Commentary and Outlook August 2009

Global equity markets staged a dramatic advance in early March as several economic indicators declined at a slower rate. The advance continued through early June. In retrospect, it appears that the advance confirmed investor expectations that a more severe recession would not occur, as it occurred in an environment of a slower pace of decline in economic activity. Investors now want evidence of further improvement as they evaluate second quarter earnings reports. Signs of an actual increase in economic activity will likely excite more demand for stocks, especially given still low levels of interest rates and benign inflation. This is exactly what happened in July. In July macro economic data has unambiguously improved, including retail sales, rate of job loss, housing sales and monthly sequential prices, as well as somewhat better than expected GDP, all of which have been well received as the equity markets advanced sharply from about mid-month.

Although all equity markets increased, emerging markets by far performed the best as the MSCI Emerging Market Index increased 34.96% in the second quarter, leaving it up 36.52% for the first six months of 2009. (it was up 11.23% in July and now is up 51.50% year-to-date.) The S&P 500 Index was up 3.17% in the year's first half, but recorded one of its weakest decades ever as it lost 2.22% a year for the ten years ended June 30, 2009. The MSCI Emerging Market Index generated an annualized rate of return of 8.97% for the same ten years, reflecting a clear shift in investor preference and stronger fundamental earnings performance and prospects. Of course, expectations for companies in the S&P 500 were at a very high level a decade ago towards the end of the dot-com boom, while emerging markets were largely ignored after the steep declines they suffered in 1998. Over the 20 years ended June 30, 2009, however, the S&P 500 annualized rate of return was 8.38% and the MSCI Emerging Market Index annualized rate of return was 11.54%. The volatility/standard deviation of return of the emerging market index was much higher than that of the S&P 500 (24.78% vs. 14.96%), but investors were paid for this excess volatility as the cumulative return for the MSCI Emerging Market Index was 837.47% vs. 420.25% for the S&P 500. High grade fixed income, the popular proxy for which is the Barclays Capital U.S. Aggregate Index, formerly the Lehman Aggregate Bond Index, produced a return of 1.19% in the year's first half and 5.98% a year for the decade.

Of course, a few indicators mentioned above indicating economic recovery may be just a head fake. Concerns that the government's stimulus program is not sufficient to reverse the decline in economic activity and the high unemployment rate have contributed to doubt about the profile of an eventual economic recovery and this was reflected in early June as the equity market rally stalled. Commodity prices that also recovered strongly in the spring began to decline modestly in June, although have recovered in July. Worries about increasing rates of general price inflation subsided as the still high and probably increasing unemployment rate and relatively low global capacity utilization remain quite visible to investors. The shift in borrowing from consumers and corporations to governments coupled with accommodative global monetary policy suggests that price inflation, while a more distant risk, is not an insignificant one, especially in the physical commodity sectors of energy, agriculture and metals, where capacity expansion is unlikely to keep up with demand when it returns to prior peak levels.

Our last quarterly letter addressed the equity market's propensity to discount improvement in fundamental factors well in advance of evidence of such developments. When investors lengthen their investment horizons, they have tended to do so dramatically and the rally witnessed this spring is a demonstration of such behavior. Although it is widely expected that an eventual economic recovery will be weak as consumers and corporations reduce their debt, the fact that the equity markets have not retreated further from levels reached in early June suggests that those with cash reserves believe that equities have the potential to produce returns competitive with bonds. The resiliency of equity markets since early June is particularly impressive given the improving, but still impaired residential housing market, the deteriorating commercial real estate market, the decline in consumer confidence and the jump in the unemployment rate. Add to such restraining factors, the likelihood of meaningful tax increases at local, state and federal levels and it is rather clear that eventual economic growth will be less than optimal. Of course, the equity markets remain volatile and are susceptible to either good or bad incremental news. However, it is difficult to see how economic conditions could be worse on a year-over-year basis in this year's fourth quarter or the first in 2010. Stocks may have approached fair value in general in the sharp rally this year and may be subject to some disappointment, but to expect a broad economic or financial system implosion as a catalyst to end this rally, as occurred last fall or early this year seems to be a stretch.

We believe that stock selection will come into much sharper focus for all investors in contrast to a broad index approach. There is some evidence of this with the popularity of sector ETF's, although managed portfolios still hold the potential to add value after fees that justifies the effort to identify the winners, in our view. We continue to advocate engaging those managers who maintain their focus on fundamental company analysis, as earnings ultimately determine the success of a company's securities in the long-term, notwithstanding the market's short-term preferences. The preference for liquidity that is clear in the wake of the near failure of the credit markets last year has resulted in a more trading oriented approach to equities and bonds that is reflected in market volatility, albeit it down from peak levels that characterized the near panic of late last year. We believe that the notion of building portfolios one stock at a time without the pressure to mimic index characteristics or be fully invested will gain adherents. Market timing will remain as seductive as ever, but will have very long odds of consistent success, in our view.