

## Commentary - 1st Quarter 2009

Spring is here. The foliage is turning green, the pollen count is up, and opening day for major league baseball is here. We are even experiencing a renewal in the financial markets. The Dow Jones Industrials and the S&P 500 are both up more than twenty percent from their lows of March 6th. And the economy is starting to show some signs of life.

Last year ended with some optimism that 2009 would see an end to the financial system maelstrom that started with the subprime mortgage meltdown in mid-2007. That optimism was dashed in January and February as expectations that the new Treasury secretary would move quickly to announce plans for helping banks sell their "toxic" assets ran into a wall of uncertainty. When Treasury Secretary Geithner held his first news conference to announce that his staff was working on a plan and would reveal the details at a later date, the stock market was severely disappointed. The selling in February was relentless as fears that most of the major banks would be nationalized and the government would be running the financial sector caused investors to head for the exits. The sell-off was not characterized by the same fear and emotion that was apparent in the high volume declines of October and December, it was just persistent. When the market broke through November's lows and traded below 7,000 on the Dow, many investors threw in the towel. The fearmongers are still receiving lots of attention, and the market could still succumb to new problems in the financial system, but the U.S. consumer is coming out of hibernation and that bodes well for the economy and the markets.

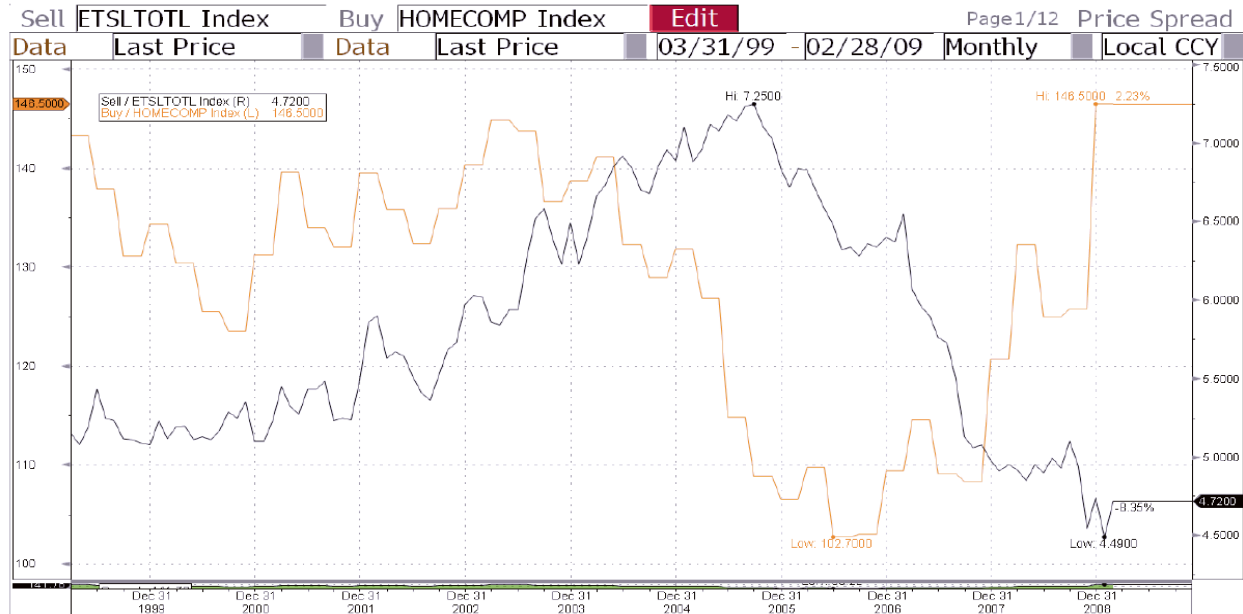
Congress passed a massive economic stimulus plan that will boost government spending over the next two years. The spending program is just now starting to take effect with new construction contracts being signed at the state and local level. The Federal Reserve has been the most aggressive federal entity when it comes to supporting the economy. The Fed lowered interest rates to almost zero last fall. In December they announced a program to purchase mortgage backed securities and Federal Agency debt to provide more liquidity to the credit markets. This "quantitative easing" program is the most aggressive tool the Fed has in its arsenal. When the Fed purchases securities, they are essentially printing money. They are using their power of the printing press to lower the interest rates on all types of fixed income instruments. They initiated the Term Asset Backed Securities Loan Facility (TALF) in March to encourage the private sector to purchase asset backed securities. Asset backed securities are similar to mortgage backed bonds in that a pool of loans is put into a trust with some form of credit support and bonds are issued by the trust. The loans in the pool may be auto loans, credit card loans, student loans or other types of loans. Over the last decade, consumers were able to obtain cheap financing for all types of activities because the asset backed securities market increased the liquidity that was available. Once the credit crisis hit last year, the asset backed securities market shut down and that raised

the cost of loans for consumers. By offering low interest financing to private investors through the TALF program, the Fed is trying to lower the borrowing costs for consumers, and the program appears to be having its intended effect. The Fed also declared their intent to begin purchasing Treasury bonds after their most recent FOMC meeting. This announcement caused the biggest one day rally in the bond market in recent memory as the yield on ten year maturity notes dropped by almost half of one percent. The Fed's intent is to keep the government's borrowing costs down and to help bring down private sector borrowing costs that are tied to the interest rates on Treasuries, thereby boosting demand for goods and averting deflation.

More recently, the Treasury launched a program to help banks sell their underperforming assets. The Public Private Investment Program (PPIP) will provide low cost financing to partnerships that are managed by private investment managers to purchase mortgage backed securities and other types of bank loans that the selling banks want to move off of their balance sheets. The partnerships will raise private equity capital that will be matched by the Treasury. The Fed will then provide low cost financing to the partnership. The idea is that the partnerships will be able to establish reasonable market prices for these illiquid securities and loans that have been causing mark-to-market losses for their bank owners. The cheap financing will support more aggressive bids by the partnerships, hopefully raising the values for all types of illiquid bank loans and mortgages. Since the Treasury is providing half of the equity capital, the federal government should reap some of the gains when and if these investments perform well. It remains to be seen if the PPIP managers will bid prices that are attractive enough for the banks to sell their securities and loans.

The economy is beginning to respond to all of the various stimulus measures that the monetary authorities and the federal government are using. Retail sales were reported at better than expected levels for January and February. Gasoline sales are increasing, with demand beginning to grow again for the first time in over a year. Home sales are picking up, especially in areas where foreclosures are the highest and banks are aggressively marketing their foreclosed properties. Southern California saw an 80% increase in sales last month versus the previous year. Existing home sales reports have been better than expected the last two months. The affordability of housing is the highest it has been in the last ten years. We think the combined effect of lower housing prices and lower mortgage rates will lead to an improving housing sector in the second half of this year. The graph below shows the national home affordability index and the sales rate for existing homes. There appears to be a strong correlation between affordability and sales. When affordability declined in 2003, home sales peaked approximately eighteen months later. Affordability began to improve in late 2007, so we should see stronger sales this summer.

Graph 1. Existing Home Sales and Housing Affordability, 1999 to Present, Source: Bloomberg



Before we get too carried away with optimism, we should point out that there are still many risks to overcome. Job losses are at elevated levels and the unemployment rate is rising. Foreclosures are still increasing. Financial markets are very fragile. Banks may not take advantage of the PPIP program so they can avoid losses. The enormous amounts of monetary and fiscal stimulus may lead to increasing inflation and cause interest rates to rise, choking off any economic recovery. A trade war could intensify. Already, many countries have enacted policies favorable to domestic industries in order to combat the economic weakness. Foreigners could lose confidence in the dollar, forcing our borrowing costs higher. Western European countries could decide the costs of rescuing the newly democratic eastern European countries from excess borrowing and failing banks are too high, leading to dramatic disputes and eventual dissolution of the Euro currency. And Iran or North Korea could cause problems militarily with their nuclear ambitions, resulting in spiking energy prices. The market has experienced four other periods since mid-2007 where investors thought the worst was over only to see more pressures on the banking system from the deleveraging process that has taken place. Is this one for real? We think the odds favor it, but we were too optimistic during the prior up moves.

Here is how our asset class strategies performed in the first quarter:

**Blue Chip Strategy:** Our large cap stock strategy declined 13.04% in the first three months of the year while the S&P 500 Index fell 10.93%. Fortunately, the Blue Chips rallied more than 16% from their lows by quarter end and have gained another 7.5% in the first two trading days of April. The woes of GM resulted in a 40% decline in its share price during the quarter. But its decline was exceeded by the two big banks in the Dow Jones Industrials.

Citigroup fell 62% and Bank of America fell 51% as they received more government support and investors worried that their capital would be depleted by loan losses. They recovered dramatically from their early March lows as the government stressed that nationalization was not a desired outcome for any rescue plan. IBM was one of the few positions that gained during the quarter, rising 15%, as their earnings came in better than expected and they maintained their outlook for the year. At one point during early March, the decline in the Dow had wiped out all the gains going back to 1997. Now that we are trading back over 8,000 on the Dow, we are hopeful the early March levels will not be retested. Most companies cut costs and production severely in the fourth quarter to bring inventories back into line with acceptable levels. Now that the consumer is starting to increase spending, the low costs and low inventories should translate into stronger earnings and production.

**Small Cap Value Strategy:** Our small caps underperformed in the first quarter, falling 27.88% versus the Russell 2000 decline of 14.95%. Surprisingly, growth oriented stocks outperformed value stocks during the quarter. Our weighting in transportation stocks hurt our performance as Hawaiian Holdings and Arkansas Best declined over 35%. Jackson Hewitt was our weakest position, falling 66%, as they warned that business was weaker than expected and they suspended their dividend. They bounced back nicely in the last two trading sessions as Liberty Tax Service disclosed they had acquired a 9% position in the stock and were interested in a strategic transaction. Air Transport Service Group was the strongest performer, tripling in value, as they announced new leasing contracts and an agreement with DHL to reduce their debt. Energy Transfer Partners and Superior Industries both gained approximately 14% in the quarter. We expect our small cap portfolio to be volatile. We have experienced periods like this before. We added one new position during the quarter, Dollar Thrifty Group, the car rental firm. A research summary for Dollar Thrifty is included for clients investing in the small cap portfolio. There are many bargain priced stocks available right now and when investors' confidence returns we should see a sharp recovery in small cap stocks.

**Convertible Securities/High Yield:** Our high yield convertible strategy rose 3.88% during the first quarter. The Merrill Convertible Index rose 2.57% and the Merrill High Yield Index gained 5.26%. The yields on below investment grade bonds began to decline in the first quarter as fears of a complete economic collapse dissipated and new issue activity increased. February was one of the highest months of issuance for investment grade bonds in the last seven years. High yield bond issuance is starting to recover and there have been some high quality convertible bonds brought to market in the last few weeks. Most of our master limited partnership positions recovered between 10% and 30% during the quarter as they maintained their distributions and energy prices stabilized. The Beazer Homes convertible bond position was the weakest performer during the quarter, down 44%, due to the continued weakness in new home construction. Ironically, Beazer improved their cash position by \$200 million during 2008 and they received a big tax refund during the first quarter,

so our bonds are better protected. Their first debt maturities are in mid-2011. We had been holding out hope that the Fed's efforts to improve liquidity in the mortgage market would rescue Thornburg Mortgage. The Fed's PPIP program is launching too late to help Thornburg and their financiers would not give them any more time to repay their short term borrowings, so Thornburg is going to file bankruptcy. Thornburg avoided the credit losses that hurt most mortgage underwriters, but their financing of long term assets with short term borrowings collapsed when the value of their mortgage backed securities plummeted. Leverage is desirable when asset prices are improving but it is scary when asset prices decline. As liquidity in the credit markets improves and the Fed/Treasury programs to finance securitizations take greater effect, we expect our high yield positions to recover nicely.

**Intermediate Bonds:** Our intermediate taxable bond portfolio declined a slight 0.05% in the first quarter versus a 0.02% rise in the Citigroup 1-10 Year Government/Corporate Index. The intermediate tax exempt bond portfolio rose 1.59% in the first three months of 2009 versus a 1.98% gain for the Merrill Lynch 3-7 Year Insured Bond Index. We are still overweighted in corporate bonds in our taxable strategy. In our opinion, high quality corporate bonds with a three to five year maturity range still offer exceptional value versus government guaranteed securities. We will be proven wrong if the wide yield spreads are predicting deflation and more global economic weakness that makes it harder for debt issuers to repay their liabilities. Municipal bonds rallied in the first quarter as investors took advantage of their relative cheapness versus taxable bonds. Many municipal bond issuers are experiencing falling tax revenues but the federal economic stimulus package is helping their budgets. We are being very selective about the regions and types of municipal bonds that we will analyze for inclusion in our portfolio. The risks for municipal issuers have risen during this recession.

We know this has been a difficult time period for our clients. We share your concerns. Some of our defensive positions did not perform as well as they had during prior market declines and we were too slow to upgrade credit quality in our fixed income portfolios. We are optimistic that the worst of the credit crisis is behind us. The rate of decline in the economy is slowing and we might even see an upturn in the second half of the year. A growing economy will relieve investor fears about declining earnings and cash flows, boosting the values of investments. As we stated above, there are risks to an optimistic outlook, but we think the odds favor a recovery.