

“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”
– Sir John Templeton

September 1, 2009

Dear Valued Client:

The late Sir John Templeton was arguably one of the greatest investors of all time. The quote above paints an accurate reflection of how market cycles evolve amidst the psychological tides of pessimism and euphoria. We selected this quote because we think it parallels well with the market psyche we've seen transpire over the past six months, as the market hit its lows in early March on extreme pessimism, and has rebounded strongly amidst a large number of skeptics who didn't believe in its merit. As the market has steadily moved higher, we are seeing greater numbers of market strategists, economists, and equity analysts who are transitioning from skepticism to optimism, which has helped produce a 15.09% gain in the S&P 500 year-to-date through the end of August.

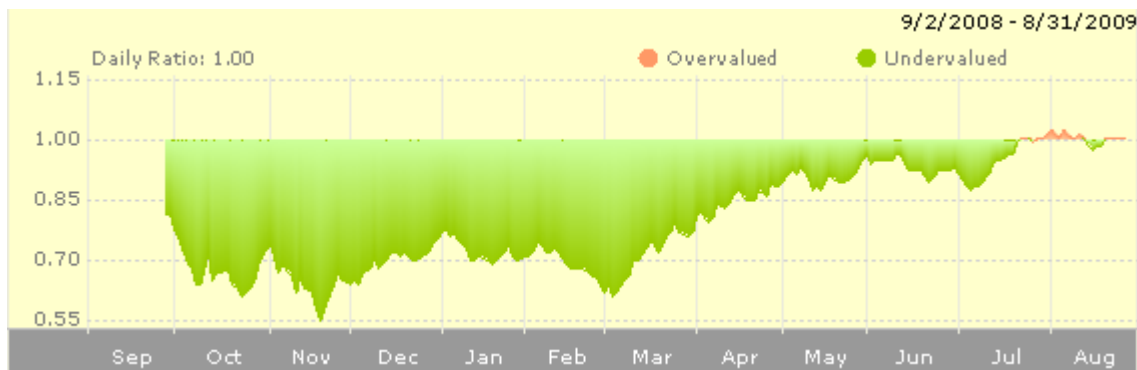
Since the stock market has moved higher in much greater proportions than corresponding economic and corporate earnings fundamentals, what accounts for the difference? The simple answer lies in improved investor sentiment, which is an important input that helps dictate the multiples embedded within the valuation of stocks. In short, stock valuations are often based primarily upon two things: 1) the level of cash earnings and 2) the future expectations of those cash earnings. Although the overall level of earnings has not changed dramatically since the lows in March, expectations certainly have, and that has been the primary driver for the stock price appreciation we've seen recently.

The economic answer to the question of why the stock market tends to rise ahead of the economy after recessions comes from a recent letter we read by Francois Sicart, Founder & Chairman of Tocqueville Asset Management. “The general idea is that when the money supply grows faster than GDP, excess liquidity is being created which, not being fully absorbed by the real economy, tends to flow into financial markets. In contrast, when GDP accelerates and starts to grow faster than the money supply, the real economy absorbs more of the available liquidity, which begins to flow out of financial assets.”¹ Thanks to the Federal Reserve, the growth in the money supply has been significant, which has allowed us to avoid the doomsday scenarios that some were predicting back in early 2009. However, now that the Fed has indicated that the economy is stabilizing, the key question remains how well the financial markets perform once the money supply begins to slow down.

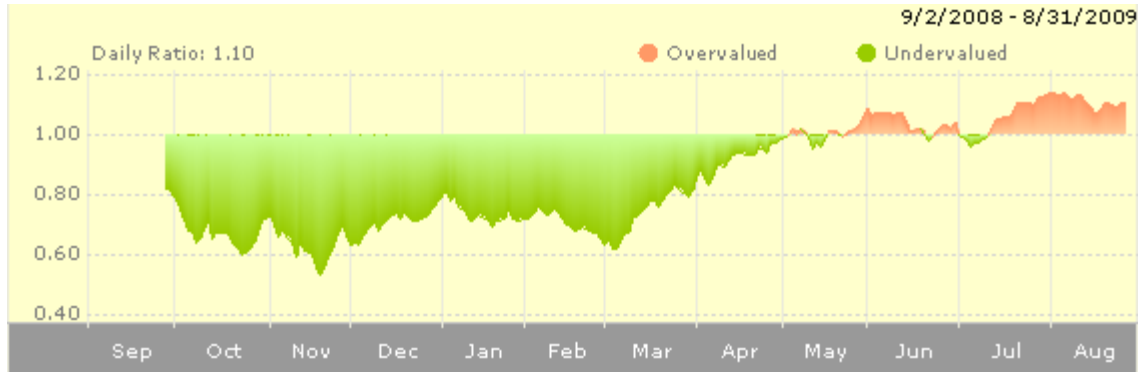
Although the market has benefited from monetary and fiscal policy “tailwinds”, the “headwinds” of lower money supply, higher interest rates, and higher taxes will produce a difficult environment for stocks and bonds longer term. However, that probably won't be a concern as the Fed won't risk raising interest rates as long as the consumer remains in such a fragile and weakened state.

Several clients ask us what we think about the market run-up and how are we positioning ourselves given the recent gains. For those clients that have made allocations to individual stocks, we have utilized the rally to take a few profits off the table as a means to lower risk and raise cash so that if the market does make a correction and move lower, we will have the liquidity necessary to take advantage of bargains as they arise. We continue to hold onto our core equity holdings, which we believe are still modestly undervalued in the vast majority of cases. If the market continues to rise, these holdings will benefit. Finally, while we continue to research investment ideas on a daily basis, we have not been active recently in terms of adding new positions to client portfolios because they do not meet our strict standards for business quality and investment value. Imagine how you would feel as a buyer going to the grocery store and seeing prices for goods rise for 5-6 months in a row. That is basically what has been happening in the financial markets, so as an investor looking for high quality bargains, the pickings are becoming slimmer by the day. Thus, we remain patient and cautious in this market environment, yet prepared to take advantage of buy or sell opportunities if the market moves higher or lower.

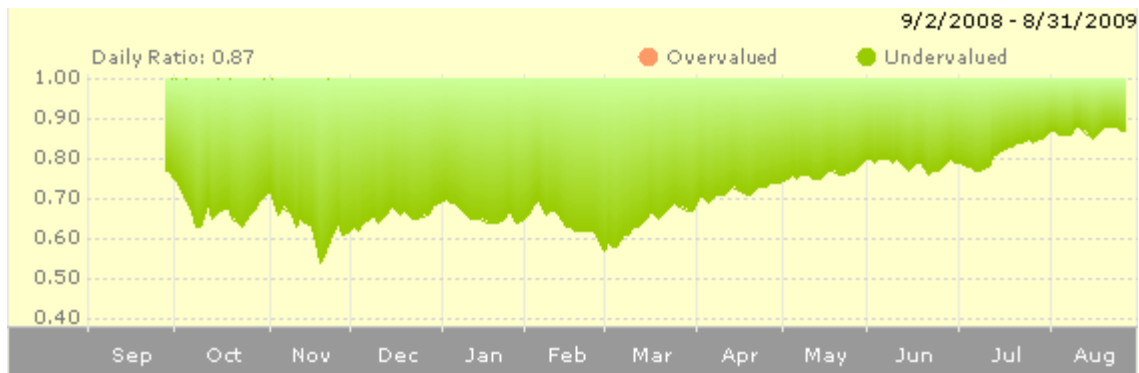
From a valuation perspective, we believe the market is modestly overvalued relative to current fundamentals and the chances of a correction occurring sometime during the next several months are elevated. However, even if we don't get a correction, we expect long-term annualized equity returns to be in a range of 5-7%. Those returns don't sound exciting, but they are much better than what we've experienced over the past decade. Below, we reference Morningstar's market valuation graph², which is a tool we often refer to when making judgments about market valuation. The graph below shows to what degree the market is overvalued or undervalued based upon the fair value estimates Morningstar analysts make for the 1,909 individual stocks within its coverage universe. A ratio above 1 indicates overvaluation, while a ratio below 1 indicates undervaluation. As of the date of this writing, the ratio stands at 1.00, which suggests that the market is trading roughly in line with its fair value.



One characteristic that has been clear during the recent market rally is that low quality stocks have outperformed high quality stocks by a wide margin. Low quality stocks are those that are generally characterized as businesses having cyclical and/or leveraged business models or those with no durable competitive advantages. Low quality stocks were punished tremendously in the market downturn last year and early this year, so it's not unusual to see them stage such a significant rally from such depressed lows. As the Morningstar valuation graph depicts below, low quality stocks it tracks as having "no moat" are now actually overvalued by a fair margin.



On the other hand, high quality stocks with strong competitive advantages and durable business models held up better relatively speaking last year and early this year, so they have not gone up as much in the recent rally, which indicates that companies within this area may have further upside potential, as the Morningstar valuation graph below suggests.



As always, we thank you for the trust and confidence you have placed in us and assure you we are working hard to continue justifying them.

- 1 Quote taken from Francois Sicart in an article entitled: Negotiating the “W”, posted August 6, 2009 at: http://www.tocqueville.com/media/NEGOTIATING_THE_W.pdf
- 2 All Morningstar graphs were used from their public domain website at: <http://www.morningstar.com/cover/pfvgraph.html>

The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

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