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Fourth Quarter Investment Commentary
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"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on." - Amos Tversksy (professor known for his work on prospect theory)

The Quarter in Review

- President Obama's approval rating sank to a new low for any president at this post-election juncture.
- Tiger Woods. Enough said.
- Winter storms battered both the East Coast and the Midwest, potentially throwing a wrench into the Christmas shopping season. However, early indications were that spending increased 3.6% over what was an admittedly weak 2008 season.
- In spite of the weather, Christmas weekend was the highest grossing weekend in the history of movies.
- The Chicago purchasing managers' index rose to the highest level since May 2007.
- The last unemployment data for the year indicated that unemployment claims fell to the lowest level since July 2008.

Looking Ahead – A Wide Range of Possible Outcomes

As in any year, there are both positive and negative outlooks on the financial markets and the economy. Let's look at both sides of the discussion and determine what it means to us as investors. There is some arduous detail involved, so if you want to skip this section and go directly to the Closing Comments, we will not be insulted.

Positives

David Bianco, U.S. equity strategist at BofA Merrill Lynch, recently detailed and argued against five common investor misperceptions:

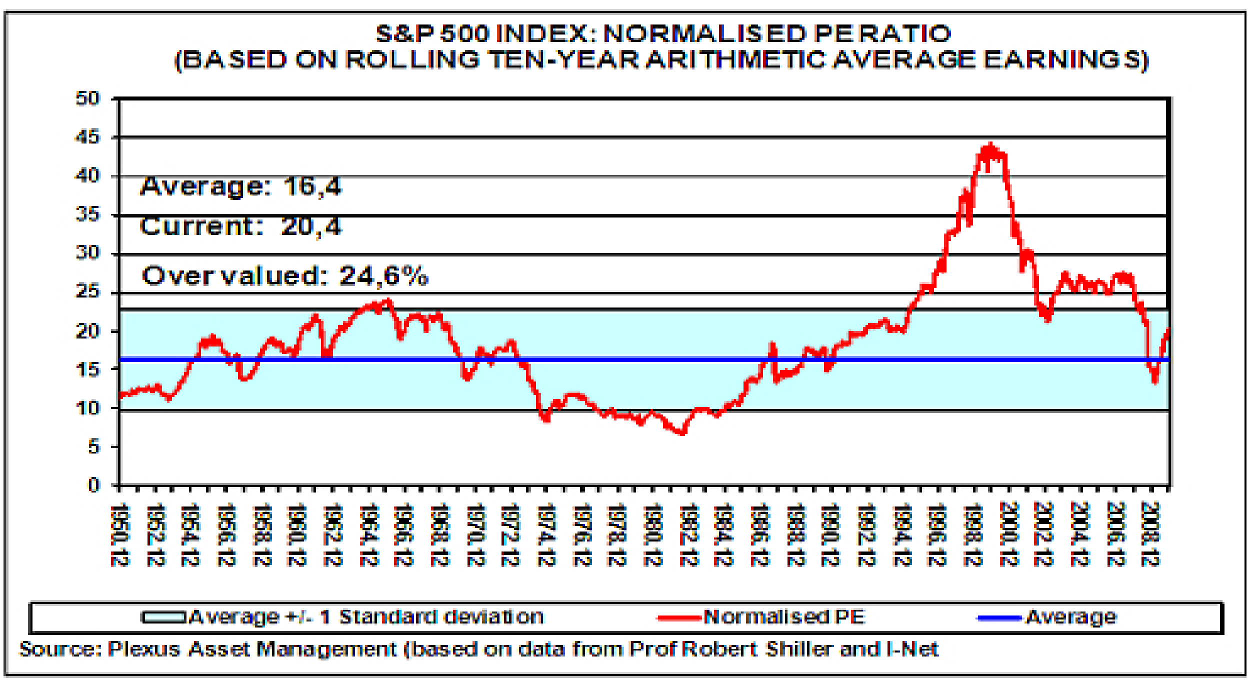
1. The outsized dependence of the U.S. on consumer spending
2. China's reliance on exports to the U.S.
3. The idea that domestic manufacturing activity is negligible

4. The degree of financial leverage in the system
5. The case that corporate profit margins must soon retreat toward a long-term average.

Without taking up each in depth, here are some key points. Of the 70% of U.S. GDP (Gross Domestic Product, a primary measure of economic growth and performance) attributable to consumer spending, Bianco figures only a quarter of it is truly discretionary. Retail sales as a portion of GDP were down from a peak of 29% in 2001, and were at just over 27% last year. Bianco goes on to note that China exports twice as much to the emerging markets as to the U.S., America still controls about a fifth of world manufacturing activity, and profit margins would actually rise if they returned to a longer-term average. In arguing against the idea that the U.S. economy is hopelessly overleveraged (i.e., too much debt), Bianco doesn't ignore the massive debt households accumulated and still shoulder—or are having written off in the form of rising bank-loan losses. But he points out that the historically low corporate debt load means the situation here is quite different from the Japanese "lost decade" scenario.

Back in our December 11th financial news update, we briefly discussed the numbers behind the unemployment rate and referenced an outstanding interactive graph from the *New York Times.* What these numbers tell us is that there is a direct correlation between a person's education and job status. Typically, the more education and training, the better the chances of being employed. For instance, the 12-month average unemployment rate for the year ended 9/30/09 for men and women of all races over the age of 45 with a college education was 4.3%. For the same demographic without a high school education, the rate was 11.2%. Since those with more education and training typically also have more disposable income, economic recovery will likely come in large part from this group.

Ultimately, how well a stock market performs is dependent upon corporate earnings and how much investors are willing to pay for the future stream of earnings. This is called the price-earnings ratio (P/E ratio). During our following discussion of P/E ratios, we will refer a few times to Chart 1 below.



First, let's look at corporate earnings. Chart 1 uses a 10-year rolling average P/E (represented by the red line) instead of the P/E from a single quarter, as this can be misleading. For instance, the P/E ratio for the second quarter of 2009 was over 700, primarily because of the tremendous losses from the financial sector. Using a 10-year average helps to smooth out the effects of such events. Corporate America has responded to the financial crisis by increasing efficiencies and by cutting costs, particularly labor costs, which is evident in the current unemployment rate. This has allowed earnings, or net profit after all costs, to hold steady or increase even as revenues have declined. Last week, estimates from various analysts for earnings of the S&P 500 for the year 2010 ranged from $65 to $85. While these estimates are open for debate, we are going to assume they are reasonable as the basis for further discussion.

Now that we have the earnings part of the equation, let's talk about the P/E ratio. As you can see from Chart 1, P/E ratios can vary widely, from a trough of around 7 back in 1982, when stocks were cheap, to a peak of almost 45 back in the first quarter of 2000 at the height of the tech bubble. The historical average is about 16.4, with a normal range of 10 to about 23. Chart 1 shows that the current P/E is 20.4, a bit above that long-term average, but still well within the historical normal range of the ratio. You may be asking what can influence the P/E ratio to be either 7 or 45. There are several factors, but the primary influences are investor sentiment and interest rates. Let's first look at when the P/E ratio was about 7, back in 1981-82. This was a time of rampant inflation rates, and the Federal Reserve under Paul Volcker was fighting that inflation by raising short-term interest rates. The prime rate climbed to 21.5%, you could get 15% on a one-month Certificate of Deposit, and a 30-year mortgage was 16%. The stock market had turned in lousy inflation-adjusted performance for the previous decade, hampered not only by inflation but by the energy crises of 1973 and 1979. So, why would an investor risk any money in the stock market when a short-term investment in an FDIC guaranteed institution would give you 15%? Why, indeed? Nobody knew if rates might continue to go up, or at least stay the same for an extended period. So, from a combination of investor sentiment and high rates of return on risk-free assets, the S&P 500 had a P/E ratio of 7. From that point, the market embarked on an 18 year bull run. Now, we will jump forward to early 2000 when the P/E ratio was a stratospheric 45, based on very positive investor sentiment, moderate interest rates and a belief that the technology companies would increase earnings exponentially forever. From that peak in 2000, the S&P 500 has had two bear markets and has gone virtually nowhere during the decade.

Let's now put earnings and P/E ratios together. We will not use a P/E of 7 or 45 in our calculations, as both of those are outside historical norms, but will instead use the historical range of 10 to 23. The grid below factors in the previously-mentioned earnings range of $65 to $85 and the P/E ratio range of 10 to 23, as well as the average of 16.4, giving us the possible range of the S&P 500 over the next few years. As a reference, the S&P 500 closed 2009 at 1115.

S & P 500 at various P/Es and earnings		
	Earnings of $65	Earnings of $85
P/E of 10	650	850
P/E of 16.4	1066	1394
P/E of 23	1495	1955

Well, you say, 650 to 1955 is a pretty broad range and you are not really stepping out on a limb here. You are right, which is why we are talking about a wide range of possible outcomes. Will we head back down to 650? Quite possibly, if interest rates take off and investors turn bearish, or if there is a non-financial event like a successful terrorist attack. Will we head to an S&P level of 1955? Possibly, if Main Street gets some confidence, earnings show some stamina, and our leaders in Washington get their collective heads in the game.

Finally, if a market is moving up, it has a tendency to keep moving up, and vice versa. On December 28th, 2009, the S&P 500 had officially recouped 50% of its losses from its peak in late 2007. Many traders look upon this as a positive (how could it not be, really) and feel that if the market can hold this level for several trading sessions, it will go higher. If it doesn't, it won't. See the chart below.

Negatives

"We never dreamed Congress would be this irresponsible. It is the stupidest policy imaginable." - estate planning lawyer Carol Harrington

Ms. Harrington was talking specifically about the ambiguity regarding the future of estate tax law, but you could apply this quote broadly to Congress over the last 20 years. This is one of our greatest fears in 2010 - that our government makes policy mistakes that hinder or even prevent an economic recovery. As an example, consider Senator Chris Dodd, who, when asked why Congress continues to pursue the healthcare bill when a majority of Americans didn't want it, said, "I think they do want it." Is that arrogance or ignorance, or a combination thereof? The Federal Reserve has a daunting task ahead of it with regard to its battle to help stimulate the economy. Holding interest rates too low for too long risks a resurgence of inflation, while increasing rates prematurely may help to derail an economic recovery.

Heading into the beginning of 2011, we have a new acronym to throw around. Several years ago, all the talk was about BRIC - Brazil, Russia, India, China – as these countries were going to be the new global giants. The new acronym is PIGS -Portugal, Italy/Ireland, Greece, and Spain – and it is not a good thing to be in this group. Housing bubbles, high unemployment and rising government debt plague each of these countries. Add the debt problems of Latvia, Estonia and Lithuania to this mix and you have a real headache for the European Union. There is suspicion that many of the European banks have not fully realized the bad mortgage debt on their books and that could roil the financial markets in 2010.

Let us not forget that we still have a mortgage default situation in our own backyard. This situation continues to evolve, as many mortgages will re-set in 2010, with many loans going from a "teaser" rate to a higher interest rate, or from interest-only to a fully amortized payment. In some of the harder hit states, borrowers are making what are referred to as "strategic" defaults. In this case, even homeowners with good jobs are defaulting, deciding instead to rent and then having disposable income for things like vacations and new cars. This trend is worrisome, but has the perverse effect of increasing consumer discretionary spending. While this next wave of defaults should not have the cascading effect we witnessed in late 2008, this will impair the recovery of the financial sector and depress the housing sector for many years to come.

The deflation/inflation debate also comes into play here. In late 2008, there were fears of a deep deflationary spiral, similar to what occurred in the Great Depression. This has given way to slight inflation over the past year: 1.4% for the twelve months ended November 30th, with the bulk of the increase coming from energy. However, we believe that there is little chance of a return to the hyper-inflation period of the late 1970's, with current high levels of unemployment, excess manufacturing capacity and a housing glut. Interest rates are also likely to remain very low for most of 2010. If investors are firmly in the deflation camp, they should own long-term bonds, while shunning both stocks and commodities. If investors believe in hyper-inflation, they should hold cash and commodities. Making a bold bet either way would be very risky. Part of the deflation/inflation debate includes the direction of the U.S. dollar. A weak dollar would make imports more expensive, while a strong dollar would negatively impact the price of many commodities, most notably oil. While a weaker dollar is needed for a more balanced global economy, there is always the possibility of a strong counter-trend rally in the dollar, opening a window for additional investment in some sectors like commodities and foreign-pay bonds.

Finally, China is playing a bigger part on the world economic stage. It has continued its growth during this global slowdown, accomplishing it with bank loans of 16%(!) of GDP this year, sparking fears of asset bubbles in stocks, commodities and real estate. (Prime residential property in Hong Kong is selling at $2,400 per sq. ft.!) Should the central powers sharply curtail this lending, this will hurt speculative investment and potentially take some of the froth out of the markets, dropping stock prices.

Closing Comments

We hope not to see another volatile year like 2009 in the near future. However, we know that a financial crisis is all but inevitable in the future, just as these events have occurred in the past. What is important is how we react to the situation confronting us, which is why having a plan and executing it properly is so important. Consider the CGM Focus fund, which has had very solid returns over time, but is extremely volatile in how it achieves those returns. During the ten years ended in November 2009, CGM returned 19% annually, but the fund recorded annual investor returns of minus 11%. This is because the volatility made it difficult to buy and hold, so investors bought when the fund was hot and then sold when the losses became unbearable. Investors with a disciplined approach, many with an advisor, did not fall prey to this fallibility of human nature.

2010 will be full of talking heads on the financial news networks, all telling you what they believe is going to happen the next day and why. The truth is that they really have no idea, but the shows need to fill air time. Why anyone would go on a television show with the intent to just talk louder than the other guests is beyond us. The few forecasters that we listen to tend to have some similarities. They are usually more analytical rather than promotional, and carefully dissect an investment idea by examining the range of likely outcomes that could occur rather than issue a bold estimate of the price of something in the future. The economic world is one of uncertainty rather than certainty, and no amount of bluster can change that. For that reason, we typically do not make predictions regarding market movements, but prefer to discuss probabilities. We can assure you, however, that we will be diligent in our research, clear in our communications to you, and ready to make adjustments should the facts before us change.

We look forward to working with you in 2010, a year in which we anticipate a wide range of possible outcomes.

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