have, in fact, made up 100%+ of the demand for the net-new issuance of Treasuries. This is not sustainable. Spreads have narrowed over the last six months and interest rates on corporate bonds of the quality we seek are not nearly interesting enough for us to allocate capital to that space in a meaningful way. We have been buying some short-duration Treasury Inflation Protected Securities (TIPS) and looking at some very safe floating rate options. Muni bonds will get more interesting as interest rates along the curve rise (as taxes increase, Municipals will also be an important after –tax investment for taxable clients) but we feel patience in this space will reward us.

- Environmental Revolution: One of the greatest tailwinds present in our global economy will be the allocation of resources to deal with climate change. The investment implications are exciting and there will opportunities to separate the speculation of start-up risks and make investments where we have a large margin of safety. Buffett and Munger's early investment in BYD Co Ltd – a car battery manufacturer for electric vehicles was such an investment.

- On the Lookout for Tail Risks: We have a heightened awareness of "tail risks" (e.g., high-impact, hard-to-predict, and rare events beyond the realm of normal expectations– think black swans) after what we have all lived through over the last two years with regard to the global credit bubble. For example, the enormous trade and fiscal imbalance between China and the U.S. is a risk we are looking at closely. Our process looks to uncover what some of these might be and determine if there are any effective hedges we can employ to mitigate the potential for downside should that particular tail risk occur. We believe a process that continually attempts to answer the question "what could go wrong?" can be effective.

Organizational Updates – Part 2:

- *Research Analysts:* We will continue to make a point of introducing the research analysts that join us from the various MBA programs we work with. The responsibility of the research analyst is split on a 70/30 basis between two critical research objectives. The majority of time is spent compiling qualitative and quantitative data to produce an East Coast defined thesis write-up on an assigned prospective investment for the team to review. The secondary task is stewarding assigned "global macro" themes as well as sourcing categories to present new information and data for the team to evaluate.

  We have two hiring periods throughout the year. We offer full-time summer positions that last from May through the end of August and we offer part-time (mostly 2nd year MBAs) positions to candidates from September to May. We have expanded our reach beyond Boston for the first time and we have engaged the Value Investing Programs at Columbia University in New York (where both Benjamin Graham and Warren Buffett taught) and the Ivey School of Business at the University of Western Ontario in Canada. Our remote analysts will connect to our bi-weekly investment meetings by web conferencing technology and have remote access to collaborate on research through our proprietary research database. Matt Lowenstein from Columbia University is our first remote research analyst. We are pleased to announce four research analysts that will be joining us through May; Greg Harrison (we must not have scared him off as he is returning after being here full-time this summer), Matt Lowenstein, Amit Shah, and Onur Sergici. Included are the bios for Greg, Matt, Onur, and Amit for your interest and we hope that you have a chance to meet them in person.

- *Farm Team Update:* Last quarter we were excited to formally announce that Jack McManus, CFA had joined us full-time as an Associate Portfolio Manager and this quarter we get to make a more collegial announcement. On October 6th, a healthy baby boy, Rohan McManus appeared on the scene at 8 pounds, 3 ounces. We are thrilled for first time parents Jack and Shilpa.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We value greatly your support and trust.

"One must pass through knowledge and arrive at simplicity."
Shibumi – Trevanian (1979)

Sincerely,

Chris

Christopher M. Begg, CFA
Chief Investment Officer

Benjamin S. Favazza, CFP®
Chief Wealth Management Officer

Research Analyst Biographies

Greg Harrison
Greg is a Research Analyst at East Coast. He is currently enrolled in the Master of Business Administration and Master of Science in Finance dual degree program at the Boston College Carroll School of Management. Greg earned a B.S. in Cell and Molecular Biology from the University of Washington and a B.S. in Finance from the University of Maryland University College. Prior to graduate school, he worked in the biotechnology industry as a validation engineering consultant. He is currently a CFA Level 2 Candidate. Greg speaks conversational German.

Matthew Lowenstein
Matt is a Research Analyst at East Coast. He is a full time student at Columbia Business School's MBA program and graduated with a B.A. in History from Cornell University. Prior to working at East Coast, Matthew worked as an analyst at JP Morgan Chase. He then went to Beijing where he studied Mandarin Chinese, worked as a consultant at Beijing Grand Consulting, and an equity researcher at Wedge-MKI. He speaks Mandarin, Spanish, and French.

Asri Onur Sergici
Onur is a Research Analyst at East Coast. Onur received a Master of Science in Mechanical Engineering degree from Northeastern University and Master of Business Administration and Master of Finance degrees from Carroll School of Management at Boston College. Prior to joining East Coast, Onur was a research associate at State Street Associates, where he worked with institutional investors on issues related to portfolio and risk management covering a range of topics such as currency hedging, share class hedging, optimal portfolio and manager reallocation, value-at-risk calculations. He sits on the board of directors of The Eliot School, a non-profit organization for crafts and fine arts education. Onur is a candidate for Financial Risk Manager designation. He speaks German and Turkish.

Amit Shah
Amit is a Research Analyst at East Coast. He is currently enrolled in the Master of Science in Finance degree program at Boston College Carroll School of Management. Amit earned a B.S. and M.S. degree in Decision and Information Sciences from the University of Florida. Prior to graduate school, he worked as an IT Security consultant. He is currently a CFA Level 2 Candidate.

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