

Advocate Asset Management, LLC

MARKET COMMENTARY

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There are always questions about the capital markets. That is because there are always uncertainties about what the future holds. Two years ago, most investors were absolutely certain that a large financial institution like Bear Stearns would not fail. One year ago, investors were certain that a large insurance company like AIG was infallible. Eight months ago, the Bush administration was certain that an infusion of \$700 billion was a large enough amount of capital to restore confidence into the financial system. How did these 'absolute truths' turn out to be so very wrong?

There seem to be many more questions these days as we try to look forward in time. In large measure, this is because of the recent past and its impact on investor psychology. The process of framing questions is a process that gives clues to the overriding concerns of investors. In this period — one reflected by fear and uncertainty — the questions expose an already compressed investment time-frame, once viewed in years and now focused on months, weeks and even days.

Richard Bernstein recently authored some lessons after ending a twenty-year research career at Merrill Lynch as head investment strategist. We would like to cite three of the lessons which mirror our view that fundamentals and rational thought really do matter, no matter how exaggerated the prevailing euphoria or despair.

- Bull markets are made of risk aversion and undervalued assets. They are not made of cheering and a rush to buy.
- Diversification does not depend on the number of asset classes in a portfolio. Rather, it depends on the correlations between asset classes in a portfolio.
- Leverage gives the illusion of wealth. Saving is wealth.

To which we would add, the key to investment success is to avoid losing a large portion of one's capital during market downturns.

Outlook

In February 2008, only 14 months ago, we cited that over-confidence in the financial markets was our primary concern. What a prescient statement this was during a time when the Dow was at 12,500. This time, we cite credit card defaults as our primary concern. The banks are tightening conditions in their credit card operations. This is while many are losing their jobs and being restricted in other forms of credit (such as home equity loans that have dried up). This causes card holders to be even more dependent on their credit cards as their sole source of credit. There is a move within Congress to place a cap on certain credit card interest rates, fee charges, and other factors. So, the banks are acting particularly aggressive at this stage of the economic downturn. But aren't they supposed to loosen credit under the stimulus packages? Somehow this inconsistency is not noticed or is being ignored as banks strive to extract profit from wherever they can generate it in their far-flung operations.

Contents

Outlook

Our economic outlook

Client Portfolios

Details of client portfolios

Market Highlights

Brief overview of broad market performance

Catchy metaphors abound alluding to the season of spring in the financial markets with references to “green shoots” popping through the cold, dank ground. But much of the so-called improvement that we have seen recently is based on opinion surveys and creative earnings reports, rather than actual hard data on economic activity. It is far easier to form an opinion than to go about making something happen. We certainly appreciate the validity of opinion during normal market cycles, but this is not a normal market cycle. We still require hard data to substantiate any sort of economic trend, especially at major turning points such as the recovery hypothesis. Based upon our experienced viewpoint, the hard data is still very weak.

Even the hard data that points to less-bad news is difficult to understand. Although the direction of some data series may be slightly improved — albeit over a very short time-frame — the aggregate level data is still quite negative. There are more than six million people currently collecting unemployment benefits in the U.S. Furthermore, this number is rising and will not peak for several quarters.

For several years, we have been cautioning about the dangers of the loose creation of debt and assumption of leverage. This includes speculation in the residential housing market, the huge appetite for risk among bank proprietary trading desks, the effect of the prime brokerage firms lending huge amounts of capital to hedge funds applauding the seemingly unlimited amount of liquidity, the large phantom income received by investment bankers who were securitizing junk debt with ‘seals of good housekeeping’ approvals from the rating agencies (who were paid fees, it appears, to be lenient in their analyses) and the surprisingly easy terms of debt covenants of private equity funds using leverage on leverage to extract huge profits and even more huge fees from willing financiers. The fuel was piled high. All that was needed was the spark.

Have we reached the ultimate stock market lows with the swift decline from early January to March 9th? This is perhaps the crucial question as the market rally has substantially recovered the losses on paper that were causing near panic during the first week of March. The broad indices were down about 25% for the first nine weeks of the year, a stunning rate of decline. As of this writing, about 75% of that has been ‘made up’ by the stock rebound. *Nevertheless, we do not believe that we have seen the bottom in terms of prices or duration of this highly volatile and unpredictable set of conditions.*

When the economy does bottom out, it is likely that the eventual recovery will prove to be uneven, causing the flow of positive surprises to be uneven. During these periods, the risks to stocks will actually be the greatest. The naturally bullish sentiment of the financial services industry and human psychology will combine (as they usually do) to try to “make up” the large losses suffered during the past 15 months. This will lead to overbought conditions and sharp corrections (further destroying capital). Periods when the market is overbought and investors have high expectations of accelerating positive data is *when vulnerability is greatest.*

What does the recent rally in stock prices mean for the average investor? Those who have followed the advice of the traditional managers, banks and brokerage firms? By that, we mean those who are “waiting it out” and maintaining the status quo, all under the guise of not “timing the markets”? Or those who are told to “buy the dips” and increase their equity exposure? If we are correct and valuations have not hit the level required for a major multi-decade market bottom and if we are correct that the market at these levels has the potential to decline another 30%, then those following the traditional approach will be decimated. If we are wrong, then this implies that the most difficult economic conditions worldwide in 80 years have been fully discounted and the markets worldwide made their lows in early March. And, that would mean that this is a new Bull Market. Implausible in our view.

In last quarter's commentary, we described various scenarios as to the possible shape of the recovery (when it comes). It will come, but not as soon as the government cheerleader wants investors to think. They want to convince investors to try to keep confident while they play with statistics to soften the blow of bad tidings. This is not an indictment of the Obama administration; both parties play these games of "spin the economic statistics" when they are in power.

Advocate does not buy into the "Glimmer-of-Hope" scenario being fed investors every day by the Washington and New York experts. There are too many hurdles to overcome. Too many debtors unable to pay back their obligations (individual and corporate). Too many weakened corporations with revenues collapsing and earnings impaired. Too many unemployed to believe that consumers with tax rebates will vigorously turn around their moribund spending to get us out of the current tailspin quickly. Too many clever maneuvers being foisted on us by companies that appear to be in recovery mode by showing improved operating earnings (in contrast with the more encompassing reported earnings). And, let's not forget the multiplier effect of one consumer's decision to pull back or postpone spending thereby causing many such decisions by others later on. The dominoes fall in sequence due to the structure of their crowded placement.

Let's examine some of the key drivers of industrialized economies to better understand Advocate's thinking to why we strongly believe that we are not at a market bottom at this time.

The aggregate level of weekly unemployment claims is still enormous. We know that this is a lagging indicator. Nevertheless, in this recession, the consumer is the key to when the economy turns around. We expect unemployment to continue rising for at least a year, and maybe taper off somewhat in the economy's attempt to grow. We expect government-reported unemployment to peak at 10% to 12% and the more accurate number (encompassing those who have given up seeking employment and those who are under-employed) to reach 15% to 17%. (For comparison, the unemployment rate hit 25% during the 1930s, and if agriculture is eliminated from those statistics, the comparable unemployment rate in manufacturing and service sectors of the economy hit 37%!). It will not get that bad this time, mainly due to various safety nets that did not exist in the 1930s. But, it could be prolonged without a firm and decisive recovery.

What is different in this cycle than all of the post WWII recessions is that unemployment among the highly educated is at a record and rising. In the past, there was a negative correlation between the number of years of school and unemployment rates. (The less schooling, the higher the level of unemployment.) This cycle has broken that correlation trend; the pain is egalitarian. In fact, the statistics may be understating how bad the situation is in the finance, accounting and legal sectors in major urban areas. Many of the professionals who have been laid off may not be collecting unemployment yet because they are still receiving severance payments from their most recent employers.

The shipping indexes, a measure of worldwide economic activity, are still at very low levels. Ocean-going container vessels are being mothballed at a rate not seen since the end of WWII (and those back then were decommissioned military vessels). The Baltic Dry Index, an index of shipping rates for dry commodity goods (iron ore, grains, coal, etc.), has reversed its incipient recovery and is in a downtrend again. Is this an indicator of a false start in the 'recovery'? When companies return to re-building inventories, this will show up in changes in the activities of the transportation companies.

Rail and trucking shipments are down and so are the courier services in unit volume. Detailed surveys of truckers by the economic consulting firm ISI highlight the low level of trucking activity and still-negative outlook (although there was a slight pick-up in March).

In the services sector — one of the areas that has been in the growth column for years — things are stagnating. People are doing without or finding ways to cut back. This is normal in a depressed economic environment. Now, replicate these attitudes throughout the service economy and you observe a different mindset about spending and the re-evaluation of what is a necessity.

Sales of luxury goods have really taken a hit globally. This did not occur during past recessions. In past economic downturns, wealthy consumers were largely untouched. High-end consumers continued to buy fancy cars, boats, jewelry, took exotic vacations, etc. This reveals the wide-spread nature of the current difficulties among consumers of all strata. Even those who are still considered wealthy are being impacted, in their pocketbooks by declining asset values and psychologically in their fears.

The best estimates from forecasters of residential home prices confirm data accumulated by the S&P Case-Shiller metropolitan area surveys. Prices are likely to decline another 10% to 15%. Some have suggested that bank-owned residential properties in foreclosure are being held back from sale to avoid overloading (and further depressing the realized prices) in local real estate markets. According to economist and market strategist, A. Gary Shilling, at a 37% peak-to-trough price decline (his estimate), almost 25 million homeowners — or nearly half the 51 million with mortgages — will be under water, with their mortgages larger than their house values. In total, the gap in value between residential debt and equity will approximate \$1 trillion. What would happen if the banks released the foreclosed homes inventory onto the market? Home prices would plummet with this glut of for-sale homes and the recovery period would stretch out even further into the future.

Mr. Shilling reports that the trend in financial preparedness for those nearing retirement — middle-aged family heads of households — has fallen dramatically. In 1983, 33% of working-age households were financially unprepared for retirement. As a consequence of reduced savings rates and greater household borrowing (especially against home equity), this “unpreparedness” number rose to 40% in 1998, to 44% in 2006, and is now over 50%.

The Employee Benefit Research Institute reports that the average 401(k) retirement account lost a fifth of its market value in 2008 — a loss of over \$600 billion. Plan participants cannot count on their homes appreciating to anything near what these values were three or four years ago. They cannot count on a vigorous and lasting stock market rise. So, we surmise that many folks who reach normal retirement age will be working past age 66, trying to supplement withdrawals from their retirement accounts and possibly even qualifying for increased Social Security benefits. *Does anyone think that these people will revert to becoming enthusiastic spenders, even if they have access to credit? The profits of consumer-oriented companies will be adversely impacted. This is not being properly discounted in forecasts of a speedy recovery.*

While the wave of sub-prime mortgage resets peaked this past winter, other mortgage delinquencies are headed for peak levels and tough times during 2010. Some of the teaser interest rates on prime loans and the passage of the 5-year mark on the 5-year ARM mortgages issued in 2005 and 2006 come due for resets in 2010 and 2011, respectively.

In a macro sense, we are in a race to the bottom in terms of interest rates and currency values. Each of the major economic power zones, the Americas (the U.S. and Canada), Western Europe and developed Asia are trying to fix systemic problems in their integrated over-leveraged banking structures. These economic zones are attempting to fix trade imbalances through floating currency relationships. Underneath these attempts are resurgent calls for economic nationalism popping up as protectionist trade barriers (as in “Buy America”). International trade will suffer greatly as this economic cycle runs its course.

Some readers may find this discussion overly pessimistic. We respond by saying that our responsibility is to try to evaluate the evidence as it exists, not necessarily as it is presented to the public by self-interested parties. For example, a great deal of the supposed profitability that the banks are announcing for the first quarter has more to do with accounting maneuvers than actual cash flow profitability. (There are, unfortunately, too many examples of this to list here.)

The free-fall period of the economic slowdown is indeed over. However, it is a mistake to assume that the recovery has therefore started. The end of the decline is not the start of the recovery. Many economic variables need to show signs of stabilizing first.

When will Advocate be inclined to invest our clients’ large cash reserves? The key to this market is to have the opportunity to earn *sustainable* yield levels reflecting *sustainable* earnings recovery and high payout ratios for dividends. That is what will bring investors back into the equity market. From our vantage point, we are not close to that point of stabilization, so we continue to maintain large cash reserves.

Client Portfolios

Last fall, we postulated that this economic correction would be far more severe than the consensus at the time. That is why we wrote each client and asked for and received special variances to their equity allocation investment policies. We sought permission to go below each client’s lower boundary to much lower levels approaching zero percent. This, more than any other action, helped to preserve our clients’ assets during this horrible period of price erosion. This type of action should be an investment advisor’s first responsibility — to preserve client capital.

There was relatively little turnover in the first quarter in client portfolios. We did execute a few profitable trades, particularly in the Financial sector, but given the low equity commitments for each trade, this did not dramatically alter performance. We continue to look for these opportunities to add value to client portfolios. But to be clear, these are opportunistic tactics, to buy a temporarily mispriced asset and sell it off on a rebound. We are not investing for the long-term at this point.

In portfolios that had exposure to long-duration U.S. government debt, we sold off this exposure at the end of March. The remaining fixed-income exposure is in very high-quality short-duration U.S. government debt and market-duration inflation-protected securities (“TIPS”). We think that there will be some terrific fixed-income opportunities to own higher-yielding bonds in the future, as defaults increase for sub investment-grade corporate bonds and municipal bonds.

The biggest impact on portfolios during this period was the full liquidation of equity positions during early April, after a 25% run-up in the S&P 500 from the March lows. We did not believe that this sort of bullish movement was based on any hard evidence (although plenty of emotional evidence), so we eliminated equity exposures completely. We thought that this was a logical move on our part, if one evaluates the evidence and not the emotion. Client cash

reserves remain very high. This is what, in our minds, is required in order to fulfill our mandate of preserving client capital. Also, this highlights the flexibility that our particular investment strategy affords.

Market Highlights

The market is showing better consistency these past few weeks (although intra-day volatility is still oddly high). Some say this is an indication of a Bull Market. Others (including us) assert that this move was managed from the sidelines by a combination of governmental cheerleaders and panic short-covering by traders who wanted to make money during the downturn. This is causing the economic and stock market forecasters to project the ending of the recession in the fall of 2009 (six months from now). The typical hypothesis is that the recovery will lead to more confidence over time. As the recovery builds, the economy gets a boost from our inherent entrepreneurial culture and then the U.S. switches to resurgence mode. To us, this is wishful thinking that fails to take into account the enormous psychological damage done to the gilded era of borrow and spend. Belt tightening is the new order of the day. We see the economic problems continuing well into 2010.

The fact is the public is not buying stocks. According to research firm Big Wave Advisors, principal trading (when a brokerage firm buys securities and then holds them to sell to some one else, hopefully at a higher price) is running 21% above its 52 week average and agency trading (the buying and selling of stocks by an agent such as a broker on behalf of a client) is running 11% below its 52 week average. Volume as a whole is down but the large banking institutions are busy and appear to be the ones moving the market. More importantly, they are buying stocks not on behalf of their customers or clients but for their own internal trading operations.

Concluding Thoughts

We think that many investors are deluding themselves by wishing and praying that the markets will recover quickly to the levels that existed as of late 2007. They want the Obama administration to quickly restore prosperity and return us to the way things were. No matter who is in power, the actual ability of government to manage organizations that respond rapidly to changing demands of the marketplace is nil. Investors should count on policy errors galore and sluggish growth during the elongated, stretched out recovery. There are a half dozen bank regulators, the SEC, CFTC, NASD, FINRA and 50 individual state insurance regulators. The U.S. regulatory system is clearly fragmented, but no fragment wants to go out of business or cede control to another agency.

Nobel laureate economist Paul Samuelson, age 93, observes that even if the downturn isn't deep enough to be called a depression, the restructuring that our economy needs to go through means that even after the economy bottoms out, there could be a "lost" four or five years of sluggish growth. Few analysts are addressing this possibility.

The sort of crisis that we are in now has always ended with massive debt liquidations and restructurings. But add to this the lack of a transparent, prudent political will. This is the biggest risk of all. Further, if government tries to do too much, it will prolong this crisis and damage most those who are least able to protect themselves. So, the watchwords are to be patient, cautious and defensive.

We thank you for your support and confidence in Advocate. Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook in detail.

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