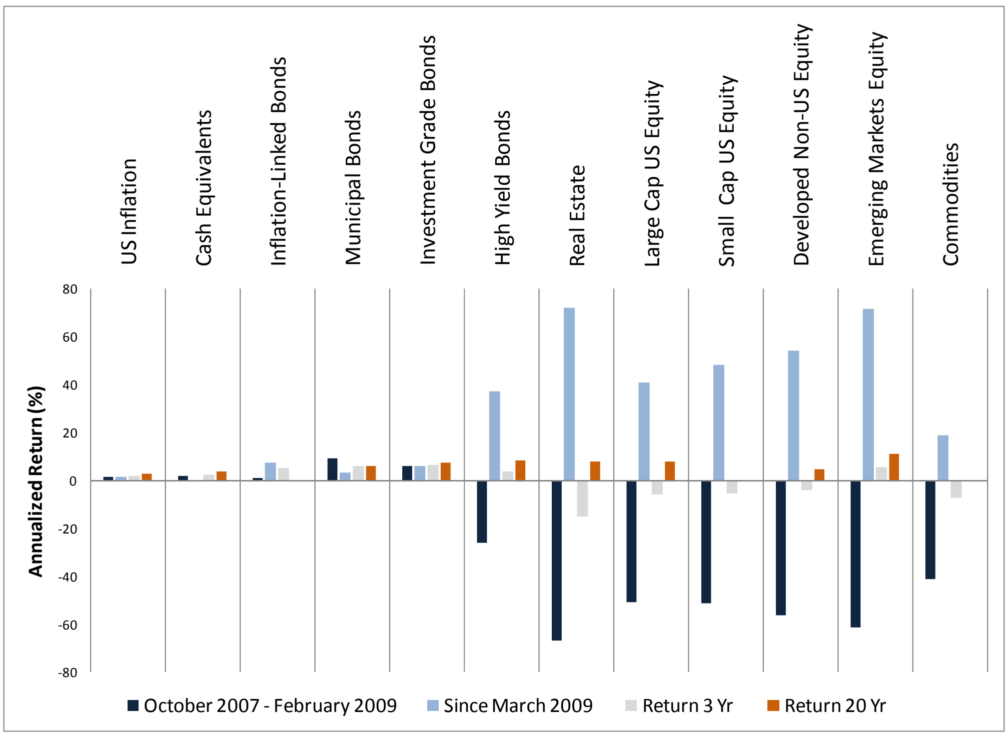
Holding Our Course

Stembrook Investment Commentary – September, 2009

A Strong Recovery, So Far

Since the middle of March, markets across the globe have staged a dramatic comeback. While much ground has been made up, there is much left to go in order to return many markets to their previous highs. The significant risk aversion and outright panic seen late last year and early this year have largely subsided and markets are returning to some semblance of normalcy.

Chart 1 – Global Market Returns as of 8/31/2009



Source: Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index.

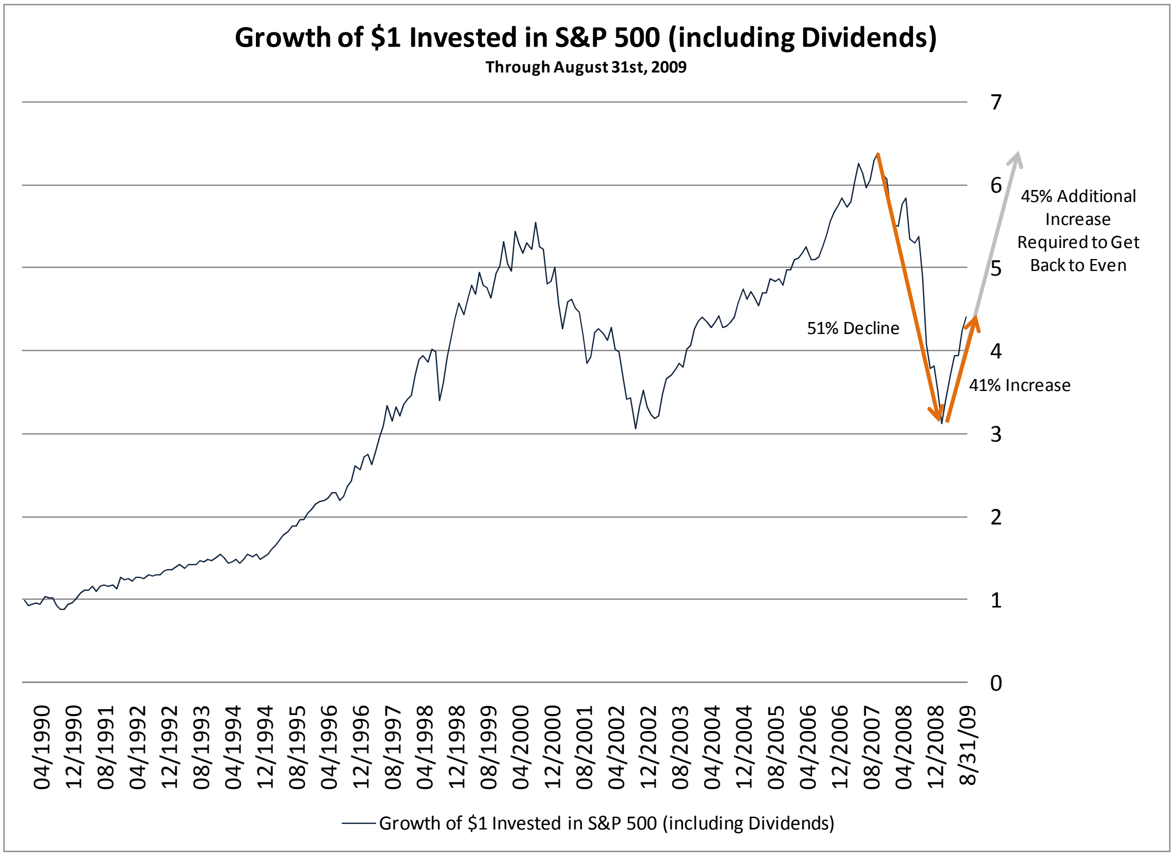
In the midst of the panic, our research indicated that a number of markets were at or below fair value as a number of asset classes were depressed due to technical factors. The three major themes that guided our subsequent investments included: oversold emerging markets, high yield bonds priced far below that which even extreme defaults would justify, and commodities at values that would almost certainly increase at the mere suggestion of an economic recovery. All three of these investments have added value to our portfolios this year.

1 - 50 + 100 = 1 - The Strange Math of Market Performance

The recent recovery in most asset classes has been breathtaking, with the S&P 500 up more than 41% from recent lows reached in March. Though this performance is impressive, there is another side to this observation, and it is one I've discussed with many clients in the recent past. After a drop of more than 50% one would, at first glance, think that a subsequent rise of 41% would bring us back to about even.

However, this is not the case. A 41% increase brings us slightly less than half way back. This can best be observed in Chart 2 which tracks the value of $1 invested in the S&P 500 index since 1990.   The orange arrows highlight the recent decline and recovery. As the chart illustrates, there is still a significant way to go - 45% to be exact - before the market returns to its former high.

Chart 2 – Returns Aren't Always What They Seem



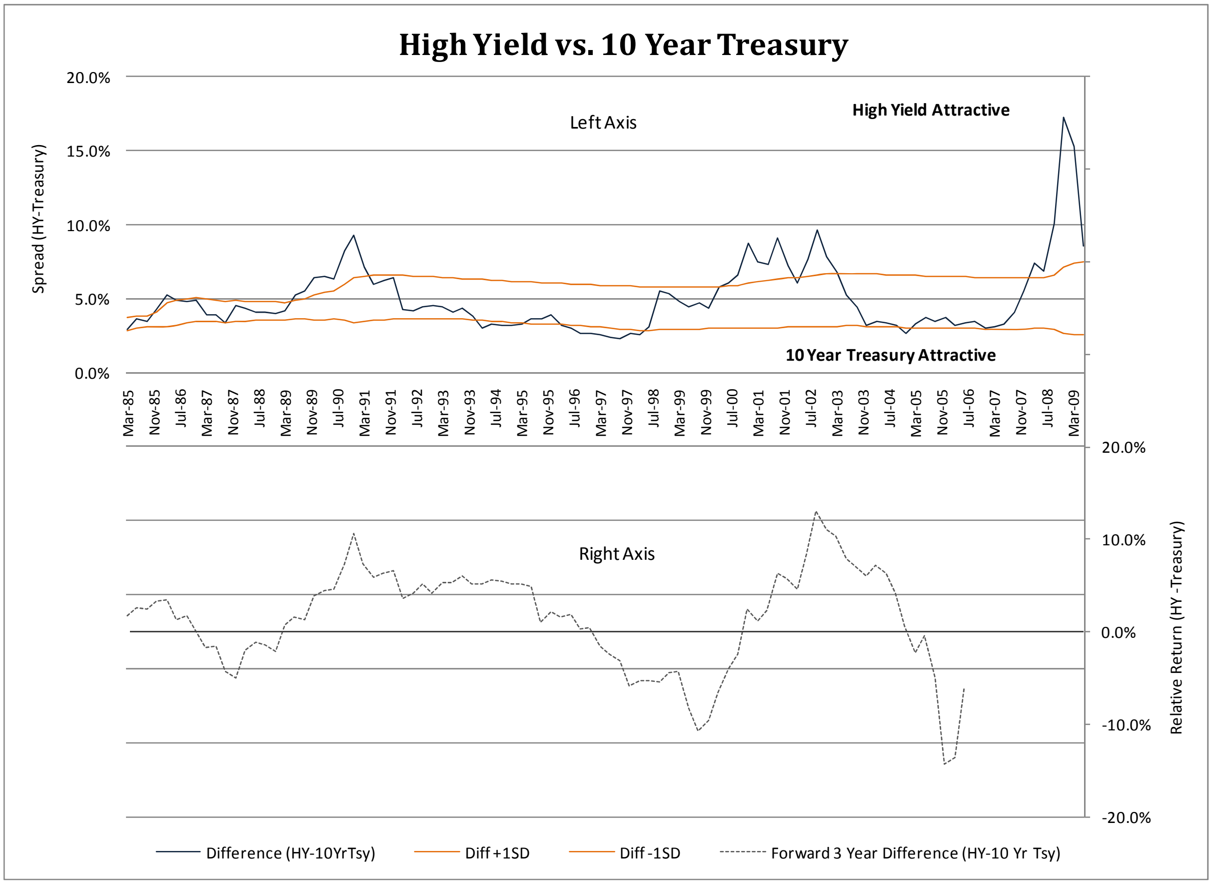
Source: Standard & Poors, Stembrook Research.

Focusing on recent returns, however, shifts our gaze away from other fundamental factors that will impact *future* returns. Other factors to consider include: corporate profits, compression of valuations, and the likely long-term rise in interest rates.

An Example of Our Research and Risk Management in Action

There are many ways to evaluate the level of fear or complacency in the marketplace. One such measure is the spread between investment grade and high yield (or below investment grade) bonds. The larger the difference in the yields, the more interest is charged to risky borrowers. The more risk, the larger the spread, the larger the spread, the more it costs to obtain funding. What is relevant to investors is that over time, this spread tends to revert towards its historical mean. Chart 3 shows the spread between an index of high yield bonds and lower risk 10 year treasury bonds in the top area. The bottom area shows the difference in returns on the two asset classes over subsequent 3 year periods. More often than not, when the spread moves above its normal range, the return on high yield bonds exceeds that of investment grade bonds.

Chart 3 – Credit Spreads and Returns



Source: Standard & Poors, Thomson Reuters, Stembrook Research

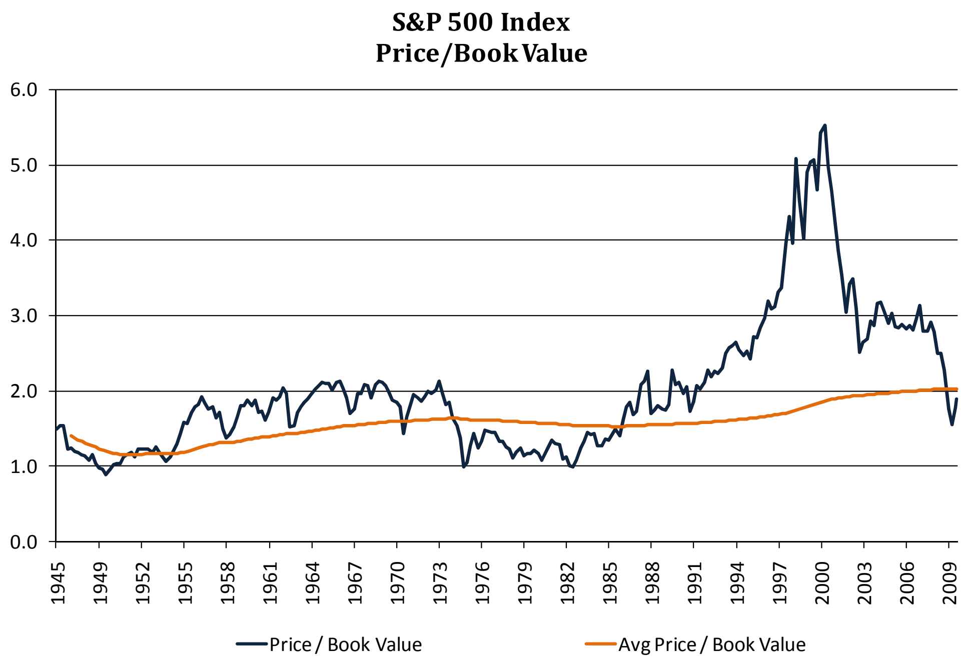
In the recent panic, spreads reached levels higher than any observed since the high yield market was formalized in the mid to late eighties, an indicator that high yield bonds would likely outperform. Of course, there was no guarantee at the time that the market would behave as it had in the past. There was also a concern that defaults and subsequent recoveries would exceed historical norms. To address these issues, we first estimated returns if defaults exceeded four times normal levels. We further handicapped expected returns by assuming that recoveries would be as bad as ever recorded. Even with this aggressive discounting, the expected return for high yield remained attractive. We next based our allocations on pre-determined allowable ranges. This kept us from being overconfident and placing a bigger bet than was reasonable from a risk management perspective. This investment worked out well (see Chart 1), so in retrospect we could have invested more. But, over time, such risk controls should help us to avoid large unintended losses.

The so called “credit spread” is one of many factors that we monitor using a proprietary database of market data and models that help to project future returns. Such anomalies do not present themselves every day, but it takes constant vigilance to watch for and capitalize on such an opportunities.

Valuations Have Normalized

In our last commentary, we observed that forward-looking corporate earnings were sufficiently obscured, and thus suggested that other measures be used to evaluate market valuations. The price to book ratio, which is highly correlated with the price to earnings ratio, is a more stable measure because the book value of companies is determined by accounting valuations rather than market estimates. While this is in itself imperfect, historical research shows that today's book value is a good indicator of future returns. With that in mind, we observe the most recent book value in Chart 4 which hovers close to its long-term average since 1945. While average is not normally something we strive for, if investors achieved average returns over the next ten years or more, that would amount to 9-11 percent, something we'd be happy with. For this and other reasons, we have been fully invested in stocks in recent months.

Chart 4 – Stock Market Valuations



Source: Standard & Poors, Stembrook Research.

Looking Forward – Letting the Research Drive Our Strategies

The following is a high-level review of some of our observations relating to prospective investments based on our most recent research:

1.) The dislocations that led to our increased allocation to High Yield and other "spread products" have subsided somewhat as a result of very strong performance. While this is still an attractive investment prospective returns have moderated.

2.) Municipal bonds still represent an attractive investment. Municipal yields are comparable to treasuries before accounting for their tax benefit and we believe adequately compensate investors for the increased risk stemming from the fiscal challenges facing many state governments.

3.) Inflation linked bonds are priced with an implied inflation rate of 1.81% for 10 years. If inflation over the next ten years exceeds this level then TIPS should provide protection against a drop in purchasing power.

4.) In US stocks, we've invested a larger proportion - though still a minority share - in active managers who focus on deep value stocks. We believe there are still significant opportunities to buy very solid companies at low prices. Small cap stocks are also looking more attractive as more and more indicators are showing signs of an economic recovery somewhere on the horizon.

5.) We continue our investment in emerging market stocks. While valuations have risen with recent strong performance, there is still a compelling argument to be made for emerging markets' growth vs. developed markets. This is another place where we believe an allocation to active managers will serve us well.

6.) We also continue to hold our commodities position. This reflects our ongoing thesis that an economic recovery and ultimately rising inflation are in our future.

Investment Planning
An important change in retirement planning is coming at the beginning of next year. At that time, the income limits on conversions from IRA's to ROTH IRA's will be lifted. Such conversions can represent significant opportunities to increase wealth accumulation for many investors and their families. While there are some rules of thumb to follow, analyzing specific situations is the only way to make a high confidence determination that such a conversion is right for your situation. We will be following up with a more in depth discussion of this topic in the coming months.

Firm Update
Over the past few months, Stembrook has further enhanced our ability to conduct research and manage your assets. In particular, we have developed an improved risk management and trading system that allows us to more accurately measure the risk in your portfolio and more efficiently trade your customized portfolios as new insights are derived from our research. We have also improved our portfolio construction methods based on a range of leading edge optimization techniques. Finally, our ability to conduct wealth planning and wealth simulations has been enhanced with the development of a revised, proprietary wealth planning tool. These improvements will allow us to serve you better and more efficiently in the future. If you have any questions about our enhanced infrastructure, please let us know.

As always, if you have any questions about this commentary or any other issues regarding your portfolios, please do not hesitate to contact me.

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Additional information is available upon request.

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