1/04/2011

To the friends and clients of Harvey Investment Company:

So far, so good. That is our assessment of the progress in 2010 as the world's economies continue the long climb back from the black financial hole that opened in the fall of 2008. The U.S. stock markets reflected this positive headway; and, for equity investors, January portfolio statements are likely to extend the holiday good cheer. For the year, the S&P 500 advanced 15.06%, punctuated by an outstanding jump of 10.76% in the fourth quarter. Though the Fed kept a lid on short term interest rates, the rates on medium-term and longer bonds moved sharply higher. There is debate as to the reason for this abrupt movement, but we believe the increase simply reflects confidence that the economy is on the mend.

Good fortune has helped us avoid the worst of the nightmare scenarios that were conjured at the pit of the recession. A quirk of history has been a savior to the fully developed U.S. and European economies. With their business prospects laid low by prior financial shenanigans, by all rights these mature economies should be mired in deep recession. Instead, their sluggishness has been more than offset by the rise in emerging economies in South America, Southeast Asia, India, Eastern Europe, and, most importantly, China. Without this rampart of growth, we would have troubles galore. Another piece of good luck is our Fed Chairman, Ben Bernanke. Though his countenance suggests one who the bruisers might kick sand on at the beach, his actions reveal a tough and intellectually sophisticated individual. Certain that the "wealth effect" is the key to engendering a lasting recovery, he has, in the face of much criticism, stuck to his guns in engineering 0% short-term interest rates. This policy directly enhances the attraction of the stock market and the affordability of housing. He understands that it is the health of these markets that gives consumers the feeling of well-being necessary to come out of their shells and start spending again. The very strong Christmas that retailers are experiencing is directly related to the rising stock prices. The most astonishing aspect of the economy at this juncture is the profitability of corporate America. The amount of costs taken out of the expense structures of most companies in a year or less is a remarkable phenomenon. In a number of cases, sizable companies whose revenues are just now recovering to pre-recession levels have shown profit increases of 20% or more from peak sales two years ago. It appears that a generation of fat has been excised from corporate budgets in one brief and painful pass.

In 2003 the Plain English Campaign gave its premier Foot in Mouth trophy to Donald Rumsfeld for this attempt to clarify a point he made in a Defense Department meeting. "Reports that say something hasn't happened are always interesting to me, because we know there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say that there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know." A spokesman for the Plain English Campaign said, "We think we know what he means but we don't know if we know what he means." This episode was called to mind as the Harvey Investment Company celebrated its tenth anniversary this year. We know exactly what Rumsfeld means. Consider these developments during our ten year existence. In our first quarter of operation (the fourth of 2000) the S&P 500 dropped by 8%. Next quarter the decline was 12%, as the internet stocks burst. Things settled down a bit for several months until two planes leveled the World Trade Towers. This catastrophe led to another 25% plunge, bringing bear market losses to 40%. The markets finally bottomed, and events few could have fully envisioned unfolded. In August of 2004 Google went public; today it has a market value of $190 billion. Earlier that year, Facebook was born, leading to a revolution in how people use the internet. Today, 500 million people are active users. iPhones made their appearance in 2007. A mere three years later millions of people spend much of their day staring at an 8.5 square inch device that gives them access to people and information across a limitless spectrum. While this whiz-bang technology was delivering remarkable capability to the man in the street, Wall Street was employing it to build a doomsday machine centered on the residential real estate business. In the blindness of their greed, investment banks couldn't see that it was their own doom they were planning. Their mischief nearly collapsed the global economic order. All the while, on the other side of the world, the economy of China was growing at a staggering pace. So much so, in fact, that its insatiable need for material resources made it the marginal buyer setting the price for nearly every commodity. This massive appetite exposed a woeful shortage of productive capacity to deliver enough raw materials to the world marketplace. The situation was most pointedly demonstrated when oil soared from an average price of $37 a barrel in 2005 to a 2008 high of $145/barrel. It has been an amazing ten years.

It became clear to us in this past decade that the fundamental investment question we must address is how to invest when hugely important investment variables are wholly unpredictable? Our answer to that question was partially articulated in excerpts we read from a talk made by Tom Gaynor at a spring investment conference sponsored by Grant's Interest Rate Observer. Gaynor is the exceptionally gifted chief investment officer of the fine insurance company, Markel Corporation. Gaynor raised the issue of strategy versus tactics in navigating an uncertain world. He quoted General George S. Patton who said, "Good tactics can save even the worst strategy. Bad tactics will destroy even the best strategy." Gaynor also cited Henry Singleton the legendary founder and CEO of Teledyne, a man canonized for his business acumen by no less an observer than Warren Buffett. Singleton was notoriously silent when pressed by analysts and shareholders for his future plans for Teledyne. He told *Business Week,* "My only plan is to come to work everyday. I like to steer the boat each day rather than plan far into the future." Buffett himself has operated the same way. Arthur Rock, a renowned venture capitalist associated with start ups including Apple, Intel, and Teledyne, wrote in a piece for the Harvard Business Review in 1987 titled Strategy vs. Tactics--from a Venture Capitalist, "Good ideas and good products are a dime a dozen. Good execution and good management—in a word, good *people* are rare. To put it another way, strategy is easy, but tactics—the day to day, month to month decisions required to manage a business are hard."

Several years ago we took a hard look at all the stocks we had purchased since the mid-1990's looking for the chief determinants of success. One conclusion was that, so long as the business was not in decline, excellent execution almost always guaranteed a satisfactory result. Charles Dickens once said, "Genius is the infinite capacity for taking pains." Taking extraordinary pains in fundamentals such as inventory control, receivables and payables discipline, obsessive accounting fastidiousness, and the endless tasks, large and small, in running a business is an absolute requirement for high achievement. Our experience during our first decade was that the companies we owned that executed excellently, even though buffeted by the unknown unknowns coming out of left field, had the resilience to bounce back fast and move to new levels of performance. We recently saw an article that quoted Mike Tyson as saying, "Everybody has a plan till they get punched in the mouth." In thinking about the next decade we expect to take more than a shot or two in the mouth, but we'll be looking to have your assets invested in companies where the management sees reality clearly, where flexibility in dealing with an uncertain world is ingrained, and where meticulous execution is the day-to-day norm.

We are grateful for the loyalty our clients have shown to us over these past ten years. Your belief in our investment approach allows us to focus single-mindedly on what we are trying to accomplish for you. We can't think of a better way to express our enthusiasm for the years ahead than the last sentence in Ben Graham's Postscript to **The Intelligent Investor.** "…. interesting possibilities abound on the financial scene, and the intelligent and enterprising investor should be able to find both enjoyment and profit in this three-ring circus. Excitement is guaranteed."

Sincerely,

Samuel C. Harvey

In compliance with Rule 204-3 of the Securities and Exchange Commission, we are pleased to offer you upon request and without charge a copy of Part II of our Form ADV. This disclosure document contains information about the business practices and procedures of Harvey Investment Company, LLC. Please call us at (502) 339-8270, if you would like a copy