

MONTHLY REVIEW—OCTOBER 2009

MARKET INDEXES

ECONOMIC INDICATORS

Index	1 Month	3 Months	Year to Date	Trailing 1 Year
<u>Domestic Equity (Large Cap)</u>				
Russell 1000 (Core)	(2.21)	5.45	18.41	11.20
Russell 1000 Growth	(1.35)	4.97	25.39	17.51
Russell 1000 Value	(3.06)	5.95	11.33	4.78
<u>Domestic Equity (Small/Mid Cap)</u>				
Russell 2500 (Core)	(5.79)	3.75	20.49	13.26
Russell 2500 Growth	(5.50)	2.75	26.81	18.21
Russell 2500 Value	(6.04)	4.67	14.63	8.55
<u>International Equity</u>				
MSCI World ex US (Core)	(1.61)	7.36	28.39	27.83
MSCI World ex US Growth	(0.51)	6.77	24.64	24.03
MSCI World ex US Value	(2.64)	7.95	32.26	31.71
MSCI Emerging Markets (Gross)	0.13	8.88	65.10	64.63
<u>Domestic REITs</u>				
NAREIT	(4.50)	15.22	11.74	0.07
<u>Domestic Fixed Income</u>				
Barclays U.S. Aggregate	0.49	2.60	6.24	13.79

	Most Recent	Year-to-Date	Trailing 1 Year
U.S. Dollar (October)	-2.6%	-6.4%	-7.4%
Housing Prices (August)	1.3%	-2.6%	-10.6%
Consumer Sentiment (level)	70.6	60.1	57.6
Retail Sales (September)	-1.5%	2.5%	-6.0%
Job Gains/Losses (October)	(190,000)	(4,226,000)	(5,504,000)
Inflation (September)	0.1%	2.7%	-1.3%

After racing higher since March, world equity markets gave back some gains in October. The only markets rising during the month were emerging markets, and collectively, they managed to gain only 0.1%. Within Domestic Equity, small and mid cap stocks lost the most, but remain ahead on both a year-to-date and trailing one year basis. The continued decline of the U.S. Dollar boosted international equity returns. Removing the impact of the Dollar, the World ex U.S. lost 2.5% in the month, but is up 18.3% year-to-date. These numbers are very close to the Russell 1000 index, providing further evidence that U.S. and developed markets move in similar fashions. REITs lost 4.5% in October, largely based on the broad U.S. equity declines. There has been no

significant development in the commercial real estate markets that justifies the volatility that REITs have seen this year. Clearly, REITs have been driven by forces other than real estate fundamentals. Bonds continued their slow march higher.

2009 is likely to be an above average year for bonds, but not a spectacular one. We have discussed the differences in performance in the various segments of the bond market in the past, but what is interesting is the fact that both bonds and equities are moving higher. You might expect that equities and bonds move inverse to each other. Logic would say that when equities appear attractive, investors would sell bonds and move into equities, driving bond prices lower. There is some evidence that this is happening in Treasuries with Treasury prices falling this year. However, it is very likely that prices are moving not because investors are selling and moving to equities, but rather the continued new issuance of Treasuries is oversupplying the markets, driving prices lower and yields higher. It appears that money entering the equity and bonds markets is coming from cash and money market funds. The fact that some cash is heading into equities and bonds tells us that many investors are unsure about the future, but they are tired of earning almost nothing in their money market funds. Those who are pessimistic about the future are choosing to extend their duration and yield by buying longer term, and slightly riskier bonds. Those with a more positive outlook are choosing equities.

Our firm remains cautious over current equity levels. We recognize that equities may have gotten ahead of themselves. The P/E of the Russell 1000 stands at 27.7 and the Russell 2000 at 122.0 (using trailing earnings). The Russell 2000 P/E has actually fallen from its value of 174.8 last month, from a combination of declining prices and rising earnings. The Russell 1000 P/E rose in October, even as prices fell. This is because earnings fell more than prices. We expect the P/E to decline towards its historical average of 18.8, but how it gets there is an unknown. To get to an 18.8, earnings need to rise 47%, assuming prices stay where they are. Another way is for earnings to stay the same and for prices to fall 32%. We think the most likely scenario is somewhere in the middle, where earnings rise more quickly than expected and prices rise less, but not negative. By the first quarter of 2010, there should be a significant drop in P/Es. The reason is the 4th quarter 2008 earnings will be replaced in the P/E calculation with the 4th quarter 2009 earnings. We do not know what 4Q 2009 earnings will be (nor does anyone with a great deal of accuracy), but it is safe to assume they will be higher than 4Q 2008, which were some of the worst earnings ever recorded. With the 2008 earnings removed, the overall earnings level of the index will be higher and P/Es should decline.