KStone PARTNERS LLC

Trustworthy, Conservative & Experienced

March 31, 2009

Financial State of the Union

The U.S. Government has moved decisively to counteract the effects of the current crisis and stimulate an economic recovery. The entire world has a significant economic stake in whether the U.S. Government succeeds. However, the actions that are being taken are so dramatic that they will have long lasting implications for all of us as investors and citizens.

KStone Partners has carefully studied the financial results, projections and financial position of the United States Government. Our research indicates that the Federal Government is highly leveraged and has been running huge annual economic deficits prior to initiating the stimulus programs. The current effective financial burden on every U.S. citizen is approaching $200,000 and growing rapidly. Recently, the Treasury Department reiterated that "the projected long-term costs (for our Social Insurance Programs) are much greater than the resources that will be available to pay for them".

At KStone Partners, we continually test our investment theses against macroeconomic factors. We maintain our outlook that equity markets will remain highly volatile and significant investment opportunities exist in the credit markets. Thoughtful arbitrage and credit managers can exploit these opportunities despite difficult market conditions. We continue to focus our efforts on funding top tier portfolio managers and making them accessible to our investors.

U.S. Government's Financial Position as of September 30, 2008 [1]

(Amounts in Billions of Dollars)

Assets	
Cash	$ 425
Property, plant & equipment	738
Other	812
Total Assets	**1,975**
Liabilities	
Federal debt securities held by the public and accrued interest	(5,836)
Federal employee/veterans benefits	(5,319)
Other	(1,023)
Total Liabilities	**(12,178)**
Net Liability ("Net Position")	**(10,203)**
Present Value of Social Insurance Programs (Closed Group) [2]	
Social Security	(17,188)
Medicare – Part A	(13,590)
Part B	(12,615)
Part D	(5,605)
Subtotal – Medicare	(31,810)
Railroad Retirement & Black Lung	(137)
Total Social Insurance Commitments	**(49,135)**
Total Net Liability	**($59,338)**

See footnotes on page 5

Summary

Based on the 2008 Financial Report of the United States Government which was published by the Treasury Department on December 15, 2008, we calculate that for the year ending September 30, 2008 the Federal Government had a Net Operating Cost including Social Insurance Costs ("Annual Economic Deficit") that exceeded $5 trillion (Schedule A). Furthermore, as of September 30, 2008 the Federal Government's Total Net Liability (including Total Social Insurance Commitments) was $59.3 trillion. This amount equals approximately $195,000 for every man, woman and child in the U.S. today. Furthermore, this figure represents an amount equal to more than 22 times the total revenues that the U.S. Government recorded in fiscal 2008.

In an effort to combat our current crisis and stimulate the economy the Administration has proposed a significant increase in Government expenditures. The Congressional Budget Office's recently completed analysis of the President's proposed Budget [3] indicates that the Budget Deficit over the President's first term would be $4.8 trillion. The estimated Budget Deficit for the 2009 fiscal year is expected to be $1.8 trillion. In order to calculate projected Annual Economic Deficits for the 2009 – 2012 period an unknown amount of benefits and other expenses (the average annual cost for these expenses for the last eight years is approximately $332 billion) as well as substantial social insurance costs (the average annual cost for the last eight years excluding Part D's initial year costs is approximately $2.9 trillion) must be added to the projected Budget Deficits.

For perspective on the size of our future Annual Economic Deficits, it is useful to review recent U.S. Government spending (Schedule A). Over the last eight years, the U.S. Federal Government has spent at the rate of almost $3 for every $1 collected. Over this period the U.S. Government generated a cumulative Economic Deficit of approximately $34.2 trillion (an average Annual Economic Deficit over this time frame of approximately $4.3 trillion). The $34.2 trillion amount is almost double the $17.5 trillion cumulative Total Taxes and Other Revenues recorded in the Financial Reports during this period. Separately, it should be compared to the cumulative U.S. Gross Domestic Product during the period of approximately $97 trillion. The cumulative Economic Deficit exceeds the reported cumulative Budget Deficit by a factor of 17. In addition, the cumulative Economic Deficit exceeds 12.8 times the Total Taxes & Other Revenues recorded for 2008. Please note that there is no year during this time frame when the Annual Economic Deficit was less than $1 trillion and it ballooned in 2004 to over $11 trillion as a result of the creation of Medicare Part D.

Consolidated Financial Statements Do Not Exist

Every advisor knows that it is impossible to get two parties to agree on a deal if they have different views of an entity's financial results. One of the difficulties that we collectively face in achieving fiscal responsibility for our government is that often our two political parties talk past one another because they don't have a common basis for discussing the U.S. Government's finances. Determining the consolidated financial results and financial position of the U.S. Government is very difficult as the Federal Government maintains multiple sets of books which, individually and in the aggregate, can be considered misleading. The most well-known set of books, and the only one that politicians want to discuss, is the Budget which is cash based and has little relationship with economic reality. Under budget accounting rules outlays are recorded only when bills are actually paid. This shortcoming is the primary reason why every publicly-traded company in the U.S. is required to use accrual accounting.

Although little known, the Federal Government has been putting together accrual-based financial statements in accordance with generally accepted accounting principles ("GAAP") since 1997. The Financial Report issued by the Treasury Department comes closer to providing an accurate picture of our Annual Economic Deficit. However, the Financial Report has several enormous flaws. It does not include the results of numerous government controlled entities including the Federal Reserve, Fannie Mae and Freddie Mac. However, the most serious omission is that the Financial Report does not include the cost of our social programs other than current year payments. This is ameliorated to a limited extent by the inclusion in the Financial Report of the Statements of Social Insurance ("SOSI"). The SOSI disclose the present values of the off-balance sheet social insurance liabilities. KStone's view of the proper accounting for our social insurance obligations is discussed below.

Entities Not Consolidated In the 2008 Financial Report

The 2008 Financial Report indicates that there are approximately 38 independent establishments and government corporations not included in the Financial Report. KStone Partners believes that several of these are likely material entities from a financial point-of-view and should be included in consolidated financial statements of the United States Government. The most obvious candidates to include in consolidated financial statements are listed below. KStone acknowledges that there are good reasons for not releasing budget details regarding certain entities.

- Federal Reserve System – As of March 25, 2009 the central bank of the U.S. has approximately $ 2.0 trillion in liabilities underpinned by $46.1 billion in capital from the Treasury Department.
- Central Intelligence Agency – The last known disclosed budget figure was $26.6 billion which was released in 1997.
- National Railroad Passenger Corporation (Amtrak) – Generates $2.5 billion in revenue and has 19,000 employees. It's total liabilities were approximately $6.1 billion as of September 30, 2008.

In addition the Government did not consolidate a variety of the public corporations and government sponsored enterprises that it either controlled outright or effectively controlled as of September 30, 2008 including:

- Fannie Mae and Freddie Mac – Recently, the CBO indicated in A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Forecast that "As a result of the degree of management and financial control that the federal government currently exercises over Fannie Mae and Freddie Mac, CBO has determined that the two corporations should now be included in the federal budget." It is unclear whether the Treasury Department will consolidate these two corporations in the 2009 Financial Report. These two corporations are estimated to have direct debt of $1.5 trillion, guarantees of $5 trillion and an estimated $3 trillion in off-balance sheet obligations.
- Federal Home Loan Bank System – Rationale for inclusion in consolidated financial statements is the same as for Fannie Mae and Freddie Mac. The system had $1.4 trillion in assets as of September 30, 2008.
- AIG – Current investment is $180 billion with likely more funding to be required. A government appointed CEO is running the company.
- Citigroup – Current bailout investment $45 billion plus $306 billion in guarantees for its troubled assets

Proper Accounting for Social Insurance Commitments

GAAP for the U.S. Government is set by the Federal Accounting Standards Advisory Board ("FASAB"). The FASAB issued a Preliminary Views document in October 2006 which outlined two views about the proper accounting for social insurance. The **Primary View** held that an expense is incurred and a liability arises when participants substantially meet eligibility requirements during their working lives in covered employment, and that some portion of the benefits accumulated at the balance sheet date should be recognized as a liability. The **Alternative View** indicated that liability arises only when the benefit is due and payable. The Alternative View is the one that every politician believes is correct.

The arguments supporting the view for non-recognition of our social insurance commitments in the U.S. Government's Financial Report include:

1) A liability can only arise if there is an enforceable claim. In the case of social insurance commitments there is no liability because the government can always alter or cancel its obligation.

2) The Supreme Court ruled in *Fleming v. Nestor*, 363 U.S. 603 (1960) that workers accrue no property rights in participating in Social Security. Social Security is a legislated entitlement, not a contract.

3) Social Insurance obligations cannot be measured with the level of certainty required for inclusion in financial statements.

4) Consolidating social program expenses and liabilities in the Financial Report would encourage the public to believe that benefits are firm commitments.

FASAB Board members discussed the economic cost of social insurance programs at their September 2007 Board meeting. "Some members said the economic cost is the change in the SOSI amounts during the reporting period. For example, if the net present value of the social insurance commitments last year was $44 trillion and this year it is $45 trillion, then the economic cost would be $1 trillion."

KStone Partners agrees with these Board members with respect to the proper accounting for social insurance commitments. We believe in the notion that annual increases in the present value of the cost of our social programs represent real economic costs. The financial statements of the United States Government should be based on all legally enacted legislation to accurately reflect the Government's consolidated results and financial position. Our social program expenses and liabilities need to be consolidated in the Financial Report to accomplish this goal.

In the attached analysis KStone Partners has included the annual change in the present value of the social insurance commitments as a cost to be reflected in determining the U.S. Government's Annual Economic Deficit. In addition, KStone Partners believes that the present value of America's social insurance commitments should be reflected in the U.S. Government's balance sheet as we have done on page 1 of this document.

After extensive hearings, the FASAB determined that no liability other than current year payments should be recorded and no commitment should be noted on the U.S. Government's balance sheet. It is noteworthy that the FASAB's Board composition changed between the date that it issued its Preliminary Views document and the date that it made its final determination.

Conclusion

The combination of the U.S. Government's sizeable projected Annual Economic Deficits and its highly leveraged balance sheet suggest that our future will be extremely challenging.

Footnotes

(1) All figures taken from the 2008 Financial Report of the United States Government or prior years' reports or the Statements of Social Insurance included therein.

(2) The Statement of Social Insurance ("SOSI") presents the projected actuarial present value of the estimated future revenue and estimated future expenses of the Social Security, Medicare, Railroad Retirement, and Black Lung social insurance programs. The estimates are based on economic and demographic assumptions outlined in Note 23. Social Insurance to the 2008 Financial Report. The estimates are based on the continuation of program provisions contained in current law. The projection period used is 75 years. The SOSI presents the present value of costs for three groups: 1) current participants who have attained eligibility age, 2) current participants who have not attained eligibility age, and 3) future participants. Current participants in the Social Security and Medicare programs form the "Closed Group". KStone believes that the liability associated with the Closed Group is the relevant one to use in determining the U.S. Government's Total Net Liability.

(3) A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook published in March 2009. The Deficit Control Act provides guidelines for CBO's projections. However, CBO deviated from that procedure for its current baseline projection. The $283 billion in discretionary budget authority provided in American Recovery and Reinvestment Act of 2009 ("ARRA") has not been extrapolated in CBO's baseline projection. This was done in consultation with the budget committees.

(4) 2001 – 2007 figures – Bureau of Economic Analysis, Annual GDP in billions of current dollars; 2008 – 2012 amounts – A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook Table 1-4

(5) 2001 – 2007 figures - U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index – All Urban Consumers (CPI-U); 2008 – 2012 amounts – A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook Table 2-6

(6) 2001 – 2007 figures - U.S. Department of Labor, Bureau of Labor Statistics, Current Population Survey, Household data, Annual Averages; 2008 – 2012 amounts – A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook Table 2-6

(7) 2001 – 2008 figures - Federal Reserve Statistical Release, Treasury Constant Maturity, 10-year; 2009 – 2012 amounts – A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook Table 2-6

(8) 2001 – 2007 figures - Congressional Budget Office, Historical Budget Data; 2008 – 2012 amounts – A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook Table 1-1

Schedule A

The Federal Budget Deficit and the Annual Economic Deficit

(Amounts in Billions of Dollars)

Economic Data (Calendar Year)	**2001A**	**2002A**	**2003A**	**2004A**	**2005A**	**2006A**	**2007A**	**2008A**	**2009F**	**2010F**	**2011F**	**2012F**
GDP (Current Dollars)(4)	10,128	10,470	10,961	11,686	12,422	13,178	13,808	14,222	14,057	14,405	15,061	15,774
% Increase (Decrease)	3.2%	3.4%	4.7%	6.6%	6.3%	6.1%	4.8%	3.0%	-1.2%	2.5%	4.6%	4.7%
Consumer Price Index (5)	2.8%	1.6%	2.3%	2.7%	3.4%	3.2%	2.8%	3.8%	-0.6%	1.6%	1.8%	2.1%
Unemployment Rate (6)	4.7%	5.8%	6.0%	5.5%	5.1%	4.6%	4.6%	5.8%	8.1%	7.9%	7.1%	5.3%
Ten-Year Treasury Note Rate (7)	5.0%	4.6%	4.0%	4.3%	4.3%	4.8%	4.6%	3.7%	2.8%	4.0%	4.8%	5.2%
Federal Budget (Fiscal Year)(8)												
Revenues	1,991	1,853	1,783	1,880	2,154	2,407	2,568	2,524	2,159	2,289	2,586	2,917
% Increase (Decrease)		-6.9%	-3.8%	5.5%	14.6%	11.8%	6.7%	-1.7%	-14.4%	6.0%	13.0%	12.8%
Outlays	1,863	2,011	2,160	2,293	2,472	2,655	2,729	2,979	4,004	3,669	3,556	3,575
% Increase (Decrease)		7.9%	7.4%	6.2%	7.8%	7.4%	2.8%	9.1%	34.4%	-8.4%	-3.1%	0.5%
Unified Budget Surplus (Deficit)	128	(158)	(378)	(413)	(318)	(248)	(161)	(455)	(1,845)	(1,380)	(970)	(658)
U.S. Government Financial Reports (1)												
Unified Budget Surplus (Deficit)	127	(158)	(375)	(412)	(319)	(248)	(163)	(455)	(1,845)	(1,380)	(970)	(658)
Federal Emp./Veterans Benefits	596	229	287	182	430	187	90	550				
Other	46	(21)	4	21	12	15	23	4				
Total Additional Costs	642	207	290	203	442	202	113	554				
Net Operating Cost	(515)	(365)	(665)	(616)	(760)	(450)	(276)	(1,009)				
Social Insurance Costs (2)												
Increase in Present Value of Cost of:												
Social Security (Closed Grp)	906	673	527	810	1,031	1,393	1,289	923				
Medicare (Closed Group)												
Part A	1,483	397	878	1,967	367	2,532	(109)	1,546				
Part B	1,087	16	1,233	1,335	845	730	(283)	2,268				
Part D				6,306	512	(561)	16	(668)				
Railroad Retir. & Black Lung	0	(1)	110	3	3	16	1	4				
Subtotal	3,476	1,085	2,748	10,421	2,758	4,110	914	4,073				
Annual Economic Deficit	(3,991)	(1,450)	(3,413)	(11,037)	(3,518)	(4,560)	(1,190)	(5,082)	***???***	***???***	***???***	***???***
Cumulative Economic Deficit								(34,241)				

See footnotes on page 5

KStone PARTNERS LLC