A View from the Tower

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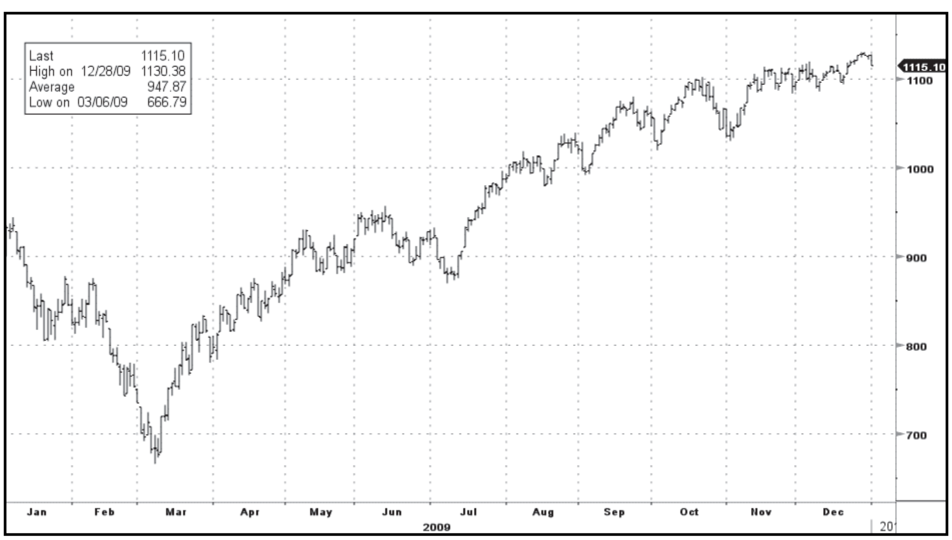
2009 Investment Overview

2009: Cyclical Risks Declined

Investors ended up liking 2009 and liking it a lot. Of course, it didn't start out that way. With the S&P down 8.4% during January and down another 10.7% in February, it appeared the ravaging of stock prices that started in Sept 2008 was continuing. But amid this decline, internal stock market characteristics were generally improving and several other markets (international stock and commodity/materials) had already begun to decisively move higher, setting the stage for what we termed the stock market's "bottoming process" or what Winston Churchill might have called "the end of the beginning". After making intermediate lows in October and November 2008, in early March 2009 the S&P made a third major low at 666. Investor's sentiment was indeed dreary, everyone who wanted to sell had sold, the bottom was in. With the market sold out, the domestic markets caught a spark of hope and a little buying was followed by more buying. Diminished supply (selling) and increased demand (buying) forces pushed stock prices higher. Interest rates and inflation expectations were low, monetary authorities around the world were pumping liquidity into the system, and stock prices were cheap and attractive with the hope of an economic rebound.

2009 S&P 500



source: Bloomberg

Economically sensitive small cap, high Beta stocks led the initial phase of the rally which pushed the market up 11% by the end of July. Interspersed with some sector rotations and base building consolidations, stock prices generally moved higher and the recession was declared over by mid-summer. With improving economic conditions, earnings forecasts were increased and with ample liquidity, stocks continued their upward push through year end. It's interesting to note that while all ten economic sectors were positive for the year, their performance was quite distinct. For example, Information Technology (economically sensitive and high beta) led sector performance with a 61% total return followed by 48% for Materials. More defensive Telecommunications and Utilities were up 9% and 12% respectively, giving the S&P 500 a total return for the year of 26.46% and the Dow Jones Industrials a positive 22.68%. International markets fared somewhat better with the MSCI All World Index returning 34.63%.

2009 Equity Market Returns (1)			
S&P 500	26.46%	International Stocks (EAFE)	31.78%
Growth Stocks	37.21	International Stocks (MSCI All World)	34.63
Value Stocks	19.69	US Bonds	5.93
Small Cap	27.17	High Yield Bonds	58.21

(1) **Please Note:** Different types of securities involve different risks. Stock investments have tended to be more volatile over time. Fixed income securities offer a fixed rate of return if held to maturity, although they fluctuate in value with changes in interest rates. International and emerging market securities involve special risks, including currency fluctuations and political developments. Small Cap stocks are subject to greater volatility than large cap stocks. High yield bonds are subject to a great risk of default.

2009 & 4th Qtr Equity Index Returns by Style (2)			
Large Cap	Russell 1000 Value (%)	Russell 1000 (%)	Russell 1000 Growth (%)
4th Qtr	4.22%	6.07%	7.94%
2009	19.69	28.43	37.21
Mid Cap	Russell Mid Cap Value (%)	Russell Mid Cap (%)	Russell Mid Cap Growth (%)
4th Qtr	5.21	5.92	6.69
2009	34.21	40.48	46.26
Small Cap	Russell 2000 Value (%)	Russell 2000 (%)	Russell 2000 Growth (%)
4th Qtr	3.63	3.87	4.14
2009	20.58	27.17	34.47

(2) The Frank Russell Company. These Frank Russell Indexes are unmanaged and do not reflect any fees, expenses or taxes.

source: Goldman Sachs

Recalling the results of the Ibbottson study suggesting the long term returns from equities are in the 9% to 10% range, these 2009 returns at 2 1/2 times the long term average were quite dramatic, made up a good part of what was lost in the preceding bear market and were significantly better than was anticipated at the beginning of the year. Coupled with an economy that is expanding, profits that are rising, consumers that are spending, investors should feel quite comfortable and ready for more of the same in 2010. Right? Well, don't take off your seat belt yet.

2010: Cyclical Risks are Rising

As investors of other people's (and our own) money, we can never afford to be anything but realistic and objective. While the intermediate term picture remains bright for stocks, we recognize some clouds gathering and 2010 may have more stormy investment periods than 2009. To observe, monitor and prepare for these possibilities doesn’t imply we are pessimistic, but rather vigilant risk managers. And we wouldn’t have it any other way. First we will set the situational background for investing in 2010 and then enumerate the principal potential risk issues.

The popular press has called the last 10 years a lost decade for investors and there is merit to that claim, as the stock indexes have made little or no progress. But digging deeper beneath the surface headlines reveals a meaningful investment perspective. First, a review of stock market history…. Since 1900 there have been four long term periods, called Secular Bull Markets (1900-1906, 1921-1929, 1942-1966, and 1982-2000) when the stock market indexes produced above average investment returns. Similarly during four periods (1906-1921, 1929-1942, 1966-1982, and 2000-?) called Secular Bear Markets, the stock indexes produced below average investment returns. Currently we are in a secular bear market that began 10 years ago when the Tech bubble collapsed. Within each secular market exist cyclical (or shorter term) bull and bear markets. In fact, one of our research partners (Ned Davis Research) has counted 34 of these cyclical bull and cyclical bear markets since 1900. For instance, after the Tech bubble cyclical bear market of 2000-2003, a cyclical bull market rallied from 2003 through 2008, followed by the vicious cyclical bear market from 2008 to March 2009. So today we are in midst of the cyclical bull market that began in March 2009 within the secular bear market that began in 2000. Being in a secular bear market doesn't condemn an investor to constant poor returns, but it changes the investing landscape. Expect more frequent sector and style rotations. Expect higher volatility spikes, as seen by both the dramatic decline of 2008 and sharp rebound of 2009.

The primary risk to the equity investor in 2010 results from the strong rebound stocks delivered in 2009. Being 10 months into the dramatic rebound without a meaningful correction suggests that excesses are beginning to build. With continued advances in price and time, the risks are rising the market could become vulnerable to a meaningful retreat at some point during the year. The catalysts to bring about such a retracement could include stock prices advancing faster than earnings thereby stretching the price/earnings multiples too far, an unexpectedly sharp rise in intermediate/long term interest rates, a significant spike in commodity or energy prices similar to the 2008 oil spike leading to sharper inflationary pressures, deterioration of the economic recovery should unemployment rise driving down consumer paychecks, and an international default or currency issue starting perhaps with the Greek or Portuguese situation.

Conclusion and Outlook

In summary the cyclical bull market that began in March 2009 and the economic rebound that it anticipated continues to provide support for higher stock prices. Knowing the domestic stock market continues to work its way through a secular bear market reminds us to carefully monitor valuations, fed/monetary activity, and investor bullish/ bearish psychology for changes in the trends of stock prices. We continue to believe having the correct asset allocation and diversification within those allotments is crucial to investing success.