INVESTMENT PARTNERS ASSET MANAGEMENT
One Highland Avenue, Metuchen NJ 08840 Tel: 732-205-0391 Fax: 732-205-0395

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"ECONOMIC REALITY

As we have stated previously, we are trying to stay mindful that while capital pursues opportunity, it can also be withdrawn from the system quickly when trouble occurs. We still feel that the process of liquidation in the housing and real estate markets isn't over and the toxic assets on bank balance sheets have not been expunged. More disturbing is the reporting of Government statistics as to somehow prove that the recession is over. While the economic climate may be somewhat improved according to the latest statistics, when you really go behind the numbers we find that most of the "growth" is merely the result of government stimulus.

For economic growth to be real, in our opinion, it should be organic. To us, a government-inspired recovery based on debt and hope is not a viable long-term strategy. Over the years, we have approached investing with a contrarian attitude, without being contrary. While it may be logical to believe that markets are interconnected globally it is often more rewarding to look for discontinuities.

RISK ASSESSMENT

We believe the world is as risky today as it was after the fall of Lehman Brothers. The leverage on the books of banks and investment banks has been replaced by debt transferred to current and future citizenry of the United States by the Federal Reserve, the US Treasury, and the US Congress. Is it any wonder that the markets recently have bid up the price of gold and other hard assets? In our opinion the rise in commodity-related assets is not as much demand driven, as it is the world's desire to diversify away from the US dollar as a reserve currency. We are astounded that our creditors in Asia and the Middle East have not yet moved to protect their own interests from Congress, and the Federal Reserve – although news this week from China, Saudi Arabia, and Turkey have warned that they are steps away from diminishing the role of the US dollar as the reserve currency. Indeed Russia and India's central banks have begun using dollars to buy gold. As a result, we feel that the shift away from the dollar as reserve could catalyze the largest transfer of wealth in human history. Maybe this dynamic could even be considered economic warfare against the US by our trading partners. Hopefully, over the long term, our fiscal irresponsibility as a nation will not lead us onto a real battlefield. We already have our hands full in Iraq, Afghanistan, and the war on terrorism.

Against that background – now is not a time to become over-confident that the world's problems are now in the rear-view mirror. Since the Fund was created to invest in smaller companies using value/growth criteria along with special situations, you might have expected us to be less conservative. In times that are more normal you can expect us to approach opportunity constructively but cautiously. At least for now, we will require that potential returns be significant because, in our view, the risks of a market decline in the short term are greater now because an air of complacency has returned. We also feel that in an economic sense, there will be a ***"New Normal"*** going forward.

THEMES

The balance of this report will be devoted to two themes that have been on our minds for some time: <u>One,</u> it appears that we have learned very little from history and events of the recent past; and <u>Two</u>, the gap between the elitist 5% of the population and the poorest 25% is widening by squeezing those in the middle, as they become more downtrodden and poorer. In the process they become more dependent on Government.

WE ASK: IS THIS A TRIP DOWN MEMORY LANE OR FANTASY ISLAND?

Last quarter we decried the demise of manufacturing, the historic inner core of wealth creation in the American Heartland. The near 29% unemployment rate in Detroit has not been mitigated by Government Stimulus. To put this in perspective, sub-prime mortgage borrowing and over-indebtedness just made an already bad situation that much worse. Government encouragement of banks to do more lending in the rust belt is a fantasy trip that only politicians can conjure. Let's face it, while it is truly a pity, many of those manufacturing jobs are likely gone forever.

The Government would probably like us to believe that the economy is on a sustainable rebound because of the stimulus they created. One year after the World looked into an economic abyss, the creators of the mischief that got us into this mess are back at it – some at the same desks, but this time with larger bonuses - richer rather than poorer, inflicting sickness, pretending things are healthier. Please excuse us if this sounds like a recitation of the marriage vows between Wall Street and Government. The only thing missing is the reminder – until death do us part.

Nothing has changed. It's the same old music, and same dances, just new dancers.

LESSONS LEARNED

In this update, we need to take a step back into the Depression Era - a time described by our grandparents that life was inherently painful financially. Times where survival meant a life of austerity, sacrifice, and hard work: a scary time with no safety nets. Over nearly a decade of boom times, the flapper era was over in what seemed an instant. It is perfectly understandable that after the boom turned to bust, that the populace became far more risk averse. In some instances, because their losses were so significant, investors swore that they would never trust Wall Street or Banks ever again. Out of the need to protect the citizenry, Government institutions were born to save the nation from systemic risk. The Federal Reserve, created in 1913 became ever more powerful. The Treasury needed to revive the Banks and put money back in circulation. Foreclosed houses were auctioned off and often sold by the banks at huge losses just to clear the inventory. If you ever meet some of the folks who can remember this era, they will recount how apples were sold on the corner and bread cost a nickel.

Some eighty years later, you need between fifty and seventy times as many US dollars to buy the same loaf of bread. The "Depression Generation" did what was required to survive: They saved and sacrificed and kept their heads above water. They survived World War II, the Korean War, Vietnam, a cold war with the USSR, forays into the Middle East, the Terrorism of 9-11 and numerous skirmishes in distant Hell-Holes.

Both the "Depression Generation" and the so-called "Greatest Generation", educated their children, eschewed debt, trusted government officials to do the right thing, and respected authority.

In their lifetimes they witnessed the faintly possible become probable; and the unimaginable become reality. Progress was the result of accepting rapid change. They welcomed technology, and understood that productivity meant profits. If they offered employers a fair day's work, the reward was a fair day's pay and an opportunity to live the American Dream. While many saved and sacrificed they learned that the rainy day assets, in many cases savings set aside for retirement, may now turn out to be woefully inadequate. What they have learned is that those who pleaded poverty and continued to take handouts from politicians anxious to buy favoritism and votes have "gamed" the system at their expense. Government squandered the advantages earned through the bloodshed of war, misallocated capital, debased the currency and destroyed faith and trust. Is it any wonder that they are mad as hell and beginning to show their unwillingness to take it anymore?

IS THIS TIME THE SAME?

Since the start of the Industrial Revolution, the United States was an economic miracle: a model for the rest of the world to emulate. Americans, because they lived in the land of the free and the home of the brave, were resilient even during periods of ebb and flow, feast and famine, boom and bust. The opportunity to experience life to the fullest rewarded risk takers, savers, and investors. Economic expansion created an environment where real wealth could be accumulated. Some thirty years ago we were **<u>still</u>** the world's largest creditor; our people were not so heavily in debt relative to their earning power or their assets. Banks made it easy to obtain credit because the collateral was significant and the money by which repayments could be made was in a sound currency: the US dollar.

Then, with the assistance of lawmakers, Congress passed laws such as the Full Employment Act and created housing-assistance programs that suggested that you need not save to enjoy the good life. You could borrow from the future and the worth of your assets would grow faster than the debts, making one feel wealthier. Ironically, the only ones locked out of the party were the savers. Not to be outdone by its citizens, the Government embarked on a borrowing spree – probably without expectation of ever paying back the principal on the debts that it created. As long as we could be the military protectors of the free world, other nations bought the debt without demanding an interest commensurate with the risk of an inflated currency. The system was foolproof, and it was such a good game.

But why stop there? Why not make it even more attractive by creating leverage on leverage? Wall Street bankers sensing that the money tree was a virtual cornucopia, created products that few understood. Rather than ask questions, Government and the banks encouraged citizens to get in the game.

We all know what happened when the music stopped.
Now, in the aftermath of this folly we still have banks that have trillions of dollars in liabilities backed by illiquid real estate at substantially reduced values, ballooning US Government debt, and a need to spur consumer spending and inflation in order to honor our commitments to foreign lenders.

OR IS IT DIFFERENT?

When you observe this through the lens of history, one could suggest that this time will be no different. Maybe since the markets have been fooled into producing a desired outcome in the past, they will do so again. In fact while the Government wants everyone to know how vigilant they will be to assure that this will never happen again, to a certain degree they'd love to see the game continue – hopefully this time with the outcome not playing itself out again until many years down the road. We feel, though, that the true difference is that the public is beginning to catch on – this time there is a larger percentage of the population who will be left out of the game.

The "New Normal" will likely impact most levels of our society, particularly middle-class savers, in the form of taxation and higher costs to pay for the sins of the past and a lowering of the standard of living for everyone, except maybe those lucky few who are still running the same institutions that created the folly in the first place. This is probably why the "Depression Generation" and "Greatest Generation" folks in particular are so frustrated. They are used to seeing those who create a disastrous result punished, not promoted.

The eventual outcome of such a reversal in currency policy will be a concentration of wealth and power, both within levels of Wall Street / Government, as well as those "connected" institutions and individuals. We are already seeing it manifest; just ask Citigroup's research team, the sizzling Boston high-end condo market, the New York Yankees (and their $2000 tickets). It seems that certain people with access to credit, who survived and prospered after last year, are still economically viable although we shall see how long their riches go untaxed by the Administration. The other 95% of humanity has been marginalized, saddled with incredible debt and the prospect of a jobless recovery. The market presently is clearly differentiating between the two worlds, with the looming CIT Group bankruptcy potentially crushing small business, the engine of job creation.

So, needless to say, as investment managers we have our work cut out for us. We expect a number of the economic trends discussed in this report to play out, but no one can predict when. The trick is for us to find companies that will somehow survive and thrive in the ***"New Normal"*** in which we find ourselves."

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