

Advocate Asset Management, LLC

MARKET COMMENTARY

THIRD QUARTER 2009

The equity and non-government bond markets have rallied substantially since the March lows. There is wide disagreement as to whether this is a new Bull Market or a rally in a major multi-year Bear Market.

At these price levels and valuations, we continue to be cautious after being very defensive just prior to the free-fall that began last September. We were largely on the sidelines then as asset prices plummeted for some assets and virtually disappeared for other assets for which there were no market makers. We traded some positions off the March lows and made some core investments. But we did not think that the equity market rally had sustainability and therefore, we did not reinvest major portions of client portfolios until June and July. Needless to say, were we incorrect on that one!

We are once again questioning the viability and sustainability of the capital markets recovery. We intellectually understand the dynamics propelling this market upward, a race out of currencies and into anything that is perceived better than low-yielding cash. But considering our capital preservation orientation, we also see the significant problems that must be overcome for a more rational market advance to be validated as being fundamentally based and solidly grounded.

Interestingly, preserving capital is not measured as a day-to-day endeavor. Who can be right consistently about short-term, virtually random events? On the other hand, the dynamic that we see unfolding is certainly not a “buy-and-hold-forever” climate that benefits from a static asset allocation and the fifty-year view. This approach will likely cause grave disenchantment should the markets decline again.

We observe several investor types in the capital markets. One is the investor who is trying to climb back out of the hole from major losses convinced that this is a new bull market. Another is the investor who was protected somewhat on the downside but missed this recent rebound. Now that their confidence is restored, they are ready to invest again. Both of these investor types are adding to the momentum that is driving the rally. In our view, they are at far more risk than they perceive themselves to be.

In another category are the investors who were not hurt as much by the downturn. Some of these think that the all-clear signal has been given and are ready to re-invest at these valuation levels. Some of them also believe that many of the same alarming economic factors are just as evident now as they were last year and are very reluctant to re-invest fully and add to the momentum.

It is naive to think that this cycle – downturn and recovery – is complete, even while indications are that many investors believe it to be. The key is to see this cycle through to its conclusion.

Contents

Outlook

Our economic outlook

Client Portfolios

Details of client portfolios

Market Highlights

Brief overview of broad market performance

Outlook

We emphasize that the dynamics that caused the problems in the first place are still present, despite the enormous amounts of taxpayer money that has been shoring up segments of the economy. To make matters worse, investor attitudes towards risk have reignited to levels seen just before the sharp market slide. This, we fear, is reinforcing the recklessness of those that are charged with regulating the global financial systems and is encouraging more risk taking than the system can handle.

Central banks across the world are keeping interest rates very low — in both absolute terms and based upon historical precedent. Investors conclude that if they extend maturities and own longer-term debt, they may increase their yield (and perhaps their total rate of return). They believe that they can get away with doing this because they suspect that the Federal Reserve, the U.S. Treasury and the Obama administration will not raise interest rates or permit large companies to fail. This is the issue of 'moral hazard' that is mentioned from time to time. Why shouldn't these investors take advantage of this implied floor under securities prices and buy questionable companies like AIG? Why shouldn't they try to gain back the money that they lost during the past year by 'following the herd'? They cannot conceive of the Federal Reserve raising interest rates to stem the incipient debasement of the U.S. dollar... although market forces overseas may be the catalyst to bring this on despite American objectives.

We have commented during these past eighteen months or so that the capital markets have become delinked from the real economy. This was particularly true at the end of last year, and is just as true now. For there to be real economy improvement, international trade would need to pick up significantly. It is disturbing that it continues to decline. Paul Krugman, last year's Nobel laureate in economics and a professor at Princeton University, had a sardonic yet practical review of a jobless recovery (or put another way, a corporate-profits-and-trade-led recovery): "The problem is that this is a global financial crisis... How can we have an export-led recovery unless we find another planet to export to?"

Consumer access to and demand for credit would need to increase significantly, but both are declining now. Employment would need to reverse course and add significant jobs, but unemployment in an absolute sense is still increasing. These tasks are enormously difficult to achieve, even more so in a practical sense (in terms of political foresight and process). Our analysis is that equity levels are anticipating a perfect confluence of political action, regulatory direction and the return of world-wide confidence in the global economy. This convergence would be a first in world history.

Today is not the type of climate in which low-quality stocks should be advancing with apparently unrestrained vigor. There were solid reasons the markets reacted as they did during 2008 and early 2009. Many of those reasons, debt quality (seriously overrated by the rating agencies), over-leverage, too little focus on systemic risk, and so on, still exist (albeit with pools of taxpayer-provided liquidity to mollify the pain).

There is much debate (certainly the case within Advocate) of a substantial and vigorous economic recovery as one of the primary catalysts propelling this market upward. This, in turn, has triggered a discussion with two opposing points of view. First, whether this rally presages a strong economic rebound largely worldwide during the next several years (not quarters). Second, whether the economic rebound will be anemic, fraught with lingering unemployment, and hampered by a cautious consumer who has decided to increase savings rather than consumption. Let's examine both sets of arguments.

Case for a vigorous economic rebound

The case for a vigorous economic rebound is that historically, the deeper the trough, the stronger the recovery (“snap-back” bounce). Many proponents for the ‘V’ recovery look back at history and apply it to the current environment. They look at the pent-up demand created during past recessionary periods and attempt to apply it to the current situation. They also look at the change in psychology which happens when the economy improves and they declare this is occurring now. These are powerful arguments that are difficult to refute, until contrary data presents itself later on in this cycle. This observation, while statistically valid, minimizes the examination of the volatility of recoveries, until a sustainable move up is possible.

Furthermore, the current very low interest rates are highly stimulative; the cost of money is so cheap that the banks can lend at a substantial profit. Because of these low interest rates, investors with future defined liabilities are forced to allocate away from high-quality bonds and low-yielding assets to higher-risk, higher-yielding assets (i.e. shifting away from U.S. Treasury notes and bonds and into lower-rated bonds and high-beta stocks). It is also believed that gargantuan stimulus programs may have unanticipated and important multiplier effects. Even through the end of this year, only about 30% of the committed stimulus funds will have been spent. There is a lot of “dry powder” stimulus cash left, and some of it is flammable in terms of potential inflationary impact.

The new maxim is that the credit crisis is over, so growth will resume. The LIBOR rate and many other bond-spread relationships in the international fixed-income markets reveal the degree of recovery since the depths reached during the winter. Also, the ability of lower-rated companies to borrow in the credit markets seems to confirm this point of the receding of the crisis aspects. Credit spreads have narrowed considerably despite the threat of record defaults in the low-quality corporate bond. It is, however, unsettling to learn that certain banks are turning downgraded securities in collateralized debt obligations into new investments with top credit ratings; they are seeking to create ‘more valuable debt’ to sell or to restructure investor holdings. (Haven’t we seen this reckless behavior before?)

Unemployment claims seem to be declining (although longer-term structural unemployment is a threat to a healthy recovery). And of course, the declining U.S. dollar will boost U.S. exports and spark an earnings recovery for multi-national corporations. Developing-country growth — as in China — may pull us forward out of the economic doldrums.

Valuations in the U.S. equity market have exploded on the upside. The quality of earnings is unfortunately deteriorating but this seems to be of little interest to most investors. In short, the case for a vigorous rebound is highly anticipatory of a perfect union of accurate political will and regulation. Is the expectation of a perfect handoff from public-sector demand to private-sector demand built into stock prices? What surprises are in store for investors who are not vigilant of downside risks at these levels of prices and valuations?

Case for an unusually protracted and elongated rebound

The case for an unusually protracted and elongated rebound — excruciatingly slow — is based on actual evidence that access to and demand for credit continues to contract in areas outside of the too-large-to-fail sector of the global economy. Banks are not eager to lend to small business. Let’s not forget that small businesses employs over 50% of the country’s workers and contributes about 38% of GDP, not inconsequential. And without access to credit, these small businesses cannot expand or hire new (or rehire laid-off) workers. Without access to the oxygen of business enterprises — credit — they simply go out of business.

Households are still hurting. Based on publically available data, household assets in the U.S. have dropped about \$11 trillion since their peak in 2007. This is a total drop from \$78.2 trillion to \$67.2 trillion. However, household liabilities have only dropped \$0.3 trillion. So, household net worth is down from \$63.9 trillion to \$53.2 trillion (an almost 17% decline).

The household savings rate is rising all over the world. Other than the pause caused by the auto-sales bonanza this summer in the U.S. and the spending on residential real estate catalyzed by the federal tax credit on home purchases, the domestic savings rates have remained very high. This is due to household fears of being laid off, of not having a large enough safety net, and of being severely restricted in their ability to borrow on credit cards. Their retirement fund asset values are down, their home equity values are down and their savings cushion is meager to non-existent. The savings rate across the world, particularly in China, is already very high with little emphasis on changing this from central-bank stimulus spending. This set of conditions will be a drag on consumer spending and consumption in the U.S. and in Western Europe. This non-virtuous circle means that employment will grow slowly, spending will be slow, housing prices will stay depressed, the full impact of a recovery will be muted and the likelihood of falling into another recession is increased.

Regarding residential housing, there are several negative aspects that continue to afflict this sector. Financial institutions have a huge excess of foreclosed homes (referred to as “shadow inventory”). The banks are slowly introducing this inventory into the housing market in a very deliberate manner, letting it out as conditions warrant, analogous to how an offshore fisherman lets out his line... slowly and patiently. This is further evidence of a major inventory overhang that will place an invisible ceiling on housing prices for some time to come (despite the government’s attempts to stem additional sales by cajoling financial institutions to mitigate foreclosure action against delinquent borrowers). Moreover, there is a coming tsunami in prime mortgage defaults and foreclosures that will start to gain attention late this coming winter.

The commercial real estate market is in even worse shape. Who owns this commercial real estate market debt? It turns out that more than 150 publicly traded U.S. lenders own non-performing loans in this market that equal or exceed five percent of their overall holdings — a level that former bank regulators say can wipe out a bank’s equity and threaten its survival. Without some intervention in this market, the threat of additional bank failures may be on the horizon, in spite of the predictions that the worst is over.

Real unemployment and underemployment (those working less than 40 hours a week) is still high. Let’s not forget those who have dropped off the list of the unemployed; they became discouraged and are no longer trying to be rehired. They have fallen between the cracks in the Labor Department’s statistical measures. State governments (funded by the federal government) are increasing the time period that unemployment benefits may be paid. Several states have gone from 26 weeks to 39 weeks of benefits. Things are still very uncertain for the unemployed. The unemployed usually lose their medical benefits. Consequently, tragic individual stories abound and place pressure on Congress to pass comprehensive healthcare legislation. Of course, this will further expand the federal deficit, crowding out private borrowers, and will tend to be a mechanism that causes interest rates to rise down the road. (This is all so interrelated, like squeezing on a water bed. The bulge shows up elsewhere.)

Right now, earnings growth is primarily a result of two forces: cost cutting and accounting maneuvers (the widening differential between “operating earnings” and “reported earnings”). This means that companies are purposely dressing up their financial reports hoping that investors will be satisfied with the *appearance* of growth. Top-line revenue growth is very

difficult to achieve in this climate. Companies in an industry or sector that are better managed will find that wresting market share from weak competitors will be the primary method of growth in the foreseeable future. There is a surfeit of manufacturing capacity and an oversupply of labor in most service sectors. This is the current operating condition for most industries and sectors. This zero-sum-game will stimulate takeovers and strategic acquisitions (a good thing, in our opinion, as long as government remains a bystander).

If investors are being highly anticipatory of a positive future by looking ahead many years (discounting the interim period of volatility), why does any of this matter? Professional investors ask themselves this question frequently. Some assert that the strength of economic growth will greatly impact the potency of corporate earnings growth. Therefore, the vigor of the recovery is an important analytical factor. How much is real earnings growth? How much is questionable bookkeeping permitted by governments and the beleaguered accounting profession?

We are long-term optimistic on America and many other economies. Our ingenuity as a nation of optimists and problem solvers will help us to overcome difficulties that other nations cannot do as easily, if at all. However, we do face strong headwinds that will slow our progress for a while.

Client Portfolios

We continued to increase equity exposure during the third quarter. This may seem counter-intuitive to our economic outlook, but we were shifting client portfolios from a very low level of equity exposures to minimum equity exposures. And this move was predominantly in sectors that we expect to exhibit real top-line revenue growth, rather than just meeting profit-margin expectations.

During early July, we initiated a position in the Oil and Gas Equipment/Services sector. Given that the projection for oil demand is stagnant to decreasing during the next several years in the developed countries (the bulk of demand for now), this was more of a tactical allocation. This initial tranche was sold at a profit during early August. Given our anticipation for continued trend weakness in the U.S. dollar (negatively correlated to the Oil/Gas sector), we again invested in this sector during mid-September.

In early August, we sold our Gold commodity position when it was trading around the \$980/troy ounce range. This commodity has rallied since then, perhaps more as a statement of the exodus away from currencies to hard assets more than any other factor. We cannot envision that this has been an inflation-hedge movement, as inflation is too distant to be an impact now; deflation continues to be the under-reported story.

During August and September, we added to existing positions in Utilities, Healthcare and Technology — all sectors that exhibit real top-line earnings growth as well as favorable prices versus earnings, cash flow and sales. Furthermore, Healthcare and Technology are dominated by multi-national corporations that benefit from revived balance of trade and a weak U.S. dollar.

In mid-August, we initiated a position in Basic Materials (industrial commodities such as copper, used as inputs in production of other finished goods). Although the valuation in this sector is not particularly low, our thesis has been that the rush to exit currencies (notably the U.S. dollar) in favor of hard assets has increased the price of global commodities (most of which are bought and sold in U.S. dollars, regardless of the locality). This is more of an accounting translation than top-line aggregate demand for these goods, but we expect this accounting translation to

continue as long as the U.S. dollar continues to be weak (in other words, as long as the Federal Reserve delays raising interest rates).

Also in mid-August, we initiated a position in residential real-estate investment trusts. This investment focuses on the portion of the residential real-estate market that invests in senior living facilities, self-storage and multi-unit apartment buildings — essentially, the non-commercial, non-retail, non-industrial, and non-single family housing segments of the real-estate market. Our forward-looking view of the real-estate market is not particularly robust, but we felt that the adequate cash flow from operations and ability to refinance debt was sufficient to justify a shorter-term investment in this specific sub-sector of real-estate. We are still negative about commercial real-estate over the next year. We have a sell target for this investment, which is well into double-digit profits now for client portfolios.

Outside of the U.S., we added to an existing position in the country of Chile. Half of this exposure is essentially in Chilean Utilities, with the remainder in Basic Materials (mainly copper) and Financials. However, most of our other investments are also global in nature (that is, revenues are from overseas), even if they are exchange-listed in the United States.

Given our high exposure to U.S. dollar-correlated sectors (sectors that perform well as the U.S. dollar weakens), we implemented a hedge by investing long the U.S. dollar. We also implemented a hedge position by investing in the S&P 500 VIX index (as a proxy for the implied future volatility of the broad S&P 500 stock index). Both of these hedges were closed during mid-October as equity markets rallied and the U.S. dollar depreciated.

For portfolios with fixed-income exposure, we rebalanced away from U.S. government debt towards U.S. agency debt and a variety of non-U.S. credit-oriented debt. We invested in foreign debt denominated in U.S. dollars (this includes developed foreign economies and emerging markets, where permitted by each client's investment policy). We believe that countries will issue more debt in U.S. dollars during the coming years, rather than in local currencies (which had been the trend for the past several years). This will make their debt-service costs smaller as the U.S. dollar continues to weaken. We also invested in non-U.S. inflation-protected debt (denominated in foreign currencies). These investments expose portfolios to debt markets in the U.K., France, Germany, Brazil, Russia, and Mexico, as well as other countries to a lesser degree.

We also invested in a hybrid asset class, convertible securities. These are securities such as bonds and preferred stock that may be converted to equities at specific prices and times in the future. At these equity levels, they tend to function similar to debt when the equity markets are declining and similar to equities when the equity markets are rising. Furthermore, sector exposures are high in Healthcare and Technology, both of which we like.

We are evaluating several new ideas. For example, on the equity side, we are evaluating the global industrial sector, specifically the corporations that focus on supplying the goods and services to the alternative energy field (solar, geothermal, nuclear, hydro, etc). As the price of petroleum increases (probably due more to U.S. dollar weakness rather than demand), the demand for these goods and services should increase. On the debt side, we are evaluating short-duration non-U.S. sovereign debt, as a low-cost view on the weakening U.S. dollar.

Market Highlights

We are not alone in deducing that the capital markets surge is being largely stimulated by central bank policies. They are operating somewhat in concert to maintain very low interest

rates, debasing the value of most currencies. They are attempting to forestall a dangerous deflationary trend like the type that has overtaken Japan again after 20 years of being in the economic doldrums.

The U.S. equity markets, as measured by the S&P500 Index, advanced about 16% for the quarter and 19% year-to-date (still down 21% since the beginning of year 2007). International developed markets, as measured by the MSCI EAFE Index, advanced 19% for the quarter and about 25% year-to-date (still down 25% since year 2007). Even Japan, a rather sterile place to invest for the past two decades, was up about 6% for the quarter, about 8% year-to-date (still down 29% since year 2007). Emerging markets advanced 20% for the quarter and a powerful 61% year-to-date (flat since year 2007, but a wild ride in the interim almost two-year period).

On the debt side (on a total return basis), municipal bonds were up about 7% for the quarter, and about 14% year-to-date (a respectable 15% since year 2007). Investment-grade corporate bonds were up about 8% for the quarter, 17% year-to-date (also about 17% since year 2007). High-yield corporate bonds were up 14% for the quarter, a strong 49% year-to-date (and about 12% since year 2007). Short-duration government bonds were essentially flat for the quarter and year, although up a total 15% since year 2007. Longer-duration government bonds were up a respectable 4% for the quarter, but still down about 5% year-to-date (yet up 25% since year 2007 after a very strong year 2008). Inflation-protected securities continued their steady results, up 3% for the quarter, 9.5% year-to-date and about 19% since year 2007.

In short, it paid to be invested in anything *except* dollar-denominated cash this quarter. Cash was the proxy for being invested in the currencies of countries that are being universally disparaged. Lower-quality investments performed the best, whether in equities, debt or hybrid assets. *But the evidence suggests that the conviction that we would like to see in such a strong rally was missing.* Using publically available data, it is estimated that this year, 18-times greater amounts of cash flowed into bond mutual funds compared with equity mutual funds.

On the optimistic side, this still means that there is a lot of cash not invested in equities that *could be* destined for equities in the future — the infamous “dry powder.” On the pessimistic side, this means that the rally has been driven by low volume, momentum investing, difficult to sustain for any material length of time.

Concluding Thoughts

Our message continues to be one of practical caution, investing in the areas where we see potential (regardless of capital markets momentum) and taking profits when prudent. We are confident knowing that by avoiding the major downdraft, we do not have to take large risks in the recovery phase to come out ahead.

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.

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