



“The US economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many ‘structural’ burdens, as opposed to familiar ‘cyclical’ problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought; the debt hangover; the banking collapse; the real estate depression; the health care cost explosion; and the runaway federal deficit.” - Time Magazine

One cannot describe the quarter ended September 30 as anything other than difficult. **A constant barrage of downbeat news surrounding economic developments and political/policy dysfunction caused a sell off in ‘risk’ assets that engulfed the globe.** Every major stock index fell by double digit percentages, with the worst markets (including Germany, France, and China) losing 25% or more of their value. By quarter’s end, even ‘safe’ assets like gold and the Swiss franc, were hit by waves of selling. In the US, stocks declined anywhere from 12% (Dow Industrials) to 22% (Russell 2000), with the biggest and highest quality companies generally faring best. Within this group, businesses selling necessary products (i.e. utilities and consumer staples) performed relatively well and, in many cases, benefitted from providing reasonable and growing dividend yields. With the Federal Reserve all but

guaranteeing low interest rates for the foreseeable future, the positive impact of these attractive income streams should continue to gain considerable favor with investors.

Bonds were a mixed bag in the quarter, with US Treasuries and other high quality issues holding up well, while lower rated and less liquid securities became increasingly vulnerable to the growing perception that Europe and the US are on the verge of recession. Spreads between high and low quality bonds have widened meaningfully in recent months, and the market for ‘junk’ bonds has endured its worst rout since the depths of the financial crisis. Yet, on average, corporate liquidity is in much better shape than was the case in 2008. In addition, municipal finances have stabilized somewhat, to the benefit of quality tax-exempt bonds. Lastly, treasuries remained strong as a result of a ‘flight to quality’, and the Federal Reserve’s

new plan, ‘Operation Twist’, to purchase longer dated maturities. Indeed, the yield on the 10-year Treasury note declined to record low levels, touching 1.70% at one point. **While one may be excused for a lack of enthusiasm with regard to new fixed income investments, high quality bonds once again provided a bastion of relative calm in the face of external turmoil.**

Much of the news flow during the quarter was not new, but the heightened intensity of the events brought back unwelcome memories of 2008-2009. Indeed, nothing much has changed. Government debt levels

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across the globe remain irresponsibly high, unemployment is a stubborn problem, the housing industry remains moribund, and too many US banks are still saddled with weak balance sheets. Many are predicting the demise of the European Union, as the fabric of the region is torn at the edges (Greece), and threatens to dissolve (Italy, Spain) if Germany and France refuse to bail out their fiscally failing neighbors. Economic growth is flagging worldwide. Many developing markets (China being the most obvious one) are in better shape than are the US and Europe, though these economies are being squeezed, as well, by the weakness of their major trading partners. Possibly of greatest concern, is the leadership void that impedes potential progress on fixing the debt and deficit problems. Worldwide, protests are becoming a regular occurrence, suggesting that patience is wearing thin.

Back at home, Bernanke & Co. announced that short-term interest rates will remain near zero for at least two more years, and that the Fed will buy long-term treasury maturities in yet another attempt to stimulate the American economy. The latter plan was tried in the 1960’s, to very minor effect. **The commitment to ultra-**

low interest rates will do little to help the economy, but a lot to hurt savers and those who depend on investment income. While ‘don’t fight the Fed’ remains a powerful market axiom, particularly with stock investors, it seems that the Federal Reserve’s quiver, with regard to the economy, is down to its last arrows.

We have carped for some time about the lack of leadership in Washington, and the inability of policy makers to tell the truth and craft long lasting solutions for the growing problems. Many of these ‘solutions’ seem quite obvious: long-term entitlement and tax code reform, much smaller government involvement in the economy, and dramatic reductions in regulations that are choking the energy, health care and finance industries. **A responsible strategy would favor economic growth for everyone, rich and poor, and would be sector neutral, not biased toward favored industries and interest groups.** Instead, Washington authorities, on both sides of the aisle, continue to demagogue each and every issue, threaten this and that constituency, and provide band-aids for problems that require tourniquets. Despite protestations to the contrary, the facts clearly show that government

regulations are stifling American business of every type. Recently, the CEO of Coke stated that it is easier to do business in China than in the US. What else need be said?

Whether it was the sovereign debt crisis in Europe, the US debt ceiling debate, S&P’s decision to downgrade the US credit rating, or a combination, August saw the weight of the world’s problems finally come down on stocks with a thud. **The S&P closed up or down more than 4% in five trading days between August 3rd and 11th, a level of volatility not seen since 1932.** Two of the 28 largest one-day percentage declines in the S&P 500 (past 60 years) occurred in August. Remarkably, the record will show that the S&P declined only slightly more than 5% during the month, a figure that obscures the frantic pace of the markets. The selling spilled over into September, though volatility subsided somewhat. While economic conditions have turned down in recent months, much of the intra-day swings in the stock market resulted from computer directed trading. **Make no mistake, the volatility is uncomfortable for all of us. Unfortunately, this condition is not likely to change soon. Yet, over time, it is indisputable**

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that equity investment returns will ultimately track the results of the companies that we own. Despite the wild ride of late, it is this factor upon which we all must focus.


Many investors (and the citizenry at large) are justifiably concerned over the lack of progress on truly significant economic issues and, frankly, the outlook for this great country. In light of the macro headwinds already addressed, Wall Street expectations for corporate earnings may be too high, and will likely need to be revised down. The magnitude of these revisions will be more important than the fact that they occur. Though some of the diminished profit outlook is already reflected in current stock prices, this near-term uncertainty may well result in further market disruption.

While mindful of the near-term challenges, history illustrates that stocks can and frequently do rally smartly during periods of distress. This theme has occurred regularly over time and may be on the cusp of repeating. Bearish sentiment is considerable, to the point where investor psychology is dour enough to potentially yield to a ‘less bad’ mindset, similar to the environment that set

the stage for the March 2009 bottom in stocks. Moreover, equities also have a remarkable history of performing well during the November – April period. Interestingly, there have been five corrections limited to 15-20% since 1962. All five were followed by 20-30% advances lasting a year or longer. If the market lows of early October hold, this would mark the 6th correction of the same magnitude. Finally, and more impressively from an historical perspective, over the same 1962 – present time frame, the S&P 500 index has gained 19%, on average, in the third year of a presidency. In only one of these 19 periods has the market ended down for the year. Of course, none of this means that the market will move higher from here but, if history is a guide, there is reason for optimism.

The *Time Magazine* quote at the top of this review aptly describes our current predicament. Yet, you might find it interesting that these words were written in 1992, amidst another recession. Like today, the environment was ugly in 1992. But, led by the Internet, and some political compromises in Washington, conditions improved and in 1995 stocks proceeded on a multi-year advance. No one knows

when, or how, the current malaise will be resolved, but revolutionary products and developments tend to come along about every 20 years. It will happen again.

In the meantime, with the future always uncertain, **we must continue to map a rational course of action, sync our respective risk profiles and time horizons, and provide for a margin of error.** There are no easy or quick solutions to the myriad of current challenges, but common sense and an appreciation for historical precedent will be instrumental in managing through this difficult period. Nestled within our course of action should be the conservative assumption that the next few years will be highly unpredictable. However, if free market principles are embraced once again, and policies are implemented to truly address our obvious fiscal problems, as opposed to only their symptoms, the stage will be set for better economic times and rewarding investment returns. 

Managing Director Profile



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Peter Flanzer
Managing Director

Peter joined Lodestar in 2002 after serving as a Principal with another Chicago-based investment advisory firm. For over 25 years, his focus has been on working with private clients in the management of their investment portfolios.

Peter earned his bachelor of arts degree from Kenyon College, and received his law degree from the John Marshall Law School in Chicago.

In addition to spending time with his family and participating in civic and

charitable affairs, Peter is an avid golfer in the warmer months and enjoys playing paddle tennis in the winter.

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Market Snapshot - September 30, 2011

<u>Equity Indices</u>	<u>Quarter</u>	<u>YTD</u>	<u>Interest Rates</u>	<u>9/30/11</u>	<u>9/30/10</u>
S&P 500	(13.80)%	(8.60)%	5-Year Tax-Exempt AA	1.21%	1.29%
Dow Industrials	(11.50)%	(3.90)%	5-Year US Treasury Notes	0.96%	1.29%
NASDAQ	(12.20)%	(8.30)%			
Wilshire 5000 Index	(14.10)%	(9.00)%	<u>Commodities</u>		
			Gold	\$1,620	\$1,307
			Oil - WTI (\$/Barrel)	\$79.20	\$79.97

“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
William A. Goldstein
John J. Sobel*