

Equity Investment Corporation

2009 Year-End All-Cap Value Commentary

January 19, 2010

We are pleased to report the magnitude of our 2009 *increase* of 25.9% (before fees) was greater than our 2008 *decline* of 23.4%. In contrast, while the S&P 500 and Russell 3000 Value indices rose 26.5% and 19.8% in 2009, they fell 37.0% and 36.3% in 2008. For the two years combined, we fell 3.5% versus 20.3% and 23.7% declines for the S&P 500 and Russell 3000 Value indices¹. *Full recovery from 2008 requires a further 3.6% gain from us, but 25.5% and 31.0% gains for these indices. That is why limiting losses is so important – getting back to even is quicker.*

Differences between our returns and those of market indices are neither random nor luck. Instead, they reflect our conscious and disciplined decisions to manage risk. Doing so during the credit bubble (2005-2008) meant avoiding companies whose earnings benefitted from the excessive credit and loose lending environment. In 2006, when this decision was unpopular, we explained it this way:

Q1-2006: “We accept this difference between our holdings and those of the indices as part and parcel of what we do for clients. To be clear, we do not believe our role is to simply generate the highest returns for clients in a given quarter or year (although we hasten to add that our long-term returns have exceeded virtually all U.S. equity indices). Nor is it our role to track a style-box index for investors who wish to blend capitalization exposures and investment styles to reduce risk pursuant to modern portfolio theory.... Instead, our goal is to provide strong absolute and relative returns over a market cycle, while doing so with relatively low risk, as defined by frequency and magnitude of loss.”

Likewise, managing risk in 1996-1999 meant avoiding over-priced, large-cap and technology stocks by owning small- and mid-cap companies. Here’s what we said when that was unpopular:

Q4-1999: “Given the continued under-performance of mid and small companies...Why do we own them instead of the big companies? Today's large stocks, and "Top 10 Contributor" stocks are at high altitudes. Rather than ignoring our preset decision rules of value and prudence, we turned back from these holdings, knowing the risks of high prices.... [referring to Jon Krakauer’s book Into Thin Air in which Mt. Everest climbers perished trying to “get to the top” after ignoring known risks]... I expect to “get to the top” over a full investment cycle, but I also plan to be a survivor. I believe this is the right attitude for your investment guide to have.”

Awareness of risks, discipline to *not* ignore them, willingness to be unlike the indices, and flexibility to follow value regardless of cap-size were the chief reasons our returns for the “Lost Decade” were so different from the indices (8.5% annualized versus -1.0% for the S&P 500 and 2.9% for the Russell 3000 Value; \$1.00 grew to \$2.26 instead of falling to \$0.91 via the S&P 500, or \$1.32 if invested in the R3000 Value)¹.

If differences between our returns and those of the indices reflect conscious and disciplined decisions to manage risk, and risks take years to play out, it follows that short-term periods (3-5 years) when our results are strong/weak versus indices should not be viewed as justifications to begin or stop using us. Yet, the industry typically focuses on such short periods in making these decisions. In our case, such periods instead reflect our consistent attitude toward risk, implemented regardless of popularity in given markets. Longer time periods ultimately confirm or reject the soundness of these decisions. *Our results over the past decade and since our inception twenty-four years ago confirm our approach.*

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Rigid style-box approaches using large/mid/small and value/growth buckets have done little to increase investor returns or reduce risk. This is partly because a company's *size* has little to do with risk/return, as demonstrated by the demise of many presumably safe large companies over the past few years (GM, AIG, Fannie/Freddie, Lehman, major banks, etc.). Likewise, growth/value distinctions are simplifications of reality. To be wrong about a business's growth ability is to be wrong about its value. *That is why managing risk should be about reducing the odds of being wrong in valuing growth. In the practice of long-term investing, reducing risk goes hand-in-hand with increasing return - just the opposite of theory.*

Managing Today's Risk/Return Opportunity Set

A great deal of press focuses on the market's rise since its March 2009 low. This dramatic rise, plus some overly simplistic price/earnings ratio statistics paint a misleading picture of the risk/return opportunity set before investors today. Given the extent of the credit crisis, government actions, and unemployment, all stocks are exposed to more-varied risks than normal. Navigating these successfully will be, in some ways, more difficult than the recent more-extreme bubbles. The below matrix can help clarify the current risk/opportunity set, as we see it, using a few selected industries. Most industries fall in the middle (reasonable expectations for recovery and reasonable prices). Industries in the upper-left (red) area generally carry high expectations for a strong earnings rebound in 2010, high price/value, and greater risk. Industries in the bottom-right (green) areas generally reflect more reasonable to pessimistic rebound expectations and low price/value. Our investments are concentrated almost exclusively in the green areas, where we believe the risk/return opportunity is favorable, and quality is high. We could be wrong, and analysts right. But if so, this will again reflect our decision regarding risk management by choosing to own stocks in less popular areas with lower expectations. *As we begin our 25th year, we have learned to accept such decisions as the lonely tradeoff one must make to enjoy returns different than the market, which in our case has meant above-market returns but below-market risk of loss.*

2010 Rebound Expectations vs. 2009	<u>Price Versus Value</u>		
	High	Fair	Low
Optimistic	Auto Parts & Autos Building Materials Truckers Machinery Materials	Computer Service Industrial Services Brokerage Apparel	Food Retailers
Reasonable	Cosmetics Railroads Chemicals Computer Peripherals	Utilities (Gas & Elec.) Restaurants Integrated Oil Office Supplies Food Processors Electronic Retailers	Medical Devices Defense Communications Broadline Retailers
Pessimistic	N/A	Packaging	Insurance Household Products Beverages

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Portfolio Review

During the fourth quarter, we purchased one new position, CVS Caremark, and added to existing positions in Dr Pepper Snapple and Molson Coors. In addition, we sold positions in Cadbury, Hershey and Duke Realty, while trimming our stake in American Express.

These moves had the net effect of increasing our exposure to companies with stable earnings, reasonable prices, and relatively low expectations (CVS Caremark, Dr Pepper Snapple, Molson Coors), while reducing our exposure to stocks with high prices (Cadbury – due to takeover bidding), threat of excessive leverage (Hershey – a potential bidder for the larger Cadbury) and exposure to continued weakness in credit markets and commercial real estate (Duke Realty and American Express).

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¹ Disclosures

Not approved for presentation to wrap program clients. Such presentations should reflect EIC's wrap composite information. EIC results are those of our All-Cap Value Composite, after commissions and before EIC management fees, and are presented as supplemental information to a full GIPS® disclosure presentation, which is available upon request. After EIC fees, our returns were: 2009: 25.0%; 2008: -23.9%; for the two years, -4.9%. Getting back to even, after fees, requires a further 5.2% increase for EIC All-Cap Value. EIC returns for the "Lost Decade" (January 1, 2000 through December 31, 2009) after manager fees were 7.7%; \$1 grew to \$2.10. All returns include reinvestment of dividends and interest. Index returns exclude fees and commission costs. Results are historical and do not imply future rates of returns or volatility for EIC or the indices, which may be materially different from the past and from one another. Individual account results may differ from those of the composite.