
LETTER FROM THE PORTFOLIO MANAGER

April 2009

Looking for Recovery

Searching for signs of a market recovery in five key areas



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Stocks began March by plunging to fresh twelve year lows, but the market finally found its footing, turned around and technically posted its quickest new “bull market” — as defined by a 20% gain — in decades. In the end, the S&P 500’s 8.8% return in March was its best monthly return since 2002 and its third best month in the last 15 years.

Is this really a new bull market? Is the coast finally clear? While we retain our optimistic long-term outlook, and feel that the current environment tends to be a better time to buy than to sell, we are not convinced that new lows are completely out of the picture.

For one thing, daily price volatility remains extremely high. High volatility usually means investor anxiety remains elevated and short-term market action could be choppy. Investor cash levels are also extremely high with investors still more willing to increase cash positions than equity positions. Also, we are about to begin the first quarter earnings season – and it is expected to be pretty ugly. These factors, among many others, could pressure prices lower. In other words, the big bear market may not be over yet.

When can we be sure that the market will ultimately recover?

The answer, of course, is that we never really know when the bottom has been established until well after the fact. There are signs to look for, however, that may give us some clues. In this report, I will look at five areas which we believe will offer some of the first clues of a recovery and address some of the factors we are monitoring in each area.

Area 1: Market Action

Broad Stock Market

Given that markets are fundamentally discounting mechanisms, they often lead the economy. In other words, stock prices will likely be higher, perhaps even significantly so, before we see similarly improved economic data. So in that respect, it makes sense to look at the market itself for the first clues that a recovery is underway.

While it seems fairly self-evident that we need to see higher stock prices for the market to establish a low that will stick, it goes a bit deeper than that. We are not just looking at the most recent direction of returns, but more importantly at the behavior of returns over time to spot a potential change in investor mood and action.

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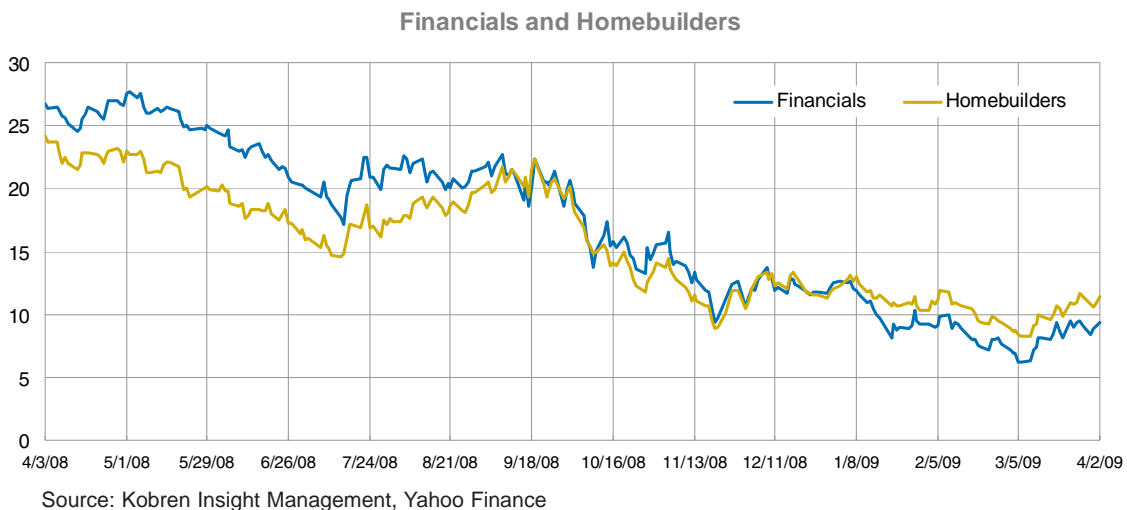


Looking at the chart of the S&P 500 above, we see that the current low in this cycle is 676, registered on March 9th. Going forward, we would like to see two things. First, during the next pullback, we do not set new lows (i.e., any decline stops above 676).

Second, in the next round of market strength, we would like to see prices close above the last notable high price of 934 (January 6th, 2009). Basically, we need the market to start hitting higher highs and higher lows instead of the reverse as we've been witnessing since late 2007.

Key Market Sectors

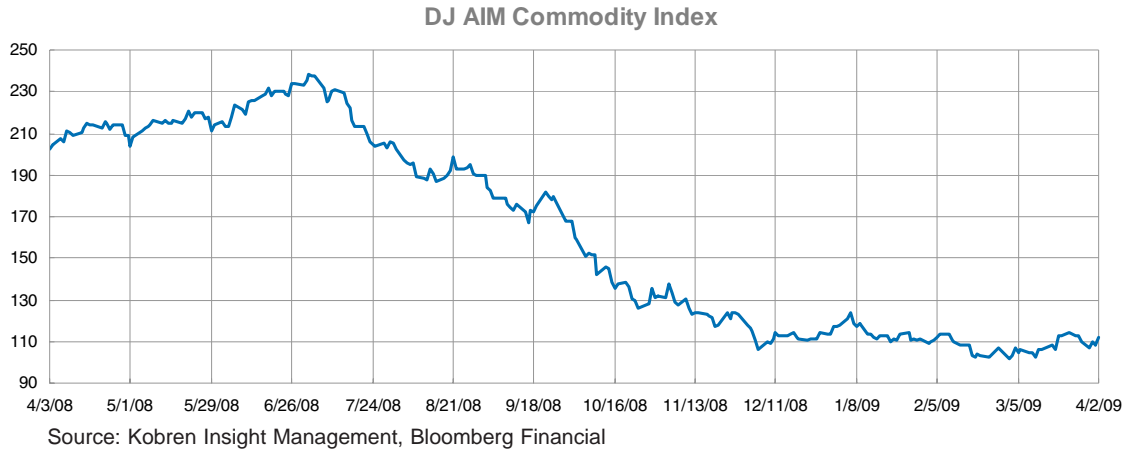
Beyond the behavior of the broad market, we will be watching the price action in the two sectors that led the market and economy into our current mess: financials and housing. As with the S&P,



despite impressive recent strength, we would really like to see a move to new highs on the year. At a minimum we will be satisfied if these two areas do not break to new lows.

Commodities

The commodity markets can also provide clues. First, higher commodity prices often suggest better economic growth. Second, higher commodity pricing could suggest percolating inflationary pressures. While we typically would not be encouraged by the latter, given current conditions, it would at least counteract some of our concern about deflationary pressures currently in the system. The market action seen in the commodities has been similar so far this year to the prior markets we've reviewed. Thus, what we're looking for is similar to what we would like to see in the other markets – that prices can stay above the prior lows and start to move above the prior highs.

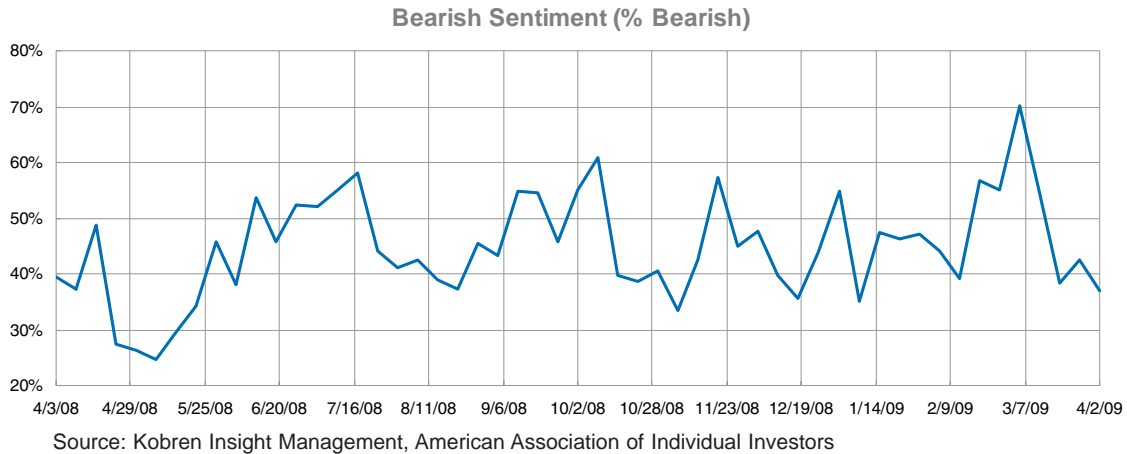


Within the overall commodity market, key individual commodity markets to monitor include copper (“the market with a PhD in Economics”), gold and energy.

Area 2: Sentiment

What Investors are Saying

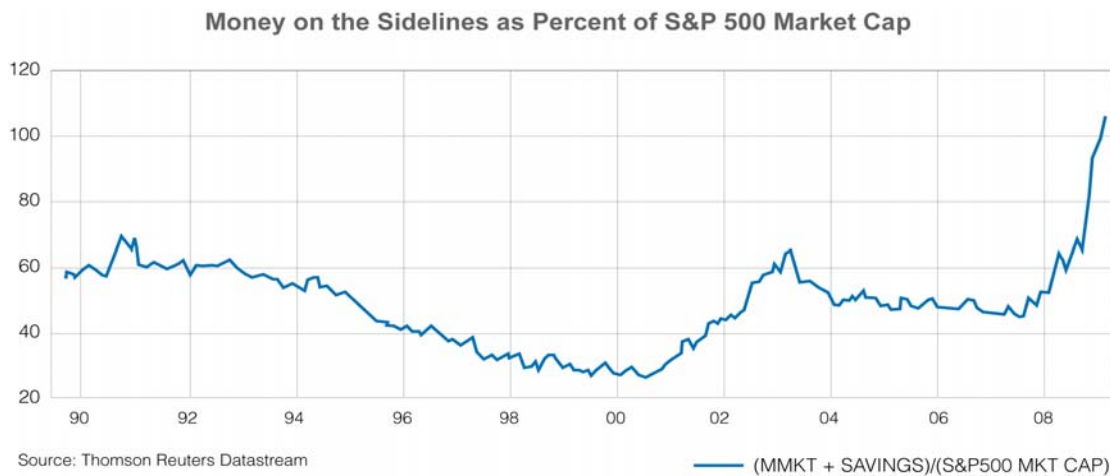
Last month, investors reached their most bearish sentiment levels yet in the current bear market, as the percentage of investors calling themselves bearish in the weekly survey by AAI reached an all-time high of 70%.



While these extreme readings are often a signal that a situation is ripe for market reversal, ideally one would like to see extreme levels start to moderate - which they did last month.

What Investors are Doing

What investors say and what they do are usually the same, but not always. In this case, investors have been bearish and to confirm, they have indeed been raising cash and dropping equity exposure. Below is a chart showing that cash levels are extraordinarily high. There are several ways this data has been presented, but all of them say the same thing – investors are extremely defensive.



This chart above is really fascinating. First, it truly captures how negative investors were in late 2008 - and still are. It also shows the tremendous buying power on the sidelines. What we would like to see is that cash being put back to work in the markets.

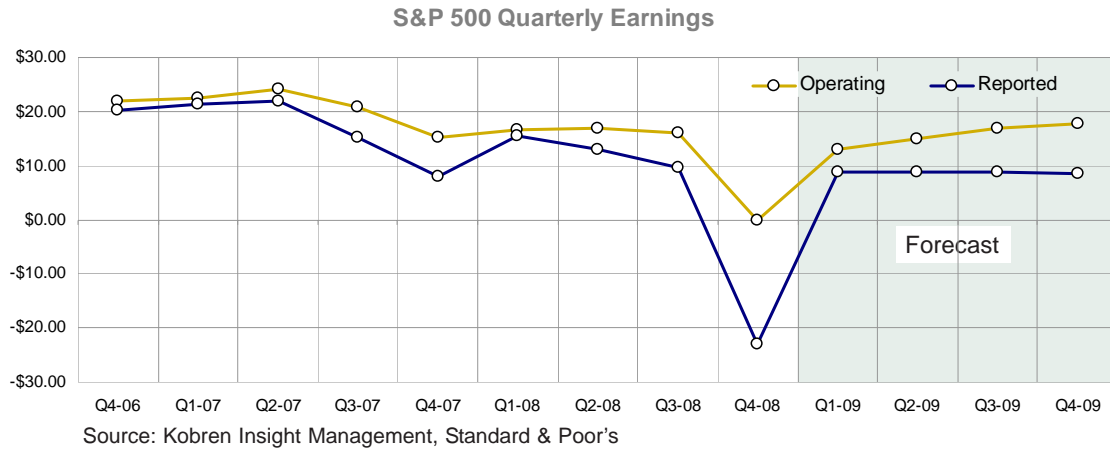
Area 3: The Economy

Earnings

The earnings environment over the last few quarters has been nothing short of historic – historically awful. Despite over 40% of the companies in the S&P 500 generating positive sales growth last year, and over 80% of the companies turning a profit, the net S&P earnings number for the fourth quarter of last year was actually negative.

This was primarily the result of a few firms that reported gigantic losses. Eighteen companies reported multi-billion dollar losses, with AIG alone accounting for approximately a third of the over-all earnings loss in the S&P. This has weighed heavily on the market. In short, we need to see improvement.

It is hard to imagine we won't see improvement in the year ahead. The comparisons should be – one would think – very easy to beat. To prove that point, despite massive negative guidance

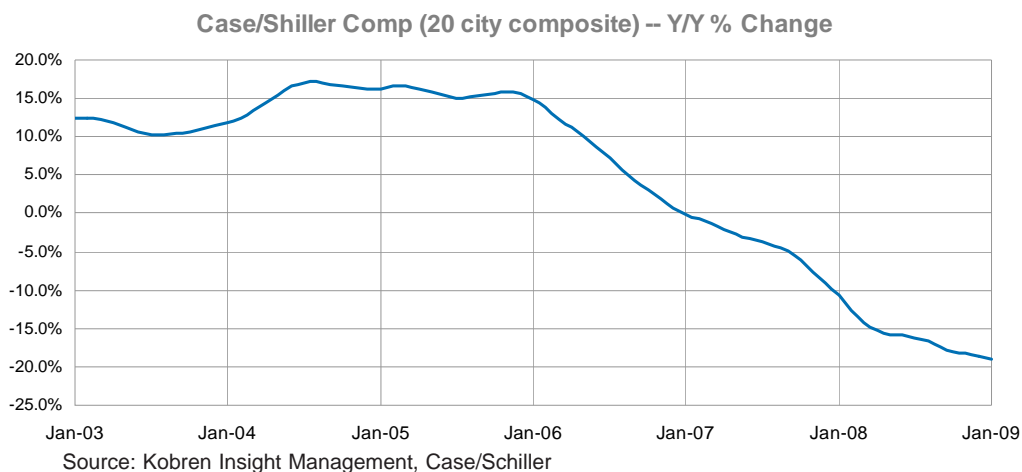


lower for 2009, the consensus expectation is that operating earnings growth in 2009 will be nearly 30% better than 2008 and that reported earnings growth will more than double! With growth rates like that, the market is likely to approve.

It is also important to note that earnings projections tend to be too negative near economic troughs (and too optimistic near peaks). If we are indeed near a bottom in the economy, it's likely that earnings will actually come in better than currently expected, not worse. First things first though — we need to start seeing some of those companies at least hitting their expectations. While earnings for the first quarter should remain very weak, the key to watch for is how many companies at least match expectations.

Housing

It is said that the housing bubble got us into this mess and that it will have to lead us out. While the cause of the current recession and bear market could be debated, and will be in the years ahead, it's hard to debate against the positive importance of a stabilized housing market. We need to see housing prices stop falling.



Currently, the bleeding has not stopped. Prices are still falling, and until they find a temporary bottom, it's difficult to imagine a decisive end to the recession.

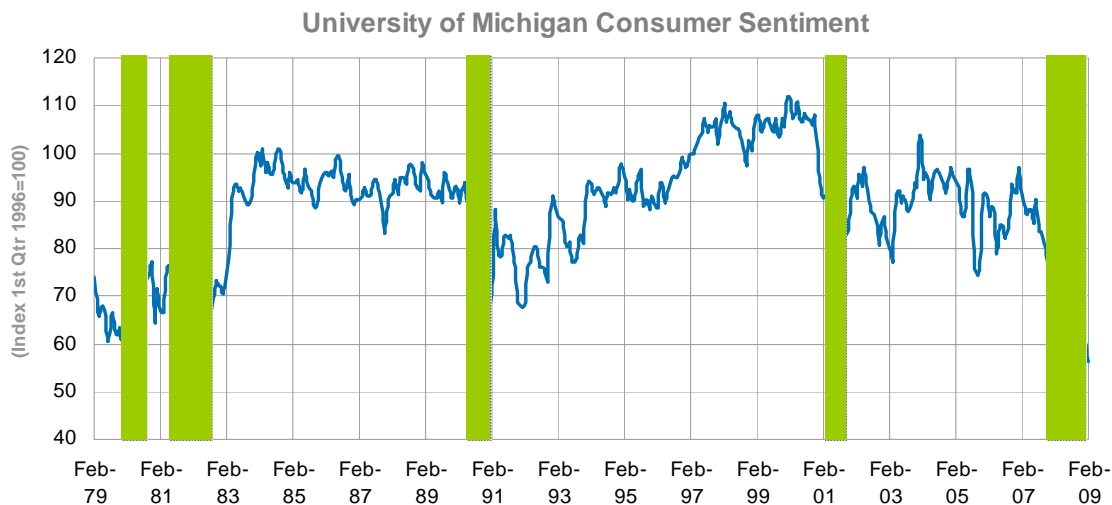
This noted, we do see some positives that suggest the bottom is near. Obviously affordability is attractive. Inventories are down. Sales are starting to improve. All we need now is for prices to improve. If prices improve, consumer net worth improves, and then consumer confidence improves.

Consumer Confidence

Consumer confidence is similar to investor sentiment in the way it moves and how it correlates to the economy and the stock market. Usually when people feel comfortable consuming, they are comfortable investing as well.

In short, as with investor sentiment, when consumer confidence is low, but beginning to rise, it is typically a very powerful and positive signal for the economy and markets.

At present, it's hard to convincingly say that we've seen the lowest levels we'll see in consumer confidence, though it would be reasonable to think that the bottom is near. Now, we just need to see some improvement.

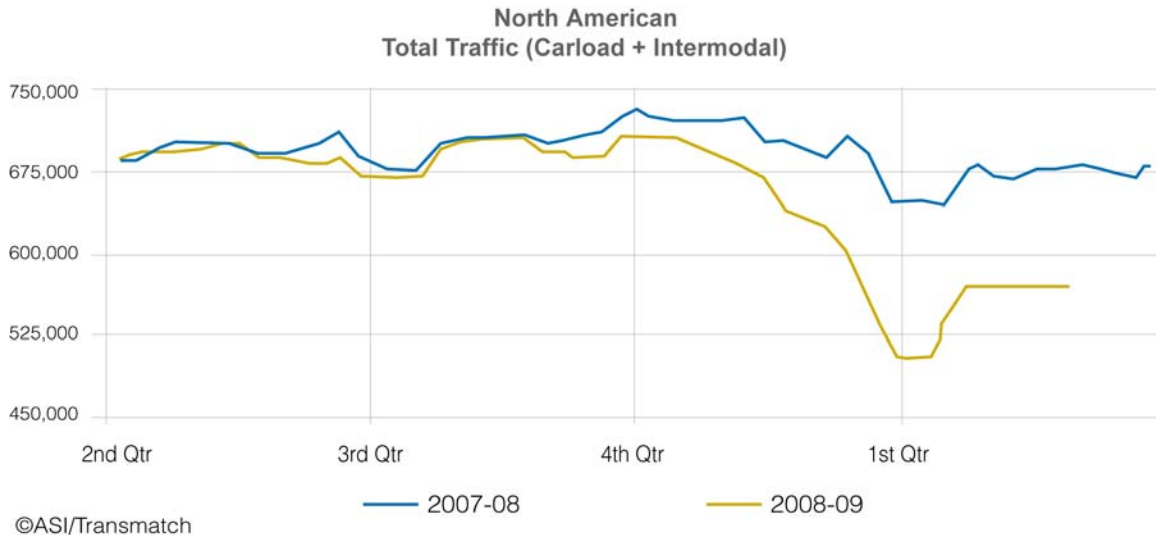


Source: University of Michigan; Shaded areas indicate recessions

Shipping

Another early warning signal is shipping; if production/sales are increasing those goods have to be shipped to markets/customers. One could look at overseas shipping, and trucking, or railway traffic here in the U.S. It seems to be a mixed read right now, though it does appear that the economy may have witnessed its worst late last year.

Let's look at railway shipping. Railroad traffic is clearly down quite a bit from last year. Yet, shipping appears to have bottomed months ago. Again, as with the other data series we're watching, we would like to see lows moving upwards and data improvement from current levels.



Area 4: Government Policy

Government policy has played a very large role in market direction in recent months. Regrettably, most of it has been negative. While it can be argued the stimulus packages are too big, or not big enough, the bigger problem early on was that there weren't enough details. The various programs needed to be introduced and explained so that people could assess and act. While all the details are still not out, there are now hopefully enough pieces of the puzzle on the table. Some of these include:

Market Liquidity Programs

- The Treasury, Federal Reserve and FDIC all have plans which have attempted to maintain a properly working market place – many officials have looked to instill confidence (both consumer and corporate) in the market place.

Asset Repurchase Programs

- TARP, TALF and PPIP plans are targeted as removing assets from bank balance sheets to which the market is not providing liquidity at this time.

Bank recapitalization programs

- Many large banks have received billions in capital injections – government has effectively taken a stake in many of the nation's largest banks.

Accounting Rules

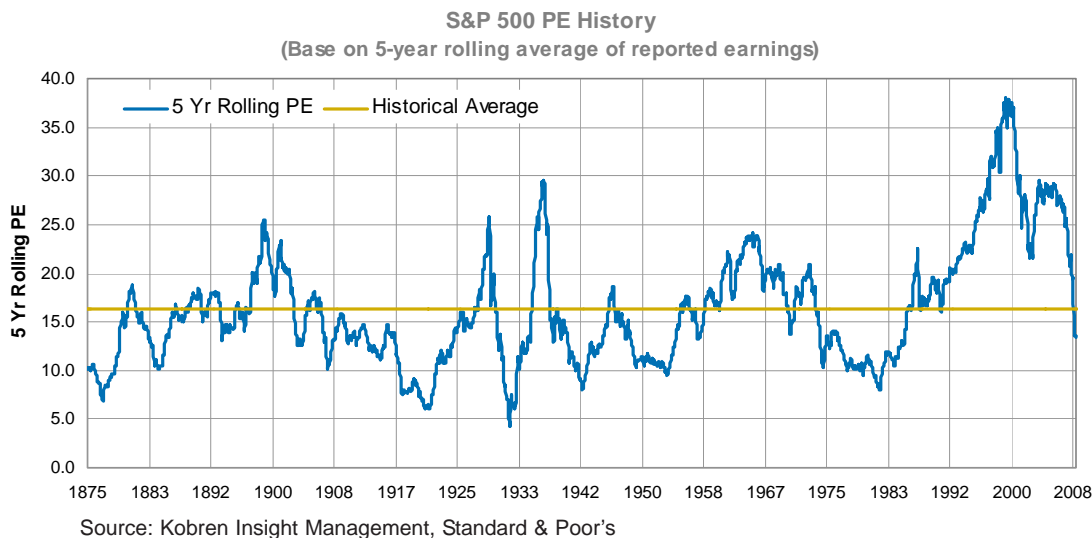
- FASB to revisit up-tick and market-to-market rules this spring – markets would likely have a positive reaction to any form of rescinding of these rules.

Area 5: Valuations

Valuations are not necessarily a short-term signal we’re focusing on, because quite frankly, while valuations appear to have a modest ability to predict returns over a one-year time frame, they are more effective at suggesting what 5- and 10-year returns might look like. In short, they look positive.

Price/Earnings Ratio (P/E)

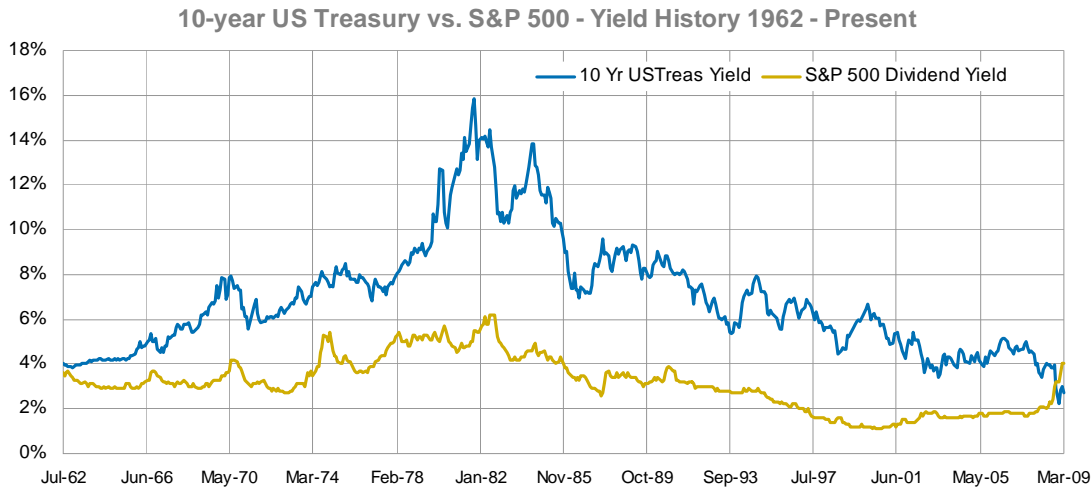
First, let’s look at a five-year normalized price/earnings ratio. We like to use a 5-year period as it helps smooth out the impact of the business cycle and provides a smoother signal. This is especially the case given the negative earnings in the fourth quarter.



In short, valuations are the lowest they have been since the early 1980s and approximately 40% below their 50-year average.

Dividend Yields

Next, we can look at dividend yields. In an absolute sense, dividend yields are the highest they have been in nearly 20 years. What makes yields even more attractive is that this is the first time they have been higher than Treasury yields since the 1950s.



Source: Kobren Insight Management, Bloomberg Financial

Summary

What the market accomplished in the last half of March was impressive. More than anything, it provided some relief from the constant pounding of market losses earlier in the year. Nonetheless, the market is still down for 2009, and we should assume that none of us are out of the woods yet. Still, there are some encouraging signs that the worst is finally behind us.

For the longer-term investor, however, whether we hit new lows or not, the current environment remains very attractive for maintaining, or adding to, current equity positions. Is the current environment the buying opportunity of a lifetime? Those are sensational words, but given the startling losses of the last year plus, it is not unreasonable to expect that the markets could generate very attractive returns in the years ahead.

Sincerely,

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Portfolio Manager