September 23, 2009

Market Commentary and Review

""It is not the strongest species that survive, nor the most intelligent, but the ones most responsive to change."
- Charles Darwin

SUMMARY:

The bond and equity markets have recovered most, but not all of their pre-crisis levels. They reflect a growing conviction that the economy is recovering.

Stocks may be overbought on a short-term basis, but valuation is still attractive and a cyclical peak is unlikely.

Tax planning is going to be a mess for the next year or two.

We reminisce about the tumultuous year just past.

In This Letter

Dear Clients and Friends,

What a roller coaster! It is worth beginning by summarizing returns for recent periods to show the dramatic swings:

	4th Qtr 2008	1st Qtr 2009	2nd Qtr 2009	3rd Qtr 2009*
Large Cap (S&P 500)	-21.6	-11.2	16.3	16.6
Mid Cap (S&P 400)	-25.9	-8.5	19.2	21.4
Small Cap (S&P 600)	-25.6	-17.0	22.4	20.6
Nasdaq 100	-23.5	+2.1	20.1	16.8
Foreign Stocks (EAFE)	-19.3	-16.2	24.4	21.4
US Bonds (Barclay's Aggregate)	+7.4	-2.0	1.7	3.1
Emerging Markets	-25.9	-0.6	31.0	21.1
REITs	-38.4	-30.1	29.2	38.2
High Yield Bonds	-13.3	-6.7	24.3	11.8
Commodities	-31.7	-6.1	12.4	3.7
Alternative Assets Group (11 Fund Avg.)	-7.9	-0.9	8.2	8.3
60/40 Balanced Index	-12.6	-5.9	10.8	11.7

**Through 9/18/09*

We have seen some dramatic events over the last 25 years, but there have not been four consecutive quarters of double digit returns since the 1930s. Is it over? Probably. Will there be a double dip recession? Unlikely. What will the economic recovery look like? Probably slower growth, but it could be stronger than expected. What does that portend for investment returns? We will try to outline our thoughts along those lines in the paragraphs to follow.

Before talking about the future, let us review a few of the events of the last twelve months. It was exactly a year ago when we began writing to you nearly every week about the unfolding crisis. Here are highlights from a few of those letters:

September 8, 2008 – The government took over Fannie Mae and Freddie Mac. This resulted in common and preferred stock shareholders being wiped out. Brad was in Cape Cod and reminded clients that "Like Hurricane Hanna, this storm will pass and the blue skies will come again". The Dow was at 11,500.

September 18, 2008 – Over a weekend, Merrill Lynch was sold to Bank of America, Lehman Brothers went bankrupt, AIG became de facto nationalized, Wachovia teetered on collapse and eventually was taken over by Wells Fargo. Soon after, Morgan Stanley and Goldman Sachs were forced to re-organize as banks and raise capital. General Electric borrowed from Warren Buffett. The Dow fell to 10,500. By this point, your allocation to equities was roughly 50% to 60% of your long-term target; and we had moved all our money market accounts to government securities.

September 28-29, 2008 – Hank Paulson, the Treasury Secretary, along with Ben Bernanke, the Federal Reserve Chairman, drafted a stabilization plan. Unbelievably, the Congress voted it down. The markets lost another trillion dollars that day and the Dow proceeded to fall to 7,500 over the next two weeks. We reminded clients that we were long term investors, that while we had raised cash and bond allocations somewhat we would not attempt to be market timers and sell out completely. We stated "The credit crisis is creating chaos in the fixed income markets, which means opportunity".

October 8, 2008 – While the markets were hitting the lows for the year, we wrote "Based on history, there are reasons to be encouraged. Stocks are now priced as if the whole world is going out of business". And, we concluded with "We have little doubt this is an excellent time to invest for the long term even though we are concerned about the near term". The Dow was at 9,000.

March 3, 2009 – By this point we had finally had an election (after three years of campaigning). The market had stabilized from October through January, but then fell to new lows in February and early March. We wrote "No market can keep punishing itself this way indefinitely", and then quoted Warren Buffet when he wrote "...never forget that our country has faced far worse travails in the past...without fail we have overcome them... America's best days lie ahead". However, the Dow had fallen to 6,500 and fear was extreme. We wrote "the market will stabilize once this administration begins offering a coherent plan". As confidence in the administration has grown, so has confidence in the market – not the whole story but a part.

May 1, 2009 – Finally, we argued in May "The most intense phase of the economic and stock market downturns are likely behind us, and the odds are good that the recession will end this year". We expected to be increasing equity allocation back toward normal levels over the remainder of 2009 and into early 2010.

September 22, 2009 – Now we come to the present. The economy did suffer its worst period last winter and this spring – falling about 6% annualized. It was easily the worst recession we have seen in 25 years, and several statistics were worse than at any time in the last 50 years. During the summer things began improving and this quarter will very likely mark the end of the recession. Retail sales, manufacturing, and industrial production have all risen. Housing seems to have bottomed. Leading economic indicators are mostly showing recovery. Low inventories suggest a need for increased production, which will demand more resources and eventually more workers. Thus, a self sustaining positive loop could be unfolding.

On the negative side are some very large issues and changes that will require monitoring. The government is more involved in the economy, implying lower future growth and profits. Consumers are likely to increase their savings rate and reduce spending. De-leveraging by consumers and businesses slows growth. And finally, what are the risks associated with huge government deficits and a weak U.S. dollar?

Some will argue these risks will result in doom for the U.S. economy; but they really do not know. Nobody does. Yes, it is appropriate to worry about these and other risks, but the economic recovery is undoubtedly happening. As written by James Grant recently, "The very best investors do not even try to forecast the future. Rather, they seize such opportunities as the present affords them."

Strategic Allocation Decisions

We began raising our equity weightings in the spring, and again in August. We now are targeting equities at 85% to 95% of normal long-term averages in our models. For bonds, we have moved to underweighted targets of 80% to 90% of normal. The Alternative Assets & Strategies Group is targeted at 10% to 15% for most clients. Each portfolio will differ, but we use models to guide our decisions. In addition to increasing equity allocations generally, we have also moved to increase sectors more economically sensitive such as industrials, technology, and small and mid cap stocks. Anticipating the dollar will remain weak for some time, we have also increased foreign stock mutual funds both in developed countries and emerging markets.

Our style / philosophy is to recognize changes in the economy and markets and adapt. We will rarely be the first in or out, but we will even more rarely be last.

U.S. Stocks

Our model continues to show the market to be undervalued, although not as much as earlier this year. Earnings estimates for the S&P 500 have been increasing markedly for both 2009 and especially for 2010. We last reported in May expected S&P 500 earnings of $60 in 2010, and the consensus is now $75. Even at the current level of 1060 the market P/E is only 14.1x. You can see how this compares to history in the table below.

Inflation	Average P/E
<2%	23.5
2-3%	19.7
3-4%	17.6
4-5%	14.8
5-6%	13.1
6-7%	9.5
>7%	8.5

Core inflation and the GDP price deflator are currently below 2%.

Our valuation model points to fair value on the S&P at about 1120, which is in line with Goldman Sachs' estimate of 1130. They point out that other approaches (Fed Model, P/E Mean Reversion) point to a valuation of 1400+.

After a 50% move up from the lows of March, the S&P 500 is now trading more than 20% above its 200 day moving average. This has happened only three times before, but while a correction or near-term consolidation might be expected, historically when the market and economy have had this kind of reversal, returns have continued to be good for some time.

Investment Grade Bonds

Previously we wrote about the out-performance of Treasury bonds, which distorted returns for certain indexes. As usually happens this distortion has been reversed. Long term treasury bonds are down more than 17% this year, whereas corporate and municipal bonds are up 12% or more. The U.S. aggregate bond index is up 5%.

Going forward we expect sub-par returns from investment grade bonds. Yields are in the 3% to 5% range, and while we believe the Fed will keep interest rates low for the next six to twelve months, there are increasing risks of rising rates in the future. Rising rates causes bond prices to fall, so total returns over the next few years is likely to be low single digits. If the economy falters, or if there is another crisis, then high quality bonds will again do their job of providing safety, liquidity, and income; so they will always be an important allocation for most of our clients. But, on a comparative basis we expect them to under-perform.

Alternative Assets Group:

This strategy has continued to do well. Over the last 12 months (ending September 18th) it returned +5.7% vs. -8.7% for the S&P 500, and this year it is up 16% vs. 20%. It has done what we expect, falling less than the market and rising less than the market, but providing most of the market return over the longer term.

We can proudly point out that using this strategy, along with our tactical asset allocation approach of modestly raising cash and bonds, performed better than two of the largest endowments, Harvard and Yale. Yale in particular became famous for their alternative assets such as hedge funds, private equity, and real estate. According to the Wall Street Journal, these two heavyweights with nearly $60 billion in assets a year ago each lost 30% of their value in the 12 months ended June 30th. An unaudited sample of our balanced client accounts lost only slightly more than half that amount (-17%).

Model Equity: *Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account is currently 1% behind the S&P 500 for the year. It is up 19.5% vs. 20.5% through September 18th. We were positioned conservatively in the first quarter which led to much better performance through February, but as the market staged its amazing turnaround we could not get aggressive fast enough. Primarily, we have been underweighted in financials and technology relative to the market. We did have excellent performance from those financials we held such as Aflac and Goldman Sachs, but we did not hold any of the banks like Citigroup or Bank of America because of our concern for the risks.

We are positive on industrials and energy. We think a weak dollar will help companies with global sales. We also believe the demand for resources such as energy, food, and water will be an important investment theme for years to come. We have recently added names such as Monsanto, AGCO, and Core Laboratories to the model equity account and will be adding these stocks to many portfolios where appropriate. We have reduced or eliminated more conservative holdings such as Wal-Mart, Costco, or Baxter. Again, while we may be quicker to pull the trigger in this account the same themes and decisions will play out through each portfolio.

Foreign Equities and Fixed Income:

While Europe's aggregate economy is expected to recover more slowly than the U.S., certain large countries such as France and Germany have turned around earlier. China is on fire with industrial production rising 12%, retail sales up 15%, and GDP likely to grow 8% both this year and next. We are increasing investments in developed and emerging markets.

Financial Planning

We are very proud to announce that Viktoria Falus has passed the Certified Financial Planner (CFP) exam. This is a rigorous program that normally takes three years to complete, ending with a two day exam for certification. The CFP study program covers investments, insurance, taxes, retirement, and estate planning. Viki took an accelerated program over the last year and passed the exam on her first sitting. Sargent Bickham Lagudis now has five professionals with the CFP designation.

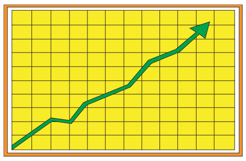
The next 16 months are likely to be one of the most tumultuous for tax planning anyone has ever seen. The government has already told us, and has little alternative with their current spending habits, that tax rates will rise. Many of the tax rates we have now are due to rise over the next year or two without any action needed by Congress. However, with an election next year there will be pressure to put off tax increases until 2011. Who knows? Nobody. We can only monitor the changes and then plan accordingly. Stay tuned. There are some changes to Roth IRAs, for example, that take place next year that present opportunity. We will try to contact those of you directly that we anticipate might benefit, but call Viki or Gary if you have questions regarding your situation.

Company News:

We are excited to announce that in a few weeks Meagan D'Angelo will bring a new baby into our collective family. She will be out of the office for a few months and we will miss her, but we have re-assigned her responsibilities until she returns. If you work with Meagan, you will be getting an email indicating who to call. We wish her the best of luck and are excited to welcome her new little girl Isabella D'Angelo in early October.

We are now in our third decade of providing financial services to clients in Boulder and beyond. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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