Market Update

January 2010 Review

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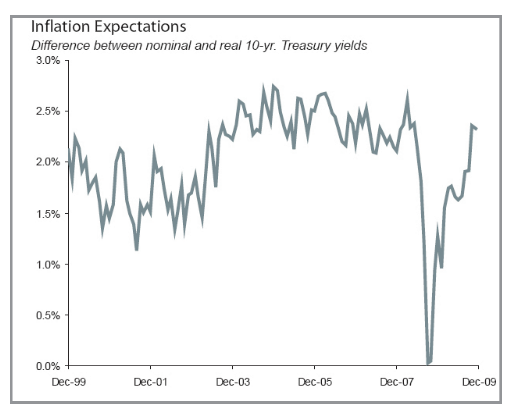
Life After the "Lost Decade" – What's Next?

January was a month of seemingly mixed results. Despite corporate America reporting generally favorable fourth quarter earnings and other positive economic data being released, most equity indices fell for the month. The Fed estimated fourth-quarter 2009 Gross Domestic Product ("GDP") at 5.7%, the largest quarterly GDP gain since the third quarter of 2003, strengthening the belief that the recession ended mid-2009. However, despite the two quarters of GDP growth and sharp returns from both the equity and credit markets during the year, calendar year 2009 GDP was still a dismal -2.4%, the worst year since 1946. As with a typical economic recovery, inventory replenishment provided the largest contribution to GDP in the second half of 2009. In fact, inventories represented 3.4% of the 5.7% fourth quarter GDP gain; the largest contribution made to GDP by inventories in over 20 years. Other positive reports included fourth quarter consumer spending, which rose a slightly better-than-expected 2%, and residential construction rising 5.7% in the fourth quarter. Business equipment spending also rose in the fourth quarter, up 13.3%. Both fourth quarter earnings and revenues have beaten consensus estimates so far, by 80% and 65% respectively.

Despite the positive data, the equity markets struggled both here and abroad during the month. The broad equity market S&P 500 Index took a breather from its strong gain in 2009, as the index lost 3.5% in January. The blue-chip Dow Jones Industrial Average ("DJIA") lost 3.3% for the month, after gaining 22.7% in 2009. The tech-heavy NASDAQ fell 5.3% in January, following a 45.3% gain in 2009. After exceptional relative and absolute 2009 returns, the international markets also experienced negative returns for the month. On the heels of Chinese inflationary concerns and a strengthening dollar, the MSCI EAFE Index posted a loss of 4.4% in January, after gaining 32.5% in 2009, while the MSCI Emerging Markets Index was down 5.6% for the month, after gaining 79.0% in 2009; the index's highest ever annual return. Much of the losses were contained to the last three weeks of January, as the first week was positive for most indices.

The retreat in equities did not infect those of the fixed income markets. The broad Barclays Capital U.S. Aggregate Index returned 1.5% in January after a 5.9% gain in 2009. Low quality credits continued their incredible rise as the Barclays Capital U.S. High-Yield Corporate Index gained 2.0% in January. The Barclays Capital U.S. Government Index returned 1.5% for the month as interest rates on government debt came down, while other sectors of the bond market benefited from investors' seeking a safe haven where they could still gain yield.

With seemingly positive data, what factors led the markets to reverse course in January? Unemployment and underemployment remain major issues as many question the idea of a jobless recovery. In order for the unemployment rate to remain steady, it has been estimated that 125,000 new jobs need to be created monthly to offset new workers. The removal of government stimulus and its effects on the consumer and the housing market are also a significant concern. The reliance of the housing market on the first time home buyer tax credit can be seen in recent pending sales contracts. Pending sales dropped 16.0% in November, as the tax credit was originally set to expire November 30. Approximately 25% of homeowners



Source: J.P. Morgan

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are under water in their mortgages, and a high percentage of the population is underemployed and over-levered in terms of credit card and loan debt. In addition, the threat of inflation is still looming in the back of investors' minds. The Fed has some tough decisions to make, including the timing of raising interest rates. Rising too soon can endanger a recovering economy and banking system. Inflation expectations can be shown in the difference between the nominal (i.e., current yield) and real (i.e., current yield minus rate of inflation)10-year Treasury yields, as shown in the chart. As you can see, expectations have returned to pre-recession levels.

With current data providing mixed signals and coming off an investment decade many referred to as the "Lost Decade," how does an investor proceed? We believe emphasis remains on both long-term outlooks and diversification* as the keys to investing success. The father of value investing, Benjamin Graham, once said "Individuals who cannot master their emotions are ill-suited to profit from the investment process." This can be seen in the results from a study from Dalbar, Inc., a leading financial services market research firm. They computed the average stock fund return and the average stock fund investor return; the results were quite alarming. The average stock fund returned a very respectable 11.6% annually from 1988-2007. However, over the same period, the average stock fund investor earned only 4.5%. Compared to the average stock fund, investors lost 7% of return potential annually, which could be from the investor trying to time the market, underlining the importance of a long-term outlook. "Buy low, sell high" is the advice always given, yet, so rarely implemented. Looking back on the "Lost Decade," diversification was vital to first-rate investor returns. If one was solely invested in domestic large-cap equities, as measured by the S&P 500 Index, the total return for the January 1, 2000 to December 31, 2009 period was a discouraging -9.1%. However, if one took a more diversified approach by incorporating domestic equities in the large and small-cap space, international equities, fixed income, and real estate, the "Lost Decade" would have not seemed so glum. Over the same 10-year period, the MSCI EAFE Index returned 17.0% and the Barclays Capital U.S. Aggregate Bond Index returned 84.8%. The small-cap stock index, the Russell 2000 returned 41.3%, while Real Estate, as represented by the FTSE NAREIT Equity REIT Index, nearly doubled with a strong return of 179.8%. A diversified strategy (25% S&P 500, 10% Russell 2000, 15% MSCI EAFE, 5% MSCI Emerging Markets, 5% Real Estate, and 40% Barclays Aggregate) returned 55.1% for the 10-year period ending December 31, 2009; far exceeding the -9.1% total return of the S&P 500 during that period. Over those 10 years, this same strategy never lost more than 23.5% in one year, which is less than all but one of the indices that it was comprised of.

A sideways market is a possibility for the near-term, with dismal economic growth rates factored into the market. Rising inflation and interest rates, coupled with a weak economic recovery, could suggest a market similar to that of the late 1970's and early 1980's. Meanwhile, economic slack and a fragile consumer could limit spending and ultimately create a low growth environment. However, it is important to look under the hood at the last sideways market, as there is more to the zero return environments than meets the eye. It is easy to look at the broad markets and assume that the underlying companies performed in the same manner. But, that is not the case as highlighted by Warren Buffet at Berkshire Hathaway and Bill Ruane at the Ruane, Cunniff & Goldfarb, Inc. Between October 1, 1975 and August 6, 1982, the Dow Jones Industrial Average returned 0%. Over these same seven years, the book value of Berkshire Hathaway rose 676% and the net asset value of the Sequoia Fund (managed by Ruane, Cunniff & Goldfarb, Inc.) returned 415%. Both Buffet and Ruane were not active traders, but holders of quality companies. If another sideways market is upon us, it is likely that stock pickers will prevail – those who can identify mispriced (i.e., undervalued) stocks.

January has kicked off the year on a negative basis for equities, which would lead some to believe 2010 will be a negative year; if buying into the "January Effect" rule. As we learned last year, this "rule" is not golden. Following a negative January, 2009 turned out to be a stellar year in the equity markets. January effects, sideways markets, buy and hold strategies, and stock pickers markets all have some merit, but are certainly not absolutes in all markets. While cycles certainly do occur, what drives the economy and markets at any point in time can be random and independent and we still strongly believe the best way to invest is to have a long-term, diversified strategy based on one's own goals, objectives and time frames.

**Diversification, or "not putting all your eggs in one basket", can be an effective strategy to help you manage risk; however, it does not guarantee against a loss, nor is there any guarantee that a diversified portfolio will outperform a non-diversified portfolio.*

Definitions & Disclosures:
An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S. based securities listed on the NASDAQ Stock Market.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital U.S. High-Yield Corporate Index is a market value-weighted index which covers dollar-denominated, fixed-rate, below-investment-grade debt securities.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

The Barclays Capital U.S. Government Index is a market value weighted index of U.S. government and government agency securities (other than mortgage securities) with maturities of one year or more. Returns are inclusive of accrued interest.

The Russell 2000 Index is a market capitalization weighted index consisting of approximately 2000 small cap U.S. stocks. It is a subset of the larger Russell 3000 Index and is often used as a benchmark for small cap stocks.

The FTSE NAREIT Equity REIT Index is an unmanaged index reflecting performance of the U.S. real estate investment trust market.