



Investment Commentary

Quarter Ended September 30, 2009

The investment rally that began in March continued with abandon throughout the September quarter. **When it became apparent in the spring that the world financial system was not descending into Armageddon, a ‘relief rally’ commenced, with stocks, bonds and commodities of most stripes surging, and money returning to ‘risky’ assets.** There is no question that markets were due to advance, if for no other reason than as a contrarian reaction to the investor despondency amidst the March lows. Not surprisingly, those market sectors most decimated in the ‘bear’ downturn, generally lower quality and more speculative securities, have lead the way on the upside. In what seemed like the blink of an eye, the panic that was so palpable early in 2009 was replaced with optimism. While higher markets do serve to calm nerves, and may indeed reflect improving economic conditions, we believe that now is no time for complacency. Call us skeptics, but many of the problems at the root of the financial crisis have not been fully addressed, and these challenges will continue to exert considerable influence on the investment markets for some time to come.

The world’s economies and financial markets are most certainly in unchar-

tered waters. **Starting one year ago, the US Federal Reserve set off on a path to save the nation’s largest financial institutions, and to reflate asset values. Giving credit where due, these initiatives have achieved impressive success to date.** At the same time, US government programs were enacted to stem job losses and rekindle consumer spending. These efforts, however, have had more mixed results. Tax incentives have somewhat softened the blow to consumer pocket-books, but the \$787 billion stimulus program has done little to help the employment picture. It is notable that during this precarious period, tax-payer funded bailouts kept the system functioning, various debt guarantee programs helped banks recapitalize their wounded balance sheets, and the Fed’s zero interest rate policy has spawned huge profits at financial institutions of all kinds. These measures contributed mightily to rescuing the global financial system.

The Fed's decision to move rates down toward zero may have resurrected the financial system, but it has hurt savers, and encouraged aggressive investment activity. Investors do not like earning nothing, and virtually nothing is what is received these days on savings accounts. Consequently, this low interest rate policy has

strongly encouraged investment in markets for riskier assets, thus driving prices higher. Now, in certain respects, investors find themselves back in roughly the same position that existed prior to the financial crises – stocks are not cheap, bond yields are meager, and many underlying economic fundamentals are shaky.

What Has Really Changed?

From an admittedly low bar, economic conditions have improved in recent months. The Index of Leading Economic Indicators has risen five months in a row, with three consecutive higher readings typically sufficient to call the end of a recession. The upturn in the ratio of coincident to lagging indicators, the decline in jobless claims, and an apparent basing in housing activity also suggest that the US economy is in the process of healing. Throw in inventory rebuilding, and **it is not difficult to**

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make an argument for resumption of economic growth in coming quarters, possibly stronger than many expect. This premise is supported by historical precedent in that severe contractions have been followed by significant rebounds all the way back to the 19th century. Of course, it is also true that post-crisis downturns, such as now exists, tend to be protracted affairs.

Rarely has there been a greater disparity of opinion as to where the economy and markets are headed. Acknowledging the folly of economic forecasting, our guess is that the economy will experience a decent rebound over the next year or so, as awful becomes less bad and stays that way. Of much greater significance to investors, however, is not the near, but rather the longer term outlook for economic growth and corporate profits. Recent improvement in the economy has been driven almost solely by temporary government programs, including ‘cash for clunkers’ and tax credits for first time home buyers. Demand in the private sector, both industrial and consumer, remains tepid, and job creation by small businesses is almost non-existent. Recoveries from American recessions are typically fueled by small company activity. **In short, the foundation for economic recovery remains fragile, with many of the major problems that led to the financial crisis and recession still unresolved.**

Ponder for a moment the following areas of concern:

- The Federal budget deficit totaled approximately \$1.4 trillion in the recently completed fiscal year, and the national debt is estimated to increase by \$9 trillion, to \$20 trillion, over the coming decade. Total credit market debt relative to GDP is well beyond any level this country has ever witnessed, and government obligations are an astounding \$60-90 trillion, depending upon the analysis one reads. Of course, much of the recent debt creation is the result of government bailouts of various industries and companies judged to be too big/important to fail. To put this in perspective, reputable research shows that bailout spending since the autumn of 2008 has been equal to the inflation adjusted cost of the Marshall Plan, Louisiana Purchase, Race to the Moon, S&L crisis, Korean War, New Deal, Iraq invasion, and Vietnam combined.
- A healthy economy requires a growing credit market. Yet, despite the best efforts of the Federal Reserve and US Treasury, credit is contracting. Credit card lines (an important funding source for small businesses) and corporate lending are both down. This is important because small businesses employ

half of the workforce, create 75% of all new jobs, and contribute 38% of GDP. This is not simply a US problem – financial institutions all over the developed world are raising capital, reducing loans and, therefore, acting as a drag on growth.

- Leaving social implications aside, active government involvement in the private sector typically inhibits economic prospects. Personal tax rates are set to rise in 2011 at the federal level and, due to huge holes in municipal budgets, state and city taxes are likely headed higher as well. In addition, an issue worthy of its own bullet point is that of trade protectionism. Free trade agreements with solid allies (South Korea, Columbia, Panama) have been put on hold, while tariffs have been applied to Chinese tires and steel pipe by the US and European Union, respectively. China is threatening to retaliate.
- The US dollar has been falling against most global currencies since the beginning of 2002. The pace of this decline has accelerated of late as capital moves to countries with less debt, better growth prospects, and more friendly investment climates. A weaker dollar may assist certain industries in the near term, though will likely be problematic over time with respect to inflation

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implications and national economic strength. In short, a devalued currency is not a sign of international confidence.

- While there were many culprits associated with the credit crisis and bear market, excessive debt and leverage lay at the bottom of the pile. In the aftermath of this debacle, and after a multi-decade borrowing and spending binge, the average American appears to have learned the consequences of irresponsible behavior. Savings are rising and spending has declined, both positive and appropriate developments. In fact, consumer debt outstanding has declined for seven consecutive months, representing a dramatic change in spending behavior. Unfortunately, this lesson in frugality appears to have escaped the government, with aforementioned debt issuance shattering all historic precedent. How these debts will be repaid or refinanced is a great unknown, and will be hugely important to the investment markets in coming years.

The point in detailing all of these issues is not to spread doom and gloom, rather to note that the path to higher asset values will likely be bumpy. Our collective actions as a country have left a difficult predicament - if high deficits are not main-


tained, the economy may fall back into recession. Yet, if spending is not controlled, we run the risk of creating a debt level that becomes impossible to finance, at reasonable rates of interest anyway. At some point, the bond market will rebel, and interest rates could rise significantly.

“If You Aren’t Confused, You Don’t Understand What’s Going On”

The main emphasis of this letter is to reassert the notion that protecting your existing assets should be a top priority. While this may be obvious, the events of the past year reveal the challenge of this objective. This is a difficult time to be an investor, given the many moving parts and tremendous uncertainties to contemplate. The quote above, from a well respected investor, says it all.

Many investors today are struggling with the apparent inconsistency of falling Treasury interest rates, normally indicative of economic weakness, while stock, corporate bond, and commodity prices are rising, seemingly in anticipation of stronger economic growth, and possibly inflation. Historically, these major asset classes do not move in lock-step. Our view is that the flood of liquidity will ultimately bring footing under the economy at the price of rising inflation in coming years. If this scenario materializes, US treasury and mu-

nicipal securities, other than those inflation protected or relatively short-term, are likely overpriced. Current stock values now almost certainly discount a coming economic rebound, with the real question being the strength and fortitude of the recovery. Low interest rates as a reason to move money into riskier investment alternatives usually ends badly, and one should be wary of that trap.

Only positive economic fundamentals can sustain a lasting bull market, and we all hope for signs of improvement on that front. However, in light of the uncertain environment, investors must pursue a disciplined approach, paying heed to quality, valuation and overall risk in portfolios. While painful bear markets, such as we have recently endured, are inevitable from time to time, wandering from these basic tenets put many behind the eight ball in recent years. All of our respective levels of risk tolerance have been tested due to the unusually high levels of volatility. Having comfort with one’s portfolio structure is critical to being able to weather the unexpected turns that are inherent in the investment process. 

Managing Director Profile



LODESTAR

William A. Goldstein
Chairman

Bill has 47 years of experience in the financial services industry. He founded Lodestar in 1989 after holding the position of Chairman and Director at Prescott Asset management, a wholly-owned investment advisor of Prescott, Ball & Turben, Inc. Prior to that, Bill was a founding principal, Executive Vice President and Director of Burton J. Vincent, Chesley & Company. The

firm was acquired by Prescott, Ball & Turben, a Kemper Corporation subsidiary. Bill graduated from Purdue University with a Bachelor of Science in Industrial Economics.

Bill volunteers as a member of the Endowment and Investment committees for 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 Chairman of the Night Ministry. Bill also is an avid bicyclist and sailor.

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

Market Snapshot - September 30, 2009

<u>Equity Indices</u>	<u>Quarter</u>	<u>YTD</u>	<u>Interest Rates</u>	<u>9/30/09</u>	<u>9/30/08</u>
S&P 500	15.59%	19.27%	5-Year Tax-Exempt AA	1.72%	3.40%
Dow Industrials	15.77%	13.46%	5-Year US Treasury Notes	2.19%	2.98%
NASDAQ	15.66%	34.58%			
Wilshire 5000 Index	16.09%	20.45%	<u>Commodities</u>		
			Gold	\$995.70	\$884.50
			Oil - WTI (\$/Barrel)	\$70.61	\$100.84

“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. Flanzger
Mark Ganchiff
William A. Goldstein
John J. Sobel*