

QUARTER IN REVIEW

Who would have dreamed at the beginning of the year that yields would be lower or that stock prices would be on average 21% higher?

After the strong rally off of the March lows, one might have expected the pace of the stock market's advance to moderate; it did not. The total return of the Lipper Diversified Equity Funds Average in the third quarter was 15.76%, only slightly less than the 17.05% gain in the second quarter. The percentage increase in the Lipper S&P (Standard & Poor's) 500 Funds Index in the second and third quarters was within less than ½ percentage point of each other. Since the low in March, the stock market has risen 62% of the time, 18 of the 29 weeks. Mid- and small-cap stocks have gained more than large-cap (Russell 2500, +28% vs. +17% for the Russell Top 200). This is not unusual in the early stages of any type of bull market. The table shown on page four (Total Return Results for Various Periods) provides more statistical detail on the financial markets' results.

Yields decline across the curve - spreads tighten

In the third quarter, value stocks took the lead from growth stocks. This reflects the robust recovery in financials during the quarter. Financial stocks declined 84% from their peak in February of 2007 to the low in March of 2009 and rose 153% to the peak on September 22. Technology stocks continued to advance and remain the strongest sector of the S&P 500 and the broader Russell 3000 on a year-to-date basis. During the quarter, yields declined across the curve; the longest maturities declined more, which resulted in a slightly flatter yield curve even though the curve maintains its unprecedented steepness. In addition, the difference in the yields of Treasury notes and bonds compared to other types of issuers continued to contract (spread tightening). Investors continue to pursue higher yields from riskier assets amid growing comfort in the possibility that financial conditions and the economy have not only stopped deteriorating, but have begun to improve.

Slightly more than one year ago, Lehman Brothers, one of the largest brokerage firms, collapsed and AIG, the world's largest insurer, was taken over by the Federal Government to prevent its bankruptcy. The market decline and economic maladies had been visible for many months prior to the calamitous events of last September. In spite of the huge rally since March, stock prices remain below the levels of a year ago and significantly lower than two years ago. The Russell 3000 total return is -6.4% and -26.6% over the last 12 and 24

months, respectively. Compared to last year, interest rates are lower across the board, although higher than at the end of 2008 or at the apex of the crisis in March.

Both the S&P 500 and the broader Russell 3000 gained about 62% from the market low in March to their

60+% Gain from the March market lows - last seen in 1933

peaks in September. The last time the stock market gained as much from a low was in 1933; in 1932, the

rally was 90%, but there was another setback. The Dow Jones Industrial Average did not pierce the summit reached at its peak in 1929 until 1954. The long bear market of the late 1960s into the early 1980s saw significant rallies such as the current one. The Dow Jones Industrials touched 1000 in 1966, again in 1972 and 1976, but did not decisively pierce 1000 until late 1982.

Yin and Yang

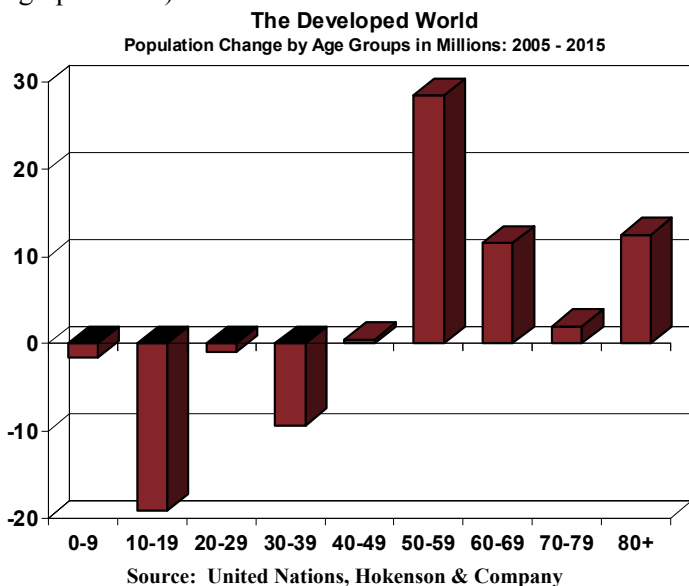
Yang is the active principle in Chinese Mandarin that is thought to produce all that exists with its counterpart yin. There is much speculation in psychology about left brain (quantitative/specialized) thinking and right brain (intuitive/generalized) thinking. Investing has qualitative and quantitative thinking; it is not pure science, but an art with scientific aspects. Yin thinking is more useful when markets are changing because the metrics of the past, yang thinking, often do not work. In the first section, we provided some yang. Below we consider some yin thinking.

Historically, the stock market rises considerably after a significant market low that is loosely connected to a major recession. (There are more bear markets than recessions.) This one has been titled, "The Great Recession." Investors have reduced their earnings' expectations after months of disappointment, but now find positive earnings surprises. Among companies in the S&P 500, 77% reported second quarter earnings above expectations. Likewise, economic data has turned: real GDP for the second quarter was revised up;

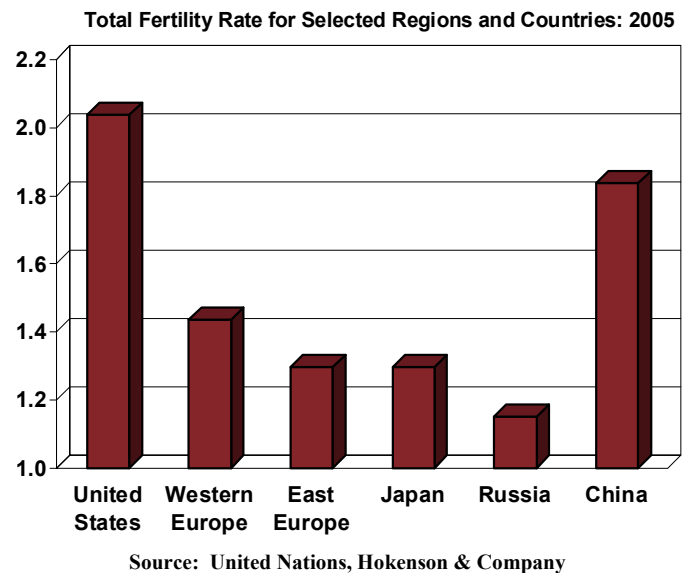
In the next few years, the risk of deflation may be higher than the risk of inflation. Deflation is terrible for the debtor and good for the creditor. Conversely, inflation is good for the debtor who pays back debts with less valuable currency. The U.S. dollar remains the world's reserve currency, but its dominance is eroding. While U.S. consumers appear to be repairing their extended balance sheets, the increase in public debt is staggering; government debt as a percentage of Gross Domestic Product (GDP) has risen from 71% early in this decade to 102.3% at the end of June. Consumer balance sheets are improving because consumers are spending less, but also because the value of their investments and retirement savings have recovered somewhat. By the way, consumer credit growth has been negative this year. Foreigners are the largest buyers of new Treasury bonds and own about half of all outstanding Treasury debt. The best way to improve one's balance sheet without painful contraction in one's standard of living, either because of inflation or foregoing consumption, is to grow.

Today, Asian economies constitute 15% of the world's GDP, more than double the amount less than 20 years ago. In Asia, only South Korea is expected to grow at a slower rate than the U.S. next year according to estimates published in *The Economist*. All of the Latin American countries, except Argentina and Venezuela, are expected to grow faster than the U.S. next year. However, the U.S. is estimated to be the fastest growing developed country.

Studying demographics is terrific because we already know who is alive. There is a strong correlation between population growth and economic growth. Longer term, faster population growth in the U.S. than in Japan, Europe and, surprisingly, China produce relatively better growth prospects for the U.S. China needs to save for its own aging population; of its 1.3 billion people only 100 million are covered by some sort of retirement benefit. Also, the biggest consumer age group, those in their 20s and 30s, will actually shrink over the next few years (see graph below).



Fertility rates are steady at over 2.0 in the U.S. and declining rapidly or are already less than 1.8 in much of the rest of the world (see graph below). As a result, the whole world is structurally deflationary because of the declining rate of growth in the workforce. There is also a very high correlation between the growth of the workforce and the growth of an economy.



Strategy Implications

Forget labels! Managers that have the latitude to invest where they can uncover mispriced securities, whether large or small, growth or value, domestic or foreign, bonds or stocks, have an edge. Managers with longer (3-5 years) investment horizons in a market that seems to be more focused on the next 12 months also have an edge because a longer time horizon lends itself to being better able to identify mispriced securities. However, risks remain high because we seem to be in a period when fundamental factors that surround the determination of value are more in conflict than has been the case in a generation or more. The fundamental issues of deflation and inflation make it so. In an inflationary period, price/earnings ratios tend to contract and interest rates increase.

Portfolios that have sufficient cash reserves to meet immediate needs, a "store of value" allocation, which may be a combination of commodities and/or inflation protected bonds, and investments in the global stock and bond markets should be



better positioned to weather the continuing volatility that we believe likely. Consider the last few years. There were times when prices were high, especially for stocks, and recently we have seen valuations among the lowest in more than a decade. Commodity prices soared and fell precipitously over the last 18 months. Interest rates on medium grade corporate bonds approached 10% and were under 6% a few years ago. Regular rebalancing and main-

taining reserves to meet any cash needs for 12 months reduces the possibility that there is a need to sell at the wrong time and permanently impair capital. That is our goal: to manage expectations, to capitalize on opportunity when emotions create high and low prices for financial assets, and to maintain purchasing power.

TOTAL RETURN RESULTS FOR VARIOUS PERIODS

	3 rd Qtr	2 nd Qtr	1 st Qtr	4 th Qtr	Annualized as of 9/30/2009		
	2009	2009	2009	2008	1 Year	10 Years	20 Years
Domestic Equity							
Lipper Diversified Equity Funds Average	15.76%	17.05%	-8.92%	-23.10%	-5.39%	2.25%	7.80%
Dow Jones Industrials Daily Reinvested	15.82	11.96	-12.48	-18.39	-7.38	1.62	9.24
Lipper S&P 500 Funds Index	15.54	15.90	-11.01	-21.95	-7.00	-0.40	N.A.
Lipper Large-Cap Core Funds Index	15.27	16.58	-9.63	-22.16	-5.47	-0.27	7.06
Russell ^a 1000 Growth Index	13.97	16.32	-4.12	-22.79	-1.85	-2.56	7.21
Russell ^a 1000 Value Index	18.24	16.70	-16.77	-22.18	-10.62	2.59	8.58
Lipper Mid-Cap Core Funds Index	19.91	18.33	-6.89	-25.87	-2.06	6.06	9.38
Lipper Small-Cap Core Funds Index	18.93	22.23	-11.45	-25.49	-4.09	6.61	N.A.
Russell ^a 2000 Growth Index	15.95	23.38	-9.74	-27.45	-6.32	1.10	5.40
Russell ^a 2000 Value Index	22.70	18.00	-19.64	-24.89	-12.61	8.05	9.78
International Equity							
MSCI EAFE + Canada IX ND	19.36	25.86	-13.14	-21.15	2.89	3.02	4.43
Lipper International Funds Index	19.80	25.64	-12.36	-21.12	4.05	3.97	6.34
Fixed Income							
Lipper Inter-Investment Grade Funds Index	6.28	5.42	0.60	-0.30	12.36	5.57	6.45
Lipper Sh-Investment Grade Funds Index	3.42	3.81	1.17	-2.07	6.36	3.84	5.19
Barclay's Intermediate Govt/Credit	3.25	1.67	-0.05	4.84	10.01	5.90	6.75

Source: Lipper, Inc.

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