

MARKET UPDATE

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Neither a borrower nor lender be.
Be an owner.

Dear Client:

The Great Recession is well underway.

Not only is the system broke and broken, but there is a lack of confidence in Washington's ability to set it right. Deficit spending got us into the mess. New unfunded government spending (albeit at a much faster rate) may not be the full answer.

Ultimately, we are witnessing a resetting of national priorities and, consequently, a reallocation of national wealth. When the dust settles, many who were once wealthy will be much less so, while others will be the beneficiaries. As investors, no doubt, we want to be in the latter group.

Investors facing large portfolio declines may believe that they are already amongst those heading for the poor house. The reality, however, may be that those who own something tangible, such as successful corporations through their common stocks, may be far better positioned to take advantage of the fast evolving economy than those exposed to cash. The world tends to change quickly. We should not conclude with too much conviction that the world tomorrow will much resemble its appearance today.

The good news is that a wealth redistribution seems apt to be driven by individual choice rather than by forces beyond our control such as a confiscatory tax program. Consequently, how well we survive may lie more with our personal decisions than with chance or fate.

Despite its discomfort, a severe recession is not all bad for long-term economic health. Recessions force poorly run and ill-conceived enterprises to fail. Without extreme financial stress, bad businesses persist for years longer than they otherwise might, continuing the allocation of resources unproductively. The nation did not need another home constructed in the Nevada desert, financed with securities purchased with money borrowed by hedge funds. Although late in coming, the quick end forced by the deteriorating economy was likely better than having the deleterious activities continue longer.

Unlike European or Japanese recessions, U.S. economic declines tend to be dynamic (some would say dramatic). But they clean out the deadwood more vigorously and conclude sooner. It is the nature of our form of capitalism.

In one view—eagerly portrayed by the media—the world economy is being torn asunder with all the destructive force of an aerial bombing. In an alternative and more positive light, the economy is being forcefully remolded as if made of clay. The most valuable features are carefully preserved while the damaged or damaging parts are discarded. The result should be a stronger economy than the one we are quickly leaving behind.

The investment climate is much changed by a recession. In a good economy, everyone wins. A bad economy, however, is a survivor's game. The survivor gets the gold, silver, and bronze medals, leaving the losers to go home empty-handed.

Consequently, ensuring that our portfolios are likely aligned with the surviving parts of the economy is more important today than ever.

WEALTH RE-ALLOCATION, STEP #1 **THE POTENTIAL WINNERS**

With each passing day, we continue to witness what may be one of the greatest reallocations of wealth in this nation's history. The steep decline and continuing gyrations of the stock market have caused investor anxiety levels to skyrocket. As a matter of investor psychology, the longer the volatility continues and the economic news remains bleak, the more likely an investor will concede defeat, selling his shares. In the industry, that

concern-driven liquidation is called “capitulation.”

Consolidating Corporate Ownership

On the other hand, for every share of stock sold, a share is bought. Someone, someplace is buying. Oftentimes the very company whose shares are traded may be the buyer. For our managed accounts, typically about 70% of the companies held have been purchasers of their own stock. Share repurchases, of course, strengthen the ownership of the remaining investors. By way of example: If we hold a single share of a company with 100 shares outstanding, we own 1% of the firm. If the company buys 20 shares from other investors, then we have 1.25% ownership in the company, a 25% improvement in our position, even though we have not actually purchased a single additional share ourselves.

Companies that are succeeding in the current environment are more likely to be buyers of their stock than are weaker companies. Moreover, companies that are struggling actually may be sellers of stock, diluting shareholder value as a means of raising cash to support ongoing operations. General Electric, badly compromised by its financial arm, has been a conspicuous example of this latter circumstance. Citigroup, now largely owned by the U.S. government, is another instance in which shareholders of a hemorrhaging company have seen their ownership dissipate along with market value.

An investor whose market value declines is hurt. An investor who, also, loses percentage ownership in his companies is compromised all the more.

Consolidating Market Share

Not only do healthy companies appear to be concentrating into the hands of fewer investors while weaker companies are diluting their ownership, but the recession is enabling successful businesses to expand their market shares.

The electronics retailers Best Buy and Circuit City provide a vivid example of the significant benefits that accrue to a surviving company when its competitor fails, as has Circuit City.*

Most obviously, Best Buy now can expect to see increased traffic flow as Circuit City stores close, removing the alternative for consumers. Less competition reduces the pressure on Best Buy to keep prices as low as it might in a more competitive environment. Furthermore, Best Buy may absorb coveted Circuit City store locations and the best employees. With more vacated big box retail space on the market, the surviving company has more power to negotiate favorable store leases. And, as a more prominent retailer, Best Buy may force more generous pricing from its wholesalers.

Effectively, the demise of Circuit City means that Best Buy's own survival and future

success are all the more assured. For Circuit City the loss is total. For Best Buy, the win is big.

Other examples include: The failure of Linens N Things which helps Bed Bath & Beyond. The domestic failure of DHL boosts UPS and FedEx. Office Depot's store closings bring relief to Staples. The slew of failures among financial institutions removes considerable competition for the remaining firms.

Slice by slice, the surviving companies and their remaining shareholders are claiming an ever larger part of the economic pie.

Therefore, as much as we might dislike the recession, the potential benefits for some shareholders would not be happening *except for* the current turmoil.

The message, then, is that it is not good enough simply to own common stocks. Rather, in this harsh economy, it is important to own the most resilient companies possible. A strict discipline of keeping a portfolio positioned in companies with strong balance sheets *and* healthy income statements seems apt to improve our prospects for being positioned in companies that are able to take good advantage of the inclement weather.

Incidentally, even the presumed healthy companies mentioned above do not generally meet our minimum buy criteria at present.

WEALTH RE-ALLOCATION, STEP #2 THE POTENTIAL LOSERS

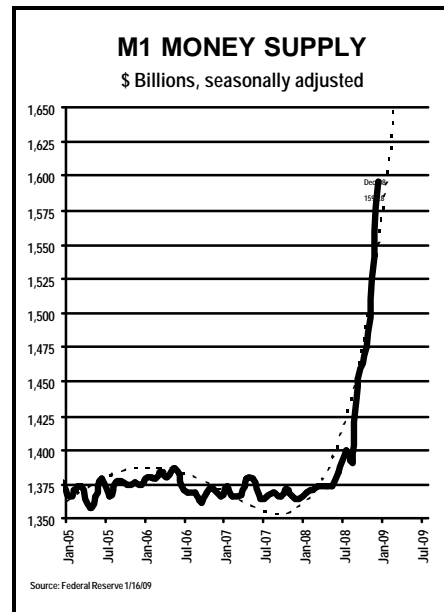
What could be the saddest chapter for many investors has yet to be written, but the writing implements are on the table.

While investors in high-quality stocks seem to be claiming a larger share of the evolving economy, other investors seem poised potentially to suffer irrecoverable setbacks in their wealth.

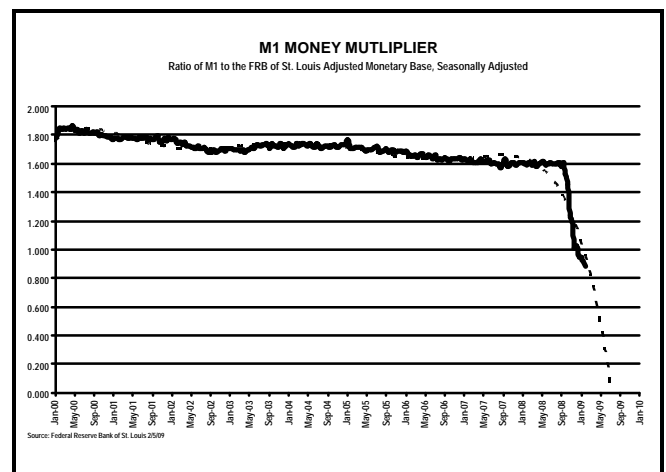
Investors tend to look over their shoulders, fearing most what bit them last. What still hurts so badly today is low asset values. Potentially, most of that pain may be behind us—or at least values have less to fall now than they did a year ago. Even so, in an effort to preserve their wealth, investors continue to exit the market, trading stocks for cash, seemingly with disregard to the prices they may receive for their liquidations.

Cash, however, could prove to be a less effective vehicle for preserving wealth than what many believe to be the case. By all appearances, inflationary forces are mounting. Worse yet, when the purchasing power of cash erodes, it rarely recovers. Periods of deflation rarely follow periods of inflation.

As indicated in the following chart, the nation's money supply already has grown astronomically in a short period of time.

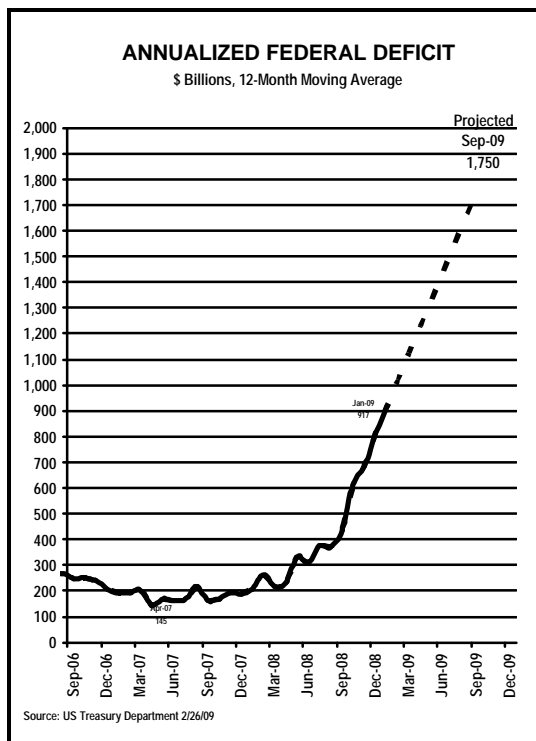


The reason inflation has not yet evidenced itself more forcefully is that the velocity of money—the rate at which consumers spend—has slowed equally as dramatically (raising the present, likely temporary, deflationary concerns). If no one spends, then the money supply can increase *ad infinitum* without causing inflation. It is, however, the moment of renewed consumption that may precipitate yet another crisis with too many dollars chasing too few goods.



The M1 Money Multiplier, a proxy for the velocity of money, illustrates the recent collapse of investor spending.

Federal Reserve Chairman Ben Bernanke comments that, once inflation emerges as a problem, the government will pull the surplus dollars out of the economy. Yet, if history is a guide, trusting the government to get it right is like entrusting Bernie Madoff with lunch money. Extracting the surplus is not a wholly uncomplicated process, with the Fed having to balance potentially derailing a nascent recovery against tolerating an eroding dollar. Note as well that, if inflation were so universally intolerable and so easily tamed, then it is difficult to explain the recurring phenomenon throughout nations and throughout history—including our own.



The fantastic growth of government spending suggests that, as a practical matter, raising taxes as much as necessary may be politically unpalatable, while selling more government

bonds may require paying exorbitant rates of interest. Allowing inflation effectively to pay off the national debt may prove to be an expedient choice.

Just as we should not predicate an investment policy on the expectation of rampant inflation, equally, we probably should *not* predicate it on the assumption that we will *not* suffer rapidly rising prices, either. Rather, a good investment policy must accommodate *both* possibilities at the *same* time.

What we most likely would not want to be holding in an inflationary environment would be cash, bonds, or fixed-rate annuities—assets that tend to be poorly able to maintain their purchasing power.

The investor who suffered the stock market decline, who then sold his holdings for the apparent safety of cash, now runs the risk of being hit once more by a tidal wave of inflation.

The saddest chapter, then, could be written thus: The stock market knocked him down. Inflation cut off his head.

RUMINATIONS

Whether it is fear of missing opportunity or fear of financial loss, investors tend to flock to the extremes *en masse*. Unfortunately, when all investors rush the same door, good judgment can be wanting. Too often

stamped investors pile out of fire exits with missing stairwells.

There have been four mass investor movements over just the past dozen years, none of them proving to be constructive:

- In the late 1990s, “New Economy” stocks came into vogue—the speculative dot.com and telecommunication issues. When stocks are running high, there often is little utility trying to explain the downside risk to euphoric investors. During that time, I used to muse that I spent more time discouraging investors from pursuing popularized investment strategies than actually making recommendations.

When the technology bubble finally burst, many speculative investors were wiped out. The NASDAQ index fell 78% from its high, while speculative stock mutual funds declined as much as 85% or more, leaving a lonely and arid landscape for their holders.

- From 2000 through 2005, the excitement, of course, was real estate. As a financial advisor, I amusingly had to compete with bathroom renovators for investors’ money. A new bathroom or kitchen, at that time, was considered by many to be a “good investment” boosting a home’s potential resale value. And, if the homeowner could enjoy the “investment” vacation home simultaneously, all the better.

Today it seems apparent that real estate investors stretched out with leveraged purchases of empty condominiums and aging home renovations may never recoup their losses.

A good rule of thumb: Never consider as an investment something you need to feed. From my experience, at least, a home requires a steady diet of maintenance, tax, and insurance payments.

- From 2006 through 2007, the popular theme was foreign investing—particularly emerging market stocks. The financial industry aggressively stoked investor enthusiasm for all things foreign. Market commentators claimed that the world stock markets had “decoupled” making international diversification all the more popular.

“Russ, why don’t I have any emerging market stocks in my portfolio? My secretary is making a lot of money on them with her advisor.”

That’s an account I lost. Men don’t like to be upstaged by their secretaries.

The recent 70% plus declines of such speculative stocks on a dollar basis has been a difficult pill for emerging market devotees to swallow.

So, just how big is today's investor stampede for cash?

In September of 2007, money market accounts equaled only 15% of the stock market's market capitalization. By year end 2008, that figure had catapulted to 40%. With the market down further in 2009, the equivalency is now surely well above 50%.

A PENDING SHORTAGE OF U.S. STOCKS?

The only reason to continue to own stocks is a belief that, eventually, the economy and stock markets will rebound. The following may prove to be the ingredients of a robust market recovery:

Excess Cash: As indicated above, there is an enormous supply of cash on the sidelines—by one estimate, \$9 trillion in cash and money market funds earning close to 0% returns. To make matters more interesting, the Federal Reserve is running the virtual printing presses at full tilt. Eventually, investors' cash may seek new homes.

Stocks Falling Into the Hands of Reluctant Sellers: From this writer's personal experience, the buyers of stocks in this market are not the types of people who sell. And they may be even more reluctant to part with their shares once the tide turns. In many instances, they have effectively taken the sellers' stocks off the market permanently.

Fewer Companies to Buy: Publicly traded companies are disappearing. In the financial services industry alone, Merrill Lynch, Wachovia, IndyMac Bank, Countrywide, Bear Sterns, and Lehman Brothers, to name a few, are gone. And, many surviving companies are dwarfs of their former selves, not worthy of many investor dollars. Stocks of companies like AIG, Bank of America, Citigroup, Ford, and GM, each trading for only a few dollars a share, seem unlikely to absorb much investor cash even in a recovering market.

Diminished Competition for Investor Dollars: Over the past decade, American and foreign investors alike eschewed the U.S. stock market for allegedly more certain returns overseas—*e.g.*, Asia, the Middle East, Europe, Brazil, Russia.

With the foreign diversification arguments now soundly refuted, it seems doubtful that investors will become re-enthused by such holdings anytime soon.

Formerly, if investment money did not go into stocks, it often went into unproductive real estate assets. Here again, it may be a long time before residential real estate will be viewed as a productive place to invest the family's nest egg.

And, if money did not go into foreign stocks or real estate, it often went into "alternative" investments such as hedge funds—which, in turn, often invested the money into foreign

stocks and real estate. Investors only thought that they had found a new animal. (As an aside, I can think of no more egregious example in which financial advisors duped their investors with the sale of these products. And, if it was not intentional, then it reflects the false expertise of the presumed investment “professionals.”)

Imagine, then, a game of musical chairs. The music is playing loudly, with crowds of investors now out of their chairs, dizzily circling the room, egged on by the media. During the confusion, other investors busily snap up as many seats as they can.

When the music finally goes quiet once more and all the cash laden investors run for their old positions, the stocks that they sold—or nearly gave away—are firmly in the hands of others. For many, the only seats left may be hard landings on the floor.

CONCLUSION

While most will agree that successful investing requires an investment discipline, it is the “discipline” part that can be particularly challenging. During an ebullient economy, investors are apt—even likely—to stray into speculative arenas, only to be hurt when the economy turns sour on them. Equally as radically, during a harsh decline, investor fear can lead to unproductive moves believed to be avenues of hope.

An investment policy of consistently owning high-quality companies through good times *and bad* is an even-tempered response to both market conditions, and one that seems best able to help ensure long-term viability of a portfolio and preserve investor wealth. Admittedly, though, there is nothing easy about that pursuit.

As a last comment, the media is fond of characterizing the current market and economy as “unprecedented.” There is, however, little that is unprecedented about current conditions, whether we point to the bursting speculative real estate bubble, ravaged stock market, investor fears, or mounting inflationary pressures (a “cash bubble”). If we trace U.S. history back, we find numerous parallels *and* plenty of examples of capitalism’s eventual triumph.

As always, whenever you have questions or concerns, we are pleased for your phone calls and e-mails.

Thank you.

Russell B. Dow

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