

Perspectives

on investing and other observations

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TABLE I - TOTAL RETURN RESULTS FOR VARIOUS PERIODS

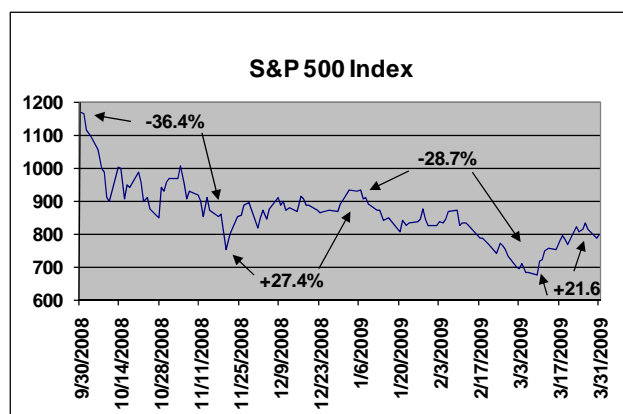
	1 st Qtr	4 th Qtr	3 rd Qtr	2 nd Qtr	Annualized as of 3/31/2009		
	2009	2008	2008	2008	12-Months	10 Years	20 Years
Domestic Equity							
Lipper Diversified Equity Funds Average	-8.92%	-23.10%	-9.91%	0.14%	-36.87%	-0.46%	6.97%
Dow Jones Industrials Daily Reinvested	-12.48	-18.39	-3.71	-6.85	-35.94	-0.36	8.79
Lipper S&P 500 Funds Index	-11.01	-21.95	-8.40	-2.75	-38.13	-3.25	N.A.
Lipper Large-Cap Core Funds Index	-9.63	-22.16	-9.38	-1.44	-37.17	-3.30	6.48
Russell [®] 1000 Growth Index	-4.12	-22.79	-12.33	1.25	-34.28	-5.26	6.85
Russell [®] 1000 Value Index	-16.77	-22.18	-6.11	-5.31	-42.42	-0.62	7.68
Lipper Mid-Cap Core Funds Index	-6.89	-25.87	-10.86	2.66	-36.84	2.97	8.40
Lipper Small-Cap Core Funds Index	-11.45	-25.49	-7.01	2.37	-37.19	3.71	N.A.
Russell [®] 2000 Growth Index	-9.74	-27.45	-6.99	4.47	-36.36	-1.60	4.30
Russell [®] 2000 Value Index	-19.64	-24.89	4.96	-3.55	-38.89	4.87	8.34
International Equity							
MSCI EAFE + Canada IX ND	-13.14	-21.15	-20.67	-1.17	-46.31	-0.39	2.61
Lipper International Funds Index	-12.36	-21.12	-19.56	-1.90	-45.45	0.67	4.82
Fixed Income							
Lipper Inter-Investment Grade Funds Index	0.60	-0.30	-3.47	-1.09	-4.25	4.34	6.22
Lipper Sh-Investment Grade Funds Index	1.17	-2.07	-2.48	-0.27	-3.64	3.25	5.12
Barclay's Intermediate Govt/Credit	-0.05	4.84	-1.19	0.14	1.96	5.44	6.90

SOURCE: LIPPER, INC.

QUARTER IN REVIEW

As was the case in the prior quarter, this period can be broken into two phases for stocks. The first two-thirds of each quarter was filled with uncertainty, confusion and significant declines in stock prices, while the last third brought kernels of hope and a rally in stock prices. In both periods, the total returns from stocks were negative, although much less so in this quarter than in the last. You can see the parallels in Graph I. The sectors that declined the most (financials, industrials and consumer discretionary) subsequently advanced the most. In the broader market the U.S. dollar, gold, emerging markets and commodities fared relatively well, while value stocks of all sizes were among the worst. Large-cap stocks outperformed small-caps regardless of strategy. International funds underperformed domestic funds primarily because the dollar rose, adding to losses in foreign markets. With the exception of Germany, France and Spain, most major foreign markets actually declined less than the U.S. measured in local currencies.

GRAPH I



The fixed income markets bear the imprint of the government's policies and of investors' fear. The flight to the security of U.S. Treasuries along with actions by the Federal Reserve Board (the Fed) and the U.S. Treasury Department (Treasury) have produced near zero rates for short-term Treasuries, yields vacillating between 2.5% and 3% for 10-year Treasuries and the lowest yields on 30-year Treasuries in a generation. In the fourth quarter, spreads (the difference in yields on bonds compared to similar maturity Treasury bonds) widened to historic proportions. Spreads for money market instruments (commercial paper, and short term Eurodollar borrowings) narrowed significantly but remain wider than before the summer of 2007. April 2nd was the first time since March 2008 that there were no takers for Term Securities Lending Facility (TSLF) money, which was designed to help non-

bank financial institutions with short-term borrowing needs. Spreads for investment grade credits tightened but remain at wide levels and yields on below investment grade debt remain historically wide.

The many government programs to get the financial markets working again have been more clearly defined and some have been launched. The Fed has begun to purchase long-term treasuries (the purchase of *long-term* treasuries is unusual), mortgage related securities including agencies and asset-backed securities (credit card debt, car loans, student loans and small business loans). Each program has its own acronym; all are financed by the taxpayer. The most risky for the taxpayer is the latest program to purchase the “toxic assets,” the Public Private Investment Partnership (PPIP), because the private sector will put up 8% in equity and the government will invest 8% in equity and loan up to almost 6 times the equity. The worst the private investor can do is lose the equity, but this is offset by the possibility of splitting the gains 50-50 with the taxpayer. On the other hand, the taxpayer shares the gains 50-50 with private investors and could lose the equity and the value of the loans. Only private firms with at least \$10 billion in fixed income securities can apply to participate. However, with the news on mark-to-market accounting, there are some who wonder whether banks will be interested in selling at prices that investors will be willing to pay. Of course, the banking regulators may intervene in some situations where banks clearly need to rid themselves of “toxic assets.”

The biggest fundamental news in the quarter was the announcement that the Financial Accounting Standards Board (FASB) would review its stance on mark-to-market accounting (MTM) and announced a decision on April 2nd. This has been at the center of a controversy surrounding how financial institutions value financial assets. When an institution writes down the value of an asset, the charge is against its equity. How this accounting policy is applied has significant impact on the determination of a well-capitalized institution or an insolvent one. Investors want transparency/disclosure of the value of assets. Politicians want to stem the bleeding caused by write-downs. Some regulators, including Paul Volker, have also pointed out that banks take short-term money (deposits) and lend it long term, and as a result MTM may not be totally appropriate. When FASB announced the relaxation of MTM on April 2nd, they made it retroactive to financial statements for periods ending after March 15th and gave significant breathing room to financial institutions who will file financial statements as of March 31st. This has been an important propellant to this stock market rally and to the tightening of spreads between financial institutions’ bonds and U.S. Treasuries.

HISTORY LESSONS

In his book, *The Price of Liberty*, Robert D. Hormats traces the financing of war beginning with the American Revolution. The United States borrowed to finance each war in its history and repaid the debt until the combination of the Vietnam War and The Great Society. At the end of his book, he expresses concern about the nation’s resources to shoulder the “war on terror” and the health care and retirement entitlements already in place. His book was published in 2007, before the financial crisis of the last 18 months that has compounded the nation’s budgetary problems or the proposed new social initiatives covering health care, education, infrastructure and the environment. How will we prioritize the security, social and financial issues we face? The so-called “guns and butter” era of the late 1960s and early 1970s wrought significant erosion in the “real value” of assets. Are we facing that prospect again?

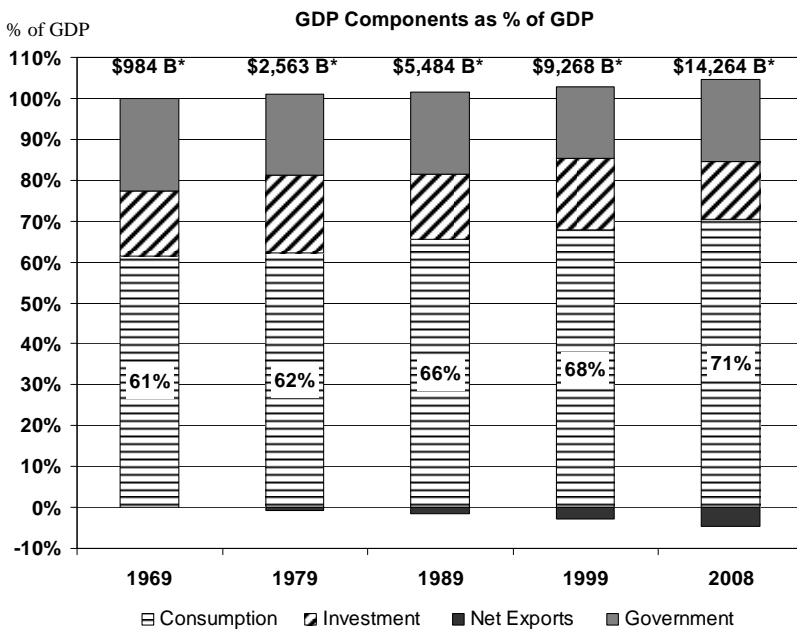
Several noted market analysts have recently discussed historical periods when bonds outperformed stocks: 1803-1871, 1929-1949 and the last 10 years. As Mike Lipper pointed out in his blog (mikelipper.blogspot.com) in the March 29th article “Should We Appreciate Bonds,” the current period is affected by the end date and if the end date had been 2006, the claim surrounding the last 10 years would not hold. The widely published and recognized analyst, Robert D. Arnott, has completed a study on the subject to be published in the *Journal of Indexes* this spring that was highlighted in *Barron’s* on March 30th. In his analysis that was concluded on February 28th, “Bonds Beat Stocks” from 1968 through February 2009, albeit by only 0.02%. As of March 31, 2009, just one month later, that would not hold true for the 40 years, just for the last 10 years. This underscores Mike Lipper’s point regarding the importance of the end date. Jeremy Siegel, a renown Wharton School professor, underscores that these are backward looking numbers and “the worse stocks have done in the past, the better they are now...” Buying stocks in July 1932 “was the single best time to buy stocks ever,” according to Siegel.

While the lessons from the “guns and butter” era of the ‘60s and ‘70s do not argue for either stocks or bonds, we need to look forward, not backward. In his latest shareholder letter, Warren Buffett comments that “the world has gone from under-pricing risk to over-pricing it.” Perhaps we are already considering the inflation risks posed by the huge expansion of money---Chairman Bernanke recently acknowledged the need to sop up this money as soon as the financial markets are functioning normally again although there is concern that will occur --- and the competing demands on our nation for security, the first obligation of a government, and social needs.

STRUCTURAL CHANGES

The Fed and the Treasury have intervened in the financial market as never before with their various programs and takeovers of significant financial institutions. Yes, the government took over more than 1,000 financial institutions during the savings and loan crisis in the 1989-91 period, as well as Continental Illinois Bank, then a major bank, in the mid-1970s. And, the government imposed wage and price controls in the 1970s and during World War II. Engineering the process of deleveraging the private sector is expanding the U.S. budget deficit as well as the Fed's balance sheet. By some estimates, the various programs are set to expand the Fed's balance sheet from about \$1 trillion in 2006 to over \$4 trillion. Foreigners now own more than 60% of the outstanding amount of publicly held U. S. Treasury debt. Will rates need to rise to attract borrowers? Will the dollar need to fall? Will Treasury borrowing crowd out private sector borrowing? The government is taking on the debt of the private sector, rather like the sin-eater of Irish folklore that ate food offerings surrounding a dead person to absolve him/her of her sins on the journey to heaven. The sin-eater was treated like a leper in the folklore.

TABLE II



* Nominal amount of GDP for the year

Economics 101 taught us that Consumption (C) plus Investment (I) plus Government (G) plus Net Exports equals Gross Domestic Product (GDP). Table II shows the value of GDP at the end of the prior four decades and last year with the percentage of each component. Consumption has been taking a rising share. Consumer expenditures have also grown faster than personal income as consumers have increased their leverage (borrowing) through bigger mortgages, mortgage equity withdrawal, and greater use of credit cards. Financial institutions facilitated this because mortgages, credit card debt, auto loans etc. could be bundled into securities and sold to investors, including the shadow banking system (off balance sheet financing such as structured investment vehicles). As we know in some cases, the fees generated from the loans and selling of the securities were more powerful forces than creditworthiness. Because consumption is such a huge part of the economy, reducing its relative importance (paying down debt and only spending from personal income) will result in slower growth of GDP. Even a significant increase in the growth of government and investment will not be sufficient to offset the slow growth of consumption. And, the shadow banking system is unlikely to return.

Various industries need to “right size” to meet the new realities of smaller demand as shown in Table III.

TABLE III

Global Overcapacity	Autos	Semiconductors	Oil
When	December 2008	Q1 2009	Q1 2009
Rate of Production	66 million cars/year	9,260 wafers/month	83.8 million barrels/day
Production Capacity	90 million cars/year	14,930 wafers/month	89 million barrels/day

Source: *Business Week*; data: CSM Worldwide (autos), iSupply (semis), Energy Information Administration

This will result in permanent layoffs, exacerbating the unemployment situation but also increasing the importance of retooling the global workforce.

HOPEFUL SIGNS

- Sales of new and existing homes increased in February, as did new housing permits.
- Housing affordability is terrific given lower prices and mortgage rates.
- Retail sales and personal consumption may have grown in the first quarter based upon recent data.
- Inventories are quickly being liquidated so that any improvement in demand should flow thru the supply chain and promptly increase production.
- The Fed and Treasury programs are finally being implemented after months of delay.
- A handful of banks have returned TARP money and others are signaling their intent to do so soon.
- Corporate investment grade debt issuance more than doubled over the first quarter of last year.

TAKE RISK TO EARN A RETURN

Treasury bills, the risk free rate, and money market funds are yielding less than 1%. What are the risks to be taken in order to earn a better return? Table IV displays some of the yields available for those willing to accept maturity and various levels of credit risk. Below investment grade debt is an equity alternative and requires careful analysis of the business and its cash flow generating ability so that the interest and principal will be paid. Debt holders have priority over equity investors. So credit research is essential for both debt and equity investors. According to the latest CFO survey, almost 14% expect to renegotiate or violate terms of their debt agreements this year, indicating that it might be too soon to consider this area. On the other hand, investment grade corporate debt appears relatively attractive.

TABLE IV

Valuation Matrix				
Fixed Income		Non-financial Corporations/Equity		
Vanguard Fund	Yield - 1 month Annualized		Current	Median Since 1950
Short-term Federal	3.0%	P/E	20.1x	16.0x
GNMA	4.4%	P/Cash Flow	11.3	9.5
Intermediate Term Bond	4.8%	P/Sales	1.4	1.3
High Yield Corporate	9.5%			

Source: Bloomberg; MBO Cleary

Source: Ned Davis Research

Equities are reasonably attractive albeit not as cheap as at some times in the past as shown in Table IV above. In 2006, operating and reported earnings were within 5% of each other, indicating that it was a rather normal year. If you assume the S&P 500 can earn as much in 2010 as it did in 2006 and sell at 15 times earnings by the end of that year, the gain would be almost 65% or 32.5% annualized over the 1¾ years to the end of 2010. Assuming the same earnings and P/E but postponing the end date to mid 2011 would produce an annualized gain of 24.6%.

The next few weeks may be important indicators of whether investors have discounted the bad news, are tired of the low returns in treasuries and are ready to assume more risk. As Buffett has said, “clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long.” Inflation will surely erode values. “Approval...is not the goal of investing,” making money and preserving purchasing power are. In our view, risks remain but prices now reflect many of the risks and offer the prospect of solid returns for long-term investors willing to persevere through the present turmoil.

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