

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

3500 Oak Lawn Avenue, Suite 240 · Dallas, TX 75219 · 214-752-5430

<http://www.larrythompson.net>

Volume 13, Issue 4

4th Quarter 2009

The Markets

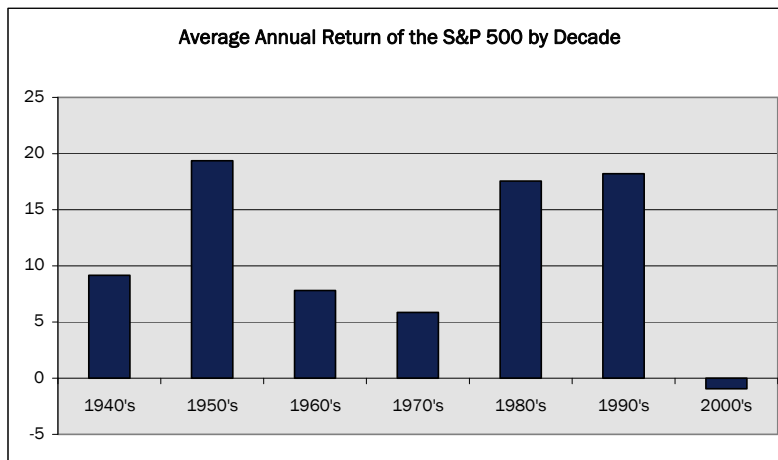
Index	Quarter to Date	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	6.07	28.43	28.43	(5.36)	0.79	(0.49)
Russell 1000 Growth	7.94	37.21	37.21	(1.89)	1.63	(3.99)
Russell 1000 Value	4.22	19.69	19.69	(8.96)	(0.25)	2.47
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	5.92	40.48	40.48	(4.59)	2.43	4.98
Russell MidCap Growth	6.69	46.29	46.29	(3.18)	2.40	(0.52)
Russell MidCap Value	5.21	34.21	34.21	(6.62)	1.98	7.58
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	3.87	27.17	27.17	(6.07)	0.51	3.51
Russell 2000 Growth	4.14	34.47	34.47	(4.00)	0.87	(1.37)
Russell 2000 Value	3.63	20.58	20.58	(8.22)	(0.01)	8.27
<u>International Equity</u>						
MSCI World ex US	2.43	33.66	33.66	(5.34)	4.07	1.62
MSCI World ex US Growth	4.29	30.65	30.65	(4.15)	4.24	(0.97)
MSCI World ex US Value	0.67	36.74	36.74	(6.61)	3.83	4.04
MSCI Emerging Markets	8.57	79.01	79.01	5.42	15.88	10.11
<u>Real Estate</u>						
Nareit Equity REITs	9.40	28.01	28.01	(12.42)	0.35	10.62
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	0.20	5.93	5.93	6.04	4.97	6.33

The final year of the decade will be remembered as a year with two distinct parts. Prior to early March, investors witnessed both a nasty economy and markets that could not seem to find a bottom. Only a few months later, investors seemed almost jubilant. True, much of the jubilation appears to be based on where we are today versus a year ago, not versus three years ago, but it is jubilation nonetheless.

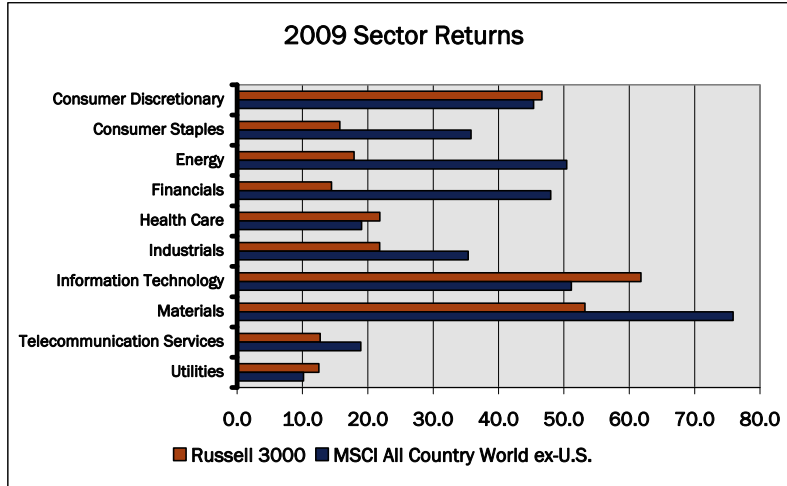
Investment Commentary is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

The financial markets did find a bottom on March 9. As of that date, the Russell 1000 had lost 24% on a year-to-date basis and 55% since its October 9, 2007 high. Many investors thought the market could, in fact, go to zero and that our economy was about to experience the Great Depression, part II. However, the markets gained over 6% on March 10 and have not looked back. The market is now up 69% from its low and gained 28% overall in 2009. The story is similar in equity markets around the world. We find this remarkable given how bleak events looked in March and for the six months leading up to it. In retrospect, it is hard to believe that most of the market collapse lasted only six months. However, due to the severity of the damage, it is likely to be an era studied and analyzed for generations.

Once the recovery was underway, almost every asset class boomed. Emerging markets led the recovery, gaining 79% during the year. The worst performing asset class was large cap value, which gained “only” 20%. Most equities rose somewhere between 20% and 40%. Longer term, the returns for equities are still depressed. For the past ten years, growth indexes around the world are negative, along with the Russell 1000 and S&P 500. **We are currently in the only negative trailing ten-year period in the history of the S&P 500 and have been so since November 2008.** A few more months of strong performance will likely bring the ten-year return above zero percent, but it will surely be a long time before we see ten-year returns close to the index’s historical average of 10%. The chart below shows the returns of the S&P 500 by decade.



Every sector in both the U.S. markets (Russell 3000 index) and the world (MSCI All Country World ex-U.S.) were up double digits in 2009. The leading U.S. sectors were information technology (up 62%), materials (up 53%), and consumer discretionary (up 47%). These three sectors combined were responsible for more than 60% of the market’s return this year. The weakest performing U.S. sectors were utilities (up 13%), telecommunications (up 13%), and financials (up 14%). Interestingly, the U.S. small cap financial sector was negative during the year. However, because the large cap financials were up 17%, the overall financial sector showed positive gains. Internationally, the top performing sectors were materials (up 76%), information technology (up 51%), and energy (up 50%). International small cap financials were definitively not negative, rising 51%.



Another surprising fact about 2009 is that both stocks and bonds were positive. The Barclay's Aggregate gained 6% during the year, which is slightly above average for the past few years, but well below its long term average of 8%. Within the Aggregate index, returns varied dramatically, ranging from -21% for long term U.S. Treasuries to +30% for bonds backed by credit card receivables. Returns in other bond segments (outside of the Aggregate) were also generally strong. High yield bonds were the best overall performer, up 58%, and the lower the quality, the better the returns. Long-term bonds with quality ratings between CC and D gained an amazing 143%! Investors were clearly willing to tolerate risk

	Market Value [%]	Count
Total	100.00	22
JOHNSON & JOHNSON	40.38	9
MICROSOFT CORP	23.95	3
SEARIVER MARITIME INC	7.74	1
PRINCETON UNIVERSITY	6.67	2
STANFORD UNIVERSITY	6.56	3
YALE UNIVERSITY	6.39	1
HOWARD HUGHES MEDICAL INSTITUTE	3.95	1
HARVARD UNIVERSITY	2.70	1
BERKSHIRE HATHAWAY FINANCE	1.67	1

once again. There were of course many safer bonds that performed well. Overall, investment grade corporate bonds gained 19%, but the 22 AAA corporates that still exist in the Aggregate index lost value. The table on the left lists the issuers of these AAA bonds. Treasury Inflation Protected Securities (TIPS) were another source of strong returns, especially since

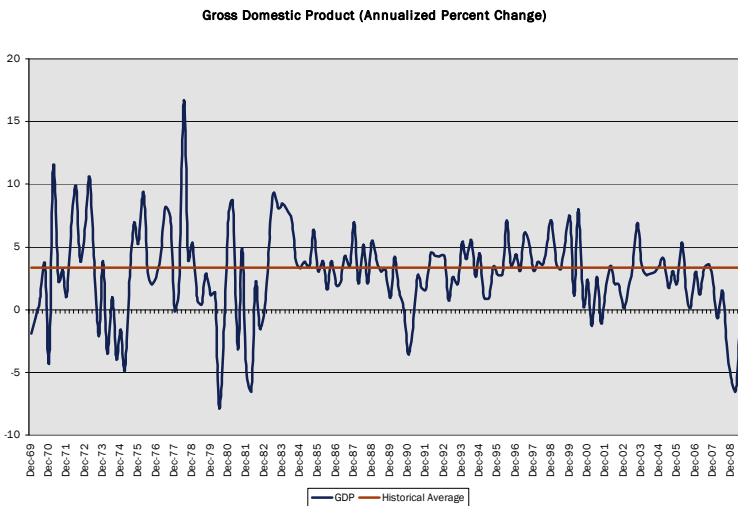
they are Treasury bonds. TIPS gained over 11% during the year, presumably because of investor's inflation expectations.

In absolute terms, it was a great year for the investment management industry. In relative terms, the story is somewhat different. Generally speaking, equity managers had a boom or bust year. After every manager suffered in absolute terms in 2008, many made dramatic portfolio changes in an attempt to stem their losses. As a result, many of these managers were completely unprepared for the sharp recovery and have underperformed – in some case by very large margins. Those managers who stuck with their beaten-up stocks and avoided the temptation to increase consumer staples, health care, utilities and other “safer” sectors tended to outperform. International managers with large emerging markets exposures also did very well. Bond managers will fondly look back on 2009. The Barclay's Aggregate index was easily beaten by any manager who underweighted Treasury securities.

The Economy

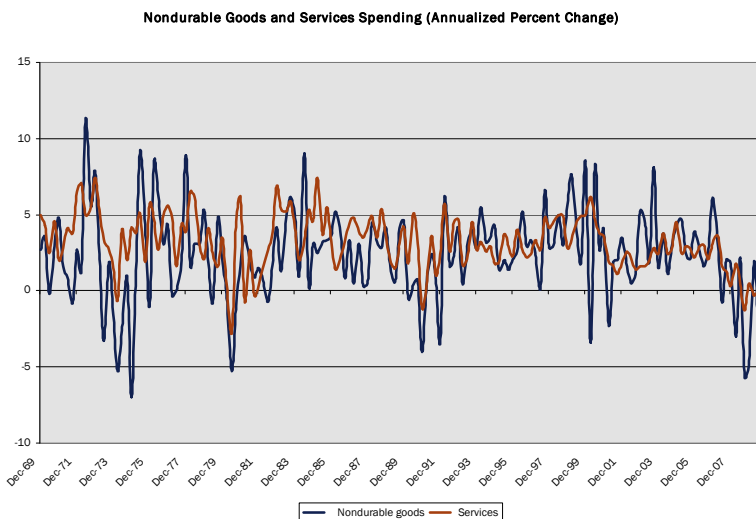
Now that the market is in its tenth month of recovery, how is the economy faring? After four consecutive quarters of negative GDP growth, the economy grew by 2.2% in the third quarter. The biggest drivers of the growth were consumers buying durable goods, businesses increasing inventories, and government spending. Of the three, the most encouraging sign was inventory improvement. Improving inventories could be a sign that consumer

demand is expected to increase and businesses are preparing for increased sales. On the other hand, even the smallest amount of spending will eventually deplete inventories, especially ones that were not replenished during the past year. Increased inventories today may be little more than rebuilding existing inventories, not increasing inventories in anticipation of increased consumer spending. Government spending will continue to add to our economy in the short term, but it may lead to larger expenses for future taxpayers. The biggest contributor to GDP growth during the third quarter – spending on durable goods – is also the most “at risk”.



Consumer Spending

After either declining or barely growing for the past year and a half, consumer spending jumped 2.8% in the third quarter. Consumer spending can be broken into three components, durable goods spending, nondurable goods spending, and spending on services. In the third quarter, durable goods spending rose 20.4%, while nondurable goods spending rose 1.5%, and spending on services rose 0.8%. The government’s Cars Allowance Rebate System (CARS), commonly known as the “cash for clunkers” program, likely drove the spike in durable goods spending. While the program was positive for consumer spending, it was a one time economic boost. Furthermore, the results of the program showed that many consumers chose to buy



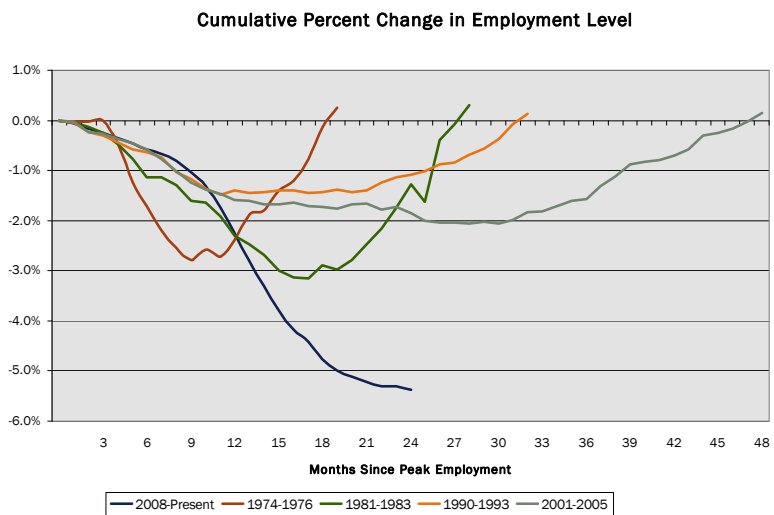
consumers chose to buy Japanese imports, instead of U.S. made cars. Therefore, while consumer spending received a strong boost, imports also rose sharply, offsetting the rise in spending. Any time a consumer buys an imported good, much of the purchase price leaves our economy to benefit

another, a negative for our economy.

Durable goods spending is the most volatile and smallest component of consumer spending. Even with the large increase in the third quarter, it still only made up 12% of overall spending. Spending on services is the largest component, representing two thirds of consumer spending with nondurable goods orders making up the remaining 22%. Nondurable goods and services spending has historically tracked economic growth closely. Neither has shown a strong recovery at this point and should be watched closely for any signs of improvement. It is likely that given the unemployment situation that still overhangs our economy, that all three sectors of consumer spending will find it hard to have a strong recovery.

Unemployment

The official unemployment rate stands at 10.0%, a slight improvement from the 10.1% (revised from the originally reported 10.2%) high from October. It is encouraging that the employment situation has not significantly deteriorated over the past few months. What



concerns us all is how many jobs have been lost in the past few years. The current total stands at 7,242,000 jobs lost. That is by far the biggest job loss the country has seen since official records have been kept. Astute readers may point out the country has many more people today than it had in the past, so the percentage of jobs lost is probably comparable. Wrong. The chart above shows the cumulative percent change in employment. As of

December, 5.4% of the population that had jobs before the recession is now out of work. The previous worse job loss was 3.1% of the population losing their jobs in the 1981 to 1983 recession. When combined with the roughly 5% of people who were already looking for jobs when the economy worsened, you get 10% of the population unemployed. Still, 90% of the population is working, but the psychological effects of the job market are causing those with jobs to restrain from spending.

The long-term prospects for the job market look grim. It will not be easy for our economy to generate over seven million jobs. After the much milder recession following the technology bubble burst, it took us four years to recoup the 2.7 million jobs lost. Many of the jobs created were real estate related and that sector is not in a position to recover strongly. A new sector will need to emerge to quickly solve the problem. As of now, the government seems to be the only "industry" putting more people to work and with the budget as it is, it will not likely be a place for long-term employment growth. As we hope for an industry to step-up and hire a significant number of workers, we are realistically planning on a possible decade long battle with unemployment.

Inflation

One positive from the depressing employment numbers and weak consumer spending is that inflation does not appear to be an immediate threat. There continues to be much discussion among investors on the prospects for inflation, but the threat appears to be more of a long term threat than an immediate one. With unemployment as bad as it is and consumer spending not likely to rebound to pre-2008 levels, there is little argument for retailers to raise prices at the moment. We continue to recommend clients to prepare for future bouts of higher inflation, but do not think it is necessary to make dramatic portfolio changes at the moment.



The fears of inflation, along with several other factors, seriously eroded the value of the U.S. Dollar in 2009. Over long periods of time, currency values tend to be **negatively correlated** to inflation levels. Higher inflation will devalue currency, as each unit of currency cannot buy as many goods as it did the prior year because of higher prices of goods. Over the short term, currency values tend to be

positively correlated to interest rates. Interest rates in the U.S. are the lowest in the world. (Because they are at zero, it is impossible to go lower!) This has given rise to the “U.S. Dollar carry-trade.” What was once only possible with the Japanese Yen, now is possible with the Dollar. Investors can borrow in U.S. Dollars for only a small interest amount, then invest in an asset that is expected to earn more than their cost of carry (interest rate). In theory, exchange rates should move to erase any potential profits from the “carry trade,” but they do not due so immediately. Too many other factors drive currency values.

The Dollar

When the global economy was shrinking in late 2008 and early 2009, the U.S. Dollar saw a major boost. Investors around the world bought U.S. Treasuries and therefore U.S. Dollars. Once the market began its recovery, the Dollar resumed its slide that has now been ongoing since 2002. Many investors will tell you that the Dollar is declining because of the ongoing trade and budget deficits, commonly referred to the “twin deficits.” However, our country has had twin deficits before, without negative effects on the Dollar. As stated above, the bigger factor is our low interest rates. It simply makes more sense for international investors to invest elsewhere and earn higher interest rates. While the U.S. Treasury is still regarded as the safest security in the world, there are many other AAA rated options that provide only slightly less safety, but pay much higher interest.

Conclusion

Overall, 2009 proved to be a great year for investors, particularly equity investors and bond investors who took advantage of the historically wide credit spreads that existed earlier in the year. Despite continued weak economic news, financial markets were able to regain a significant portion of their 2008 losses – although we still have a long way to go.

Although it is not robust, our economy *is* recovering and absent some unforeseen negative event, the economic recovery should continue as we move through 2010. As we saw in 2009, all economic sectors are unlikely to prosper equally. More importantly, it is doubtful that the collective positive market response will be so dramatic in 2010.

On the plus side, corporate earnings may appear to be surprisingly strong. This is in part due to the cost savings associated with laying off workers – clearly a double-edged sword. Also, there is a bit of “mathematical trickery” going on. Consider a company that was earning \$1.00 per share in year one, \$.01 in year two and \$.02 in year three. While the year three over year two earnings improvement will be reported as 100% (wow!), the company remains far behind where it was only a short time ago. Despite this reality, investors often respond positively to these earnings improvements despite the longer term realities. We witnessed this in 2003 as we emerged from the 2000-2002 downturn.

Also on the plus side are the significant funds still sitting in bonds, bond funds and money market instruments. If equity markets continue to offer positive returns and do not experience any major setbacks, investors are likely to become dissatisfied with the returns they are getting on their safer investments and re-enter the equity markets. While there are those who may never go back to the equity markets – especially those who were hurt badly during the 2000-2002 period and then again more recently, most investors actually have pretty short memories.

Negatives include our ever-present unemployment rate of over 10% and the lack of meaningful job creation. This is in part a real fundamental problem, but more so, it is a tremendous psychological negative. Will we be the next to lose our job? As mentioned earlier, consumer spending also needs to pick up. Meaningful economic growth cannot occur without consumer participation. There are also real problems with certain economic sectors. In all likelihood, we will see a significant number of bank failures during 2010. Perhaps the “giants” are out of the woods, but many of the smaller financial institutions are still in harm’s way. Residential real estate is sporadically showing signs of improvement, but barely. On the other hand, commercial real estate is still on life support.

Our summary view suggests a modest, but uneven, economic recovery, modest equity returns across both domestic and developed international markets, and muted returns in the debt markets. Our more thorough report on the global economy and the various components of the financial markets will be expressed in our annual ***Global Analysis and Capital Market Assumptions***, which will be released by mid-February. Please check our website and feel free to download a copy if you would like.