



## Baltimore Capital Management

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Dear Client,

For the year 2009, your account has had a gain of xx%.

What an interesting year it has been! Equities around the world did exceptionally well, with gains of 20% or more after a horrible 2008. By contrast, twenty-year US government bonds declined 21%, and seven- to ten-year government bonds declined 6%. Corporate bonds, on the other hand, increased 9% and lower quality bonds did even better. All this, while mutual fund investors spent the year selling equity mutual funds and pouring the proceeds into bond funds. Sadly, the losses for bond investors have only just begun. When interest rates start to go up, and they will at some point in 2010, bond losses will continue to accumulate.

It is now clear that the economy is on the mend, even if unemployment remains very high by historic standards. As we have repeatedly pointed out in past letters, stock markets anticipate events, and they certainly have done so this year. Those predicting that we would have another depression like the 1930s have been wrong. Many of them now predict another economic decline or so-called "second dip." While I doubt that will happen, it does not mean we only see clear skies ahead.

We remain very concerned about the declining US dollar and the record government budget deficits. While government actions to save the financial system have been effective in keeping the system from failing entirely, the various government stimulus programs have been generally less effective. Of specific concern is the potential impact on the housing market when the government stops the stimulus of low interest rates and rebates. While these measures have been helpful in stabilizing real estate, we just don't know what will happen to that market when the stimulus is reduced.

Investor psychology is always of interest to us. As stated above, many investors spent most of 2009, and especially the early part of that year, selling equities at the bottom. These actions were motivated by fear, yet have been detrimental to many savers. It is not hard to understand the fear, especially given that the S+P 500 index is actually lower now than it was ten years ago (BCM-managed accounts have done substantially better than that). It is important to note that, while the market crash negatively impacted the net performance of the S+P over the past decade, foreign markets, and in particular emerging markets, have done better. Commodities have also done better, with gold being a factor of that performance.

Although the crash is behind us, investors are still risk-averse. I remember that five years ago, all anyone wanted to know is why the value of their account was not increasing at least 15% a year; now what I hear is concern over when the stock market will tank again. My guess is that we will not see another decline of the

recent vintage for many years. That does not mean, however, that volatility is gone, nor that we are not overdue for a correction of some type. In anticipation, we are maintaining cash reserves on the order of 20%, and would welcome a correction should it occur.

The stock market is not currently expensive, trading at a price-earnings ratio of 15 X 2010 earnings estimates. We are of the view that quality equities are overdue for a rally of sorts. For proof of this we need look no further than 2009, when quality names like Exxon were actually down for the year. We continue to favor dividend-paying names for income and capital appreciation, and are focused on that sector of the market.

As a final note, I am intrigued by several studies I have seen lately and thought I would mention them. One is a study by the Boston Consulting group showing that companies that grew by acquisitions between 1992 and 2006 did less well than those that grew organically. Intuitively this makes sense, as making acquisitions is always a risk since you never really know everything about the company you buy. Internal growth, like that of McDonalds, is just doing more of what you already know well. The other interesting study shows that companies with overpaid executives do less well than those with reasonable pay. This one is harder to explain, but it may have something to do with the alignment of executive's interest with those of the shareholders. If an executive is a large shareholder and not just an overpaid hired hand, he clearly has the same interest as the passive investor in his company.

In summary, we are cautiously optimistic going forward, with concerns as stated above and the additional concerns I know we all share about current world events. I wish you and your family a safe, healthy, and prosperous New Year.

Sincerely,

Alec Graham

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*Upon written request, we will deliver a copy of our Part II of the form ADV and a balance sheet.*