

Perspectives

on investing and other observations

CLEARY GULL

TABLE I - TOTAL RETURN RESULTS FOR VARIOUS PERIODS

	2 nd Qtr	1 st Qtr	4 th Qtr	3 rd Qtr	Annualized as of 6/30/2009		
	2009	2009	2008	2008	1 Year	10 Years	20 Years
Domestic Equity							
Lipper Diversified Equity Funds Average	17.05%	-8.92%	-23.10%	-9.91%	-26.52%	0.16%	7.50%
Dow Jones Industrials Daily Reinvested	11.96	-12.48	-18.39	-3.71	-23.00	-0.41	9.02
Lipper S&P 500 Funds Index	15.90	-11.01	-21.95	-8.40	-26.27	-2.47	N.A.
Lipper Large-Cap Core Funds Index	16.58	-9.63	-22.16	-9.38	-25.69	-2.34	6.87
Russell [®] 1000 Growth Index	16.32	-4.12	-22.79	-12.33	-24.50	-4.18	7.14
Russell [®] 1000 Value Index	16.70	-16.77	-22.18	-6.11	-29.03	-0.15	8.11
Lipper Mid-Cap Core Funds Index	18.33	-6.89	-25.87	-10.86	-27.20	3.46	8.92
Lipper Small-Cap Core Funds Index	22.23	-11.45	-25.49	-7.01	-25.01	4.32	N.A.
Russell [®] 2000 Growth Index	23.38	-9.74	-27.45	-6.99	-24.85	-0.89	5.07
Russell [®] 2000 Value Index	18.00	-19.64	-24.89	4.96	-25.24	5.00	8.91
International Equity							
MSCI EAFE + Canada IX ND	25.86	-13.14	-21.15	-20.67	-31.62	1.63	4.11
Lipper International Funds Index	25.64	-12.36	-21.12	-19.56	-30.14	2.44	6.07
Fixed Income							
Lipper Inter-Investment Grade Funds Index	5.42	0.60	-0.30	-3.47	2.06	5.00	6.18
Lipper Sh-Investment Grade Funds Index	3.81	1.17	-2.07	-2.48	0.29	3.59	5.10
Barclay's Intermediate Govt/Credit	1.67	-0.05	4.84	-1.19	5.27	5.66	6.65

SOURCE: LIPPER, INC.

QUARTER IN REVIEW

The rally in March and April can be viewed as an offset to the decline of January and February. The fears that the financial system was in jeopardy and the lack of detail surrounding the government response correspond to the first two months. The rally began with the announcement of some details in early March and continued into May, then stalled in June. Year-to-date, the average Diversified Domestic Equity fund tracked by Lipper, Inc. gained 6.6%, lead by Mid-Cap Growth funds (13.0%), while the average Large-Cap Value fund, which typically has had significant investments in financials, was only able to eek out a gain of 0.9%. International funds outpaced domestic funds regardless of category, led by huge gains in some of the Emerging Markets. The recovery in financial shares boosted this sector to the top of large-cap stock gains, but in the mid- and small-cap area, energy stocks gained the most. Increasing yields on Treasury securities --- higher yields produce lower prices --- and lower yields for most other types of credit resulted in much stronger gains for bond funds than for comparable indexes. General bond indexes reflect the fact that the largest amount of bonds outstanding are those issued by the government. As you can see in the table above, all equity strategies remain down over the last 12 months and, in many cases, over the last 10 years. Only small-cap value funds have produced returns that equal those of intermediate bonds, as measured by the Lipper Intermediate Investment Grade Funds Index, over the last decade. Ten years ago, small-cap value stocks and funds had just completed an extended period of significant under-performance.

Last quarter, we discussed the dangers of backward looking investing in the section titled "History Lessons" that highlighted Michael Lipper's comments (mikelipper.blogspot.com) and studies by Robert Arnott and Jeremy Siegel. If money had been shifted from financials, value and small-cap funds, the worst areas in the first quarter, to consumer

staples, growth strategies and large-cap funds that had been the best earlier in the year, the recoveries in all three laggards would have been missed, and the losses incurred in the first quarter would have been locked in. Following trends, especially short-term trends, can be hazardous. Long-term fundamental analysis accompanied by valuation disciplines tend to produce much better results.

June is the time when Russell rebalances its indexes. Standard & Poor's (S&P) makes changes when they deem appropriate, but also made notable changes in June; GM and Covidien were replaced with DeVry and FMC Technologies. These changes are worth noting since the expected earnings of the S&P 500 Index improved because of the change. The changes in the Russell indexes shift some value stocks, whose prices have risen, to growth indexes, while the fallen growth stocks shift to the value indexes. Similarly, successful small-cap stocks move to mid-cap, etc. One interesting aspect of the small-cap indexes is that S&P requires that the 600 stocks in its small-cap index have four consecutive quarters of positive earnings and at least 50% of the shares outstanding publicly traded, while the Russell 2000 has many companies that are operating at a loss and only requires that 5% of shares trade publicly.

CONFLICTS AND CONTRADICTIONS

On the one hand, the huge increase in liquidity courtesy of the Federal Reserve Board (the Fed) has begun to facilitate a return to more normal markets. On the other hand, the increase in liquidity may simply offset the disappearance of the so-called shadow banking system, which included liquidity provided by securitization of all types of consumer and commercial credit that was sequestered off of banks' balance sheets or leveraged in hedge funds. In addition, the increase in liquidity has not produced an expansion in lending because banks are reducing their own leverage and have tightened their lending standards. Finally, borrowers (businesses and individuals) are paying down debt and saving, resulting in a collapse in the velocity of money.

Government urges consumers to spend to stimulate the economy and even provided a tax cut to middle and lower income people, including those who do not pay taxes. Instead, consumers have increased savings to 6.9% of personal income in May, the highest level since December of 1993, which compares to the record low of -2.7% in August of 2005, near the height of the mortgage equity withdrawal. The increase in the "savings rate," as computed by the government, reflects paying down debt as well as actual increases in savings.

The Administration is concerned about job creation; however, the current proposals are not likely to create jobs in the short run. Key legislative initiatives are focused on health care, education, the environment and the financial system; none are big job creators. A relatively small amount (about \$200 billion) will be spent on infrastructure, which would translate into jobs and may also employ some of those unemployed by the collapse in housing.

The proposed legislation addressing the environment, called "cap and trade," as it currently stands, provides *free* "cap" credits for up to 10 years to the biggest polluters so that these industries have time to adjust even though the goal is to reduce pollution by putting a price on it.

REGULATION STRANGULATION

Efforts to address the problems in the financial sector are focused on a massive increase in regulation, not reform. To date, only one agency may disappear, but at least one new agency will take its place. Legislators and regulators are busy protecting their interests and their jobs. The Administration's proposed legislation also requires the Federal Reserve to seek "prior written approval from the Treasury Secretary" to lend in "unusual and exigent circumstances." If this provision survives, this would erode the independence of the Fed.

The health care proposals include more regulation and a new government health insurance company. A government health insurance company would compete with HMO's, which have proven the most effective so far in the containment of costs and provision of incentives for improved outcomes. Regrettably, none of the proposals include efforts to change the system from "fee for service" to rewards for measurable positive outcomes. In addition, there is no mention of tort reform that appears to be one of the contributors to more services in order to reduce the risk of medical malpractice suits.

According to the *Wall Street Journal*, the total amount of “economic value-added” that the Administration’s proposals seek to reshape amounts to about 45% of the U.S. economy.

HURDLES AHEAD

Useful capacity and jobs

As we discussed last quarter, many industries face difficult adjustments to global overcapacity. Today, capacity utilization, which measures manufacturing capacity, in the U.S. is below 70%, lower than at any time in the last 50 years. According to the Congressional Budget Office (CBO), the U.S. Output Gap, which measures all types of economic activity including government and services, as a percent of potential Gross Domestic Product (GDP) is at the lowest level since these calculations began in 1950. Unemployment is approaching 10% with no signs of stabilization in the near term. Inventories of unsold homes and autos remain high. The recession began in housing. There are signs of stabilization in some areas, but foreclosures and delinquencies continue to mount. Continued job losses and mortgage rate resets add to concerns that there may be a second wave of foreclosures.

Debt and financing

The Fed has expanded its balance sheet by almost \$1 trillion in 18 months. Total U.S. debt outstanding exceeds \$11 trillion. The projected budget deficit next year is almost 10% of GDP. We do not believe the current liquidity that the Fed has pumped into the system will be inflationary in the next year or so because of significant excess productive capacity and high unemployment. When and how the Fed withdraws this liquidity will be a crucial determinant of future inflation, interest rates, the relative value of the dollar and economic growth. At the present time, some of this liquidity seems to be seeping into the capital markets and boosting prices of traditional inflation hedges, such as commodities, in addition to absorbing the huge supply of new bond and stock issuance. In addition to the challenges facing the federal government, state and local governments (which cannot utilize deficit financing) face mounting challenges including lower tax receipts, federal mandates, aging infrastructure and under-funded retirement plans.

Consumption

U.S. consumers need to consume relatively less, while Chinese consumers need to consume more. However, the respective government policies are more geared to boost U.S. consumption and Chinese investment. These shifts would allow more stability in foreign trade and currencies, along with renewed growth of world trade, a necessity for rising standards of living globally.

STRATEGY

Our assignment is risk management and purchasing power preservation, if not purchasing power enhancement. To move forward we must examine what we have learned over the last two years and adjust our process where necessary in order to improve our ability to meet our clients’ investment goals. In addition, we need to evaluate the mistakes of funds and managers, what they have learned and how they are adjusting their own processes. Bob Rodriguez, a noted manager at First Pacific Advisors (FPA), addressed his peers at a conference in May on this subject; the complete text is available at www.fpafunds.com (Rodriguez and his colleagues identified the risks in the mortgage market in 2007 and held substantial cash throughout the last two years). No one foresaw the interdependence that enveloped all asset classes in this crisis. We know that successful long-term investors do their homework, analyze what could go wrong, and invest with a significant margin for error. The conviction allows investors to stay the course when everyone around them is either overjoyed or demoralized. We are further integrating our thinking across asset classes and tightening our devil’s advocate process. We continue to invest with funds/managers that are willing to be eccentric, unconventional and, even at times, “rash in the eyes of the average opinion,” a quote from Rodriguez’s speech. We also are working to keep our focus on long-term investing even in a volatile environment, since that is how one can identify the short-term anomalies. We learn from history, then look forward, examine structural changes and evaluate their impact on investing and security values.

On inflation and interest rates

What happens to interest rates in a low inflation/deflation environment compared to when inflation is rising?

What are the key variables that could help identify when the deflation/inflation environment may be changing?

Is the yield curve (difference in yields on bonds due in a few years vs. those that mature far into the future) so steep because high unemployment, excess capacity and more emphasis on debt reduction should keep interest rates low for now? Do future risks related to how the huge amount of liquidity will be withdrawn and government deficits financed require significantly higher rates to invest in longer maturities? We think the answer is yes to all of these questions. We believe we have a few years before the long-term problems surface. Meanwhile, rates paid by corporate borrowers are significantly higher than those paid on Treasuries and government agencies, more than enough to accept the credit risk so long as the research and evaluation of the issuer has been thorough.

On earnings and valuations

How will investors respond to improving earnings comparisons that should surface late in 2009 and 2010? Earnings should be better, if only because the results will be compared with the fourth quarter of 2008 and early 2009. Have consumers permanently changed their consumption patterns and the penchant to buy now and pay later, maybe not forever, but for a lengthy time? If so, why have consumer discretionary stocks been among the strongest since the lows? Are health care stocks relatively cheap and lagging because of fears surrounding government policies? How do current valuations compare to long-term norms? How do we make those comparisons given the shifting nature of indexes and other benchmarks? Based upon the history of stock valuations since World War II, stocks appear reasonably valued on expectations for 2010, whether considering earnings, book value, sales or return on equity. However, interest rates are currently lower than the average over this period, which should justify higher P/Es. Therefore, stocks appear more attractive than cash and Treasury bonds.

Where are the anomalies?

The new “Build America Bonds” that are taxable municipals appear relatively attractive, probably because they are a new type of bond, not well understood, and have not been issued in sufficient size to be exploited by major institutions. Small-cap stocks tend to be less well followed by institutions and do not trade as well as large-caps, resulting in less pricing efficiency for the fund/manager that focuses resources in this area of the market. At times, the small/mid-cap area of the stock market can be very attractive because these companies generally are well seasoned and have better access to credit to grow their businesses than truly small-cap stocks. Companies of all sizes that produce and sell products in the growing markets of Asia and Latin America may be as interesting, as well as less expensive than some of Emerging Market stocks that have had big share price gains so far this year.

Risk and reward

Current yields on intermediate corporate bonds are about 5 1/4%, more than 3 percentage points above estimated inflation for the next few years and substantially more than short-term interest rates. Since the equity markets have rallied strongly, stocks appear to be reasonably valued, but no longer as cheap as they were. The estimated return over the next year assuming, 15 times 2010 estimates for the Standard & Poor’s 500, is about 22%. But, if P/Es were to contract substantially or earnings disappoint, then the market could decline as much as 18% to about where they were in March. Even if earnings growth is not as strong in the future as we have experienced in the last 25 or 30 years, we expect earnings to recover and well-managed companies to grow in-line with the very long-term averages of about 7% plus 2% dividend yields.

What ever the “new normal” is, the crisis seems to have passed, even though many challenges remain. Careful risk taking should produce reasonable returns over the coming years.

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JULY 6, 2009

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