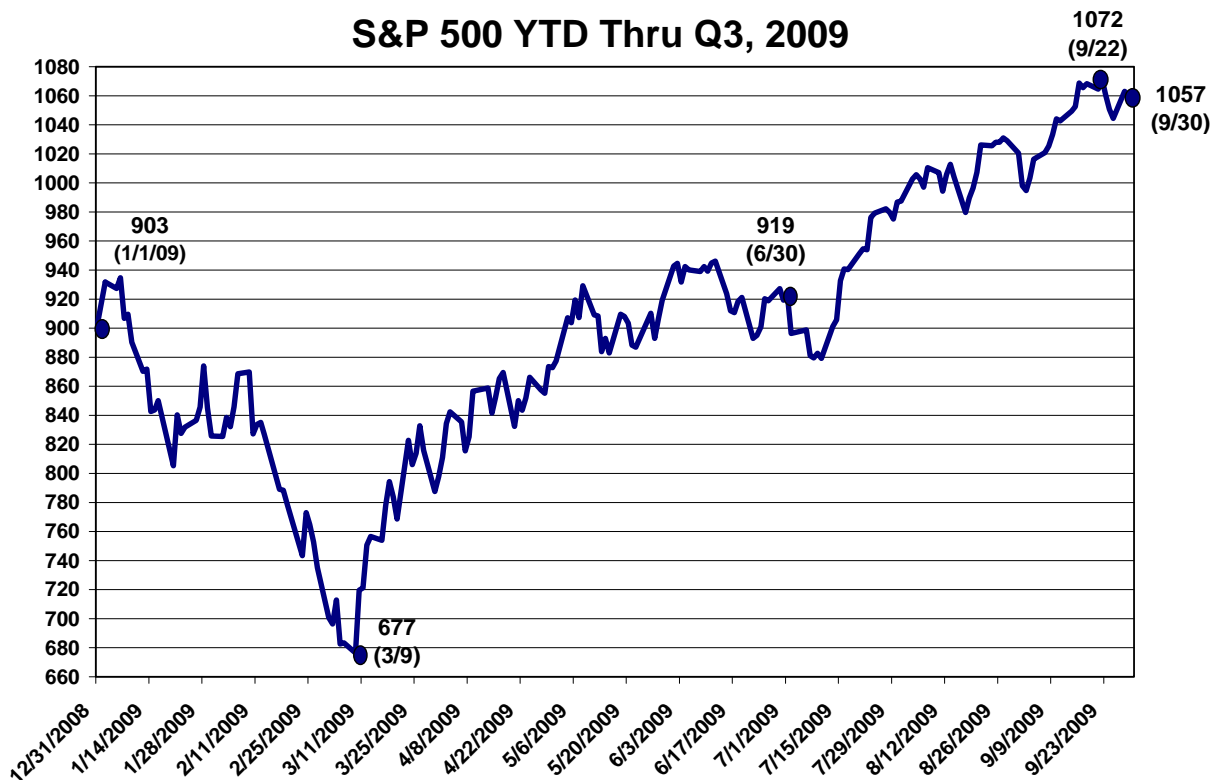


Q3 2009 Commentary: *I Have to Admit It's Getting Better*

By Bob Marshalla
Oct 14, 2009

Markets Continue to Rally

Last quarter I said that the economy was “slowing down slower”. Now I am happy to report that it appears to have actually turned the corner and is getting better in many ways. The equity and other investment markets began anticipating this last spring, and the strong rally that began after March 9 has continued in full force through the third quarter. The S&P 500 advanced 16% in the third quarter, matching its 16% gain in the second quarter. Since the market’s bottom on March 9, the S&P has now gained an amazing 58% (dividends included) in just over six months (as of September 30). It has now recovered close to half the maximum amount it had lost starting from its all time high two years ago¹.



¹ The S&P 500 hit its all time high of 1565 on October 9, 2007, and reached its maximum loss at 677 on March 9, 2009. This constituted an 888 point loss, or 57%.

Also continuing a pattern noted last quarter, most other equity and real estate market segments we track (and invest in) did even better than the S&P 500, both in the third quarter and year to date. This includes mid and smaller cap domestic stocks, international developed and emerging market stocks, and both domestic and international commercial real estate. The figures are shown in Table 1.

Table 1 - Market Returns Thru September 30, 2009

	Representative Index or Fund (blue font)	3rd Quarter 2009	Yr-to- Date 2009
Equities			
Full U.S. Market (98% by MC)	Russell 3000	16.3	21.2
U.S. Equities by Market Cap			
Large Cap	S&P 500 (incl. dividends)	15.6	19.3
Mid Cap	Russell Mid Cap	20.6	32.6
Small Cap	Russell 2000	19.3	22.4
Micro Cap	Russell Microcap	20.9	28.1
Value & Growth			
Growth Stocks	Russell 3000 Growth	14.1	27.3
Value Stocks	Russell 3000 Value	18.6	15.0
Economic Sectors			
Best in Q3 2009	Financials	25.1	
Best for YTD 2009	Information Technology		44.8
Worst in Q3 & YTD 2009	Telecommunications Services	3.9	(3.1)
International Equities			
Large Cap	MSCI - EAFE	19.5	29.0
Small Cap	MSCI - EAFE Small Cap	22.1	48.3
Emerging Markets	MSCI - Emerging Markets	20.9	64.4
Real Estate			
Equity REIT's - Domestic	NAREIT Equity Index	33.3	17.0
	Morgan Stanley US Real Estate*	30.7	20.2
Equity REIT's - Foreign	EPRA Global ex US Index	20.1	41.9
	Eur. Investors Int'l Property*	16.3	47.4
Commodities			
Commodity Futures	Dow Jones AIG Com Index	4.2	9.1
	PIMCO Commodity Real Return*	9.4	25.3
Fixed Income			
Investment Grade Bonds	Barcap Aggregate Bond Index	3.7	5.7
Inflation Protected (TIPS)	Barcap US TIPS	3.1	9.5
	PIMCO Real Return Fund*	5.5	16.4
High Yield Bonds	Barcap High Yield Corp Bond Index	14.2	49.0
Floating Rate Bank Loans	Eaton Vance Floating Rate*	8.9	41.6
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds*	14.0	22.2
Emerging Mkts Currencies	PIMCO Developing Local Markets*	7.4	19.6
Short Term Money	3 Month T- Bills	0.04	0.15

* Based on mutual fund returns. Others are costless market indices.

In fact, five of the asset classes we track have generated returns greater than 40% year to date, including:

- International Small Cap Equities 48%
- Emerging Market Equities 64%
- International Real Estate 42%
- High Yield Bonds 49%
- Bank Loans 42%

Keep in mind these are year to date figures. Had we measured them from the market bottom in early March, the returns would be even more robust. Furthermore, the market has continued to advance since the end of the quarter, gaining another 3.3% in the two weeks from the quarter's end up to the date of this writing (Oct. 14).

The Economy

It's now widely understood that we've been living through a period for the financial history books. The stunning failure of major financial institutions (Fannie and Freddie, Lehman, AIG, Washington Mutual, and others) in August and September of 2008 triggered a series of events that almost resulted in the collapse of the global financial system. The lending markets may have been within days of a total shut down and only extreme government actions prevented a meltdown and probably an economic depression. But while government intervention averted an all-out economic disaster, it was not enough to prevent the worst recession since the 1930s in combined terms of its length, magnitude of GDP decline, and increase in unemployment. In the months that followed, market volatility was the highest since the 1930s, resulting in stunningly rapid shifts in investment risks and opportunities.

By last winter the fear of systemic collapse of the financial sector had mostly abated, and the trajectory of the economic slowdown began to moderate. Although this was apparently enough to re-ignite the stock market, it has only been in the past three months or so that the real economy has begun to show genuine signs of life. There is definitely now a case for optimism, but optimism for what is the larger question. Some economists hold out hope for a rapid "coiled spring" type of recovery² such as we have experienced after other severe recessions, but it appears more likely to me (and most other economists I have read) that it will be a long and plodding recovery.

I will summarize in bullet point form the key factors making up the case for optimism, followed by a list of mitigating factors that still could at worst derail the recovery or at best slow it down³. I will follow this up with some words about the implications for the investment markets, and then conclude with a discussion of the investment moves I have been making and am contemplating making in the future.

The Case for Optimism

- GDP growth has very likely already turned positive, as we will see when third quarter figures are released. Next year's real GDP growth (i.e., after inflation) may well be as high as 4% .⁴
- Initial unemployment claims have come down sharply for the past several months, and are now 20% less than their peak rate in March. Initial unemployment claims is

² Liz Ann Sonders, the chief economist for Charles Schwab, made a strong case for this in a presentation at the Schwab Impact meetings, September 15, 2009.

³ Every economist is required to have and show an "other" hand at all times!

⁴ David Kelly, JPMorgan Asset Management chief economist in JPM's Guide to the Markets, Q4, 2009.

considered a powerful forward indicator of the economy's progress. Historically, all recessions have been over by the time this indicator has fallen as much as it has this year. The fact that total unemployment is continuing to rise is fully expected. This has happened in every recession since World War II (this is the tenth).

- Business inventories have fallen faster than consumption and have reached record lows. The decreases in inventories in the past three and six months have been the largest ever recorded in history for a three or six month period. Even short of any other good economic news this is a trend that must reverse, since inventories cannot go negative.
- Auto sales (other than during the "Cash for Clunkers" period) have been well below their scrappage rate. Roughly 13 M autos are retired from the streets each year, and about 2.5 M new drivers enter the system, leading to a native demand for new autos of about 15.5 M per year. Nonetheless, the rate of auto sales in July fell as low as 8 M per year. Clearly this cannot continue. Auto sales increased to a rate of 14 M in August, though much of this increase was due to the phenomenal popularity of the now expired "Cash for Clunkers" program.
- The housing market is showing signs of revival. Housing prices and existing plus new home sales have both been increasing for the last two months. As discussed in last quarter's commentary, the housing market was the chief culprit in getting us into this mess, and it remains the lynchpin for economic recovery.

There is also an inventory argument for houses similar to those for business inventories and autos. For the past 50 years new housing starts have averaged 1.5 M per year and never in the 50 years had there been a single month in which housing starts had fallen below the annual rate of 700,000. But by June of this year the rate had fallen to 582,000, and in August it was only back up to 598,000. This rate of housing starts cannot even sustain basic population growth.

- Exports have increased significantly. Our current account deficit is now below 2.8% of GDP versus 5% a year ago. (Remember, net exports is one of the direct components of GDP.)
- A steep yield curve such as we definitely have today with the Fed Funds rate at zero generally portends expansion. You'd have to be a pretty dumb banker not to figure out how to make money when short term interest rates are so much lower than longer term rates.
- By several measures, both consumer and business loans are becoming more accessible, as fearful banks have begun to ease up on credit conditions (which had been tightened to the point of freezing credit for most everyone last fall and winter).

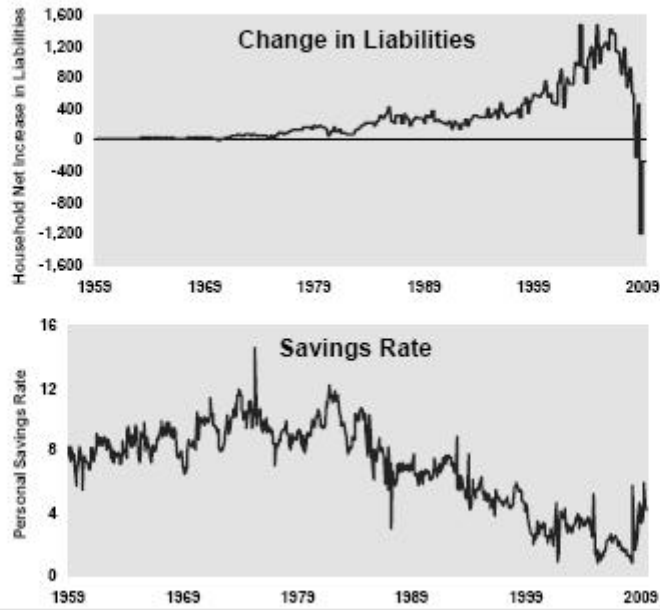
Mitigating Factors

The case for optimism is substantial. But there are risks and mitigating factors that could surely slow things down, or at worst lead to a double dip recession.

- Consumer deleveraging will be massive and long lasting, and this is what provides the most significant headwind to the pace of recovery. Consumers have been paying down debt like mad, but the overall level of private debt remains stratospheric. This is illustrated in the following two graphs. The light gray line in the second graph shows that household debt as a percentage of disposable personal income has barely budged despite the significant recent increase in the personal savings rate.

Household Debt Contracting Massively

Savings Rate is Big Beneficiary, But Not GDP

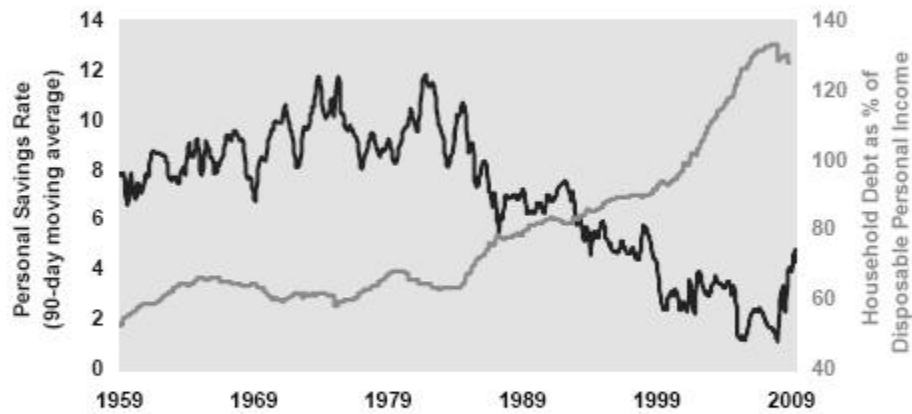


12 Consumer net increase in liabilities as of 1000. Personal savings rate as of 700. Source: Bureau of Economic Analysis, FactSet, Federal Reserve.

(2009-7530)

Savings Rate Will Go Higher...

...If Households Want to Get Serious About Debt



13 Personal savings rate as of 700. Household debt as of 1000. Source: Bureau of Economic Analysis, FactSet, Federal Reserve.

(2009-7530)

This is the paradox of thrift. Consumers are individually doing what is rational and good for them by paying down debt and finally living within their means. But the effect on the overall economy is to decrease aggregate economic growth. It is the evil opposite of Adam Smith's invisible hand. If left unchecked it can lead to a downward spiral in economic activity: consumer spending cutbacks lead to less production which leads to more worker layoffs, which then leads back to more consumer spending cutbacks and so forth. Be it right or wrong, this is the rationale for the Fed and Treasury to take contra-valing actions, pumping new liquidity into the system and purposely running larger public spending deficits in the effort to stop these negative feedback loops.

- The unemployment rate will almost certainly continue increasing well into next year. Although the rate of initial unemployment claims has been on a mostly downward slide since March, there are still more people losing jobs than gaining them. This pattern repeats itself in every recession and ensuing recovery. Also, the unemployment rate always takes much longer to come down than it does to go up. A reasonable expectation, assuming the recovery continues on course, is for the overall unemployment rate to come down about one percentage point per year. Seeing as it will peak somewhere north of 10% next year, this implies the depressing prospect that it will take us about five more years to get back to full employment, which is generally considered to be five point something percent.
- Credit availability is indeed loosening as mentioned above, but relative to normal times it still tight. Further, there is no guarantee that the loosening trend will continue. Delinquencies on residential mortgages and other debt (credit cards, auto loans etc.) continue to increase. While this is by now all well within the range of expectations, surprises are very possible.
- Commercial real estate fundamentals are very weak, with foreclosure and mortgage reset problems ahead. The commercial real estate market is even more of a lagging indicator than residential real estate, so we have definitely not yet seen the worst of the commercial real estate problems.
- Our longer term federal and state budget deficit outlooks are horrendous. This is not a problem right now, and in fact one of the biggest risks to the recovery is that policy makers try to address the budget deficit problems too soon (whether by cutting spending or raising taxes), and send us careening back into a deeper recession. But even if we get the timing just right, the deficit problems are real and have to be dealt with some day. Even in a best case where we wait until the recovery is in full bloom, paying down our deficits will present a public sector deleveraging headwind to growth in very much the same way that consumer and business deleveraging does right now.
- Inflation is currently almost non-existent, yet has not flipped over into deflation. So far so good. But deflation remains a risk as long as aggregate demand stays low, and inflation may become a big risk in a few years if the Fed does not get its timing down just right (i.e., choosing when and how much to tighten). One good thing though is that in the current economic environment, it is very hard to believe that inflation will be any kind of a problem over the next couple of years.

Investment Markets: Can Recent Advances Continue?

So what does this all mean for the investment markets? Even if the news on the economy is good, how much of this has already been discounted by the furious market advances of the past six months?

On the positive side, there are some powerful indicators that suggest that equity markets could continue to perform well, including:

- Low interest rates
- Low inflation
- Reasonable PE's and other valuation metrics⁵
- Easy earnings comparisons upcoming

Eventually interest rates are sure to increase and inflation may reassert itself as well, but neither of these things is going to happen soon. The environment of low interest rates and inflation will likely persist at least until late 2010 if not quite a bit longer. Combining this with the current resumption of economic growth – which means growing corporate earnings as well – there is reason to believe we can earn decent returns from stocks, real estate and commodities in the next couple years.

But this by no means implies that investment markets should keep rising like they have in the past six months. I do not expect that to happen. Given that valuation metrics are now within reasonable ranges, I think that by and large we should expect future investment gains to match earnings growth⁶, which in turn will be driven by the pace of the macroeconomic recovery. This would imply stock returns in the mid to upper single digits. This may not be an exciting prospect, but it nonetheless implies that future equity and other risky asset class returns will still likely be better than those of conventional bonds or cash equivalents, and that our balanced asset allocation approach is still the best bet going forward.

Current & Upcoming Investment Moves

The statement above may read much like a “stay the course” argument. As far as our basic investing philosophy is concerned, this is true. However, in the last year or so we made more and larger changes in strategic asset allocation and tactical portfolio shifts than we had ever made before.

Current Moves - Most recently, about a month ago we implemented these across the board changes in everyone's portfolios:

- More in Emerging Markets Equities - Increased emerging markets stock weights to 9% of equities. Previous targets had been between 5% and 7% depending on the portfolio.
- Shift to Fundamental Indexing Approach for Emerging Markets - Changed the vehicle by which we access emerging markets stocks. Until this round of changes we had been using

⁵ The one year forward PE of the S&P 500 stood at 15.8 on September 30. The long run average has been in the 15 to 16 range (depending on one's data source), so this is about average. However, the “correct” or fair value PE depends very much on the interest rate used to discount future earnings. Since long term interest rates are very low currently, the fair value PE ought to be above average.

⁶ Simple arithmetic argues that if a stock's PE ratio stays constant, then the investor's total return will equal the growth rate of earnings per share plus any dividends paid.

a market cap weighted index fund (VWO). We have now shifted to using a fund based on the fundamental indexing approach⁷ (SFENX).

- Decrease in Commercial Real Estate Holdings – Decreased our asset allocation targets for real estate approximately in half for most investor types. Prior to this change our real estate targets had ranged from 4.0% to 5.5% of invested assets, depending on one’s investor type. After the change, the targets have been decreased to between 2.0% and 3.0%.

The change was initially implemented by selling all holdings of our domestic REIT fund, Morgan Stanley U.S. Real Estate (MSUSX). The real estate securities we continue to hold are now predominantly in a “go anywhere” international real estate fund.

- Further Small Increase in High Yield Bond Holdings - Increased our high yield bond fund holdings a bit more by investing some of the REIT fund sale proceeds into more shares of the JPMorgan High Yield Bond fund (OHYFX). On average, we bought enough to increase the percentages for adventurous bond funds to 9% of equities, up from 8% previously.

These changes, as well as the process for implementing them were described in an email to all clients last month⁸. I am now in the middle of the second stage of this process, which is comprised of rebalancing everyone’s portfolios to our latest top level targets, plus replenishing each accounts targeted cash reserves (which you may recall are no longer counted amongst the assets balanced to our asset class targets).

Likely Upcoming Moves - Some further investment moves I am contemplating but have not yet finalized are the following:

- Still More in Emerging Markets – I have just increased emerging markets equities to a larger position than ever before, but I am considering going even further in this direction possibly to as high as 12% of equities. As discussed, we may reasonably expect the economic recovery in the U.S. and other developed markets to be slower than usual due to the headwinds of continued debt deleveraging. But this is not an issue in many emerging markets economies (Brazil, China, India), since they are net creditors, not debtors. Further, as development ensues, internal demand in these countries is becoming an ever more important component of their economic growth, as opposed to export driven growth only.

On the omnipresent “other hand”, I do expect emerging markets as a group to continue to be more volatile than developed markets, even though the trend is towards relative stability. And, there is no guarantee they will continue to grow at the pace we think likely. So placing too big a bet there could come back to bite us.

There is no optimal weight for emerging markets equities. But as a point of reference, the market cap of all emerging markets stocks is now about 9% of the market cap of all worldwide investable equities. Further, the percentage would be even higher if we counted the market caps of all equities, not only those investable by U.S. investors. So from this vantage point, a 9% weighting for emerging markets is roughly a market weight, and 12% would only be only a modest overweight.

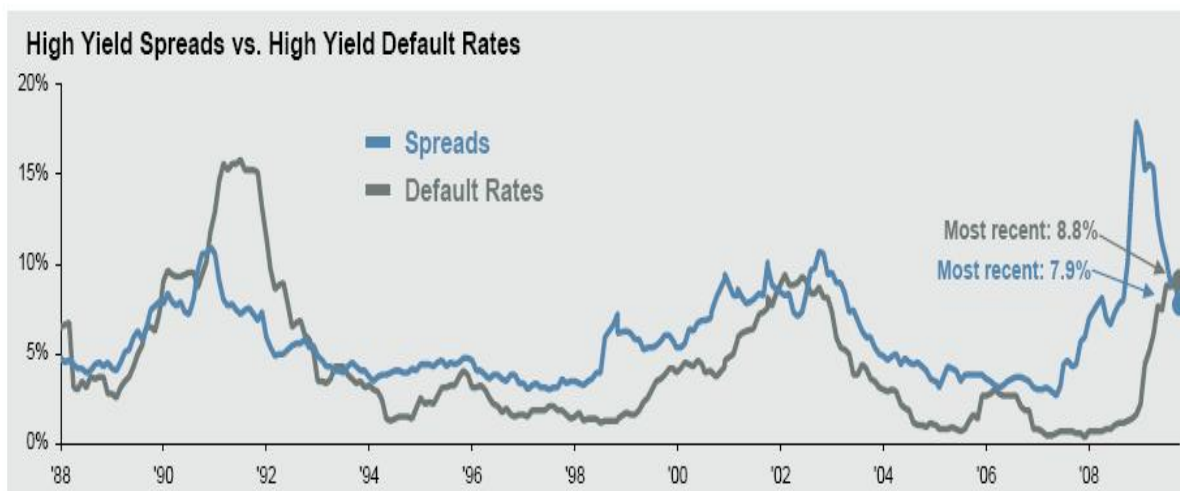
⁷ For a thorough description of fundamental indexing, see my earlier paper “Fundamental Indexing”, from April, 2006. It can be found on the Marshalla Asset Management website, or I will be glad to email you a copy of it, and lots more information too for those who may be interested.

⁸ If you’d like me to forward another copy to you, please let me know.

- Unwinding of High Yield Bond Positions – All along I have considered our investments in high yield bonds and other “adventurous” bond funds to be an opportunistic or tactical move, as opposed to introduction of a permanent new class of investments⁹. Further, because of the magnitude and nature of risks involved, I have considered these investments to count against our equity targets rather than our fixed income targets.

When we began investing in high yield bonds last winter, their valuations were so compelling as to cause them to be a “fat pitch” for investors. Year-to-date the three high yield bonds in which we have been invested have returned between 33% and 40%¹⁰, with the lion’s share of this coming in the last two quarters. For our portfolios, the date of first purchase varies by client, but in most cases was in February, March or early April. So these investments have surely worked out extremely well for all of us.

The most commonly used metric of valuation for high yield bonds is their “spread”, defined as the difference between their yield and that of similar duration Treasury Bonds. When we began buying high yield bonds, this spread was greater by a long shot than it had ever been in history. But now as the financial situation has calmed down, and as investors like us have moved into this asset class, the spread has fallen progressively back down (which is what has in fact caused the high returns). This is illustrated in the graph below. Based on the JPMorgan index, the high yield spread had fallen to 7.9% by quarter’s end, versus close to 20% at the end of last year. The current spread is still definitely on the high side historically, but is now finally below the previous record peaks of around 10% attained in 1991 and 2003.



Source (top chart): U.S. Treasury, J.P. Morgan Asset Management.

Spreads indicated are benchmark rates over comparable Treasury yields. Corporate bond spreads are of 10+ year maturity.

Data are as of 9/30/09.

J.P.Morgan
Asset Management

I am keeping a close eye on this and other fixed income metrics to decide if and when it may be time to exit this investment. I think the great majority of the excess -- even “windfall” -- returns have already been gained. Therefore, I may decide to unwind our dedicated high yield bond positions sometime very soon. I don’t believe we are

⁹ In fact, our clients have been in and out this asset class several times since 2001.

¹⁰ As Table 1 shows, the Barclays High Yield Bond Index is actually up 49% year to date. But the bonds in the funds in which invest are by choice not as low quality as those comprising the index, so I fully expect the index to show more extreme variations, both on the upside and the downside.

necessarily getting close to the time when this is a highly vulnerable or risky investment. It just may be that we would be better off shifting those assets to another type of investment. If and when I do sell our high yield bonds I will likely move the assets either into conventional equities or other “adventurous” bond funds¹¹.

Further Down the Road – I am in the midst of evaluating some other brand new investment ideas that I find quite intriguing. I hasten to add that these may or may not ever make it to the implementation stage, but I thought it might be interesting to some of you to hear what I am thinking about.

- **Arbitrage Strategies** – I would like to beef up our Alternative Investments asset class. Currently it is comprised of only one fund, the Arbitrage Fund (ARBNX), which pursues a merger arbitrage strategy. I am currently evaluating a new fund that pursues a much richer variety of arbitrage strategies, including arbitrage on convertible bonds, fixed income, closed end funds and other things as well as on corporate mergers. These strategies have been pursued for many years by skilled managers within hedge funds, but have heretofore not been available in a conventional mutual fund format¹². If we ultimately decide to invest in this fund it will likely be in addition to rather than in place of our current arbitrage fund.
- **Momentum Investing** – It has been established in financial economics research since the early 1990’s that stock prices exhibit considerable momentum over short periods of time (several months or quarters), and that excess returns could be earned if one could invest in the highest momentum segments of the market on a regular basis. But there has not been any systematic and well tested investment approach for exploiting this effect. Even if there were, high trading turnover and tax inefficiency would present serious obstacles to success. But I think at last there might such an approach. A firm named AQR, founded by a person whose intelligence I hold in the highest regard¹³ has created a new set of momentum indices and a series of mutual funds that attempt to passively follow these indices. Such funds do not fully surmount the high turnover, low tax efficiency obstacles, but they promise to do a lot better than would a typical active manager trying to chase winners. Furthermore, since this is based on a systematic, transparent and repeatable quantitative approach, it can be back-tested over multiple time periods, market segments and economic environments in a rigorous manner. This is what might be termed “passive momentum” investing, a term that would sound like an oxymoron if I didn’t know the full background.

Summary and Wrap-Up

Equity and other investment markets have been in “party mode” now for over six months, even though the underlying real economy is just now lethargically beginning to lift itself off the floor. The last six months have been the best half year in the stock market since 1950. I ascribe part of

¹¹ What I have called “adventurous” bond funds are simply funds run by managers who are ungoverned by any specific benchmarks, giving them the freedom to invest in any mixture of bond types they believe are worthy, be they high yield, emerging markets, asset backed securities or Treasuries. Further, in some cases they even have the freedom to be short in some categories and long in others. Another common moniker is “go anywhere” bond funds.

¹² At MAM we do have the ability to invest in hedge funds, but I have serious reservations about them. As a quick review, these reservations include: ultra high costs, high minimum investments, lack of transparency as to investment approach or holdings, illiquidity, lack of trustworthy performance reporting and generally lack of reasonable regulations to protect investor interests.

¹³ Cliff Asness

this to overcoming the extreme fear that caused markets so fall to absurd lows as investors fled every type of risk based investment, and part to the stock market acting in its usual role as a leading indicator of economic recovery. But now that prices and expected earnings have more or less moved into synch, I don't expect either of these factors to add much fuel for future rallies.

I remain comfortable with the asset allocation targets we currently have, and I am in the process of rebalancing everyone's portfolios to them. Because equities have moved up so much since our last rebalancing, this round calls for selling equities and other risky assets on net, and adding to safer investments. This implies we are taking some profits off the table, something I am quite comfortable with right now. I plan to be done with this round of trades within a couple of weeks.

As always, please be sure to call me or Amy if you have any questions, or if you would like to get together to discuss these topics more fully.

Sincerely,

Bob Marshalla
Your Financial Advisor