

AUGUST 8, 2011

Reality is merely an illusion, albeit a very persistent one.
- *Albert Einstein*



Dear Investor,

While just over a month since our last quarterly letter, it has certainly been a period worth commentary. Since June 30, the market as measured by the S&P 500 has dropped 9.0% (and is likely to fall further today).

In our second quarter letter, we expressed caution given both the debt ceiling debate and the Eurozone crisis. We also opined that a resolution of these issues might be a positive factor for market sentiment. Unfortunately, neither crisis has yet been satisfactorily resolved.

Washington spent all of its political capital to call attention to our economic negatives, and then did basically nothing to address them. Worse yet, the uncertainty still remains as the tough decisions were once again deferred and the 2012 election season is fast approaching. In the meantime, we don't have stimulus, we don't have a rational tax system, and we don't have a balanced budget. We are not publicly stating our own political philosophy, but we certainly believe you can't do "none of the above."

The European currency crisis, in the meantime, has grown worse as Europe seems to be stuck betwixt and between. The European Central Bank inexplicably seems firm in its fight against inflation, as the economies of its member countries deflate one by one. And, the political will within the core of the Eurozone is insufficient to take the steps necessary to stabilize the periphery.

Investors tend to overstate narrow factors, but pessimists are not wrong to focus on current policies here and in Europe as being a series of compromises and half-steps that are neither fish nor fowl. And while central bank and government policies are important factors - to us, psychology and sentiment are ultimately the decisive economic drivers. We are not just referring to stock prices but to actual economic growth. The consumer must want to buy things. The employer must want to hire people. The CEO must want to build a new factory; and yes, the stock investor must want to buy stocks. Again, while we are not assigning blame, belligerent and ideological showdowns in Congress and in Europe do not exactly build confidence.

Just this weekend S&P added to the growing discomfort with its well-telegraphed, but still disconcerting, downgrade of the US credit rating. We will not wade into the discussion of the motivations and controversy surrounding S&P's decision, instead will focus on the key issue of the soundness of US debt. Despite a bitter debate leading up to the debt-ceiling increase, there is still no scenario we can construct in which the US Treasury will not service its debt. No matter what our opinion, S&P's actions are meaningful and likely, due to the timing, to exacerbate market fears.

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Outside of politics, there is no doubt that recent economic data is weak. To be clear, it largely indicates growth slowing – not a recession and certainly not a return to panic and crisis. Corporate earnings have largely been strong, but expectations were high and many companies have struck a cautious note about the near-term future. We do believe that valuations are reasonable, but when the market gets nervous market participants will sell first and analyze later. That reality is no illusion.

While volatility has returned, we are not passively standing by. Over the past few days, we have been searching for the quality investment opportunities that inevitably present themselves during times of market uncertainty. We have very strong conviction in the companies we currently hold (even, or in some cases especially in the face of a potentially weakening economy), but if we find something we like better we will not hesitate to take advantage of the current market turbulence. We are also looking at every position in taxable accounts to make sure that we take all appropriate steps to minimize tax obligations. While we believe steadfastly that rash actions often yield poor long term results, we remain attentive and ready to act.

Sincerely,

Spears Abacus