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LETTER FROM THE PORTFOLIO MANAGER

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Buy The Dip

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Key Points:

- *Many investors expect a repeat of last year's sell-off. While the markets always possess that possibility, we believe that this year is different.*
- *If the markets do correct this month, this should provide a fresh opportunity to "buy the dip" and add to existing equity positions.*
- *Investing in the health care sector might seem unattractive given all the current headlines and emotions, but the sector's expectations have been reduced enough that relative valuations are now attractive. Don't run and hide from this sector.*

Just over a year ago, my wife and I took our children on vacation and met our parents in the Black Hills of South Dakota. The weather was excellent, the crowds and traffic were surprisingly manageable, and the scenery was even better than I recalled from my own childhood visits. It was a great trip; at least it should have been.

At the time it was particularly difficult to truly escape from work. While that is nearly always the case these days given the advent of Blackberrys and laptops, last year's vacation was saddled with the additional concern of a potentially rough autumn for the markets. Even though the bear market and earnings recession were already qualified as mature by historical standards, and upcoming corporate earnings growth was expected to turn a corner in late 2008, there was considerable angst in the air, and for good reason. There was significant concern and chatter about the financial system, and the market was quickly approaching its most negative time of the year from a seasonal perspective. A few weeks later, of course, Lehman Brothers declared bankruptcy and the panic sell-off of 2008 began in earnest.

One year later, in many respects, it still feels like last year. At the very least it sounds like last year, depending on which voice you are listening to. For starters, there is no avoiding a collision with the month of September, which easily ranks as the worst performing calendar month of the year. It seems everyone knows of this seasonal factor these days. Second, concerns about the financial system still abound. Given these concerns (and more), and despite the strong gains of the last 6 months (the strongest 6 month rally in nearly 80 years), investor sentiment is as negative at the end of August this year as it was at the end of August last year. In fact, to many investors, there is even more reason for fear now than there was twelve months ago, and they have positioned their portfolios accordingly.

Nonetheless, while we recognize there are some legitimate concerns, we think that the worst is behind us, and any potential price weakness in the stock market should more likely be viewed as a fresh buying opportunity ("buy the dip") than a reason to abandon course.

Some Bad News

Let's get to some of the bad news first. Historically, September has been the worst month of the year for the stock market. Whether one wants to look at the last 20 years, 50 years or 100 years, September tends to have the highest likelihood of negativity and has the largest average loss. The Bespoke Investment Group examined

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data on the Dow Jones Industrials Index over the last 100 years and determined that the average loss has been just under 1% and the market has been negative 58% of the time. Why is September so foul? There are some potential reasons floating about, though none of them are entirely convincing. Some just write it off as a market superstition. Either way, the consistency of the market's September track record is something to note.

The offset to this, however, is that the rest of year tends to be pretty good for stocks. While there have clearly been some negative Octobers (last year was no exception), the fourth quarter of the calendar year tends to be the strongest quarter of the year for the stock market. In other words, September tends to be a good time to add to stock holdings.

More fundamentally, however, there are still legitimate concerns about the banking industry. Some of the statistics are indeed frightening. In 2009 so far, there are already 84 banks that have failed. This compares to 25 in 2008, and only 3 in 2007. Some analysts are projecting anywhere from 100 to 300 more banks to fail in the upcoming years, primarily due to concerns over commercial real estate.

Indeed, the FDIC has 416 banks (about 5% of all U.S. banks) on their "problem list," which is up from 305 from the first quarter of this year. How does a bank get on the problem list, and what are the chances that they will fail once they make that list? To get on the list, banks must be considered to have significant deficiencies in some aspect of their business that may threaten their survival. The list is published quarterly, though names are not actually listed. It is interesting to note that historically 13% of the banks (according to a 2007 study) on the list eventually go broke. That would suggest another 50+ banks are in trouble. Not quite as bad as some of the bears in the press are stating, and perhaps even more evidence that the worst is actually behind us.

Nonetheless, while another 50 bank failures is still serious, especially for those communities that they serve, does that necessarily mean more pressure on the stock market? On this measure, it's important to remember that the stock market is a discounting mechanism that is forward-looking, while headlines of bankruptcies tend to lag the economy. Even the Federal Deposit Insurance Corporation (FDIC) Chairman Sheila Bair recently said: "Banking industry performance is, as always, a lagging indicator."

It is also important to note, that this current pace of financial institution bankruptcies is still a far cry from the saving and loans crisis of the early 1990s when thousands of financial institutions actually closed down. However, the early 1990s wasn't a bad time to buy stocks either. Though the S&P suffered a loss in 1990, if someone had purchased the index at the end of that year, they would have earned an above-average stock market return over the following 1, 3, 5 and 10 years.

Some Good News

Given the negative news in banking and September's ugly history, it should not be a surprise to know that individual investor sentiment (according to the American Association of Individual Investors) at the end of August was back at bearish extremes. Many investors feel as if they have seen this story before. As the saying goes, "Fool me once, shame on you; fool me twice, shame on me."

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This can partly be explained by a concept from the increasingly popular school of thought in finance called Behavioral Finance (BF). Essentially, BF is a study of how investors make decisions, and how those decisions impact security pricing. A key point of behavioral finance is that investors are human and aren't always rational. We all know that feeling!

There are many behavioral biases that have been identified, but one relevant to the current situation is called the "recency effect." This basically states that investors tend to overemphasize the probability that a recent market event will repeat itself. Dramatic events, such as sharp bear or bull markets, tend to stick in investor's minds. Last year's panic sell-off that spilled over into this year is one of those events that many of us won't forget for a long time.

As a result of the recent bear market, punctuated by the fright and price declines of the accelerated sell-off last fall, are many investors now overstating the likelihood that another dramatic sell-off could happen? *While a sharp correction should always be considered,* we think there are many key differences this year from last year and that the stock market will likely continue surprising many investors to the upside before the year is over.

A big difference between this year and last is that we are now on the other side of the maelstrom of conjecture regarding what would happen next with major financial firms such as Fannie Mae, Lehman Brothers, and AIG. A plan was eventually put into place, and whether or not investors liked the government's response (few did), a level of stability was finally achieved.

Other factors point to the differences this year, including liquidity being restored, instead of removed. The fixed income markets, which were an early indictor of upcoming financial market stress last year, are now behaving and have already returned to pre-Lehman bankruptcy levels. Accounting rules on mark-to-market accounting, which were implemented in late 2007 and arguably amplified financial firm's losses at the worst possible time, were modified back in March of this year. Also, prices and valuations are now more attractive; prices are still off over 20% in the broad market from a year ago, prices in the financial sector are down over 30% from year-ago levels, and valuations for the S&P using normalized earnings have contracted nearly 25%. In addition, short-term interest rates are much lower, essentially yielding only a bit more than 0%. Economic and earnings data appear to be on the mend. In sum, many of the concerns from last year have been alleviated.

Another positive factor for the market is that investor sentiment and allocations remain quite defensive. There is still a mountain of cash sitting on the sidelines in money market accounts — that is earning virtually nothing. With the economy and markets behaving better, cash is finally starting to be re-invested, but it is coming back slowly. In fact, there is still approximately $3.4 trillion in combined retail and institutional money market accounts, which isn't far from the combined $3.6 trillion that peaked back in March of this year. Not only was this an absolute record for money market holdings, but it was also the first time in over 15 years that money market assets exceeded assets in equity mutual funds (only two years ago, at the peak of the market, assets in equity funds tripled those in money market funds). In short, this is an incredible amount of buying power which should provide a powerful tailwind for the stock market as it gradually moves out in search of potentially higher returns.

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What About Health Care?

One sector that has generated a lot of press and emotion of late has been the health care sector. It is indeed an important issue and debate.

What is an investor to do? Many feel that simply avoiding the sector due to political concerns is the best course of action. Many are avoiding the sector because it has been one of the worst performing sectors over the last six months. Historically, health care also tends to be the worst performing sector 6-12 months into a new bull market. Putting it all together, it looks like an easy decision to underweight (health care makes up a bit less than 1/8th of the over-all stock market capitalization) the sector, if not just outright avoid it. However, we wouldn't recommend doing so. While we recognize the poor momentum, we also recognize some attractive fundamental characteristics, including valuations.

From a valuation standpoint, health care is attractive. Looking at price/earning ratios, the sector has typically traded at a 20%+ premium to the S&P the bulk of this decade, but is now at a 20% discount. Health care also has the lowest price/earnings ratio among all economic sectors using expected 2009 earnings – and nearly the lowest (the utility sector has a slightly lower expected P/E) using expected 2010 earnings.

Political concerns are a big reason why valuations for health care have become attractive, but not because of earnings. Health care was one of the few sectors that had earnings growth in 2008 and it is expected to have one of the higher growth rates in 2009. Additionally, examining expected earnings through the third quarter of this year, health care is expected to comprise approximately 26% of the S&P's total earnings over the past twelve months. Even factoring in a better economy, health care is still expected to make up 17% of the S&P's earnings in 2010.

In sum, expectations are beat down for the health care sector. That is not a bad thing, as low expectations usually creates attractive relative valuations and sets the stage for relative outperformance moving forward. Once again, we would not avoid the sector.

Summary

Our bias continues to be better buyers than sellers of the stock market. While valuations have expanded considerably since March, they are still in the ballpark of being "fair" and in a position to provide returns similar to what stocks have generated over the last 100 years instead of the last ten. In addition, stocks are more attractive than usual versus other asset classes such as Treasury bonds, and particularly relative to money markets given their current yields. Lastly, on an expected real return (i.e., after inflation) basis, stocks also look more attractive than normal given current market-based inflation expectations.

Still, one may ask, if September is likely to play to historical form, then why not just make a dramatic move now and significantly raise cash? In short, it is not that easy to do. If over the last two decades we sold stocks every time we thought they would be lower, it is more likely we would have generated lower returns – and higher tax bills! To re-iterate this point, we quote from Warren Buffett and his oft-men-

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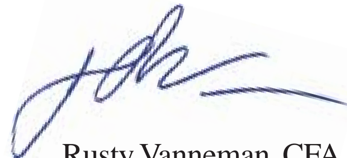
tioned op-ed in the New York Times last fall: *"Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: 'I skate to where the puck is going to be, not to where it has been.'"*

Instead, price weakness may create a fresh opportunity to add to our stock market positions. Of course, there are always other variables that we will monitor and evaluate, including the movement of interest rates and commodity prices, but all else being equal, lower prices should create more attractive valuations.

Sincerely,



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