Prepared Comments from 7/15/2009 Conference Call

My last conference call was on April 15th. US stocks have since risen 9%. The current catch-phrase is 'green shoots,' indicating that the early signs of an economic recovery have been appearing. Investors want to know if it is safe. Of course it isn't safe—it's investing. It wasn't safe when the markets turned down starting in October 2007, nor when they turned up starting in March of this year. If you want safety, use money markets, CDs, and bank accounts.

The Markets

The broad S&P 500 index peaked at 1,565 in October 2007. It had fallen 57% by March 9th, and despite a partial rebound to over 900, it remains 41% below the October 2007 levels.

The past calendar quarter was the best for the S&P 500 stocks in over ten years. Foreign stocks did even better. Natural resources and real estate had good results, and yet all major stock areas remain down 25% or more in the past year. Bonds did well, especially corporate, and most especially high-yield bonds.

The quarterly Market Review and Outlook was mailed out last week, and is posted on our website www.mallardadvisors.com, under Client Resources and then under Newsletters and Articles.

The Economy

When you are digging a hole, the first step to get out of the hole is to stop digging. It appears that the US Economy is close to ending the digging—the declines in economic activity are ending. This is required before we begin to grow again. Economic growth is expected by the 4th quarter, if not the quarter just begun.

Unemployment has risen to almost 10%. Many companies will continue to lay off workers while sales are depressed, and will wait until their sales rise to hire these workers back. Other companies are waiting for greater clarity in their economic future, and greater access to borrowing (from banks) before they will proceed with expansions, and the hiring that comes with that. For this reason, unemployment is expected to remain high after the economy has begun its recovery.

Expectations of passing the bottom have led to rising oil prices, and rising stock prices, in the past few months. Much of the oil price rise has been tied to a growing level of concern over future dollar weakness. This concern is partially based on the worry that the Fed will fail to effectively unwind the purchases of over $1 trillion of bonds, purchases which had and will be done to help stabilize the capital markets, but is more tied to the larger worry that the federal government (Congress and President) will fail to drive the budget deficit down sharply after the current economic storm-front passes. Lacking confidence in US fiscal and monetary policymakers, investors may refuse to continue to purchase US debt, driving down the value of the dollar and driving up inflation, and US debt interest rates.

I agree with many economists who feel that the current inflation worries are premature at best, and illogical at worst. They note that you cannot have inflation without an imbalance of demand overwhelming supply. The US economy has a very large amount of unused supply, and most new demand is coming in the form of the stimulus packages passed in the past year, stimulus which will naturally run out in two to three years.

Corporate profits and cash flow increased in the 1st quarter, after falling in the prior quarter. The Producer Price Index has risen three straight months. Again, it appears that the hole is no longer getting larger and deeper.

Consumers are on the fence. Due to concerns of upcoming layoffs, many consumers are cutting back, and many are sharply boosting their savings. The personal savings rate is currently 6.9% of disposable personal income—it was only 0.6% two years ago. Personal consumption (spending) has waffled, but is largely unchanged from November levels.

The second pressure on consumers is housing and credit. 7% of mortgages are at least 30 days delinquent, and this has been rising. 17% of credit card accounts have been closed (combination of voluntary/involuntary closures), and the total value of credit lines has fallen a similar amount over the past year. With US consumers unable to borrow from the equity in the house, or from their credit cards, they have been forced to 'do the right thing,' and limit spending to earnings. While this restricts economic growth over the short-term, it is hard to argue that this isn't good for society in the longer-term.

The current global economic crisis has been good for US trade—while our exports have fallen, our imports have fallen more. The trade gap shrunk 10% in May, as exports rose while imports fell.

Stocks are Cheap

Who cares about all of that? What does this mean for investors? Is it safe to invest in stocks now? My answer is that it is **not less safe than normal** to invest in stocks now. The risk of the US economy 'falling off a cliff' has dissipated, and the bulk of indicators imply that the US economy will resume growing later this year. As the stock market remains 40% cheaper than it was less than two years ago, I feel strongly that it is neither too late nor too early to build stock allocations up to target levels.

The stock markets had a very sharp rebound from March 9th to May 7th. Presumably many nervous investors who had retreated to cash regretted their decisions and began to rebuild their stock positions. The rebound was so sharp that I wouldn't be surprised if those two months brought the strongest rebound during the entire market recovery following 'the Great Recession.' As such, I expect normal ups and downs, but with an upward bias from this point forward, for a minimum of two years.

I feel that the 'easy money' was already earned, as panicked investors finally recognized that the sky was not falling and in the process drove the S&P up 37% in under two months. On October 23, 2008 I issued a Market Alert (http://www.mallardadvisors.com/files/081023%20Market%20Alert.pdf). In it I noted that I was boosting the stock allocation for my IRA and Pam's from the 'normal' level of 70% up to almost 100%. I am beginning to cut that back, and I expect to continue to cut it back towards the long-term 70% level as the stock market recovery continues, and as investors become more rational.

The Market Review & Outlook (posted at http://www.mallardadvisors.com/files/090709%20Market%20Review%20Insert.pdf) includes my recommendations for investors bonds and stocks. For bonds I continue to feel that corporate bonds provide superior risk/return characteristics than Treasury bonds, and I prefer bond funds that minimize their government bond holdings. For non-core bond holdings (which I typically limit to 20% of client's bond allocations), I have been pleased with the returns that high-yield bonds have provided in the past six months, and so at this time recommend taking profits from high-yields, and return to primarily using 'multi-sector' bond funds rather than only high-yield bonds for non-core bond holdings.

For stocks I have made a fairly significant shift. I now recommend that 40% of clients stocks be invested beyond the US, through foreign stocks, global and international stock funds. This is a

7% boost from the prior 33% level. For a client with 60% allocated to stocks, I therefore recommend that 36% be invested in US stocks and 24% in foreign stocks.

I made this change based on my conviction that a growing proportion of global growth continues to come from abroad, and that a US-centric approach limits investment results. I recognize that volatility is typically higher overseas, and that in the past ten or so years, foreign stocks have failed to provide diversification benefits during downturns. I am making the change based on my expectations that good times will be better with foreign stocks than with US stocks, and that bad times will be similar.

Value stocks have taken a beating during the past year, as this grouping of stocks included most financials and housing companies. As a result, many investors have seen their allocation to value stocks shrink and their allocation to growth stocks rise. I recommend making a conscious decision on your growth:value balance. Over the long-term, I favor value stocks, and at this time I recommend that you at least maintain an even balance, between value and growth stocks.

Smaller US stocks fell more than large ones, and smaller US stocks have been rebounding higher than large ones. Again I recommend that each investor be intentional with their allocation to large, mid-cap, and small-cap stocks. I expect that mid-cap and small-cap stocks are more likely to outperform large caps during the economic recovery, however I expect that large-cap US stocks will provide a smoother ride.

Closing Thoughts

You don't fly a plane without a flight plan, and you shouldn't manage an investment portfolio without a plan, either. The Great Recession that we have been suffering has tested portfolios, both those with and without plans. The foundations have been shaken, and investors have been tested. Our portfolios and our economy, are far different than three and six months ago. As stocks are priced based on expectations for the future, where do you see the economy going in the future, and how do you plan to harness that through your portfolio's allocation?