



## 2009 – 3RD QUARTER REVIEW AND PREVIEW

### LOSING A RECESSION, SEARCHING FOR A *REAL* RECOVERY



#### BOB'S CORNER

I want to thank all of our clients for trusting in the All Star Financial Disciplined Value-driven Money Management Process. We have come through this severe downturn and eventual roller coaster ride up with flying colors. We have preached for 22 years “**IT’S NOT HOW MUCH YOU MAKE, IT’S HOW MUCH YOU KEEP**”. We can now go back and show you that it has really saved a lot of money and time for you.

Overall, the markets dropped 50-60% from 10-9-2007 to 3-9-2009. Over those one and a half years our four portfolios lost on average approximately 30%. That is a big deal because to regain our clients’ principal we only have to make 43% (.70 cents x 43% = break-even). As I stated, we saved you money on the downturn and time in recouping your losses on the upturn.

The market lost roughly 60% and in order for the remaining .40 cents of every dollar to become \$1.00 again, you have to make 150% (.40 x 150% = break-even).

So, if the “New Normal” gives us an 8% annual rate of return, which may still be optimistic, we will be back to even in slightly less than **5 years** as opposed to losing 60% and having to make 150% back over **approximately 12 years!**

Thank you for your confidence and please do not keep us a secret. Tell your family and friends!

#### MARKET OVERVIEW

What a difference a year makes! At this time in 2008, we were licking our wounds from a 778-point drop in the Dow Jones Industrial Average on a single day after Congress failed to pass a \$700 billion bailout package for banks. Confidence in the financial system and the economy was at its lowest point since the Great Depression. Lehman Brothers collapsed and Wall Street as we knew it had changed dramatically.

One year later, the financial system and the economy have both stabilized. We’re coming off the best two consecutive quarters of stock market performance since 1975. A dramatic boost in government spending appeared to play a major role in moderating the economic slowdown. This included government involvement in approximately 85% of real estate transactions and the \$700 billion Troubled Assets Relief Program (TARP) that has helped to recapitalize the banking sector. The government also had a hand in helping General Motors and Chrysler emerge from bankruptcy.

The economy is on the mend, but it appears that a newfound frugality among consumers may be here to stay. This is one of the key trends that have been dubbed, by some of the leading investment executives in the country, as “The New Normal.” In short, the expectation is that a structural change has occurred in the economic environment that will lead to slower growth in the U.S. economy in the coming years.

This “New Normal” will require an economic shift as consumers shift toward less spending, concerted efforts to reduce debt and increase savings. It will likely limit the rate of growth in the economy in the future as compared to past expansions. Growth in exports to overseas markets on the business side and government spending will have to play a bigger role!

#### ECONOMY

##### THE 3RD QUARTER

All signs point to the likelihood the economic decline has finally been curtailed. In the second quarter, the economy (as measured by Gross Domestic Product – GDP) declined just 0.74%, a significant improvement from the 5% to 6% declines that occurred in the two previous quarters. It is anticipated that GDP for the 3<sup>rd</sup> quarter will show an increase of as much as 2% to 3%.

The manufacturing sector showed signs of life in the 3<sup>rd</sup> quarter. In particular, the auto industry benefited from the government’s “Cash for Clunkers” program, giving car sales a temporary boost. Improvement was visible in the housing market as well, again triggered in part by a government tax credit for first-time homebuyers, but also supported by a low interest rate environment.

With the massive growth in government debt and the Federal Reserve putting tremendous liquidity into the market, a long-term concern about the risk of inflation has become commonplace. The Fed is faced with a balancing act between keeping the economy moving while tempering the risk of inflation. In the current environment, at least, it appears the weak demand for commodities is helping to keep inflation in check.

We anticipate that consistent with previous scenarios, the Federal Reserve will not jump the gun on raising short-term interest rates. Historically, the Fed waits until about six months after the unemployment rate peaks before boosting rates. Currently, unemployment stands at 9.8%, but many analysts anticipate it may possibly exceed 10%.



## **LOOKING AHEAD**

The economy may not be on the verge of a massive turnaround, but at least it appears to be moving modestly in the right direction. Still, the general environment remains weak. As Mervyn King, governor of the Bank of England recently remarked, “It’s not the growth rates, but the levels that matter here.”

There are a specific number of measures where, at this time, the levels demonstrate that obstacles to a satisfactory economic recovery still remain:

- Consumer debt has declined but remains high as a percentage of GDP.
- Charge-offs on bank loans and credit remain high and commercial real estate losses could add to the problem in the months ahead.
- Unemployment, while not rising as quickly, is at a 25 year high, with few signs of immediate meaningful improvement.
- Government debt as a percentage of GDP is the highest since World War II.

Concern over these factors appears to have increased the risk of a “double dip” recession, particularly if government spending, to boost the economy, begins to subside. We think the economy will eventually sustain growth on its own; however the risk of a second drop in GDP is real. In the meantime, investors need to adapt to the reality of a “New Normal” economy with slower growth in the years ahead.

## **BOND MARKET**

### **THE 3RD QUARTER**

Bond markets continued to benefit from an environment of a slow economy and low inflation. However, investors’ appetite for risk is on the rise. After a significant drop-off in activity triggered by last year’s financial crisis, corporate issuance of debt began to rebound and buyers jumped in looking for higher yields than they currently receive in short-term securities. Default activity on corporate issues declined as more companies cut costs and benefited from lower interest rates.

With investors more risk tolerant, high-yield bonds, emerging market bonds and corporate issues all performed well during the quarter. High-Yield bonds rose 13.4%, Emerging Market bonds gained 11.1% and Investment Grade Corporate bonds tacked on 8.3%. Less risky Government and Agency Mortgage-Backed bonds were less in favor, returning 1.9% and 2.3%, respectively during the period. Foreign bonds benefited from the dollar continuing to weaken against other major currencies, generating a 7.3% return.

### **LOOKING AHEAD**

It seems likely the high-yield and corporate sectors of the market have generated the bulk of the gains they will see in the current rally. Credit spreads (the difference in yield between corporate and government issues) have narrowed to historical averages. Bond market returns will moderate given that interest rates are already near historic lows. Within the fixed income marketplace, high-yield and corporate bond issues should be better positioned than treasury bonds.

Expectations that the dollar will remain weak should continue to generate opportunities for foreign bonds. Taxable accounts should benefit from continued potential in the municipal bond market. While the long-term inflation threat is real, it may be too early to put any significant emphasis on Treasury Inflation-Protected Securities (TIPS).

## **DOMESTIC STOCK MARKET**

### **THE 3RD QUARTER**

Just as risk aversion has been evident in the bond markets; it also helps explain much about the dramatic recovery in stocks. Earnings improvement (far from a full, pre-recession recovery) has helped to fuel the rally. We anticipate the positive trend to continue as companies report 3<sup>rd</sup> quarter earnings over the coming weeks with actual growth in earnings (over year-ago levels) potentially occurring in the 4<sup>th</sup> quarter. There are signs of a return to normalcy in the markets as more companies are successfully raising capital.

Third quarter gains in the stock market were broad-based. Leading the way were small-cap stocks with a gain of 19.3% compared to a 16.3% gain for the large-cap segment of the Russell 3000 Index. Value stocks rose 18.6%, outpacing the gain of 14.1% for Growth stocks. The biggest driver of value’s strong performance was the recovery in the financial sector. Financial stocks gained 25.1% while industrial and material sector stocks, boosted by a rebound in manufacturing, both gained 21%.

Among the lagging sectors were health care stocks, rising just 8.9% due in large part to uncertainty about the future of health-care reform efforts in Washington. Utility and telecom stocks rose just 5.0% and 3.9% respectively, as investors shifted away from defensive sectors.



## Performance Update

### Annualized Returns

Market Index	3rd Qtr	1 Year	2 Years	3 Years	5 Years
DJ Ind Average	15.73	-7.45	-13.85	-3.35	1.88
S& P 500	15.56	-6.75	-14.79	-5.44	1.01
Russell 2000	19.28	-9.55	-12.05	-4.51	2.41
S&P Mid-Cap 400	19.98	-3.11	-10.15	-1.40	4.53
<b>Russell 3000</b>	<b>16.31</b>	<b>-6.42</b>	<b>-14.30</b>	<b>-5.06</b>	<b>1.56</b>
MSCI EAFE	18.79	-0.02	-17.84	-6.26	3.47
MSCI Em Mrkt USD	20.07	16.15	-12.90	5.51	14.51
NASDAQ Comp	15.66	1.93	-11.36	-2.05	2.27
Barclays High-Yield	14.22	22.34	4.21	5.31	6.13
Barclays Agg Bond	3.74	10.56	7.05	6.41	5.13
Barclays Credit Index	6.10	17.20	6.47	5.87	4.85
Barclays Gov Bond	2.03	6.74	7.32	6.75	5.19
Barclays Corp	7.47	19.49	6.66	5.84	4.72

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

### LOOKING AHEAD

The improvement in corporate earnings generated thus far is attributable in large part to cost-cutting efforts including significant job layoffs. Now, investors are hoping to see more revenue growth. We expect improved sales numbers as foreign demand for exports grows and a gradual pickup in the economy to have an impact.

There are reasons for optimism about the potential for notable earnings improvement. With enhanced operating leverage and low borrowing costs, the degree of upturn in profits might outpace expectations. We think results from the 3<sup>rd</sup> quarter of 2009 will still reflect a decline from a year ago, but 4<sup>th</sup> quarter earnings growth will almost certainly outpace a disastrous 4<sup>th</sup> quarter in 2008. The key issue for investors now is whether an improved profit picture is a reflection of short-term government stimulus or a sign of real, sustainable growth.

### INTERNATIONAL MARKETS

#### THE 3RD QUARTER

The global economy moved past the recession in the 3<sup>rd</sup> quarter. China and other key Asian economies are clearly ahead of the rest of the world in terms of growth. Loan growth in China subsided during the quarter, prompting us to take some profits from investments in that market as a result. European economies showed early signs of economic improvement in the quarter, and stock markets in Europe and Latin America outpaced Emerging Asian markets for the three-month period.

European stocks rose 23.5%, with Germany and France leading the way. Latin American stocks gained 25.5% with Brazil outpacing other nations. Brazil is benefiting from its commodities industries (including expanded oil discoveries) and the expansion of a middle class that is increasing domestic consumer demand.

Developed Foreign markets in Europe jumped 20.3% in the 3<sup>rd</sup> quarter, edging out the 19.3% gain in Emerging markets. The situation was reversed in Asia, where Emerging Asia gained 16.4% compared to a 6.4% rise in Japan. Long-term issues such as an aging population, along with short-term uncertainty on the political front, kept a lid on Japanese stock returns during the quarter.

### LOOKING AHEAD

While we have cut back overseas positions as valuations rose, we maintain our belief in the importance of diversifying in foreign stocks. Emerging markets, chiefly in Asia, continue to be a prominent position in our portfolios. These economies are benefiting from a reduced reliance on exports to the U.S. as a rising middle class is building another important growth engine for the global economy.

Europe's recovery is encouraging as well, and we're encouraged by the fact that consumer confidence in the Euro-zone has risen to its highest level in a year. We anticipate adding back to our international small-cap positions in the near future to take advantage of an ongoing economic recovery through much of Europe.

### SUMMARY

It will be some time before we receive official confirmation that the U.S. recession has ended. However, strong performance across virtually all markets since early March in anticipation of a more favorable environment has greatly benefited our portfolios.

In the meantime, we're far more concerned with what kind of recovery lies ahead. Markets are likely to be less enthusiastic going forward, particularly if the pace of economic recovery is slow. Given the "New Normal" environment we anticipate will occur over the next few years, investors must proceed with caution as consumers will contribute a reduced amount to overall economic growth. An increasing focus on yield, total return and risk management may be more critical than ever to achieve investment goals.

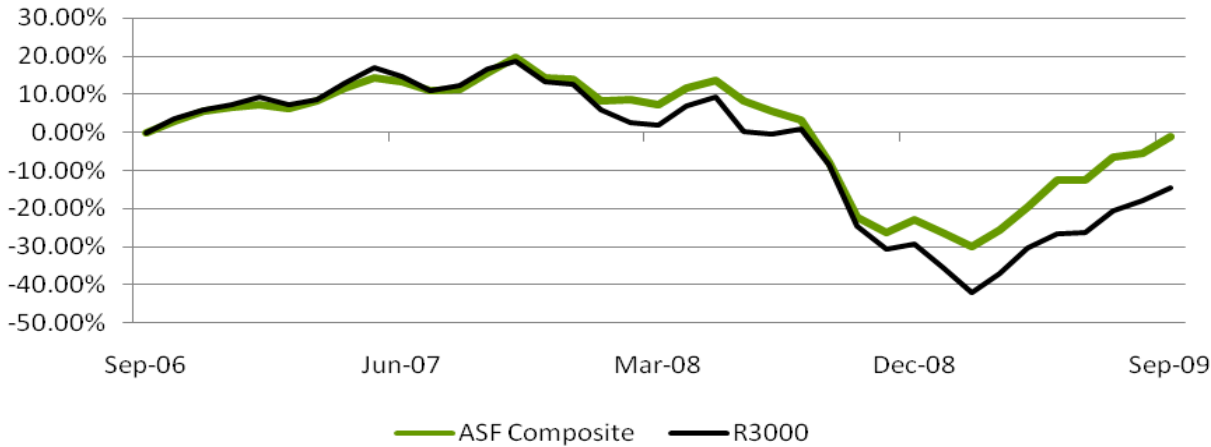


## DOES STRATEGIC & TACTICAL ASSET ALLOCATION WORK?

Looking back at the market over the last three years, it is clear to see that it has been the roller coaster of all roller coasters. The do-it-yourself investor had many chances to be emotional when making decisions about their money. That is why we at All Star have a disciplined sell high and buy low process based on value that makes critical investment decisions easy and more efficient. Our process is contrarian in nature and in many of the instances when public sentiment is saying sell, we are the ones saying buy!

Please read through the history that we have painted for you below and you can see why over the last three years our consolidated return (all four portfolios) has outperformed the market considerably. We are usually selling when the public is buying and buying when the public is selling.

QUARTER-YEAR	MARKETS/ECONOMIC CONDITIONS	ASF STRATEGIC/TACTICAL DECISIONS	PUBLIC SENTIMENT BUY/HOLD/SELL	ASF VIEW BUY/HOLD/SELL
Q4 - 06	Market surges +7.12% Economy is slowing	Sold all domestic small cap exp. Added emerging mkts	Buy	Sell / Buy
Q1 - 07	Mkt rides roller coaster +1.28% Housing shows signs of weakness	Sold large cap growth Bought Long-Short fund	Buy	Sell / Buy
Q2 - 07	Mkt strong early summer + 5.77% GDP slows	Hold	Hold	Hold
Q3 - 07	Mkt manages small gains +1.55% Housing heads south	Sold all financials	Hold	Sell
Q4 - 07	Mkt volatility continues -3.34% Consumers keep spending	Sold foreign small cap	Hold / Buy	Sell
Q1 - 08	Credit mkt. hurt -9.52% Fed lowers rates	Bought commodities, muni's and corp. bonds	Hold/Sell - Denial	Hold / Buy
Q2 - 08	Mkt. continues to fall -1.69% Unemployment spikes	Hold - Patience	Sell - Fear	Hold
Q3 - 08	Financials fall fast -8.73% Gov guarantees loans, banks	Sold foreign large value	Sell - Panic	Hold / Sell
Q4 - 08	Collapse of financial trust -22.78% Gov intervenes, buys public co.	Bought Large Growth and more emerging mkts	Sell - Capitulation	Buy / Hold
Q1 - 09	Panic continues -10.8% Bottom is near	Bought more emerging Asia Bought high yields	Sell - Depressed	Buy / Buy
Q2 - 09	Cash on sidelines, mkt. up +16.8% Recession close to an end	Added to small domestic Trimmed emerging mkts	Buy - Can't miss uptick	Sell / Buy
Q3 - 09	Global economies recovering + 16.3% Recession ends? Will not feel like it	Hold - Wait and see	Buy - ?	Hold / Buy



**3 yr Return**  
 ASF Composite = -0.17%  
 Russell 3000 = -14.43%

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