



2009 – 2ND QUARTER REVIEW AND PREVIEW



**BOB'S
CORNER**

**AWESOME
RETURNS**

I know I have continued to preach that we do not sell returns. We sell risk levels and the returns are just a byproduct of the risk you are willing to take. I cannot help but brag though.

	Beta	YTD	Risk Adjusted Return	Alpha
<u>Income</u>	0.49	8.58%	2.06%	6.52
<u>Balanced</u>	0.61	10.32%	2.56%	7.76
<u>Cons Growth</u>	0.74	11.92%	3.11%	8.81
<u>Growth</u>	0.87	13.65%	3.65%	10.0
<u>Russell 3000</u>	1.0	4.20%		

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WAITING FOR RECOVERY

MARKET OVERVIEW

After a period of mostly depressing economic news, the 2nd quarter saw flashes of hope. Actually enough to ignite a notable rally in the stock market and build encouragement for investors. While far from being an “all clear” in the near term market outlook, the increasing frequency of hopeful news indicated the recession may be close to reaching its trough and stability and an eventual expansion may be developing.

As notable as the impressive returns of the 2nd quarter was the sudden lack of volatility experienced in both the stock and bond markets on a day-to-day basis. This was in marked contrast to the environment that shook investor confidence, particularly since the meltdown in the financial markets in the fall of 2008. Investors began to move money out of low-yielding cash and government bonds and back into riskier assets, including stocks, corporate bonds and commodities.

Significant economic challenges still remain including rising unemployment, idled factories and home foreclosure/delinquency rates heading higher. The Federal Reserve and the government remain heavily engaged in efforts to move the economy in a positive direction through monetary and fiscal stimulus measures. Additional stimulus may be necessary within the next 6-9 months.

The questions now are: when will the recession end and when will a recovery begin to take hold? Based on the market’s performance in the 2nd quarter, investors are clearly encouraged. However, with the likelihood of ongoing challenges for the economy, we won’t be surprised to see some moderation in the markets over the summer.

ECONOMY

THE 2ND QUARTER

The government’s final report on Gross Domestic Product for the 1st quarter showed a decline of 5.5%, coming on the heels of a 6.3% drop in the 4th quarter of 2008. We expect 2nd quarter numbers (the 1st reading is due at the end of July) to show another contraction of 2.0% to 3.0%. Based on those numbers, **we can describe trends in various areas of the economy as “less worse” than they were before.** In fact, even though the Index of Economic Leading Indicators improved steadily in the past months, most economists are not willing to declare an end to the recession. We have witnessed however, what many believe to be a sustainable shift in consumer spending patterns. The savings rate in the U.S. has risen from 0.0% to 6.9% over the past year, its highest level since 1993. Consumers are paying down credit cards and repairing their personal balance sheets after experiencing steep declines in both housing prices and investment portfolios. Historically, the nation has worked its way out of a recession as individuals and families boosted savings and cut debt.

One of the biggest concerns is the increasingly bleak employment picture. The unemployment rate edged up to 9.4% by the end of the 2nd quarter. Personal income managed a 1.4% rise in May due primarily to increased government payments, but it still remains well below past levels. Personal spending managed a modest but encouraging 0.3% rise. There are some indications the housing market may be near its bottom as existing home sales rose 2.4% in May and housing inventory (the supply of homes currently on the market) dropped to less than 10 months.

The focus of the economy’s struggles has increasingly shifted to the business sector. Industrial production declined 13.4% from last year. Retail sales fell 10.8% and capacity utilization dropped to 68.3%, the lowest level on record (going back to 1948). Further weakness in the sector is evidenced by the 37.6% decline in business investment and a 30-35% drop in both exports and imports. All of this should add up to an expected 35% decline in corporate year to year earnings that will be reported for the 2nd quarter.

What should not be overlooked is that inflation is still a non-issue, coming in at 1.8%, under the Federal Reserve’s own 2.0% target. This gives the Fed the leverage it needs to keep interest rates at extremely low levels, a vital component of any economic recovery plan. Historically, lower inflation also tends to work to the benefit for equity investors.



LOOKING AHEAD

The recession of 2008-2009 now represents the longest, most severe decline since World War II. In the past, steep recessions are often followed by sharp recoveries. Few economists believe that this will be the case in the current environment. One trigger to a rebound however, could be a dramatic ramp up in production, which could occur to offset what has been a steep drop in business inventories.

A sure sign of recovery will be an improvement in the employment picture. The unemployment rate is projected to peak at more than 10.0% by the end of 2009. Once the job market stabilizes, we anticipate the Fed will begin to raise interest rates and focus on controlling inflation more than adding liquidity to the economy. We will not be surprised to see this economic expansion display far different characteristics than those of the past. These new characteristics include more modest consumer spending, higher savings rates and increased government regulation and intervention. This would also lead to a more moderate growth pattern for the stock market.

BOND MARKET

THE 2ND QUARTER

For the 2nd consecutive quarter, riskier segments turned in the best performance in the bond market, as investors demonstrated a willingness to move away from the safety of government bonds. The bond market as a whole, as measured by the Barclays U.S. Aggregate Bond Index, returned a respectable 2.5% for the three-month period.

High-yield corporate bonds rose 18.2% during the quarter and investment grade corporate bonds gained 9.4%. Emerging market bonds and World bonds returned 14.8% and 7.5% respectively, while Municipal bonds managed a 2.5% gain. By contrast, the once safe haven of Treasury bonds actually declined by 1.7%.

Our mix of government, investment-grade corporate, high-yield and foreign bonds worked well during the quarter, registering a 9.0% gain!

LOOKING AHEAD

We believe the Fed will continue to recognize the importance of maintaining low interest rates through the rest of 2009. We also continue to believe that high-yield and corporate bonds are well positioned to benefit as the economy slowly begins to move into recovery mode. Municipal bonds should remain attractive for tax-sensitive investors and foreign bonds will continue to provide valuable diversification and some protection if the dollar should weaken further.

DOMESTIC STOCK MARKET

THE 2ND QUARTER

As investors spotted “green shoots” in many areas of the economy, stocks rebounded sharply. The **Russell 3000 Index** (a measure of broad stock market performance) gained **16.8% through the period**, erasing last quarter’s decline. In fact, the index is now in positive territory for the **year at +1.75%**. The rebound was widespread as both growth and value stocks generated comparable gains. Bargain hunters were particularly focused on attractive values among hard-hit financial stocks.

From a market capitalization perspective, smaller was better, a trend that is typical in the transition stage from the end of a recession to the start of a recovery. While Mid-cap stocks gained 20.8%, Small-cap issues jumped 20.7% and Micro-caps fared even better, with a 25.0% return. Large-cap issues trailed the rest, but still returned 16.5%.

Financial stocks, which have been responsible for much of the market’s pain in the past year-and-a-half, jumped 35.1% in the 2nd quarter. Investors were encouraged by signs of improved (though still weak) earnings in the banking sector. Technology and Industrial stocks gained 19.4% and 18.0% respectively, while defensive sectors lagged the market as Healthcare stocks gained 8.3% and Telecom stocks rose a mere 1.9%.

LOOKING AHEAD

One obvious concern is the markets regained too much ground too quickly. Any disappointing economic news should result in a temporary setback for the market rally. An encouraging factor however, is that investors are still holding a lot of cash, waiting for the right time to return to stocks. As investors become weary of low interest rates on cash instruments, we expect more dollars to flow into equities; **potentially triggering a continuation of the market’s rebound by year end.**

The area of the market that looks most at risk of getting ahead of itself is the financial sector. Even though some banks have repaid the government TARP (bailout) dollars they received in 2008, most have not. What’s more, a number of banks needed to raise capital by issuing more shares of stock, diluting the value for existing shareholders. Underlying business factors, such as rising mortgage and credit card delinquencies and soft loan demand, increases the risk that banks will generate disappointing earnings results the remainder of 2009.



Performance Update

Annualized Returns

Market Index	2 nd Qtr	YTD	1 Year	2 Years	3 Years	5 Years
DJ Ind Average	11.92	-2.00	-22.97	-18.26	-6.34	-1.63
S& P 500	15.94	3.26	-26.15	-19.93	-8.23	-2.26
Russell 2000	20.69	2.64	-25.01	-20.73	-9.89	-1.71
S&P Mid-Cap 400	18.75	8.47	-29.02	-18.33	-7.54	0.36
Russell 3000	16.82	4.20	-26.56	-19.93	-8.35	-1.84
MSCI EAFE	23.76	5.64	-33.55	-23.99	-10.49	-0.37
MSCI Em Mrkt USD	34.73	34.26	-28.07	-15.24	2.95	14.72
NASDAQ Comp	20.05	16.36	-19.97	-16.04	-5.47	-2.17
Lehman High-Yield	23.07	30.43	-2.40	-2.33	2.09	4.33
Lehman Agg Bond	1.78	1.90	6.05	6.58	6.43	5.01
Lehman Credit Index	7.59	7.53	4.28	4.41	5.05	4.04
Lehman Gov Bond	-2.21	-3.17	6.63	8.15	7.28	5.41
Lehman Corp	8.81	6.87	4.08	3.95	4.86	4.08

The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.

Our general position with equities is one of cautious optimism. If the economy can continue its trend toward recovery, we'll expect to add to small- and mid-cap allocations and eventually return our stock positions to normal levels. The key variable is the direction of corporate earnings in the coming months.

INTERNATIONAL MARKETS

THE 2ND QUARTER

Improved investor confidence spread overseas as well. The broad MSCI EAFE index turned in a solid 23.8% gain in the 2nd quarter. Emerging markets led the rally, with the **MSCI Emerging Markets Index rising 33.6%**. This included gains of 61.1% in India, 41.6% in Brazil and 38.1% in China. So far in 2009 very aggressive stimulus efforts in China have had a notable impact on the nation's economic growth rate.

Europe is taking a more conservative approach to stimulus, which could lengthen the recession there. Still, investors appeared to be encouraged by the general direction of economic news. Markets in the United Kingdom, Germany and France all gained more than 20%, as did stocks in Japan.

LOOKING AHEAD

Despite a global recession, China appears to have given its economy a sufficient boost to generate growth in the range

of 6.0% to 8.0%. India and Brazil also seem to be weathering the recession better than most. This is the big reason why we continue to focus on the growth opportunities in the **"BRIC" emerging economies (these three countries plus Russia)**.

Growth in developed nations in Europe may be delayed as the European Central Bank has been slower than the Federal Reserve to respond to the economic crisis. Likewise, Japan will continue to struggle by virtue of its aging demographics. These economies will likely become increasingly dependent on exports to emerging markets and may offer less growth potential in the near term than many emerging economies.

SUMMARY

Thanks for your patience through what has been one of the swiftest and deepest recessions in recent memory! As the credit markets are healing and stocks are finding their footing, you can see how our disciplined investment process is once again paying off. During the 1st quarter we declined less than the market, and during the 2nd quarter our growth model actually did slightly better than the market-with less risk!

"It's not how much you make, it's how much you keep!"

The recession has brought dramatic changes to our economy. The "new normal" will look different than the past. Though painful, some of these changes will be for the better. Consumers are spending less, saving more, and creating a better foundation for the next expansion in the economy. A frugal American consumer means markets will look to the rest of the world for demand, creating a more balanced global economy.

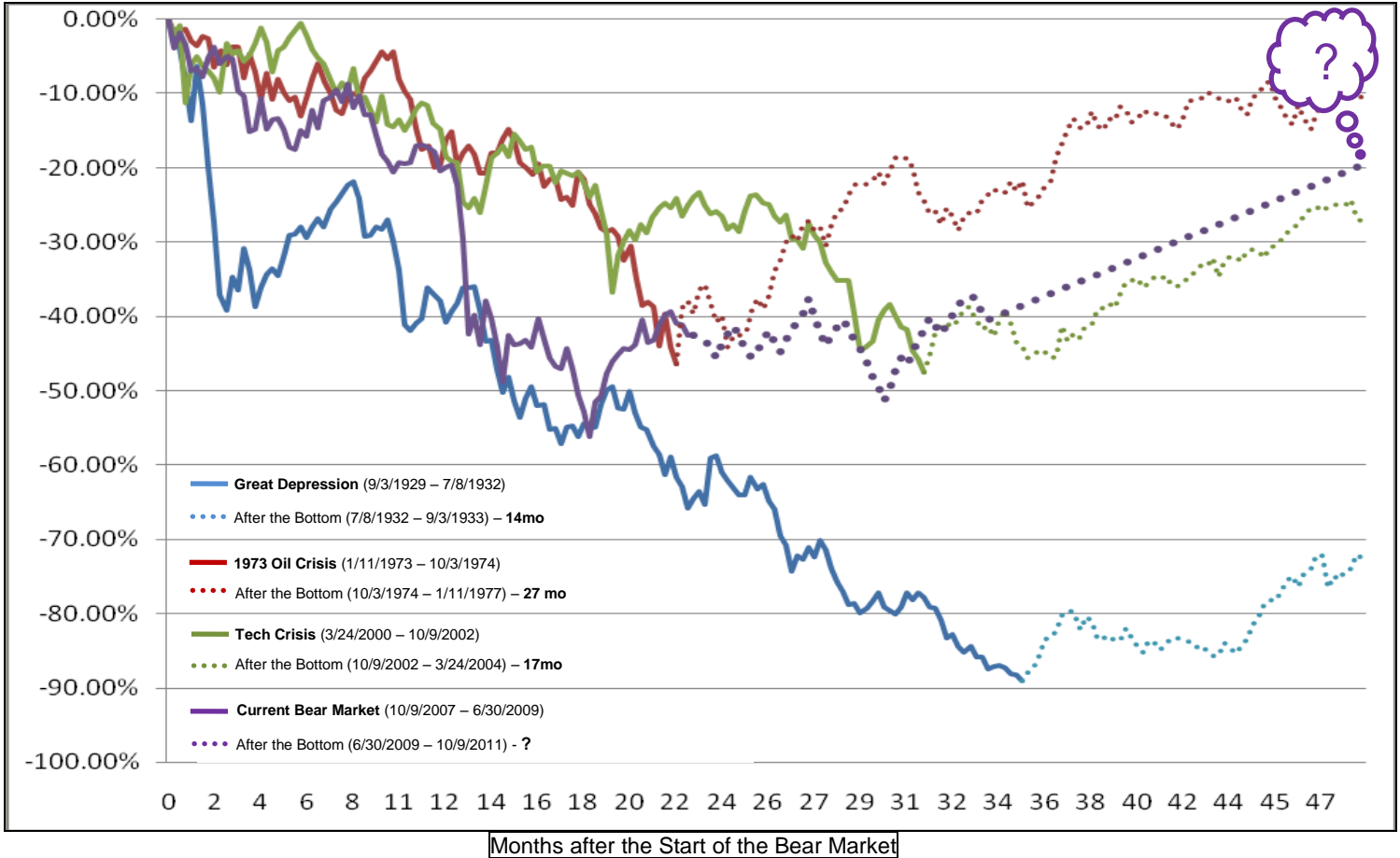
The government has been and will be more involved in the markets down the road. We have already seen this with the banking system, as well as the energy and transportation sectors. It looks like it will happen in the health care sector as well.

We also expect to see more regulation in the financial sector. As the 2nd quarter came to an end, we saw Bernard Madoff, a formerly well respected NASDAQ chairman, sentenced to 150 years in the largest white collar crime of all time. This and the collapse and fire sale of major investment banks and wire houses such as Lehman Brothers, Merrill Lynch, and Wachovia, will usher in a new wave of regulation in the financial services industry. This is exactly what we need to gain confidence that we do have an umpire keeping everyone honest (Glass-Steagall Act 1933).

We welcome any and all scrutiny and oversight! All Star Financial always strives to uphold our fiduciary duty to you our valued client. All of our investments are publicly traded, liquid, and transparent. We use either Charles Schwab or Fidelity, the two largest and strongest discount brokerages to custody your assets. We always do our due diligence on each investment and apply our long-term disciplined investment process to help us keep a step ahead of the market. We strive to seek out the best values and growth opportunities for your portfolio and your risk profile.



Can History Help Forecast our Future?



Using history to help forecast the future has been a very successful tool over the past 15 recessions. How fast the market goes down, how long it takes to show a bottom or consolidation, and what does the bounce off the bottom and future expansion look like for each is really fascinating to research.

You have all heard the statement, “but this is different.” We would agree, every recession and expansion is slightly different, but what remains the same is the **GREED** and **FEAR** that perpetuates the overvaluation of the market and creates the opportunity to buy when the market is oversold.

The three “Big Bears” **1) The Great Depression** (9/3/1929 – 7/8/1932), **2) The 1973 Oil Crisis** (1/1/1973 – 10/3/1974), **3) The Technology Bubble** (3/24/2000 – 10/9/2002), have one thing in common and that is they all presented significant opportunities. These opportunities were not without risk, but the average gain after the market bottom for these historic recessions has been **86%** over the following **19 months**. **What does this cycle have in store for us?**

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