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US stocks continued their strong advance from spring lows, posting a +15% return in the third quarter. The S&P 500 is now up over +55% from its low on March 9, 2009. Some investors have taken these gains as evidence that the bear market is behind us and economic recovery lies ahead. But as we penned in a recent editorial for the Fort Wayne Business Weekly (“Market Rally May Not Really Reflect a Recovery,” October 2-8, 2009), using the stock market as an indication that the economy is healing and therefore stocks should advance further is a dangerous case of circular reasoning. The table below shows pronounced stock market rallies that occurred in the midst of continuing bear markets (Dow Jones Industrial Average):

Beginning Date	Ending Date	Duration in Months	Rally's % Gain	Subsequent % Loss
Nov-29	Apr-30	4.8	46.7%	-86.0%
Dec-30	Feb-31	2.3	22.8%	-78.9%
Jun-31	Jun-31	0.8	25.2%	-73.4%
Oct-31	Nov-31	1.1	36.0%	-65.0%
Jul-32	Sep-32	2.0	93.9%	-37.2%
Mar-01	May-01	2.0	20.8%	-35.7%
Sep-01	Mar-02	5.9	29.1%	-31.5%
<i>Mar-09</i>	<i>Sep-09</i>	<i>6.3</i>	<i>50.0%</i>	<i>?</i>

We are not fully convinced that the problems that plagued the economy last fall have been fully remedied. Residential real estate markets are not out of the woods and commercial real estate markets may be just showing up to the “default party.” This, combined with relaxed accounting rules that will eventually reverse course, may once again put pressure on bank balance sheets. A number of economists have forecasted a “jobless recovery.” But this recession may render that term an oxymoron; increasing levels of unemployment could continue to push up foreclosure rates and delay the debt-driven purchases (cars, houses, etc.) that usually pull economic growth back to its trend.

Investors need to be weary of letting economic concerns dominate investment decision-making though. Warren Buffett spoke to this point in his 2008 letter to Berkshire Hathaway shareholders:

We’re certain, for example, that the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall.

Economic fundamentals could be horrific, but if investors price even more dire economic assumptions into investment securities than potential investment rewards could still be large. A study of history exhibits periods of economic underperformance coupled with stock market outperformance and vice versa. Unfortunately, we believe that the strong rebound in domestic equity markets has taken most stocks to levels that don’t grant investors a reasonable margin of safety. Based upon various models we employ to measure the valuation of the equity market, stocks are not currently priced for stellar returns over the next 7-10 years.

Because we remain cautious towards the economy and feel that current stock prices are not cheap, we have used the recent rebound in domestic equity prices to reduce some of our stock market exposure. But we will not make absolute, wholesale shifts away from equities at current valuations for several reasons:

- We may turn out to have been overly pessimistic on the economy. While we think the odds are stacked against a strong and quick recovery, some analysts that we admire think otherwise. Usually, a recession as deep and painful as this one is followed by a strong recovery as pent-up consumer demand fuels subsequent consumption.
- Stocks are not cheap, but that does not preclude further market advances. Valuation levels in the early 1990's were close to today's levels. At that time, the US was recovering from a crisis similar in nature (though not proportion) to today's crisis, resulting from the meltdown of real estate markets and the widespread failure of Savings and Loans institutions. If investors had decided to exit the U.S. stock market, they would have missed the greatest bull market of all time. We obviously do not believe that a replay of the 1990's is likely, but we do not rule out a further market advance. While stocks may not be cheap, they are not yet expensive.
- As a whole, the current valuation of the stock market isn't overly compelling, but there exists "deviations around the mean." As bottom-up analysts, we look for companies that are trading at prices below their intrinsic value and we have been purchasers of some securities that fit the bill during the past quarter. As the market has risen, the percentage of companies trading significantly below their intrinsic value has decreased, but there still remain suitable issues for value-conscious investors. The attractiveness of large capitalization, high quality blue-chips are of particular note. Jeremy Grantham, a well-known value investor, forecasts annual real returns (net of inflation) for US equities of 2.5-4.6% over the next seven years, in-line with our internal forecasts. He expects that US high quality stocks, however, will return real rates between 10-12%. These higher quality stocks often carry lower risk profiles and above-average dividend yields. Some blue-chip names are trading at their lowest valuation level in years and are only slightly above their bear market lows.
- We still like emerging market stocks long-term and will continue to build exposure there over time by allocating resources from equities in developed nations to equities in emerging markets.

Stocks grabbed all of the headlines during the quarter, but bonds also posted respectable returns. Intermediate-term bonds posted a +1.62% return in the third quarter as measured by the Citigroup 1-10 Year Treasury Bond Index. Current interest rates remain depressed, though. The yield on 30-year U.S. Treasuries recently dipped back below 4.0%. For our part, we have no plans to lock in such low nominal rates over such a long period of time. Recent increases in the country's monetary supply coupled with deteriorating structural fundamentals in the US fiscal deficit greatly increase the long-term threat of inflation.

But inflation requires that consumers begin to cycle through money quicker, banks lend out excess cash and the unemployment rate revert back to more normal levels. While short term commodity shocks or shifts towards protectionist policies could pressure domestic prices, inflation is likely at least a few years away. Deflation, or a falling price level, remains the chief concern. Accordingly, while we won't go out too far in the maturity curve, we won't stay too short either. Japan faced a crisis strikingly similar to the US in the early 1990's, which included a ballooning federal deficit and faltering banking system. The "Lost Decade" that followed witnessed continuing bouts of deflation and short-term interest rates that remained near 0%. Japanese investors who continually rolled over 6-month CD's were penalized.

Given our cautious long-term return forecasts for US equities and depressed yield levels on bond instruments, we have continued to build exposure to alternative assets. We expect the bulk of our investments in this space to be relatively uncorrelated to stocks and bonds and to post more-than-competitive rates of return going forward. Alternative investments represent a multitude of strategies. We generally describe the space as "not stocks or bonds." It includes more recognized investments like commodities, gold and real estate, as well as more complex strategies such as hedged equity, global macroeconomic fixed income, arbitrage and distressed debt investing. While these strategies can be difficult to explain, their inclusion in investment portfolios helps decrease risk and increase expected return.

Despite market gains over the last two quarters, we are not growing complacent. We do not view a return to March's stock market lows as probable, but we will not rule out another significant market decline. We feel confident though that our portfolios are well positioned for a range of possible market outcomes. We once again thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict