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Inside this Edition

Our Take on "Is it Safe to Invest in Stocks Again?"

The most frequent question we hear from investors is whether the market decline is over and it's safe to invest in equities again.

Our response is a bit different than most. We don't know if the declines are over or if the market has settled into a long-term uptrend. But we also don't need to know. That is the beauty of active management.

When it comes to investing, it's very important to realize that financial markets rarely advance smoothly from point A to point B. Rallies followed by retreats are common in bear markets, as are pull backs in bull markets. Even if you were to precisely pinpoint the bottom of a market decline, history shows it won't be all uphill from there.

> *"The stock market is much more volatile than most investors realize. One measure of volatility is the range of annual moves in the market from year-end to subsequent year-end. The market moves dramatically both positively and negatively to ultimately produce its modest long-term average return."*
>
> Unexpected Returns: Understanding Secular Stocks Market Cycles, Edward Easterling, Crestmont Research.

If you are a buy-and-hold investor, "when is it safe" is looking for a long-term forecast. If you are willing to take an active approach to the financial markets, it doesn't matter if the absolute bottom has been reached, or if the market may decide to take back its gains. What you are looking for is whether or not the market appears to have established a trend with a little staying power.

While the S&P 500 was declining in 2001, ending the year with a loss of -11.9%, there were two periods in which it rallied in excess of 15% and 13%. Capturing those gains did not require answering the question of whether or not the market had reached bottom, but rather whether or not an up trend appeared to be in place and when a reverse occurred.

With active management, if a trend reverses, you take your gains and exit the position. There will also be times when you will need to cut short your losses and exit accepting that every investment approach has the potential for gains or losses.

Knowing that we can exit a position and cut our losses short if it turns against us is very liberating. By establishing a definitive sell point, such as 3% drop in value, you limit the risk you are willing to accept and also build in a methodology to preserve gains.

Another benefit to active management is that you can invest beyond the "evergreen" indexes or stocks. For example, if your investment time frame is 10 to 20 years, investing in cyclical assets such as gold, which tend to move counter to the overall market, may not be your best strategy. But there are points in the economic cycle when gold tends to shine. Active management allows you to pick and chose sectors with the potential for outperformance in the current market environment. Even in the midst of a bear market environment, we still have opportunities for profit, but they are not the same opportunities as during a bull market.

Save the Economy or your Future?

"Since consumer spending accounts for about 70% of total economic activity, the economy will not rebound until consumers reopen their pocketbooks."

March 2, 2009, The Huffington Post.

Feeling guilty because you are not doing your bit to save the economy? While saving the economy may be a good excuse to spend money, over the long run increasing your personal savings offers the greatest benefit.

In the 1980s, the consumer savings rate was 12%. By 2005, Americans were spending more than they made.

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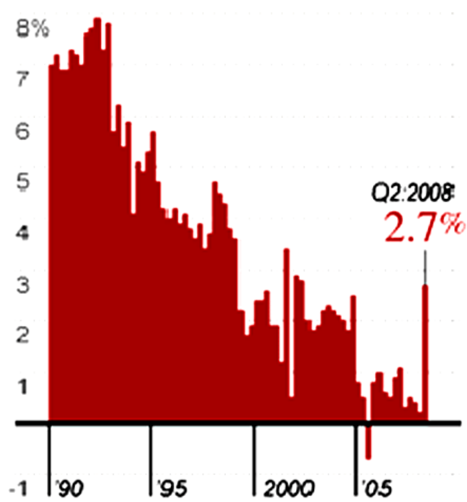
Americans are Saving Again

Personal savings rate, quarterly



Source: Bureau of Economic Analysis

When the safety net of savings is missing, stress increases, particularly among women. Interest payments begin taking up a larger share of each paycheck, actually decreasing the amount of money available to consumers. Savings also give you the ability to cope with setbacks such as the loss of a job or an unexpected expense. With savings, you have options that don't exist if your net worth is tied up in illiquid assets. A lack of retirement savings also means many Americans working much longer.

Increasing our savings rate isn't painless, but it is necessary for the health of families and individuals and ultimately our nation. With that said, up with savings! And, let's put them to work.

The recession is likely ending, but risks remain. Historically, the sharper the decline, the steeper the recovery – and the economic plunge we experienced in the fall of 2008 was without precedent. In line with history, since the beginning of the quarter, we have seen the S&P increase by 15.22%, and the Dow Jones Industrial Average gain 11.01 %.

After a rally off of the March lows that can be considered nothing less than exceptional, the stock market has recently shown a bit more uneasiness. For the second half of the quarter, the U.S. market has largely traded sideways, with a couple of decent-sized down days mixed in. International markets (most specifically, emerging markets) have also shown signs of some fatigue. Are these signals of a more serious breakdown to come, or something more benign? It certainly reminds us that the importance of managing risk in portfolios never loses favor.

Massive global stimulus has aided these rallies, but we're watching to see what happens as the stimulus measures fade and the real economy starts to function on its own. As an expert on the Great Depression, Chairman Ben Bernanke has undoubtedly noted that much of the blame in that particular crisis lies with a Fed that, at the time, tightened monetary policy prematurely – a scenario he's surely trying to avoid this time around. Indeed, while inflation may become a concern in the future, for now, a weak money multiplier, high unemployment, excess global capacity, and low wage pressures lead us to agree that monetary tightening is not yet necessary to fight potential price increases.

On another note, the U.S. has not experienced the type of consumer deleveraging that still lies ahead, and therein lies the risk of a "double-dip" in economic activity. The market rebounded on the potential for the first leg up of the economy, and is now looking for evidence of more concrete sustainability. In short, merely getting worse at a slower rate isn't going to cut it any more; it appears that actual signs of growth may need to emerge to push the market higher.

"Big Picture" issues that are influencing the market:

- LEI - The Conference Board's Index of Leading Economic Indicators (LEI) index rose in April and May, which was the first sign of strength in 18 months, and the best consecutive two-month improvement since November/December 2001 (just after the last recession ended in October 2001). This index is comprised of 10 individual components, and as an indicator, has had a strong track record in identifying the end of previous recessions.

- Deleveraging - Consumers comprise 70% of GDP in this country, and they remain bruised. They are embracing frugality, saving more, and postponing large purchases. Consumers are allocating funds away from expenses and towards funding "emergency funds" in case of job losses and/or cutting debt levels.

- Political Tensions – Threats of strict oversight of emergency funding recipients, including congressional efforts to tax bonus payments retroactively, have led to a degree of distrust as well as to questions about the government's support of free and competitive markets. Many large banks are developing plans to return bail-out capital earlier than expected on the basis that government interference is hindering their ability to compete.

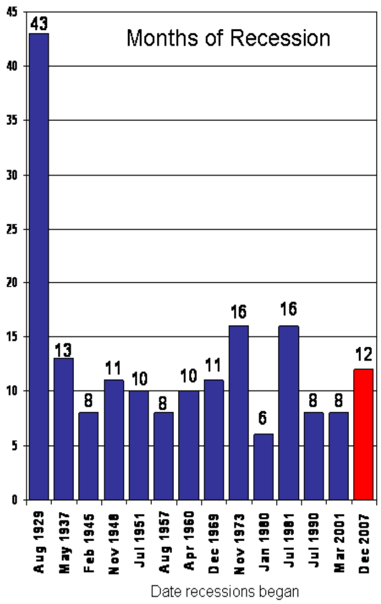
Rates, Unemployment, and the Dollar – The rise in mortgage rates has the potential to stall the tentative housing stabilization we may be seeing, and there are still concerns over the commercial sector in real estate. Unemployment will likely continue to increase, possibly registering a double-digit figure. We have also seen a modest decline in the dollar; however, historically a drop in the dollar has been consistent with economic recovery. The "reflation trade" is a sign of investors transitioning to a risk-taking environment.

Though we are seeing some "green shoots" appear on the horizon, our optimism remains contained. As the year progresses, the risks to our outlook remain high, especially as business and consumer confidence have yet to improve meaningfully. There are a number of developments that could prolong the recession into 2010, including delays of key policy initiatives, adverse commodity price trends, or further increases in the savings rate.

Forecasting is an Uncertain Art

Most forecasts interpret the present based on the past. By looking back, we know that the average recession has lasted 10 months with the longest, excluding the Great Depression, coming in at 16 months.

But a number of factors make this recession different. Will government intervention spur a recovery? What effect will tripling the federal debt over the next decade have on the recovery? How will the new debt, plus legacy programs such as Social Security and Medicare, impact the economy? How will economic interventions by other countries that are major trading partners alter the recovery? These are all uncertainties that impact consumer confidence, which is ultimately at the root of any market recovery.



Another problem with forecasts is that there are so many of them, and the rationale behind the forecasts varies by the training of the individual. It's like going to a doctor for a headache. The orthodontist will tell you it's the result of temporomandibular joint (TMJ) disorder, the oncologist will suspect cancer, an immunologist will look to allergies, the chiropractor will target misalignment, and so on. While the medical profession has clinical tests they can use to pin down the potential cause, the only effective proof for an economic forecast is time.

With investing, however, we don't necessarily have the benefit of time. Staying out of the market until we have proof of a recovery foregoes opportunities for profit. Which is why we come back to our major premise - what matters in the market is what is happening right now. We don't know the future, and past performance is not a guarantee of future returns.

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Market truisms we believe in:

- Markets are not random. There is a reason for price changes. That reason may be more emotional than logical at times, but there is still a reason.
- While there will always be short-term volatility, there is also a phenomenon known as persistence of performance in which market trends develop and continue for a period of time as the reasons for price changes are accepted and acted upon.
- Market behavior is not always rational based on our perceptions and trying to force our view of what should happen on the market will have little effect. *"The market can stay irrational longer than you can stay solvent,"* said John Maynard Keyes and the wisdom of that statement has been proven over and over.

2nd Quarter Newsletter

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