



Financial Markets Commentary

January 2010

Although most people seem to be happy to see 2009 pass with a sentiment of good riddance, it turned out to be a banner year for investors as stocks, bonds and commodities continued to appreciate throughout the 4th quarter. What had been a significant possibility at the beginning of 2009, financial and economic Armageddon, was avoided with the help of extraordinary measures on the part of governments and central banks around the globe. These quick fixes were necessary, but whether they catalyze a sustainable return to growth, or merely delay a train wreck, remains to be seen. Our base expectation for 2010 is for sluggish U.S. economic growth leading to modest stock and bond index returns and ample opportunity to add value through active portfolio management. However, there are some reasons to believe it could be better and plenty of unresolved problems that could derail the train. We believe our clients must continue to incorporate these possibilities into their financial plans.

A summary of our recommendations follows:

- It is time to review your long-term objectives and target investment allocations. Also, take the opportunity to evaluate the structure of your tax-advantaged accounts with respect to new rules and the expectation of rising tax rates.
- Stocks have made a strong run and are currently pricing in a significant earnings recovery in 2010. Rebalance back to your long-term targets, or if it is necessary to increase in order to get to your long-term targets, only buy on dips. In any case, stay with the tilt toward high-quality, less levered, cash flow-positive businesses, active investment managers and a globally diversified portfolio.
- Maintain allocations to bonds near your long-term targets. Avoid or reduce U.S. Treasury and other sovereign issuers in favor of corporate and municipal issuers and a portion of high-yield bonds. Utilize active multicurrency managers.
- Maintain a target allocation to managers or funds that execute active global tactical allocation strategies as well as other alternative strategies.

Economy

U.S. GDP was reported to have expanded at a seasonally adjusted annual rate of 2.2% for the third quarter of 2009, its first quarterly increase since the 2nd quarter of 2008. The first official estimates had come in higher but were revised down throughout the 4th quarter. Year-over-year GDP growth remained in the red at -2.2%.

This growth was not unexpected. The main driver was an increase in consumer spending, which recovered from the “buyers’ strike” mentality that had prevailed over the previous year and was enhanced by government stimulus programs. Currently, most economists are expecting that GDP accelerated in the 4th quarter as well. Despite the growth, the National Bureau of Economic Research (NBER) has yet to pronounce the recession over.

The rate of unemployment in the U.S. reached 10.3% in October 2009 but pulled back slightly to 10.1% in November. The rapid loss of jobs in the U.S. may be over but note in the chart below that after the most recent two recessions, the unemployment rate continued to climb well into the following recoveries. This was likely due to technology driven productivity improvements and the increasing globalization of the workforce, both of which could easily contribute to a “jobless” recovery again this time. Since consumer spending is such an important part of GDP growth, this employment lag makes fiscal and monetary stimulus fairly tricky and increases the possibility of a double-dip recession. During the past two

recoveries, the Federal Reserve (the Fed) responded by lowering its policy interest rate and keeping it very low well into the recoveries long after employment statistics started improving. This basically encouraged consumers and businesses to borrow their way to economic growth, and it worked.

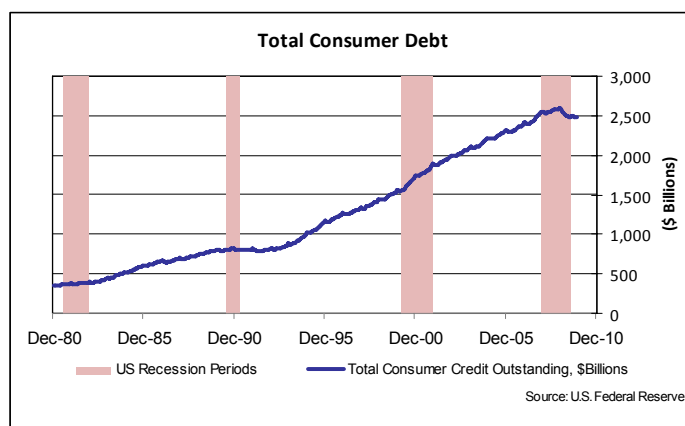
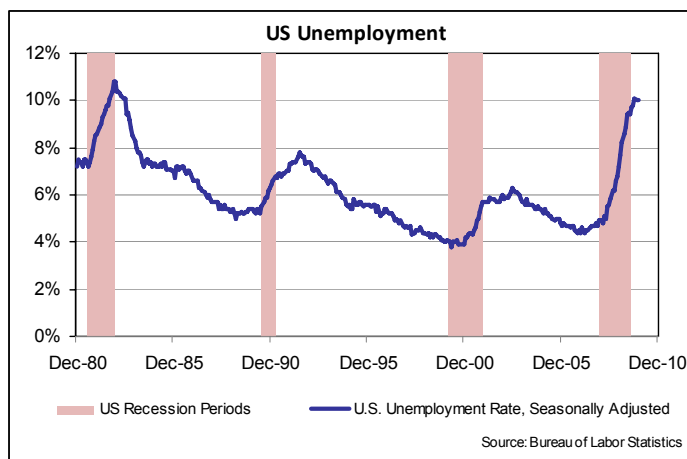
So far, despite historically low interest rates consumers have continued to reduce their debt. We believe this is a very good thing for the medium and long-term health of the U.S. economy, but not for near-term economic growth and is contrary to what the Fed is trying to accomplish through stimulus. Since its peak in December 2008, total consumer debt outstanding has dropped by more than 4% through November 2009, the first time consumer debt has ever fallen over a period greater than seven months and by far the largest correction we have ever witnessed. This could be because consumers are already overextended, particularly relative to the diminished value of their homes and because banks are raising their credit standards in an effort to improve their balance sheets. In addition, the loan securitization market, often referred to as the “shadow banking system,” has been severely diminished. We have heard plenty of anecdotal evidence that consumers and small businesses are having difficulty obtaining loans even with solid credit records.

Various other statistics often used to forecast the economy are indicative of moderate growth going forward. The Conference Board's Consumer Confidence Index remained stagnant around 50 for the second half of 2009 but Michigan's Consumer Sentiment Survey has been rising since February. The ISM Purchasing Managers Index steadily moved higher throughout 2009 with a December reading of 55.9 which indicates economic expansion. The Fed's Industrial Production Index has begun to recover, although it remains at levels last seen in 2002. Combining a few of these

factors with other market related indicators, such as stock prices, the Conference Board's Index of Leading Economic Indicators has moved steadily higher since March 2009 (97.9 to 104.9).

Also, confirming that the financial markets are operating free of panic and crisis management, the Bloomberg Financial Conditions Index, recently recovered into slight positive territory for the first time since August 2007, suggesting that financial conditions are just about average.

Most other developed economies showed a similar pattern, which was very modest 3rd quarter growth but still a significant year-over-year contraction. For example, Eurozone GDP rose 0.4% during the 3rd quarter for a year-over-year growth rate of -4.0%. Japan's real GDP fell 5.1% year-over-year after a 3rd quarter gain of 0.3%. Real GDP growth for the United Kingdom was reported to be -0.3% for the 3rd quarter and -5.1% for the trailing year. Conversely some of the important emerging markets economies grew rapidly. The Indian and Chinese economies grew 8% and 9%, respectively, over the trailing year. Brazil and Russia showed strong growth in the 3rd quarter but were still lower year-over-year, and South Korea grew by 3.2% in the 3rd quarter resulting in year-over-year growth of 0.9%.



Stocks

Stocks moved steadily higher in the 4th quarter, finishing near their highs for the year for their best calendar year return since 2003. The rally slowed from its previous pace and growth biased indices returned to the forefront, handily outpacing their respective value counterparts. More specifically, this was reflective of the significant strength within the information technology, consumer discretionary, healthcare and materials sectors, while the financials sector retreated modestly. Within the S&P 500, the information technology sector rose more than 10% for the 4th quarter and 61% for the full year. The consumer discretionary and healthcare sectors each rose 9% during the 4th quarter and 41% and 20%, respectively, for the full year. Notably, the materials sector continued to provide solid gains, rising 7% for the quarter for a full year gain of 41%. This was a common theme across all foreign and domestic markets, which was driven by rising commodity prices. Conversely, the financials sector, which had rebounded vigorously after the dismal 1st quarter, was the only sector to retreat during the 4th quarter, falling 3% and leaving its full year return at 17%.

Small-cap stocks also rose but not quite as much as large caps during the 4th quarter. The sectors played out a bit differently as well. Within the Russell 2000, the materials, consumer staples and energy sectors led the pack, information technology, consumer discretionary and industrials provided average returns while the healthcare and financials sectors lagged. For the full year, however, small caps provided returns about in line with large caps, while the mid-cap indices proved to be the best performers. Importantly, in the 4th quarter, stocks of higher quality companies performed as well or better than lower quality more speculative names, a distinct change from the two previous quarters.

Foreign stocks also continued higher in the 4th quarter with the exception of the financials sector, which pulled back. In the developed stock markets, the materials sector rose more than 14% in local currency terms while consumer staples, energy and healthcare rose more than 6%. But the financials sector, which makes up more than 25% of the foreign developed markets capitalization, dropped more than 3%. However, this was not a problem in the emerging markets which again outpaced the developed markets with strong returns in all major sectors including financials.

The S&P 500 Index returned 6.04% during the 4th quarter, while the S&P Mid-Cap 400 returned 5.56%, and S&P Small Cap 600 returned 5.12%. For the full year, these three indices returned 26.47%, 37.38%, and 25.56%, respectively. Nevertheless, these and other U.S. benchmarks remain well below their peaks reached in early October 2007. The MSCI EAFE index returned 2.18% and the MSCI EM Index returned 8.55% (US\$) for the 4th quarter, bringing the returns for the full year up to 31.78% and 78.51%, respectively.

Private equity activity remained subdued in the 4th quarter. Reflecting recent poor performance, 2009 resulted in the slowest private equity fundraising effort since 2004. An estimated \$264 billion was raised, representing a 60% drop from 2008: leveraged buy-out and corporate finance fundraising fell 73%; venture fell 55%; and, mezzanine was down 92%. In the 4th quarter, total funds raised declined 80% year over year. In addition, the average time from fund inception to closing lengthened from 12 months to 18 months. The only bright spot was secondary market fundraising, which rose 83% from 2008. However, most of the funds have yet to be deployed.

In 2010, current private equity investors will have less capital available to allocate due to a lack of distributions from existing investments. The good news is that valuations have bottomed and are starting to increase. According to the Cambridge Associates U.S. Private Equity Index, private equity returns were positive in the 3rd quarter, rising 6.2%. For the year-to-date through September 2009, the Index rose 7.43%.

Bonds

The U.S. Treasury yield curve steepened during the 4th quarter as very short-term rates (less than 1 year) remained near zero because the Fed remains very accommodative, but long-term rates rose more than 50 basis points (0.50%). This is reflecting investors' increasing concerns about inflation and/or the continued heavy supply of U.S. Treasuries coming into the market. Hence, longer-term U.S. Treasury bonds provided negative returns again during the 4th quarter. The Citi 10-year U.S. Treasury Index returned -3.62% during the 4th quarter and -9.92% for the calendar year.

While the rise in U.S. Treasury yields put a dent in bond returns, the yield premium (spread) on corporate credits continued to contract so that, on average, yields (and prices) for investment grade corporate bonds remained stable. Consequently, investment grade corporate bonds provided returns similar to their current yields. High-yield bonds continued to provide outsized returns as their yield premiums contracted by about 140 basis points (1.40%). As a result, high-yield and investment grade corporate bonds followed one of their worst performing years ever (2008) with one of their best ever (2009).

The Merrill Lynch Corporate Bond Index returned 1.22% for the 4th quarter bringing the full year return to 19.76%. Meanwhile, the BarCap US High Yield Index returned 6.19% for the 4th quarter and 58.21% for the calendar year.

This was facilitated by extremely low short-term interest rates which enabled and/or forced investors to expand their risk exposure in order to earn returns. Some money went into stocks, but many investors were attracted by the yields and relative safety offered by bonds. For example, according to Morningstar, investors added a net \$262 billion to taxable bond mutual funds in the first 11 months of 2009, raising the total allocation by more than 25%. Municipal bond mutual funds received \$67 billion in cash flow, an increase in assets of 20%. In contrast, over the same 11 months, investors withdrew more than \$17 billion from U.S. stock funds, reducing their allocation by about 1%.

The yield curve for municipal bonds followed the U.S. Treasury curve higher and for many of the same reasons: expectations of significantly higher supply in coming months as municipalities struggle to balance their budgets. However, tax-free issuance will continue to be pared by municipalities' use of the Build America Bonds Program (BABs) to issue taxable debt subsidized by the U.S. Government. The BarCap Municipal Bond Index returned -0.96% for the quarter and 12.92% for the year. The shorter term BarCap Municipal 5 Year Index returned 0.55% for the quarter but only 7.40% for the year.

With long-term yields on the rise and the U.S. dollar appreciating modestly against major currencies, foreign developed market bonds lost value during the 4th quarter. The BarCap Global Aggregate Bond Index returned -0.85% for the 4th quarter and 6.93% for the calendar year.

Cash

Commercial paper markets continue to function and funding rates remain low. Three month LIBOR (London interbank offered rate) declined slightly from 0.29% in September to 0.25% at year-end. As previously noted, although this is extremely stimulative for the economy and for borrowers, it is unattractive for investors. According to iMoneyNet, the current yield for the average money market mutual fund is 0.03%.

Alternatives

According to the CS/Tremont hedge fund indexes, most hedge funds strategies finished the 4th quarter on a positive note, adding to earlier quarterly gains. As a result, alternatives had their best calendar year performance of the decade.

In 2009, the top performing sectors included Convertible Arbitrage (47.4%), Emerging Market (30.0%), Fixed Income Arbitrage (27.4%), Multi-Strategy (24.6%), Distressed (20.9%), and Long/Short Equity (19.5%). Convertible and Fixed Income Arbitrage, Multi-Strategy (mostly credit strategies) and Distressed managers seized on a multitude of cheap opportunities in the high-yield, leveraged loan and convertible markets that arose from forced liquidations at the end of 2008, and then rode tightening credit spreads throughout 2009. Emerging Market and Long/Short Equity managers enjoyed global market rallies following the early March lows.

The least performing sectors in 2009 included Dedicated Short Bias (-25.0%) and Managed Futures (-6.6%), the latter relinquishing 3rd quarter gains due to 4th quarter reversals in gold and the U.S. dollar.

Attractive returns brought investment flows, which combined to raise total hedge fund assets to over \$2 trillion. Following a turbulent 2008, most hedge fund managers used very little leverage throughout most of 2009, only adding to exposure in the 4th quarter. New hedge fund start-ups could not keep pace with hedge fund closings, so that there was a net decline in the total number of hedge funds at year-end.

In 2010, alternatives should continue to provide attractive returns, since in all likelihood, market volatility will rise and leverage will become more accessible. In addition, with fewer hedge funds, any investment opportunity sets should be easier to capture.

Real Estate

REITs and publically traded REOCs traded higher along with the stock market during the 4th quarter, but commercial real estate in general remained mired with high vacancy rates and a difficult business and financing environment. Although there may be some opportunities in distressed properties, we do not believe that the commercial real estate market is immediately attractive and still presents a significant risk to the banking system.

Residential real estate prices remained stable on average during the 4th quarter, after beginning to rise earlier in the year. The total number of existing houses sold rose rapidly and is now back to early 2007 volumes. This is good evidence that the market is normalizing but is also reflective of increased foreclosure activity. We do not expect home prices (on average) to rise meaningfully any time soon.

Commodities

Commodities prices proceeded significantly higher in the 4th quarter, led by industrial metals and precious metals. The S&P GSCI Index rose 8.42% for the quarter, finishing up 13.49% for the year. Although gold has received headline attention, rising 8.8% during the quarter and 24.4% for the full year, industrial metals rose 82.4% for the year paced by copper which appreciated 135%. Demand for raw materials is apparently emanating from China which is reportedly stockpiling. Silver appreciated only marginally in the 4th quarter but rose more than 47% for the calendar year.

Crude oil prices rose almost \$9 during the 4th quarter to just under \$80 per barrel despite evidence that there is a glut of oil sitting in tankers around the world. Having started the year at \$44.60 per barrel, crude oil rose 78% during the year, leaving retail gasoline prices near \$3 per gallon again.

Agricultural commodities appreciated in the 4th quarter, finishing the year widely divergent. On the up side was sugar which appreciated more than 86% for the year, and on the downside there was wheat which depreciated by more than 23%. All others fell somewhere in between, with crops mostly rising while livestock mostly fell in price.

Looking Forward

Although the United States has been the super dominant economic power over the last half century, we believe that while it will remain a super power its dominance will be diluted over time. This has already started, and it will have important ramifications over the ensuing decade, particularly with respect to our exposure to inflation, the purchasing power of our currency, interest rates and more. Related to this, we expect that over the course of the decade, many countries now considered to be “emerging” will evolve to be considered developed and hence, core components of investment portfolios.

More specific to the coming year we have identified a few important themes that will influence your finances.

Inflation/Deflation

Inflation is just another word for an increase in prices, and prices in a market economy are driven by the relationship between supply and demand. Since our own economy has contracted significantly, factories are far from their capacities of utilization, there is high amount of unemployment, and our demand for resources is not growing rapidly. In addition, we still have a glut of housing inventory and a steady stream of foreclosures will keep residential real estate prices in check despite low mortgage rates. There is no inflationary pressure and, in fact, some deflationary pressure being driven by the U.S. economy, particularly in the core categories of labor wages and cost of housing. However, in a global economy there are other forces to consider.

Although most of the developed market economies, including our own, have contracted, some significant countries, such as China and India, continue to grow at a rapid pace, even if it is as a result of massive government spending. These countries have been creating significant demand for commodities such as

base and precious metals and energy and there is widespread belief that they can continue to do so for a sustained period. This factor, whether it is real or merely perceived is what sent commodities prices soaring before the financial crisis and what sent them higher again in 2009. Furthermore, in an effort counteract a severe reduction in activity and fund stimulus and bailout programs, the U.S. Treasury and the Fed have increased the monetary base by more than 140% over the past two years. Hence, although the U.S. economy is presenting no inflationary pressure, U.S. monetary policy and rapidly growing demand for materials could erode the purchasing power of our U.S. dollar, driving materials and energy prices higher. Rising materials and energy prices would act as a tax to further hinder growth. Overall, we expect to see very low core inflation in the U.S. and developed markets this year, but with a significant risk of commodity price inflation.

Investments such as TIPs will not effectively hedge this kind of inflation, particularly if interest rates rise. In our view the best investments to confront this situation are stocks of companies in the materials and energy sector along with related service companies that will benefit from rising prices and increased extraction activities. For diversification from equity risk, some investments in commodity ETFs may be useful. In addition, alternative managers that tactically trade in commodities should prosper in this environment.

U.S. dollar firms versus major currencies but . . .

For most of the year, the U.S. dollar weakened versus other major currencies, resuming a seven-year trend that was interrupted in 2008 by the global flight from risk and into the U.S. dollar. Despite the challenges noted above, we believe there is a good chance that the U.S. dollar firms and/or rallies against the major currencies (i.e., the euro, yen and pound) in 2010. This is driven by the observation that the European and Japanese economies are even weaker than the U.S. and have equal or greater challenges going forward. On the other hand, emerging market economies with trade surpluses and excess reserves should expect to have strengthening currencies. Although some of these currencies are pegged to the U.S. dollar (e.g., the Chinese renminbi), to the extent that they are allowed to move, they will likely rise versus major currencies including the U.S. dollar.

We do not advocate that clients try to invest directly in the foreign exchange markets. Instead, we believe it is important to diversify across currencies through global equity and debt allocations.

Rising Taxes

It is no secret that the U.S. federal government has been in deficit spending mode for some time now, and the recession has exacerbated the circumstances for federal, state and local governments. Merrill Lynch estimates that the U.S. national debt currently totals \$111,000 per tax payer. In the 1990s we benefited from the "peace dividend", and although we have been at war for almost a decade, we have not begun to pay for it yet. Although we can run a deficit in perpetuity, we cannot grow it exponentially forever. We can grow our way out of the deficit, but the necessary growth rate is significantly higher than anyone rationally believes we can achieve. We can inflate our way out of it, which is a possibility. Or we can pay higher tax rates.

The caveat to this thesis is the observation that 2010 is an important mid-presidential term election year, and we should expect that, just as capitalists do, politicians will act in their own self interest. Politicians will avoid raising personal income taxes in 2010 if at all possible, but eventually it will be necessary and we are likely to see new creative tactics, aimed at affluent tax payers and other politically popular targets. For example, as we write, the administration is proposing a special \$90 billion tax on large banks. State and local taxes will rise as well.

We recommend you seek ways to diversify and reduce your tax exposure. This would include allocations to tax-free municipal bonds and taking full advantage of available tax advantaged accounts such as 401(k)s, IRAs, 512 plans, etc.

The new rule allowing high income individuals to convert their IRAs and 401(k)s into Roth IRAs is an interesting opportunity that is worth everyone's consideration. Recall that the benefit of a standard IRA or 401(k) is that people can save and invest pre-tax money and defer paying the tax on the original income as well as all dividends, interest or realized capital gains until that money is withdrawn from the account at some later date. It enables the investment to compound returns unimpeded by income tax payments.

The only draw-back is that individuals are forced to begin withdrawing the money at a minimum specific rate once they turn 70 ½; after all, the IRS wants to get its cut at some point. A Roth IRA is just the opposite. Pay the income taxes upfront before the account appreciates, and then never pay taxes on the dividends, interest or realized capital gains, ever. In addition, since the IRS isn't waiting for its share, there is no mandatory withdrawal schedule.

Keep in mind that the rule change is not simply an altruistic gift from our U.S. federal government to its affluent citizens; it is a way to accelerate the receipt of billions of dollars of tax revenues. It generally goes against the standard rule of thumb which is to defer paying taxes whenever possible for as long as possible. Nevertheless, it may be useful and effective for all or part of your retirement assets, particularly if you believe that your tax rates will increase in the future. There are several important intricacies to the rules and the only way to make an effective decision is to model your specific situation and assumptions.

Rising Interest Rates

The now exorbitant and still increasing debt of the U.S. federal government will drive U.S. Treasury yields higher. This should happen even if only from a supply vs. demand perspective, but it may also come from deterioration in the perceived credit quality of the U.S. Treasury. Much of the extreme leverage present before the financial crisis has not been eliminated. It has merely been transferred from private to public entities. As the U.S. Treasury has been issuing more bonds, the marginal purchaser has been the Fed with its quantitative easing (QE) program. Other major market sovereign issuers are in a similar position, and some less major sovereign issuers have been losing credibility. Hence we do not think U.S. Treasuries or other major foreign government bonds are attractive. In addition there is a risk that yields on mortgaged backed securities are artificially low due to the Fed's QE purchases.

All that said, we do not expect rates to climb sharply this year. On the short-end of the curve, the Fed has control, and if it tightens at all in 2010, it will be modest and only if the economy and employment figures demonstrate significant improvement. On the long-end of the yield curve, low core inflation, weak real estate prices and high unemployment will encourage the Fed to continue quantitative easing. Foreign purchasers of U.S. Treasuries will most likely continue to support their significant investment. The risk to this view is that of a sustained strong recovery.

This leaves room for corporate bonds to provide acceptable returns. Although much of the capital appreciation potential has been removed, yield spreads for investment grade bonds are above average (1.75% over treasury yields) and any improvement in the economy that would drive rates higher should also compress yield spreads. This is also the case for high-yield bonds where average spreads remain around 590 basis points (5.90%). Barring another significant deterioration in the economy, credit analysts are predicting that default rates have peaked already.

In addition, emerging market bonds continue to display attractive yields, and combined with stable or rising currencies they offer compelling return potential and diversification.

The tax adjusted yield premium for tax-free municipal bonds also remains attractive because of investors' wariness about municipalities' financial strength and because the BABs program has reduced the supply of tax free issuance.

Increasing Mergers and Acquisitions Activity

Throughout the crisis and recession, corporations have been conserving cash. Capital expenditures have been trimmed and acquisition activity has been limited. We expect that companies with strong balance sheets facing a slow growth environment will seek to consolidate their competition and grow by acquisition. This should be a positive influence on stock prices.

Fundamental Quality Will Be Important

Overall, stocks are not cheap relative to historical valuations, but in the context of low U.S. Treasury bond yields they are not expensive either. As revenue trends become more visible we expect company fundamentals to become increasingly relevant as compared to the technically driven market in 2009; delivering revenue growth and positive earnings will be important. Based on consensus earnings estimates for 2010, domestic stocks are valued at about 14.5 times earnings, but this reflects an average forecast earnings growth rate of more than 24%. For foreign stocks the numbers are similar; price to

expected earnings of about 14 times earnings with an average forecast average earnings growth rate of more than 28%.

Analysts are clearly expecting significant earnings growth. Experience shows that analysts rarely underestimate future earnings but often over estimate them, and as usual there is a wide dispersion of valuations based upon growth expectations and past performance. We believe that high quality companies with solid balance sheets and positive cash flow, which did not rally as much as low quality stocks throughout 2009, are more attractively valued and will perform better in what remains an uncertain environment.

From an economic standpoint we believe there continues to be solid growth potential in emerging markets. Importantly, however, one does not have to invest in companies domiciled in the emerging markets to gain exposure to them. We advocate holding a diversified portfolio of domestic, foreign developed and emerging markets companies with ample exposure to emerging economies and currencies. We continue to recommend allocating to active equity managers that practice bottom-up analysis to identify high quality companies.

Finally we continue to believe there is a need and opportunity for skilled tactical allocation strategies in your portfolios. Active and alternative strategies that employ technical and behavioral factors are a constructive addition to a portfolio of fundamentally based managers or passive allocations.

January 20, 2010

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Chief Investment Officer

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