



# Investment Commentary

## Quarter Ended September 30, 2010

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Equity prices advanced nicely during the third quarter, with significant gains achieved both in the US and overseas. The rally was somewhat volatile, with each of the three months experiencing sharp moves. Quite surprising was that **the market enjoyed its best September since 1939, a month that has historically been particularly difficult for stocks.** What a difference the passage of one month made, as investor psychology rapidly morphed from despair to euphoria. At the end of August, renewed fears of a ‘double-dip’ recession in the US, resurgent stress within the European Union, dire forecasts proffered by notable pundits, and a technically oversold market, had created severe pessimism, setting the stage for the upside burst that ensued. Once prices moved higher, investors began to focus on the now widely held belief that Congress will be more balanced after November 2nd, creating political gridlock, and on the recent Federal Reserve announcement that new efforts to stimulate the economy are forthcoming. The advance was not limited to equities, as most other ‘risky’ assets, particularly commodities, surged as well.

Bonds of all stripes gained during the quarter as interest rates continued to fall, and demand remained strong. Remarkably, and to provide some context, Elvis was still topping the pop charts the last time mortgage rates were this low. **Treasury securities currently offer puny yields, with the 10-year maturity resting near 2.45%, and the 30-year bond at 3.81%. This is not simply an American phenomenon, as yields around the globe have collapsed,** with investors seeking the ‘safety’ of government backed bonds. Yields have dropped so far that some have dubbed the bond market as a place to obtain ‘return free risk’, meaning that returns are awfully meager considering the current risk/reward scenario in longer term fixed income securities.

While extraneous shocks to the system could change the equation at any time, **interest rates will likely remain subdued until economic growth prospects improve, and/or inflation expectations shift.** The Federal Reserve has restated its commitment to leave short-term rates near zero, and weak economic conditions serve to depress longer term rates. One can sensibly

question the wisdom of purchasing long dated bonds at current yields, though many investors are convinced that the return of capital is more important in the present environment than is the return on capital. We will remain opportunistic as to fixed income purchases but, in aggregate, intend to maintain a high quality, low duration approach. **We continue to believe that the seeds are being sewn for troubling inflation at some point, and that bond portfolios should be positioned to mitigate this risk.**

### Same Old, Same Old

Unfortunately, despite the recent jump in stocks, investment conditions have been less than hospitable since 2000. This is the nature of secular bear markets. We have noted on numerous occasions that

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*“... the market enjoyed its best September since 1939, a month that has historically been particularly difficult for stocks.”*

these periods are not events, but processes that require patience, perseverance, and discipline. Such cycles typically move valuations gradually from severe overvaluation (i.e. year 2000) to obviously cheap levels, with that process normally taking many years. Stock valuations are currently ‘normal’, neither rich nor bargain basement. As events unfold, and human emotions react, each cycle spawns numerous mini-bull and mini-bear phases. For instance, the 1966 - 1982 bear market incorporated 5 baby bears and 4 baby bulls.

Our July 2010 investment review expressed the expectation for a meaningful stock market rally, and it will not surprise us to see prices move higher from here. Indeed, based on historical precedent, the duration of major advances from off-presidential election year bottoms suggests that this positive market interlude could last for many more months, and carry the major averages 15-20% higher. These constructive market conditions should be enjoyed while they last, but this story line has been observed on many occasions over the past decade. Indeed, **while ‘risk’ assets have moved higher, and may continue to do so in coming months, current stock market strength should not necessarily be confused with improving economic fundamentals.** Again, a mere 6 weeks ago, market

sentiment was extremely negative, as stocks had finished a miserable August. Negative headlines garnered all the attention, fewer than 29% of stock analyst recommendations worldwide were ‘buys’, and US equity mutual funds continued to experience substantial outflows. It is at such extreme moments that sharp market rallies can, and frequently do, occur. These moves often have little to do with real world fundamentals and are more about human emotion, which can drive market direction dramatically over short periods. **For the moment, it seems certain that the Federal Reserve will be pouring liquidity into the financial system, a process that provides support for the capital markets and comfort to some investors. This may prove to be a short-term tonic however, as more fundamental solutions, beyond political gridlock and monetary stimulus, will be needed to resolve the several intractable economic issues that burden our country.**

#### **Less Bad Is Good . . . Is Worse Better?**

After the events of recent years, few question the fact that we live in difficult and unprecedented times. We previously suggested that ‘less bad’ was a sufficient condition for the market to rally off of the March

2009 panic bottom, but that economic underpinnings had to meaningfully improve to sustain the market’s recovery. Instead, judging by the stock market anyway, ‘worse is better’. **Put simply, the economy remains under great duress.**

While many on Wall Street and in Washington DC opine to the contrary, here are some notable facts that warrant concern: (1) if this were an average recovery, the economy would be growing at a 6% rate by now, rather than the current figure of 2.4%, (2) by this point following recessionary conditions, employee payrolls have typically exceeded the previous peak by 700,000 jobs. Unfortunately, current employment levels are still down roughly 8 million from the December 2007 crest, with the broad U6 measure of unemployment and underemployment over 17%, meaning that almost one in five Americans are struggling for an adequate job, (3) new home sales are at record lows, despite the historic decline in mortgage rates, (4) the US federal deficit is nearly 10% of GDP, double the amount during FDR’s depression-era administration. Total debt now exceeds \$13 trillion, and is projected to rise dramatically in coming years, (5) countries throughout the world are working to devalue their

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currencies in order to stimulate exports, with the US dollar among the weakest, and (6) US policy makers seem determined to start a trade war with China, our third largest export market, never mind that US exports to China grew more than 70% faster last year than did China's exports to the US.

**After all the monetary, fiscal and bailout stimulus, the economy should be roaring ahead. The fact that there has been little sustained response to these massive efforts is a testament to the view that this has certainly not been a garden variety downturn.** We can all understand the need and desire to be optimistic, but it is more important to recognize that it took a decade of parabolic credit growth to arrive at this position, and that there is no easy or quick fix.

**The markets are telling us something valuable, though it is admittedly difficult to ascertain the exact message.** Bonds, commodities, and stocks in most every world market are rising. If economic improvement is on the way, as suggested by these price advances, and if the US dollar is being purposely devalued, then both inflation and interest rates should be moving up. Instead, some

government bond yields are lower now than at any point during the credit crisis, inflation is muted, and a return to weak conditions appears to be the market's expectation. It is possible that depressed yields do not reflect dire economic prospects, but simply the reality of the central bank's intent at keeping borrowing costs down in a debt laden economy. Still, the Fed would not be so concerned with borrowing rates if the economy was recovering well. On the other hand, if conditions are so poor, why are stocks and corporate bonds so strong? **In our view, these tremendous cross-currents reflect investors struggling to reconcile short-term market influences with long-term structural impediments.**

### Control What You Can

One of our most important functions is to help our clients navigate challenging times. In light of economic conditions, continued volatility in all markets should be expected for the foreseeable future. Investors should strive to maintain a reasoned and disciplined investment approach, and avoid the extreme swings in emotion between unabated optimism and unjustified pessimism. Indeed, investing success requires making informed decisions and judgments based on facts and logic,

and focusing on opportunities where there is a reasonable likelihood of a good result, rather than the hope of a great one. None of us can influence the macro economic or political environments, but asset allocation, security selection, and the degree of portfolio risk assumed are within our control. **Change in the investment world is a certainty, yet certain things will not change:** our time-tested, disciplined, quality oriented approach to building and managing portfolios, and a steady focus on doing what is best for you at all times. ☀

## Managing Director Profile



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Robert H. Dearborn, CFA  
Managing Director

Bob has over 29 years of experience in the financial services industry. He joined Lodestar in 1991 after holding the position of Vice President and Principal at Stein Roe & Farnham, Inc., a Chicago based investment advisory firm. Prior to that he was an officer with Northern Trust Bank.

Bob earned his undergraduate degree (BA) from Kenyon College, and received a Master's in Business Administration degree from the University of Chicago. He is a Chartered Financial Analyst (CFA) as well as a Chartered Investment Counselor (CIC).

In addition to spending time with his family, and involvement in community affairs, Bob is an avid golfer in the warmer months and enjoys playing paddle tennis in the winter.

Bob can be reached at 312.630.9666 or at bob@ldstr.com

## Market Snapshot - September 30, 2010

| <u>Equity Indices</u> | <u>Quarter</u> | <u>YTD</u> | <u>Interest Rates</u>    | <u>9/30/10</u> | <u>9/30/09</u> |
|-----------------------|----------------|------------|--------------------------|----------------|----------------|
| S&P 500               | 11.30%         | 3.91%      | 5-Year Tax-Exempt AA     | 1.29%          | 1.72%          |
| Dow Industrials       | 11.13%         | 5.58%      | 5-Year US Treasury Notes | 1.29%          | 2.19%          |
| NASDAQ                | 12.30%         | 4.38%      |                          |                |                |
| Wilshire 5000 Index   | 11.07%         | 4.09%      | <u>Commodities</u>       |                |                |
|                       |                |            | Gold                     | \$1,307.00     | \$995.70       |
|                       |                |            | Oil - WTI (\$/Barrel)    | \$79.97        | \$70.61        |

**“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*