

## THIRD QUARTER COMMENTARY

Los Angeles, October 15, 2009

Dear Fellow Investor:

We were wrong. We said in our second quarter commentary, among other things, that we were relatively confident that the market would not traverse a straight line back to more normal valuations. As it turns out, it has come pretty close.

The remarkable rally off the March 9, 2009 bottom continued largely apace over the last three months. After rising 15.9% in the second quarter, the S&P 500 rose another 15.6% in the third quarter. To summarize the two-year picture, after losing 900 points from October 2007 to the March 9th low, the S&P 500 rose 140 points the last three weeks of March, 120 points in the second quarter and another 140 points in the third quarter. Yes, that means the S&P 500 would need to rise another 500 points to return to October 2007 levels. Don't hold your breath.

Bristlecone's Large Cap Value portfolios continued to outperform during the quarter, with the average portfolio up by about 21% during the period. This again topped by a fair margin both the S&P 500 (up 15.6%) and the Russell 1000 Value index (up 18.2%). When it rains, it pours—a lesson for those trying to time the market. Those who thought it prudent to wait out in cash the steepest recession in decades missed out on about six years of average returns over the last six months.

Our current run of outperformance will surely end, as did the previous run of underperformance. This recurring cycle of multi-year periods of out- and under-performance is a source of frustration to us, as we realize that only those of you who've been with us for more than 5 years (or for a year or less) have seen their portfolio returns exceed the market's. Nonetheless, we are pleased, as shown in the table below, that our average portfolio has netted roughly 2% annually over the S&P 500 since April 1st, 2000 (9 1/2 years).

### Large Cap Value Composite Net Returns Through September 30, 2009<sup>1</sup>

	Since Apr. 1, 2000	5 Year	3 Year	1 Year	3Q 2009
Annualized	0.5%	-1.4%	-9.8%	-5.7%	
S&P 500	-1.8%	1.0%	-5.4%	-6.9%	
Cumulative	4.9%	-6.8%	-26.6%	-5.7%	21.0%
S&P 500	-16.2%	5.2%	-15.4%	-6.9%	15.6%

<sup>1</sup> PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Performance quoted is that of the Large Cap Value Non Wrap Composite net of fees and may include estimates for the most recent quarter. Investment returns for the composite and the S&P 500 include the reinvestment of dividends and/or interest income. Inception is April 1, 2000. The US dollar is the currency used to express performance. Bristlecone Value Partners, LLC ("Bristlecone") is a registered investment adviser founded on June 1, 2004. Prior to June 2004, the composite represents performance generated by the portfolio management team at a prior firm and includes wrap accounts. Bristlecone claims compliance with the Global Investment Performance Standards (GIPS<sup>®</sup>). A list and description of all composites and/or a presentation that complies with the requirement of GIPS is available upon request.



#### NEW INVESTMENTS:

NONE

#### INCREASE IN EXISTING INVESTMENTS:

WASHINGTON POST (WPO)

#### REDUCTION IN EXISTING INVESTMENTS:

EXPEDIA (EXPE)

#### INVESTMENTS SOLD:

IAC INTERACTIVE (IACI)

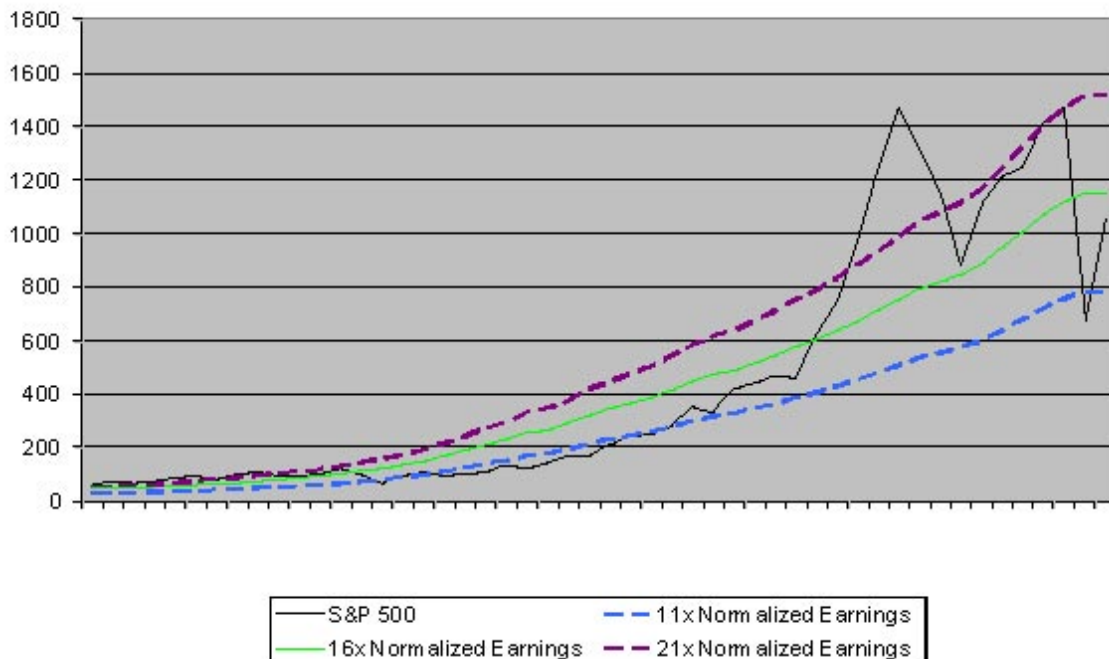
WESTERN UNION (WU)

## Re-Visiting Market Valuation

As part of our first quarter commentary, we published a chart we find very useful in gauging—roughly—the overall market’s valuation. To recap, in March the market touched the very bottom of its typical valuation range, about 11x normalized S&P 500 earnings. As of the end of the third quarter, the market stood much closer,

within about 10%, of what we consider an average valuation. Another valid approach to this question is Robert Shiller’s price to earnings ratio, in which he derives normalized earnings by using a trailing 10-year average. This approach also shows the broad market close to, actually a little above, its average historical valuation.

### S&P 500 and Normalized Corporate Earnings



What does this mean? At the time, we observed that a return to average profitability and average valuations—importantly, over some unknown period of time—should combine to produce superior returns to what investors had suffered through the prior ten years. Whether that mean reversion occurred over six months or six years would determine the level of returns. From today’s vantage point, with the market closer to a typical valuation, our long-term outlook is necessarily for something much closer to the long-term average returns of the market. As a reminder, the total return of the S&P 500 from 1926 – 2008 was about 9.7%. For our purposes, however, ignore the precise figure and think of a range around that level. Such returns would be comprised of approximately constant valuations, GDP-level earnings growth (6%

- 7%), and dividends (about 2.5% currently).

Although much of the expected outperformance may already have occurred, there are at least two points worth making here. First, more “normal” returns can still be quite good when compared both to the last ten years (the ten-year trailing total return for the S&P 500 through September 30 is slightly negative) and to other alternatives (intermediate-term US Treasuries yield only 3% - 4% and may produce lower total returns if rates rise). Second, it is important not to mistake an expectation of more normal returns over the long term, with an expectation for normal returns in any given period. Rare is the “normal” year in the stock market and rest assured corrections can and will occur.



## Large Cap Value Portfolio Commentary

Most of the portfolio's outperformance in the third quarter came from the previously hard hit consumer discretionary sector, our second largest sector weighting after financials. The top contributors to the portfolio's performance were, in order: Expedia, American Express, Liberty Media Interactive, Cintas, and Walgreen. The first three of these, at least, are dependent on consumers spending discretionary dollars, and the stocks benefited nicely from mounting evidence that the recession is ending. The stocks of Walgreen's and Cintas both jumped due to better than expected profitability demonstrated in recent results. Walgreen's is benefitting from a substantial increase in free cash flows as it slows down its new store openings.

Not surprisingly given the breadth of the quarter's rally, there were only two stocks in the portfolio that declined during the quarter, Sprint and Exxon Mobil.

Portfolio activity was biased toward selling during the quarter, as valuations rose. We sold IAC Interactive and Western Union from the portfolio, and decreased our holdings in Expedia.

We had purchased IAC Interactive four years ago because we believed the underlying collection of businesses (which included Expedia, TicketMaster, Match.com, Interval Leisure, Ask.com, and many others) was worth more than the market was giving the company credit for. As we had hoped, management began to spin off these subsidiaries into independent companies, some of which, like Expedia, have returned value for us. What is left at IAC Interactive is a collection of mediocre businesses with an expensive hand (Barry Diller's) at the tiller.

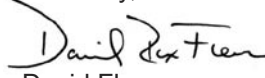
The sale of Western Union reflects doubts we have about the long-term competitiveness of the company's money transfer business. Through an incredible international network of nearly 400,000 agent locations around the world, the company

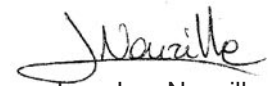
built a solid competitive moat around its business that delivered outsized returns for years (this is a business we've owned off and on for nearly 12 years). Gradually, we have come to believe there is a reasonable chance that some combination of the internet and mobile phone networks, coupled with the increasing penetration of electronic (think credit/debit cards) payments, will undermine Western Union's competitive advantage. That belief reached a tipping point this quarter and we decided to free up capital for re-deployment.

We did add to one of our holdings during the quarter, the now mis-named Washington Post Company. Casual observers and even many investors understandably associate the company with its namesake Washington Post newspaper. The reality is that we assign little value to the newspaper business (or the Newsweek magazine business they own), but find great, unrecognized value in the company's education (much of it under the Kaplan brand name) and cable businesses. Despite the severe cyclical slump in advertising and what looks like a long-term secular decline in newspaper readership, Washington Post actually grew earnings and revenues in the first half of 2009, something that cannot be said for many companies out there.

In closing, we're pleased you stuck with us through a stomach-churning downturn to enjoy the benefits of the last six months. It has been just about the best six months, speaking of both absolute and relative returns, that we could have imagined. While we remain vigilant in balancing out opportunities to grow value and protect recent gains, the potential for much near-term volatility remains. We will keep our eyes focused on the long-term horizon.

Sincerely,

  
David Fleer  
Portfolio Manager

  
Jean-Luc Nouzille  
Portfolio Manager

### CAUTIONARY STATEMENT

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