Lassus Wherley ...a view from the top

Building Better Futures

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A New Year and a Clean Slate: Not Quite!!!

Food for Thought

Happy New Year and welcome to the year "Twenty Ten." I certainly am one of those people who was ***really*** happy to say goodbye to 2009 and hello to 2010. 2009 didn't turn out to be quite as bad as it could have been but the extreme volatility in the market certainly created more stress than I look forward to having in life on a day-to-day basis.

The good news is we started the new year off well. The bad news is we are seeing the "market correction" we have been looking for during the last few weeks of December and coming into January. But let me first review 2009 and then we will talk about where we are today as we look forward to 2010.

The Year in Review

by
Anne L. Kehl, Investment Officer

Stocks staged a dramatic rally in 2009 which went a long way towards reversing the losses suffered in 2008. The rally was one of the fastest in history. Both 2008 and 2009 were years marked by extreme levels of volatility as seen by the frequency with which the market moved up or down by more than 1% in one day. The years 2008 and 2009 can be considered opposite sides of the same coin and unlikely to be seen again soon.

As explained by Jerry van Horn, the portfolio manager of Stratton Small Cap Value fund, the market action in 2009 can be broken down into three phases: 1) Market Capitulation, a Mid-Year Rally and a Return to Fundamentals.

The **Market Capitulation Phase** lasted from the start of the year until early March. This was perhaps the most unsettling period for stock investors since it followed a period in late December, 2008, when the markets had firmed up and it looked like the worst of the financial crisis was over. January and February, 2009, were unfortunately characterized by almost wanton selling of stocks. This occurred as the "Armageddon Scenario," which assumed the collapse of the global financial system, and was widely embraced.

In the **Mid-Year Rally Phase**, investors chased after risky assets as evidence accumulated that the financial system had been saved and the global economic recovery was for real. The stocks which did the best during this time frame, which lasted from the market bottom on March 9th until late August, were the smallest, most highly leveraged and most economically sensitive ones. Many of the best performers were stocks which were rewarded by investors just for having survived the crisis.

As inevitably happens as time goes on, investors began to become more discriminating in the last quarter of 2009, or the **Return to Fundamentals Phase.** Toward year-end, investors dialed back on risk and no longer wanted to chase profits. Attention began to shift gradually towards larger, less risky and higher quality assets and away from the high-octane assets that fueled the early stages of the rally.

We have included here some of the representative returns for the year 2009 with the returns for 2008 shown as a point of reference. Please note that the only 2009 returns that made up for the negative returns experienced in 2008 were the last three sub-asset classes – Short-Term Bonds, Inter-Term Bonds and Emerging Market Stocks.

	2009	2008
US Large Cap	28.19%	-37.87%
US Small Cap	31.82%	-36.60%
Intl Large Cap	31.31%	-44.15%
Europe	47.61%	-49.76%
Global Real Estate	36.93%	-46.94%
Short-Term Bonds	9.32%	-4.24%
Inter-Term Bonds	13.96%	-4.85%
Emerging Markets Stocks	73.78%	-54.54%

Source: Morningstar Fund Category Returns

What about 2010?

As market action has shown this past week, we would expect investors to take profits in some of the areas that led performance last year, including Emerging Markets stocks. This is happening now because China has become concerned that its economy is growing too fast and has begun to raise reserve requirements on banks. This is just one way to cut back on the monetary stimulus with which they had (successfully) stimulated their economy and the global economy as well in 2009. Such actions will not be limited to the Chinese and are in fact expected throughout the global economy.

While US investors were very aware that the Federal Reserve would be acting to raise their target Fed funds rate by late this year, they were not really expecting that China and India and others would be taking actions to "remove the punch bowl" quite so soon. This may cause investors to continue to take profits in Emerging Markets stocks, thereby providing an opportunity to increase exposure in these areas.

We have also seen uncertainty surrounding Federal Reserve Chair Bernanke and his confirmation for another term. Markets absolutely hate uncertainty and this is no exception. Even those who don't believe he should be confirmed, have moved their dollars to the sidelines in recent days. Add in the implosion of health care reform and all the uncertainty surrounding that and it makes for a more volatile market than we have seen recently.

We are just beginning to see a move to higher quality in our markets. We expect to see a continuation of this as investors recognize that many of the higher risk assets have become more fairly valued and in some cases, even overvalued. We expect that larger, more stable companies will perform better in the current year.

In spite of the continued issues, consumer confidence rose for the third straight month in January rising to the highest level since September 2008, according to the Conference Board. While this doesn't guarantee a continuation of positives, it is certainly a better indicator than many we follow. The Conference Board's labor market assessment improved somewhat but remained pretty pessimistic. Unemployment continues to be a major concern for consumers.

One other area that we have been seeing more headlines on recently is commercial real estate. Major complexes are getting hit with higher vacancies and are facing tougher times in refinancing debt. Cohen & Steers (a fund manager) has recently stated that "REITs are telling us that valuations on commercial real estate are going to settle out at much higher levels than folks thought in 2009." They believe losses are not likely to be as bad as had been thought and REITs will benefit from good acquisition opportunities. This is an area we will continue to follow. In the meantime, the economy continues to grow at a slow pace. Corporate earnings have been positive for the most part but are another area that we will be monitoring as we peer into our "crystal ball" for 2010.

We have received some great questions over the past month or so. Here are some of the questions with our responses:

Question: *I keep reading and hearing a lot about China raising reserve requirements on banks. Why should we care about what's happening in China?* **Answer:** We live in a totally interconnected world now, and any move taken by the Chinese central bankers will impact investors around the globe. This reflects the size of the Chinese economy (now number 3 behind the US and Japan) and the importance of China to the growth in global GDP both in the recent past and in the future.

Question: *I know I have investments in Emerging Markets but after the big run up in value, shouldn't we be selling rather than buying?* **Answer:** We expect that Emerging Markets stocks will continue to post positive returns but do not expect them to repeat their extreme outperformance of 2009 when they beat the US Large Cap asset class by over 45%.

Most of our portfolios have had an allocation to this asset class for some time, and we actually increased our target last year. In fact, since late last year we have been adding to this asset class in accounts that are underweight as the markets have weakened.

The primary reason for increasing our exposure to emerging markets is to participate in the expected long-term growth of these countries; not because we expect quick returns. It is also based on the fact that Emerging Markets are increasing as a percentage of the total value of the world markets.

The market capitalization or total value of the Emerging Markets has been growing along with the growth in their economies, and they now make up about 13% of the total world market capitalization. This contrasts with about 42% for the United States and 45% for the Developed Countries such as the United Kingdom, Germany and Japan.

We will be making gradual changes in the asset allocation in portfolios over time to bring our allocation to domestic U.S. and international stocks more in line with the value they currently hold in the global markets.

Question: *How can we expect positive returns on stocks after the big move up last year?* **Answer:** We expect that the global recovery will continue through 2010. This should lead to further improvements in earnings, which are necessary for stocks to do well. We do not believe that the Federal Reserve will be making moves to tighten monetary policy any time soon, so we don't see interest rates moving up very quickly before year-end. Both of these factors are positive for stocks. Another positive factor is the huge amount of cash still sitting on the sidelines. Many investors chose to sit out last year's rally and could provide fire power for the markets on any significant dips.

The major concerns regarding the markets are that stocks are not as cheap as they were a year ago and have discounted a lot of the economic recovery already. The stock market doesn't like uncertainty, and we have plenty of that right now, including many of the things that President Obama talked about in his State of the Union last night. The President's proposals are in addition to many already floating around Washington and will certainly impact the financial industry and the markets at some level. So……...stay tuned.

We have continued to maintain a more defensive allocation because of the uncertainty and our expectation that we could have a pullback in the financial markets in the short-term. However, the financial markets have climbed this type of "wall of worry" in the past. We could very well continue to climb in spite of the many challenges and potential issues we are facing both politically and economically.

Question: *According to many reporters, including the WSJ, individual investors didn't participate in last year's stock market rally. Why would that be the case?* **Answer:** As recently reported in the Wall Street Journal, data from the Investment Company Institute indicate that individual investors were largely absent from the party in 2009. Individuals, shocked by the market meltdown in 2008 and searching for higher yields than were available on money market funds, moved some $349 billion into bond mutual funds between January and November, 2009. This contrasts with some $4.1 billion in outflows from stock mutual funds in the same time frame. Individual investors have been focused on the high unemployment rate and not on the housing, auto, inventory and capital spending data which indicate that the global economy is indeed improving after a very long and deep recession.

You might ask how the rally could go so fast and so far without the participation of the individual investor. Well, markets are dominated largely by institutional investors, including pension funds, mutual funds and hedge funds and professional investors such as Lassus Wherley, who invest for their clients. All of these investors are increasingly using ETFs which may also have some impact on the amount of dollars which are flowing into open-end mutual funds.

Question: *I keep hearing more and more about how ETFs are going to be the investment vehicle of choice in the future. Do you think we will be using ETFs more in the future?* **Answer:** We have been using ETFs or Exchange Traded Funds for some time and continue to look for new ways to use these investments in combination with open-end mutual funds. Our portfolios are primarily made up of index funds which have the lowest costs and track various indexes, such as the Russell 2000. We have used the iShares Russell 2000 Index ETF (IWM) for some time in order to gain exposure to small cap US stocks. (Buying ETFs is another way to buy a distinct part of the stock or bond market.) Besides low cost, other advantages of ETFs are the ease with which they can be traded, their transparency (you know exactly what they own since they track an index) and their tax efficiency (they do not typically pay out capital gains).

Question: *I received an IPS (Investment Policy Statement) in the mail. Does that mean something has changed or is it just for review?* **Answer:** We review clients' investment objectives periodically to make sure their investment program is in alignment. The IPS is the written statement that explains the investment policy as we understand it. We do this on an ongoing basis but recently decided to redraft the actual documents and send them out for client review. We will be processing them over the next 6 months, so when you receive your IPS, please review it and sign one copy and return it to us. If you have any questions concerning it, please give us a call.

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We continue to review asset allocations and asset classes to determine where we may need to make adjustments. Our recent changes have been made to fine-tune portfolios and continue to focus on risk management. We have continued to rebalance and add dollars to underweighted asset classes as the financial markets have fallen over the last few weeks. This is in line with our thinking that the markets are in a trading range where we buy at lower prices when the opportunity presents itself.

Looking Forward

The challenges in 2010 are just beginning. The unknowns always "worry" the markets and we still have plenty. Will health care reform survive? Will Bernanke be confirmed? Are we going to bring back Glass-Steagall? (*The Glass-Steagall Act of 1933 prohibited any one institution from acting as any combination of an investment bank, a commercial bank, and/or an insurance company. The repeal of Glass-Steagall in 1999 opened up the market among banks, securities companies and insurance companies leading to what many individuals today believe is the root of many of our problems.*) We should get many of these answers soon, and then we will look to the next group of questions that evolve from these answers. The reality is that there will always be the next group of unknowns for folks to worry about because no one has a crystal ball. So……….stay tuned and know that we are continuing to focus on risk management as we track what is happening in the world.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

Please let us know if you have any questions or concerns. We are definitely looking forward to a continued recovery in the markets and the economy. Stay warm and look forward to a wonderful Spring!

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