MARKET COMMENTARY - OCTOBER 2009

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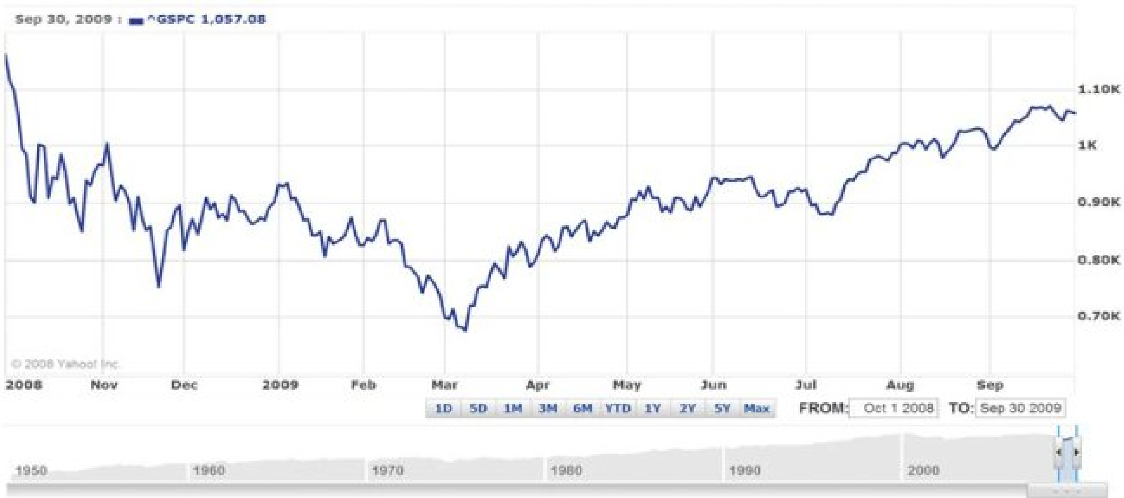
Dear Clients,

Today the Dow hit 10,000 and the S&P 500 index is very close to 1,100. Believe it or not, it has been just over a year since the financial crisis began with the collapse of Lehman Brothers in September 2008. So I thought this would be a good time to look back at where we have been, consider the lessons learned, and look forward to the future. Here is a one year chart of the S&P 500 index from September 2008 to September 2009:



TO HELL AND BACK AGAIN

We have come a long way from the bottom on March 9, 2009. We managed to avoid a complete collapse of the banking system and another Great Depression. The S&P 500 index of large cap stocks is up more than 50%, mid & small cap stocks are up about 70%, international stocks are up over 60% and emerging market stocks are up almost 80%. And all of the major indexes are in positive territory for 2009.

More importantly, we have almost fully recovered from the losses incurred since September 2008. Over the past year, the S&P 500 index is down about 7%, mid & small cap stocks are down 4%, international stocks are up 3% and emerging market stocks are up 17%. And these numbers do not take into account the continued run-up in October. Overall, a well diversified portfolio that includes cash, bonds, domestic and international stocks should be back to where we started a year ago, assuming we held our ground and resisted the urge to sell at or near the bottom.

LESSONS LEARNED

It has been a very stressful year for all of us! But from my point of view, here are some of the important lessons we should have learned from the past year in the markets:

- **Focus on the Long Term** - If we had gone into hibernation during the past year, avoided all of the news, and recycled our brokerage statements, we would be in the same place now that we were a year ago, but without all of the stress and emotional turmoil. The history of the markets demonstrates that over long term holding periods (e.g. 10 years), a well diversified portfolio of investments will generate positive returns with limited downside risk. So as long term investors, we should try hard to ignore the short term fluctuations in the market, even when they are huge fluctuations. This is easier said than done, but I am proud to say that all of my clients held their ground during the past year, and did not panic or capitulate.

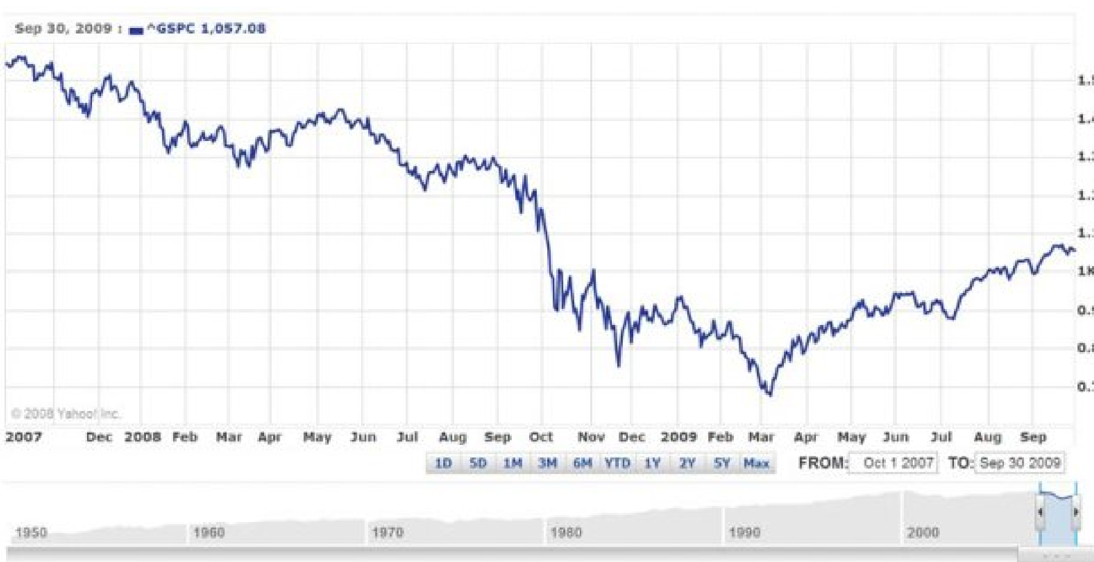
- **Avoid Selling at the Bottom** - Studies in behavioral finance indicate that most individual investors tend to sell and become more conservative at or near the bottom of the market, when the economic news is at its worst. Investors who sold in early 2009, when panic was spreading through the markets, would have missed some or all of the quick bounce back. Of course, it is easier to call the bottom in retrospect. But the lesson we should learn from this experience is to avoid selling when everyone else is selling. It is better to take a contrarian approach to the markets.

- **Avoid Buying at the Top** - Behavioral finance studies also show that most individual investors tend to buy or become more aggressive at or near the top of the market, when the economic news is at its best. So back in late 2007, when the economy and markets had been growing for more than 5 years, many investors became more aggressive and bought more risky assets. The same thing happened back in 2000 during the tech stock bubble. Again, hindsight is 20/20, but we should avoid buying when everyone else is buying. A contrarian approach would suggest that we sell on the way up, taking profits off the table along the way.

- **Rebalancing = Discipline -** One way to enforce a long term strategy, combined with a contrarian approach, is to regularly rebalance your portfolio. The rebalancing process results in the sale of asset classes which have increased in value and the purchase of asset classes which have declined in value. At the same time, your portfolio is brought back in line with your long term asset allocation strategy and risk/return profile.

LOOKING FORWARD

We have come a long way, but we are still not completely out of the woods. The economy is still suffering from a very deep recession. And we are well below the peak of the markets in late 2007. Over the past 2 years, from September 2007 to September 2009, large cap stocks are still down about 25%, mid & small cap stocks are down almost 20%, international stocks are down 30% and emerging market stocks are down 20%. Here is a 2 year chart of the S&P 500 index.



So where do we go from here? We have come a long way back from the bottom of the markets in March. Some people believe we have come too far, too fast. And they argue that we still have serious economic issues to worry about, including high unemployment, ongoing weakness in residential and commercial real estate, and a slowdown in consumer spending. These issues are very real, but I am cautiously optimistic that the economy will continue to recover over the next few quarters and that corporate earnings will continue to increase to more normal levels. Unless there is a new shock to the economy, I believe the combination of positive economic news, positive earnings announcements and positive investor sentiment will continue to support a recovery in the markets. Here are some more specific thoughts and recommendations:

- **Square Root Recovery** - There has been a lot of talk about the shape of this economic recovery. The most optimistic scenario is a capital **V** shaped recovery, quickly rising back up to where we were before the recession and credit crisis. A more conservative view is the **U** shaped recovery, with a long drawn out recession before the recovery begins. Another pessimistic scenario is a capital **W** shaped recovery, sometimes referred to as a double dip recession. My personal view looks more like a square root symbol (small **v** followed by a straight line)**.** I believe we will have a quick economic rebound, then a long period of slow economic growth, As a result, I believe stock prices will continue to recover but probably not back to the peak of late 2007 for a long time. Still, to capture these returns, I recommend that clients maintain their long term asset allocation strategy going forward.

- **Limited Inflation Risk -** There has been a lot of talk about inflation as a result of low interest rates, increased money supply, and government deficits. I agree that these conditions can lead to inflation but it is not likely as long as we have high unemployment and low capacity utilization. So I am not concerned about the general inflation rate over the next couple of years. However, as economic activity picks up in the US and around the world, I do believe we will have an increase in commodity prices, as demand increases for limited natural resources. So I recommend that clients devote a small part of their asset allocation to a diversified mix of commodities.

- **Weak or Falling Dollar** - I believe there will be a lot of pressure on the dollar in the months and years ahead. Investors will move away from the safety of Treasuries and back to more risky assets around the world. We still have a big trade deficit. And some countries are talking about a diversification away from the dollar for their reserve balances. I expect these forces will result in a slow depreciation in the value of the dollar instead of a rapid devaluation. I will continue to recommend that clients invest a reasonable share of their asset allocation in international securities with a focus on international stocks.

- **Emerging Market Growth** - Economic growth in the US and other developed countries could be relatively strong in the next few quarters as we rebound from a deep recession. However, once we reach more normal levels of economic activity, I believe that growth in the developed world will be relatively slow and stagnant. The real growth in the global economy will be centered in the emerging markets. As such, I will continue to recommend that clients include a small but healthy mix of emerging market stocks in their investment portfolio.

- **Higher Interest Rates** - Eventually, as the economy recovers, the Federal Reserve will begin to execute an "exit strategy" from the dramatic monetary stimulus measures enacted during the crisis. This will result in higher interest rates, especially for US Treasury securities. So I will continue to recommend that clients avoid US Treasury investments and focus their fixed income allocation on municipal and corporate bonds instead. In addition, we may want to move to fixed income investments with shorter maturities so we can reduce the negative impact of rising interest rates on the value of these investments.

Over the next couple of weeks, I will be working on your quarterly investment analysis. Then we can schedule a call or meeting to discuss your individual situation in more detail. In the meantime, feel free to call me if you want to discuss this commentary or your investment portfolio. I look forward to talking with you soon...