Market Review and Outlook—October 7, 2009

Wow! Stocks chalked up their best quarter in over a decade. Despite beginning the year with losses of 10-20%, stocks now have year-to-date gains of 20-30%. Investors on the sidelines have missed one of the strongest rebounds in memory, while earning one-seventh of one percent on their money markets.

Are We Out of the Woods? Of course not! There are large problems remaining, including a massive budget deficit, rising unemployment, identifying proper regulation of the financial industry, winding down two ongoing wars, debating in DC on both health insurance reform and energy policy, and preventing inflation from steamrolling the country. Investors have come to accept a New Normal phase, in which consumers save more and spend less, and therefore companies will be less profitable than they have in the past.

What's Going On? Stock prices fell to absurd levels in early March, and the sharp rebound of more than 50% since then merely represents the reduction of the insanity. It is NOT the result of companies' profits jumping, nor of investors rushing to buy stocks. It is very noteworthy that bonds have returned more than 10% in the past year. <u>Here I see a new bubble forming</u>, and a fresh risk that investors need to monitor. When investors in the coming quarters, chasing yesterday's gains, move the hundreds of billions of dollars they had moved in the past year from their stock funds into their bond funds back into stocks, bond prices will fall. You heard it here first.

What to Do? Stocks are not overpriced, and value stocks in particular seem attractive, not only at low prices, but at relatively high dividend yields, greater than most municipal bonds, and some corporates. If your portfolio's allocation to stocks is sharply below long-term target levels, strongly consider starting now to close that gap—monthly, quarterly, whatever, but move it upward. Take profits from your bonds (especially high yield bonds and longer-term bonds), and reduce the risk by shifting to shorter maturities. When bond prices fall, return your bonds to a 'neutral position.'

The future remains very uncertain, however this is not the time to let your portfolio drift. There have been dramatic moves in both stocks and bonds in the past two years. Be intentional in preparing your portfolio for the future.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.03%	+0.76%	+2.92%	+2.85%	+2.79%
Intermediate Term Bond	+6.13%	+11.81%	+4.47%	+3.82%	+5.38%
Intermediate Muni Bond	+6.19%	+12.00%	+4.26%	+3.68%	+4.69%
Large-Cap Blend Stock	+15.59%	-5.46%	-5.13%	+1.22%	+0.69%
Mid-Cap Blend	+18.96%	-3.19%	-3.87%	+2.60%	+5.30%
Small-Cap Blend	+19.04%	-6.97%	-5.19%	+2.02%	+6.79%
International Stock	+18.75%	+1.06%	-3.95%	+5.78%	+2.52%
Real Estate	+32.45%	-25.86%	-13.42%	+0.36%	+8.85%
Natural Resources	+13.85%	-10.73%	+0.14%	+8.80%	+10.82%
Technology	+17.95%	+11.68%	+0.28%	+4.61%	-3.26%
Multi-Cap Growth	+15.50%	-2.56%	-3.46%	+2.33%	
Multi-Cap Value	+18.08%	-5.08%	-7.00%	+0.65%	
Conservative Allocation	+9.52%	+5.29%	+0.87%	+3.15%	+3.43%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center. Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

The past year and a half have been dizzying. So much has happened in every sector, and these events compel investors to carefully consider every corner of their portfolio. I will spend some time in each on this page.

Money Markets—Investors added over $600 billion to money markets in 2007 and again in 2008. This drove down yields to the current, near-zero level. Money markets serve three purposes—to provide income through their yield, to provide for withdrawals, both foreseen and unforeseen, and to provide a storage tank, for money that you want to shift to an attractive investment in the future (bonds, stocks, whatever). The yields mean that the first purpose is not currently being accomplished. However money markets are doing a fine job on their 2nd and 3rd purposes. Don't abandon money markets, but recognize that you will need to earn returns from the other areas of your portfolio for the near future. In the past year at Mallard, in addition to CDs, I have been using very short-term bond funds as a cash-alternative. This is not risk-free, as money markets and CDs are (almost), however I feel that the higher yield provide sufficient cushion to justify the modest risk level.

Bonds—Bonds come in many styles—municipal, federal government, corporate, high yield, foreign (which itself has several subtypes), and inflation-linked. As a group, bond funds have enjoyed a net inflow this year of over $200 billion. This has driven up prices and returns, but driven down yields, and this has setup the overall bond market for upcoming disappointments. We were very active with our bonds in the past year, cutting our use of government bonds and shifting to corporate bonds, and building up a modest position in high yield bonds. Both of these strategies paid off well this year, and we are unwinding them. We will be cutting the average maturity of our clients' bonds, using shorter-term bond funds than 'normal,' in order to reduce the risk of painful losses when bond yields rise.

US Stocks—While up more than 55% from March lows, US stocks remain 33% below their October 2007 highs. I consider US stocks to provide attractive value at this time. I have a preference for value stocks, due to the steadying influence of their dividends, and due to their poor results in the past few years (due to value funds' higher concentration of housing and financial stocks). The large/mid/small-cap horse race should continue, with little to help investors identify which will lead in the coming quarters. I suspect that large-cap US stocks will at least keep up with their smaller brethren, due to investors' tendency to start with the safer end of a range, when getting back into the market.

Foreign Stocks—While US stocks are down several percent in the past year, foreign stock funds are actually up 1%. Foreign small cap stocks are up almost 10%, and emerging markets stocks are actually up over 13% (due to representing stocks in countries whose economies which grew slower in the past year, but didn't actually shrink the way that most larger countries' economies did, including ours). Going forward, I will continue to spread clients' dollars amongst global stocks/funds, smaller company foreign stock funds, and emerging markets funds. Critically, this summer **we shifted our overall stock strategy to aim for a 60/40 split between clients' US and their foreign stocks**. Thus for a client with a 60% allocation to stocks, we would target 36% of the portfolio to US stocks and 24% to foreign stocks.

Inflation—Inflation worries have been in the headlines for months. How should you position your portfolio for future inflation? Critically, while inflation is a serious concern, it seems clear that it will take more than two years for painful inflation to appear in the US. This is due to the depressed level of consumer activity, which is partially due to the high and rising level of unemployment. <u>Without consumers chasing products and services, prices simply can't rise</u>. Rising inflation requires a recovered consumer sentiment, which appears two years or more down the road.

In the past, money markets barely keep up with inflation, and you never get ahead of it. Normal bonds are hurt the most by rising inflation, since bond's interest income is set and fails to rise as inflation ticks upward. There are special types of bonds whose interest income is dynamic, and rises as inflation rises. The most common are TIPS, Treasury Inflation Protected Securities. I have used them in the past, however I am always careful to avoid overpaying for them. Currently a 10-year TIPS yield only 1.5% more than inflation, which I consider too low. When 10-year TIPS yields rise to 2.5% or higher, I expect to build up large TIPS positions in clients' portfolios. At this level, I remain on the sidelines.

Stocks often provide solid inflation protection, as companies are most often able to pass on their rising costs in the prices they charge for their products/services. More common inflation hedges (investments which protect investors from sharply rising inflation) are real estate, natural resource and commodity stocks/funds and precious metal funds (up 34% in the past year), including gold. I use 5% as a neutral position in such inflation hedges. In times of high concern for inflation, I would lean to boosting that level towards 10%. I am currently building this up to a 5% level, and expect to boost it up from there in the future.