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Market Update

Summer, 2010

¾ *Russell B. Dow, J.D.*
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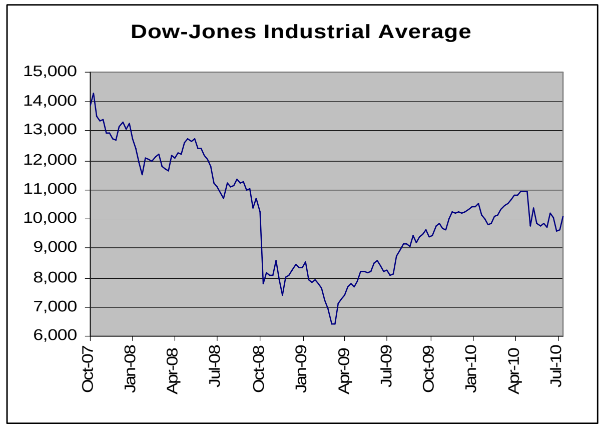

In Remembrance of *The Great Abyss*

Dear Client:

The Great Recession, the Great Credit Crunch, the Great Abyss. The economic debacle starting in 2007 and continuing today surely will be remembered as the "Great" something. The Great Wealth Redistribution could prove to be the most fitting description.

From the October, 2007 high watermark, stock prices declined for 18 months as increasingly panicked investors flooded the markets with their sell orders. At its crescendo, the speed of the fall exceeded the worst pace for percentage decline set during the Great Depression.

Unfortunately, like distressed travelers caught in quicksand, investors' collective thrashing only sank the market deeper. On March 9, 2009, a final gasp of selling drove investor losses to nearly -60% below the broad market's former high.

Ironically, and to the regret of those sellers who believed that their urgent sales were saving their financial selves, a year later stock prices had catapulted ahead +70%.

Still today, even after somewhat retrenching, the recovery calculates to over a +60% rebound. Despite earlier fears of an imminent cataclysm, the U.S. economy is widely believed to have halted its decline (for the moment, at least), and the Federal Reserve and Treasury Department are now weaning the financial system from life support equipment.

Nonetheless, the economy is not yet repaired; it remains seriously ill and at risk of another crisis. Unemployment and *under*employment are unacceptably high. Consumers and businesses still do not spend. Bank extension of business credit is anemic. The heavily mortgaged commercial property market is believed by some to be imperiled as landlords with distressed properties fail to refinance buildings worth far less than the loan amounts that they secure—potentially a subprime redux. Ominously, half of all commercial mortgages are expected to be underwater at the end of 2010.

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Yet more: The European currency and debt crisis has soiled our own shores. The euro's collapsing value undermines U.S. companies' competitiveness while a slowed Continental economy lessens demand further. And our own federal government's measures to right the ship are not a free lunch. In time, Washington's whopping borrowing, spending, and money supply expansion will generate an end-of-dinner tab that is difficult to digest.

Now being well into Year Three of the economic decline, looking out from under the covers, there is a lot not to like.

As a measure of the nation's precarious economic health, we should not be surprised to find that the financial markets have continued to be "dynamic," a euphemism for heart-wrenchingly volatile.

With luck, this 9.0 worldwide earthquake will prove to be a once-in-a-lifetime event for all except those of us with the best longevity genes. Yet, the lessons that we might draw from the event likely will be equally as relevant during more modest tremors in the years ahead. In addition, the shocks have not entirely abated and could start anew bringing an altered set of challenges for investors. Careful attention to how one is invested, therefore, should probably remain a special concern.

The Great Wealth Redistribution

While recession-induced anxieties will fade in the years to come, the recession's impact on many investors' portfolios may prove to have been profoundly injurious and regrettably indelible.

It remains my contention that, when economists prospectively assess the Great Recession, discussion over its causes may take a back seat to its potentially massive redistributive effect. The rich may have become richer, and, relatively, much richer. The middle class seems slated to become permanently poorer.

An eventual recovery of the economy and financial markets will not raise up all who fell because, with extraordinary speed, the recession precipitated a shift in the *class* of assets that many investors own.

What happened?

In many instances, the recession caused investors to lose their equity ownership, sometimes by force of circumstance and, at other times, willingly as investors exchanged their equity for the apparent safety of cash, debt securities, and fixed annuities.

The process began with the reversal of the housing market, as overstretched homeowners suddenly discovered that their equity had evaporated. Then, on the heels of the growing mortgage crisis came the 2008-2009 stock market crash, with the crash itself egging ~~nervous~~ terror-stricken investors to jettison shares for fractions of their former values.

The two charts following help illustrate the magnitude of investors' collective behaviors, using mutual fund data as a proxy for the larger picture. Beginning in 2007 and continuing into 2009, investors withdrew a mountain's worth of cash from equity mutual funds. Unfortunately for them, most of the dollars were withdrawn *after* the stock market had substantially fallen and only moments *before* its massive rally. Equally as telling of investor aversion for risk: Unlike times before when a rising market was met with increased equity fund buying, the big 2009 upsurge in stock prices barely budged investor enthusiasm for the stock market. In late 2009, net outflows from equity funds resumed.

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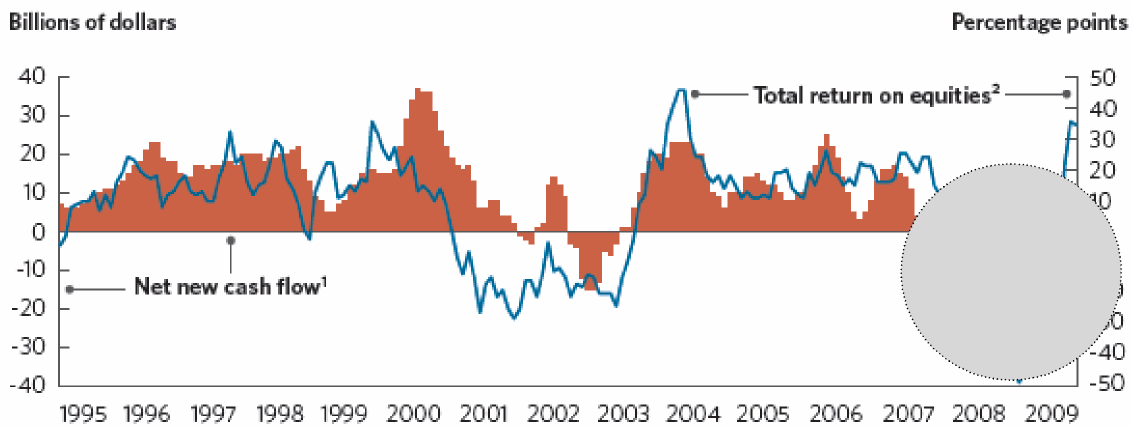
Mutual Fund Outflows:

Net Flows to Equity Funds Related to Global Stock Price Performance
1995-2009

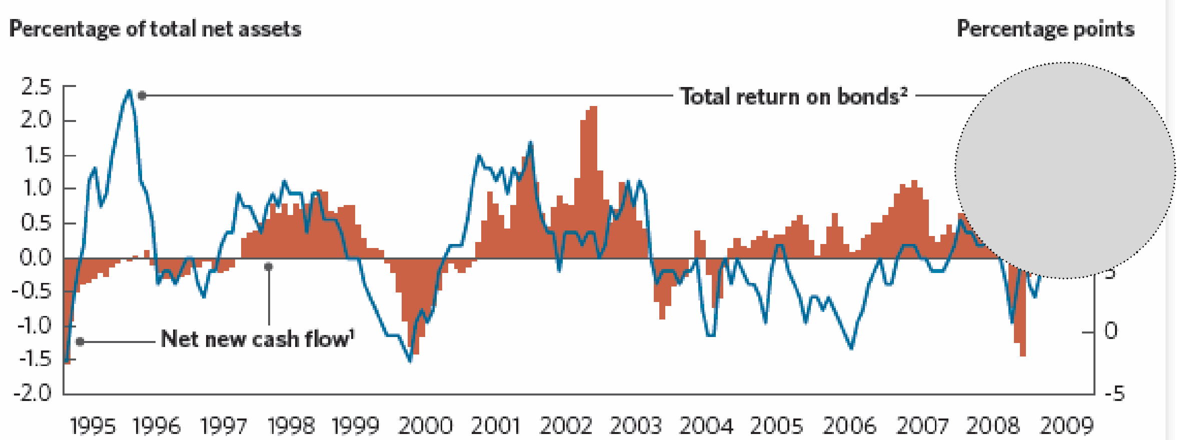


[1]Net new cash flow to equity funds is plotted as a six-month moving average.
[2]The total return on equities is measured as the year-over-year change in the MSCI All Country World Total Return Stock Index.
Sources: Investment Company Institute and Morgan Stanley Capital International

As investors fled the agony of the stock market, they focused on bond investments more robustly than ever.

Bond Fund Inflows:

Net Flows to Bond Funds Related to Bond Returns
1995-2009



[1]Net new cash flow to bond funds is plotted as three-month moving average of net new cash flow as a percentage of previous month-end assets. The data exclude flows to high-yield bond funds.
[2]The total return on bonds is measured as the year-over-year change in the Citigroup Broad Investment Grade Bond Index.
Sources: Investment Company Institute and Citigroup

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In an instant, the nation's asset soup has been ladled out to investors less evenly than ever before. Some received all the meat while millions of others now sit, seemingly contentedly, with bowls of warm broth. To be sure, from this author's perspective, equity is the meat, and cash and debt are the thin soup.

Why debt versus equity ownership matters?

What one owns matters because various asset classes can offer profoundly different risks, protections, and rewards depending upon the prevailing economic climate. While the recessionary period itself created new sets of winners and losers, the redistribution of *asset classes* may have set the stage for a more insidious reallocation of wealth that is yet to come.

Successful long-term investing requires the *simultaneous* protection of a portfolio's principal *and its purchasing power* from *irrecoverable*-type losses. It is this purchasing power aspect that, I think, should be especially concerning to many investors. While insured cash deposits and high-quality bonds can help ensure the safety of an investor's principal, those assets are notoriously poor at preserving buying power during inflationary times.

Successfully guarding $100 does us little good if on Day One it buys the groceries but on Day Two it pays for only the ride fare to the store.

Consequently investors who believe that they protected their assets by fleeing stock holdings for fixed-income securities may have only opened the door to a potentially more pernicious problem.

Inflation During Recent Times

Over the past thirty years, inflation became an increasingly inconsequential (and now, perhaps, an often forgotten) concern for having not much mattered for so long. The U.S. economy has enjoyed a period of generally declining annual consumer cost increases. The prime lending rate hit 21.5% in 1980 when inflation reached 13.5%. During the intervening years, the prime rate eased to its present 3.25% level while inflation became nonexistent in 2009.

Investors who rely on trend lines to guide their decisions could find this 30-year period compellingly indicative of an inflation-free future. Conversely, however, a three-decades long trend may be a louder argument for a reversion to the mean than for continuation of the status quo. As recent history has reinforced, the nature with financial markets is that change sometimes comes suddenly, violently, and unexpectedly—for the better or worse.

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Notably, the current climate is a jobless recovery facing a possible near-term second downturn. Couple that with a government not bashful in its willingness to monetize the debt to finance spending. A second contraction met with yet another stimulus effort would heighten the already palpable concerns that something troubling could be afoot.

Consequences of Rising Rates to Fixed-Income Securities

The following table illustrates the magnitude of the expected decline in bond values, if yields to maturity were to rise.

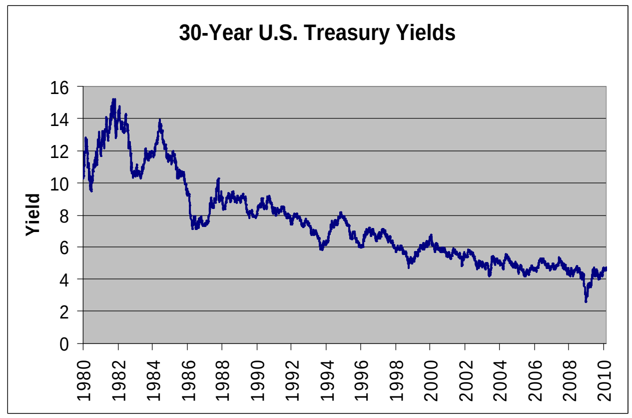
Potential Consequences of a "Bond Bubble" Burst*

Projected Market Value of a $100,000 Bond Investment: 4% Coupon, 30-Year Maturity

Yield to Maturity	Projected Market Value	% Decline
4%	$100,000	-
6%	$72,000	-28%
8%	$55,000	-45%
10%	$43,000	-57%
12%	$35,000	-65%
15%	$28,000	-72%

Note: Even if the bonds were held to maturity when the $100,000 face value could be redeemed (thus preserving the *principal* value of the investment), the inflation-adjusted future *purchasing power* of the $100,000 owed plus interest is reflected in the diminished present market value caused by the higher yield to maturity.

Furthermore, by referencing the following chart, we can see that we do not need to travel back in time too far to find periods of higher rates, making the above table less surreal. Notably, the 8% yields found in the mid 1990s came at a time when the pressures for rising interest rates could be said to have been far less alarming than at present.



It is worth appreciating, also, that we may not necessarily need to confront increasing inflation in order to have rising interest rates and, therefore, declining bond prices. Demand for borrowing has exploded in recent years, from cash strapped national governments, states, municipalities, and corporations. Tapped out lenders might be expected to demand higher returns as borrowers compete for their attention.

Although it is impossible to predict moves in either inflation or interest rates, a well structured portfolio must be prepared for the consequences of change in whatever form it might arrive. Like the prudence in wearing a seatbelt, we do not need to be predicting a car crash on our next trip in order to justify the preparation for one. Unfortunately, many investors now appear to be more poorly situated than ever before.

What about stock owners?

The key, if there is one, for surviving an inflationary period, is to own something for which the replacement cost increases *because* of inflation. Historically, stocks have tended to fill that role well and are considered to be a natural hedge against rising prices.

By way of example, as the costs of steel and labor rise because of inflation, a car manufacturer may be expected to raise its selling prices to compensate. That effort, in turn, protects corporate earnings and stock dividends.

To be sure, high inflation rates would not be inherently good for stocks. However, unlike bonds, equity investments tend to hold the potential to recover from its corrosive effects. Conversely, the inflation antidote for fixed-income securities is a period of deflation which, unfortunately, is an historical rarity.

Corporate Fundamentals and Stock Prices

If keeping out of trouble is the first goal of investing, earning a positive investment return should be no less than a second priority. I want you to know that this objective remains much on our minds.

As discouraging as the investment world has seemed lately, there are signs for a better period ahead.

According to data compiled by Bloomberg, analysts project that earnings for U.S. companies will rise +36% for 2010 and another +18% for 2011. Those would be good numbers by any measure.

High-quality companies—those that generally comprise most of the equity portions of our clients' portfolios—tend to be thriving. In addition to enjoying high profit margins, these types of companies have been paying down debt, buying back outstanding shares of their common stock, and acquiring the assets of less sound competitors.

In the face of such good earnings news, a persistent question of many investors has been, why has the stock market recently failed to make further strides upwards?

Though characteristically long-winded, a possible answer follows.

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<u>An Analogy:</u>
<u>Dog Charlie, a.k.a. "Stock Price"</u>

I have a new puppy. (I promise that this relates to investing. But, for color, he is a not-so-golden-colored Golden Retriever named Charlie.) He brings to mind an analogy that is worth dusting off.

Imagine that we were to look out the window and see Charlie wandering in the street. Suppose further that we are sufficiently interested (or concerned for the irresponsibly an unleashed dog) that we wish to learn where he may be headed. If we were to focus on the dog, we would witness, no doubt, an apparently random direction of travel—his running forwards, then backwards and sideways, only to collapse in a seemingly narcoleptic slumber. Moments later, he is up again resuming his circuitous and random behavior. By watching Charlie, we would quickly become dizzy and soon frustrated in our efforts to discern any true direction of travel.

However, suppose that we look further down the road and see a boy who is charged with walking the dog. We decide to pay attention to him and his direction of travel which, hopefully, proves to be more consistent.

Significantly (and affirmed by my recent experience), even a highly distracted puppy will, in fact, keep within a reasonable distance of its owner. Hence, the dog's pattern is not entirely without direction. It only seems that way during the short term.

As we watch the two together, we observe that the puppy sometimes runs well ahead of the boy and sometimes falls painfully far behind him. But, as the boy steadfastly heads down the road, we notice that the dog, too, finds his way in the same direction.

With that observation in mind, we might conclude that the best way to figure out where the dog is headed is to focus on where the boy seems to be going. In fact, we even might do well simply to ignore the dog.

Now name the dog "Stock Price" and name the boy "Ernie" (for corporate earnings).

Over long periods of time, like "Stock Price" following "Ernie," stock prices have tended to track corporate earnings growth. Over shorter periods, however, prices may exhibit the same deprived conviction of purpose as we find with the puppy.

It is a matter of considered faith, then, that, if our portfolio is heavily populated with companies whose *earnings* have been moving strongly upwards, we might expect eventually to enjoy the companionship of the higher stock prices that we so much desire.

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As with all good things, patience and a disciplined approach tend to be important parts of the formula in getting us to our destination.

That all said, it is tempting to take an occasional glance back at Stock Price just to be sure that he has not left us altogether in pursuit of a squirrel.

* * * * *

As always, I am most grateful for your continued confidence during these challenging times. Whenever you might have questions or concerns, I am pleased for your phone calls and e-mails.

Thank you, and I wish you the best of summers.

Most sincerely,

Russell

Russell B. Dow
President & Senior Portfolio Manager

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*** Projected market values were calculated using the online bond calculator at www.calculator.com/calcs/bondcalc.html, specifying 30 years to maturity, a 4% coupon, $100,000 face value, and the indicated various yields to maturity.**

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