# Q3 2009 Quarterly Investment Commentary

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After the rough markets a year ago that kept hurting well into this last winter, spring brought a solid revival to investors. While summer has frequently been an unexciting time in the markets (Sell in May and go away), this year's good weather provided a solid follow on to the turn initiated in spring. With the end of the U.S. recession and the beginning of at least a mild recovery, we are even seeing those gains extend into the fall, with positive returns thus far in October.

## Third Quarter Market Performance

**September Benchmark Returns (Preliminary)**

| Large-Cap Benchmarks | Sep | 3Q | YTD |
|---|---|---|---|
| Vanguard 500 Index | 3.7% | 15.6% | 19.3% |
| Russell 1000 iShares | 4.0% | 16.0% | 21.0% |
| Russell 1000 Growth iShares | 4.2% | 13.9% | 26.9% |
| Russell 1000 Value iShares | 3.8% | 18.2% | 14.8% |
| **Mid-Cap Benchmarks** | | | |
| Russell Midcap iShares | 5.6% | 20.6% | 32.5% |
| Russell Midcap Growth iShares | 5.7% | 17.5% | 36.9% |
| Russell Midcap Value iShares | 5.6% | 23.5% | 27.4% |
| **Small-Cap Benchmarks** | | | |
| Russell 2000 iShares | 5.8% | 19.2% | 22.4% |
| Russell 2000 Growth iShares | 6.5% | 15.9% | 29.1% |
| Russell 2000 Value iShares | 5.0% | 22.6% | 16.3% |
| **Other Benchmarks** | | | |
| Vanguard Total Int'l Stock Index | 5.2% | 19.7% | 32.5% |
| Vanguard Emerging Mkt Stock Index | 9.3% | 21.1% | 62.6% |
| Vanguard REIT Index | 6.7% | 34.6% | 18.8% |
| Vanguard Total Bond Mkt Index | 1.2% | 3.7% | 5.9% |
| Merrill U.S. High Yield Cash Pay | 5.8% | 14.5% | 47.7% |
| Barclays 7 Yr Muni Bond Index | 2.3% | 5.1% | 8.3% |
| Citigroup World Govt. Bond Index | 2.3% | 6.2% | 4.6% |
| JPMorgan ELMI+ | 3.3% | 8.6% | 18.6% |
| DJ-UBSCI (Commodity Futures) | 1.6% | 4.2% | 9.0% |

Markets surged this summer as initial signs of an economic recovery emerged. The S&P 500 stock index fund gained 15.6% last quarter. Large value stocks exceeded large growth by 4.3% while midcap stocks surged 20.6% and small cap returned a solid 19.2%. Emerging market equities had another strong quarter, rising 21.1%, while developed international gained 19.2%. Turning to fixed income, the intermediate-term, investment-grade Vanguard Total Bond Market Index Fund (representing the BarCap Aggregate Index) was up 3.7% for the quarter and is now up 5.9% to date in 2009. High-yield bonds, as measured by the Merrill Lynch U.S. High Yield Index, nearly matched the gains of domestic equities in the third quarter and their 47.7% year-to-date return is more than double that of the S&P 500 Index. Global Bonds also did well as the BarCap Global Bond Index increased by 6.2%.

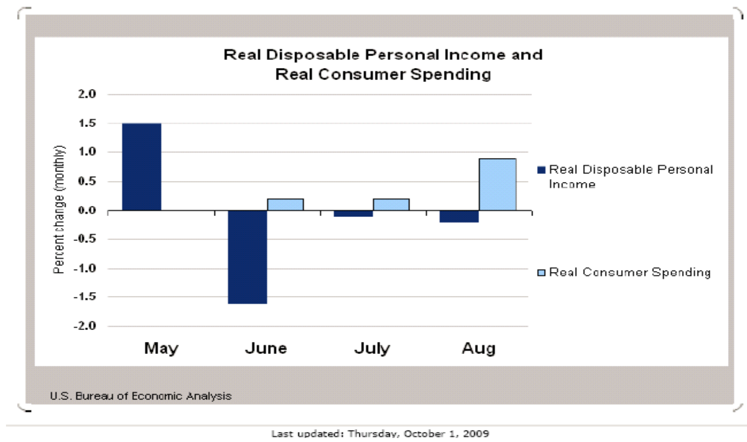
## The Economy

Evidence suggests the recession ended sometime this summer. There are several reasons for the improving near-term economic statistics and optimism, including a replenishment of business inventories, added spending by consumers, and continued worldwide governmental economic support.


*We've experienced the worst inventory draw down since the 1930s. The rebound from this will contribute to a burst of growth.*

Inventory replenishment: Businesses have been extremely slow to restock inventories due to this recession's large slowdown in consumer spending. In fact, inventories have been falling at record rates as shown in the chart below. At some point accelerated restocking will occur, which will bring back some of the idle capacity in the manufacturing base and generate job creation.

Consumer spending: Faced with the sharp declines in the value of homes and portfolios in 2008, consumers cut back their spending drastically in 2009's first quarter; the savings rate shot to 7% from less than zero. Even those still employed remain somewhat cautious in their spending through today. However, as markets have rebounded and an economic collapse has been averted, consumers have begun to increase their spending. The savings rate has declined back to 4% despite lower mortgage payments for those that have refinanced over the last 9 months. As can be seen in the graph below, consumer spending is rising at a faster rate than disposable income. While August was pulled higher by "cash for clunkers", the rising trend in consumer spending is there. While a solid recovery in consumer spending is not yet in place, retail spending is coming in stronger than many analysts had anticipated.




Government support: Governments around the globe have instituted unprecedented measures in an attempt to stimulate demand in their respective economies. In the US, programs such as "cash for clunkers", new home buyer tax credits, extended unemployment benefits, and the Federal Reserve's aggressive purchases of mortgages have all been implemented and positively influenced the economy. Central bank actions worldwide have provided massive injections of liquidity to backstop their financial institutions, while additional support has been provided to various private U.S. companies such as GM and Chrysler. Fiscal stimulus measures have been instituted by most of the major economies worldwide, including China's large program to increase spending and investments within their borders.

Whether or not these governmental measures, consumer purchases, and business actions have jump started self-sustaining economic growth is yet to be seen. Though these are all good signs, it does not mean that we are assured a lengthy period of robust growth that will quickly return the economy back to its long-term growth trend line and support a sustained bull market for stocks. The areas of concern we highlighted last quarter remain:

Housing: On the positive side, conditions have improved as the Case-Shiller Housing Index rose the past three months in 18 of the 20 markets where it is tracked. Prices are beginning to rise in many areas as investors are buying properties and inventories are beginning to recede somewhat. Mortgage rates at historically low levels along with the significant house price drops have made home affordability quite high. Some unique issues temper this positive news, however. The Federal Reserve's substantial purchases of Mortgage Backed Securities have helped drive down mortgage rates, and those purchases will end within six to nine months. Mortgage rates will rise in the future. A foreclosure moratorium during this last spring has ended, with an increased level of defaults expected; about 1/3 of properties are worth less than their mortgages. With more foreclosures, more homes will come onto the market and potentially lead to further price declines. Finally, seasonal factors tend to increase home prices during the spring and summer while leveling or dropping them during the late fall and winter. As we come into this winter, some housing experts believe prices will begin declining again, with a final bottoming in prices towards the middle of 2010.

Employment: Layoff notices have slowed over the past few months, but unemployment and underemployment remain stubbornly high (over 16% of workers are underemployed and unemployment duration is at 25 weeks, a record high dating back to 1948). Business owners have been reluctant to hire, with 26% telling McKinsey & Co. that they expected to decrease their head count while 48% are expecting to maintain current employment levels. Given such sentiments, an improvement in unemployment is likely to be slow to come; we anticipate hearing the words "jobless recovery" many times over the coming 12 months.

## Market Recovery and Portfolio Positioning

From September 15, 2008 (the day Lehman Brothers declared bankruptcy), to the market low on March 9, 2009, the S&P 500 fell by -42.6%. From this low the index has increased by 53.2% through September 30, a dramatic recovery. What is important to note, however, is that a drop of -42.6%, followed by a gain of 53.2%, still leaves investors down almost 13%. This computation is one of the fundamental underpinnings to our strategy of risk management and our work to diligently diversify and protect portfolio value.

We have developed a systematic process of blended tilts to improve the effectiveness of our actions for the sake of both moderating risk and generating net of fee returns. In almost every asset class, Opes portfolios contain both an active manager and a lower cost Exchange Traded Fund (ETF) or index fund. We strongly believe that good active managers add value, and that when market volatility is high, they have the expertise and strategies to cull out poorly performing companies and buy better ones. In 2008 the markets penalized many good companies and good managers, but during the recent market advances, those few good active managers have more than recovered. Other managers performed relatively well during the downturn, protecting value relative to their respective benchmarks. While their focus on good quality companies helped them in the downturn, they have lagged during the subsequent recovery. Following is a composite of these two types of managers, both adding value over time but doing so at different times and in different ways.

| | | |
|---|---|---|
| **Underperforming managers have rebounded sharply<br>Composite of Managers that Underperformed in 2008** | | |
| | **2008** | **2009 (through 9/30** |
| | Underperformance | Outperformance |
| | to Relative Index | to Relative Index |
| Manager Composite | **-6.44%** | **17.17%** |
| | | |
| | | |
| **"Defensive" managers outperform in weak markets, underperform during strong recoveries<br>Composite of Managers that Outperformed in 2008** | | |
| | | |
| | **2008** | **2009 (through 9/30** |
| | Outperformance | UnderPerformance |
| | to Relative Index | to Relative Index |
| Manager Composite | **15.00%** | **-17.70%** |

We have added three new money managers in our U.S. fixed income allocations and two in our global fixed allocation. We are widely diversified, minimizing our exposure to Treasury bonds while adding to agency mortgages (Government guaranteed), high grade corporate bonds, high yield bonds, general international bonds, and emerging market focused fixed income. We have strengthened our fixed income research and more broadly diversified our managers and strategies in order to protect value with core holdings while opportunistically taking positions in specific bond sectors that have higher return potential.

As we look forward, the market recovery has surprised even the most bullish investors (those who anticipated a robust V-shaped economic recovery). As noted above, we think a recovery is underway, but note the continued risks to that expansion as Government programs are reduced or eliminated. Both consumer and Government spending are facing major transitions and we are not confident about how those transitions will be handled. As a result, we are maintaining our more conservative tactical allocation we recently implemented. Should the markets falter or flatten for the next couple of quarters, our stand for protecting value will be additive to relative performance after the strong returns of this year's first nine months.  However, we also note that should the market continue to advance strongly, our results will likely lag their indexes on a relative basis.  In such a scenario, of course, we would expect strong absolute returns adding to this year's surprisingly positive results. Given the good relative and absolute performance of our clients' portfolios so far this year, we consider this slightly defensive stand prudent and necessary as we face these extensive economic transitions.