LODESTAR

# Investment Commentary

## Quarter Ended June 30, 2010

Earlier this year, the long awaited economic recovery appeared to be unfolding and the financial markets were generally sanguine. Despite this more upbeat mood, we noted in our last report that a meaningful stock market correction would not be a surprise, given the nearly unabated market advance of the previous twelve months. Asset prices do not typically travel in one direction for such extended periods, and, sure enough, the past quarter dispelled any expectation of an 'all clear' signal. Most of the major stock indices were down in excess of 10%, with global stock markets trading as real-time gauges of economic anxiety. In fact, China's economy, with seemingly endless growth prospects, showed signs of cooling, leading their market to drop 25% from its April peak. On a positive note, due to the recent pullback, equities now offer good value, which should be expected during periods of economic stress.

**While the current correction in the US market is uncomfortable, it has been equally unsettling to see the macro-economic environment turn for the worse in such short order.** Canvassing the daunting headlines of the past three months is a less than upbeat exercise. Included among these developments have been a monstrous oil spill, continued massive legislative initiatives, Europe living its own version of the 2008 financial crisis, and job woes plaguing more and more families on a daily basis. In short, economic and investment uncertainty returned in full force.

In the US, recent employment figures have been uninspiring, income growth weak, plans to purchase discretionary items falling, and the housing rebound appears to have stalled. Reflecting investor anxiety over the economy and international unrest, the 10-year treasury yield dropped to 2.93% by quarter-end from 4.00% as recently as late-April, a stunning decline over such a short timeframe. In addition, money supply figures have been anemic for this point in a recovery, and consumer inflation is at its lowest level in 60 years. **Whereas anecdotal evidence was trending positive early in 2010, more recent indicators suggest a slow and grinding recovery, uneven across business sectors and industries**, and one not likely to gain solid traction until these numerous areas of uncertainty are alleviated.

**Bonds fared far better than did stocks in the most recent quarter, as most fixed-income sectors accomplished the important goal of preserving capital through a volatile period.** Reflecting the economic softness discussed above, concerns over credit quality have justifiably increased. Consequently, demand for the highest quality bonds has grown, resulting in diminished yield levels. In a sense, this is the price for credit 'comfort'. In the near term, inflation and interest rates should remain low, due mainly to excess resource capacity worldwide. **Longer-term we are less optimistic on the inflation front, due to the 'easy money' policies being pursued by the Federal Reserve.**

Last year we discussed how the market was reacting positively to 'less bad' data, and that a more enduring recovery would be required

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to keep stocks moving higher. Currently, the data is uniformly 'less good' than it was even two months ago, thus the recent shift from euphoria to discomfort on the part of investors. With the broadest measure of unemployment still extraordinarily high (16+%), and credit tight, the contours of these unusual economic times have become apparent. Last year's rebound was not the start of a normal V-shaped recovery. Instead, **investors continue to battle the consequences of a long and overly generous credit cycle, one global in nature, and marked by a spate of unintended consequences**.

Surrounded by economic uncertainty, talk of 'sustainable growth' and 'double dip recession' trade places regularly. As a result, sentiment was almost as negative at the end of June as it was positive at the end of March. **On a hopeful note for near-term stock returns, the US election cycle offers reason for optimism.** Corrections of the sort just experienced have been followed by strong rallies in every off-presidential election year since 1960. This remains our expectation for the remainder of 2010. However, longer-term, investors should expect meaningful volatility until the considerable financial problems facing our country are put on the road to resolution. **Regardless of the economy's path, the companies we own continue to be in very good position to ride through the on-going storm. The vast majority are industry leaders that are not dependent on a strong economy to generate earnings growth, enjoy solid balance sheets, and are attractively valued.**

## <u>There Are No Easy Choices</u>

Eighteen months and $12 trillion worth of stimulus, bailouts, and debt guarantees should have been a sufficient commitment to regain our economic footing. **While most believe that government actions prevented a 1932 style depression, one could argue the remedies have only kicked the growing can of problems down the road.** Instead of creating conditions to allow the job producing private sector to work, government policies have accelerated its reach into the economy, instituting new entitlements, developing vast new and costly regulations, and adding more national debt in 18 months than was issued, in aggregate, during our Republic's first 232 years. It is alarming, but no surprise, that paychecks from private business have sunk to their smallest share of personal income in history. At the same time, government provided benefits have risen to a record high. While we do believe the economy is slowly moving forward, a certain malaise has set in partly due to the uncertainties that have been formed by legislative policies, or lack thereof. Questions surrounding the cost of health care reform, the duration of specific industry subsidies, and the extent of coming tax increases are on the mind of business owners and investors. It is indisputable that small business drives job growth, yet for any business on the verge of employing more than 25 people, the level of employees that triggers many increases in government oversight and expensive mandates, the propensity to add a 26th job is next to nil. And just over the next hill is the potential cost of bailing out some state and local governments. Needless to say, the consequences of these actions will be far reaching, and will greatly influence all aspects of society, financial and otherwise, for many years to come.

**From a financial perspective, we did not arrive at this point overnight. In fact, the US and many other developed countries have been living beyond their means, spending far more than has been taken in, for some time.** The resulting problems of slowing growth, high unemployment, and soaring debt have reached the point where there are no good solutions.

All of the historically tested tools, most notably monetary ease and fiscal stimulus, have been deployed, to little avail. Unfortunately, the US cannot simply grow out of these problems, since the fiscal hole is too deep. Former Federal Reserve Chairman Paul Volker recently suggested that "time is growing short" to address these challenges. "Today's concerns may soon be tomorrow's existential crises" he stated because "little has happened to allay my concerns that dangerous and intractable problems are rising in the US . . . intractable not just because of the combination of complicated issues, but because there seems to be so little willingness or capacity to do much about it".

So, we can continue on the current course and hope that debt financed spending morphs into legitimate economic growth, the plan followed for over a decade. Alternatively, the bitter pills of debt reduction and spending restraint can be swallowed, ultimately allowing for a sustainable economic expansion, and the healthy investment opportunities that would follow. It is true that these measures would retard growth for some time, yet Western Europe has now embarked on this course, while the US shows little inclination to do so. Across Europe, initiatives are underway that cut or freeze government payrolls, raise retirement ages, and reduce welfare spending. By no means are the European nations out of the woods, but their citizens and elected officials have been forced to address the issues head on. There seems little doubt that unless the US changes course, we will have little choice but to follow the European example.

## This Too Shall Pass

Unfortunately, many of the overarching issues that roiled the financial markets over the past few years, while addressed in part, are alive and well, and will not easily go away. We must be aware of these 'big picture' concerns, and understand that they will flare up intermittently, leading to bouts of downside volatility such as occurred in May. The sooner that decisive action is taken to reduce the debt and unfunded liability burdens the better, since at some point, if left unresolved, the markets will be unforgiving. Greater numbers of market observers now acknowledge these challenges, which is a positive development. **If history is a guide, and it almost always is, these difficult times will eventually yield to lengthy periods of prosperity, and innumerable opportunities for outsized investment returns. Against this backdrop, owning the highest quality stocks and bonds to generate income, preserve capital, and take advantage of the occasional spirited market rallies is, in our judgment, the appropriate investment approach.**

The past several years have been unlike any most of us have ever witnessed. Investors need to be realists, searching for opportunities, but always mindful about what could go wrong. **While we fully acknowledge the frustration associated with the unpredictable and drifting investment environment of recent years, we firmly believe that investor patience will ultimately be rewarded. Having the financial and psychological capital necessary to enjoy the next secular bull market will be critical.** Among our most important goals is to persevere during this difficult process of deleveraging, and be in good position to prosper once a long-lasting recovery takes hold. Though the timing of this process is elusive, we are optimistic that highly favorable investment conditions will emerge in due time.

## Managing Director Profile

LODESTAR

William A. Goldstein
Chairman

Bill founded Lodestar in 1989. He has 49 years of experience in the financial industry.

Bill has long been active in community and charitable organizations. Bill volunteers as a member of the Endowment and Investment committees for both the Evanston Community Foundation and the Chicago Symphony Orchestra. In addition, he serves on the Board of Trustees of the Chicago Symphony Orchestra and is Board Chairman of the Night Ministry.

When not working or volunteering, Bill enjoys sailing on Lake Michigan, cycling and spending time with his family.

Bill can be reached at 312.630.9666 or at bill@ldstr.com

## Market Snapshot - June 30, 2010

| Equity Indices | Quarter | YTD |
|---|---|---|
| S&P 500 | (11.41)% | (6.64)% |
| Dow Industrials | (9.36)% | (4.99)% |
| NASDAQ | (12.04)% | (7.05)% |
| Wilshire 5000 Index | (11.45)% | (6.28)% |

| Interest Rates | 6/30/10 | 6/30/09 |
|---|---|---|
| 5-Year Tax-Exempt AA | 1.78% | 2.25% |
| 5-Year US Treasury Notes | 1.77% | 2.41% |
| **Commodities** | | |
| Gold | $1,244.00 | $934.50 |
| Oil - WTI ($/Barrel) | $75.63 | $69.89 |

**"Lodestar":** *1 A guiding principle, interest, or ambition. 2. A star, especially Polaris, that is used as a point of reference.*

Lodestar Investment Counsel was formed in 1989, as an independent registered investment advisor, with the above definitions firmly in mind. All of our principals have extensive experience working with high net worth individuals, families, corporate and individual retirement plans, and charitable organizations, like those who make up our client base today.

We recognize and respect the need to grow and preserve our clients' core assets. Our services are designed to provide a risk-averse approach to long-term capital appreciation, that is tailored to the unique financial circumstances and needs of each specific investor. We provide discretionary account management for taxable, tax-exempt, balanced and fixed-income portfolios.

To assure that all our clients receive a high level of personal service, our minimum account is $1 million in investable assets. In all aspects of our business, we strive to adhere to the guiding principles of focus, consistency and service.

We would welcome the opportunity to meet with you, or others you know who might benefit from our services.

*Robert H. Dearborn*
*Peter W. Flanzer*
*Mark Ganchiff*
*William A. Goldstein*
*John J. Sobel*