



# Investment Commentary

## Quarter Ended December 31, 2009

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At the risk of sounding like an annual broken record, investors just closed out another year for the history books. Each of the past three years has witnessed breathtaking events that rarely occur in decades, let alone over 12-month periods. Since 2007, financial markets worldwide have endured extreme volatility, stemming from highly uncertain and weakened economies, and unprecedented responses to these conditions from governments, businesses and consumers, alike. **While investment returns were nicely positive in 2009, many investors feel as if they have recently disembarked from a roller coaster, slightly exhilarated and happy to be in one piece.** Fifteen months ago, the bankruptcy of Lehman Brothers unleashed a financial panic. Global economic activity, from industrial production to foreign trade, fell faster than in the early 1930's. This time, though, the decline was stemmed quickly, as teetering banks were rescued with a multi-trillion dollar net of government cash and guarantees. Central banks slashed interest rates, and governments worldwide adopted a variety of fiscal stimulus measures. Without these actions, the Great Recession of 2008-2009 might well have become the Great Depression II.

By March of 2009, immense amounts of government support, together with unabashed pessimism, combined to forge a 'bottom' for global investments. The stock market experienced an intra-

year swing of roughly 60% from bottom to top, while US treasury bonds proved to be the most perilous sector within an otherwise favorable fixed-income arena. A major surprise to us was the extent to which investors regained their appetite for risk.

**Indeed, 2009 rewarded the most risky of investments, generally those most devastated during the downturn.**

**Securities of the lowest quality and most highly leveraged companies, including both bonds and stocks, performed the best.** In fact, stocks rated A- or better by Standard & Poor's advanced a respectable 14% in 2009, but stocks ranked B+ or worse were up almost five times as much, on average. Adding to the disparity, 2009 was the worst year on record for dividends, as S&P 500 companies cut payments by a combined \$58 billion. Despite the historical importance of dividends to equity returns, dividend paying stocks performed far worse than did stocks with no payout. While not as extreme, the same phenomenon played out in the fixed income arena, where low quality 'junk' bonds generated significantly higher returns than investment grade securities. **In short, the 'flight to quality' that was pervasive through the harrowing decline, became a 'flight from quality' through the advance.** The rapidity of this dramatic shift in sentiment, from total risk aversion to total risk assumption, was remarkable. We all know that the emotions of fear

and greed regularly move markets through short timeframes. The year just closed represents another vivid example of this historical fact.

On a macro level, two primary factors accounted for the rally in global stocks, bonds, and commodities: 1) recognition that the financial world would not collapse, and 2) the combination of liquidity and low interest rates. Near 0% short-term rates encouraged the movement of funds from money market accounts to riskier assets. From a micro standpoint, the underpinning of the stock market, corporate earnings, has fared better than many feared. In fact, the bottom lines of the strongest companies held relatively firm. This is not to suggest that business conditions were not exceedingly challenging. Revenue growth was virtually nonexistent, thus profitability was realized primarily through cost reductions. Importantly, as we have noted in past letters, industry leading businesses, those typically with the greatest financial strength, routinely improve their long-term earnings power

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*“...the ‘flight to quality’ that was pervasive through the harrowing decline, became a ‘flight from quality’ through the advance.”*

during economic declines. These advances come from opportunistic acquisitions – in effect, taking advantage of weaker competitors – better cost management, and production efficiencies. This has, once again, occurred during the current downturn, and the stage has been set for strong earnings growth once economic activity accelerates.

### Where We Are Now

The consequences of the worst global economic crisis since the Great Depression have been milder than many predicted. In developing countries, at least, governments have not collapsed, as they did after the Asian crisis of 1997-1998, nor have they battled their own populations on the streets, as happened in Europe during the 1930's. Most economists believe the US recession is over, though this conclusion has not been officially recognized. The good news is that some indicators are improving (i.e. rising US personal savings rate), while others are simply less bad. The genius of American business for doing more with less has been evident in earnings reports showing profits improving far more than revenues are growing.

The flip side is that the current economic stability is worryingly fragile. Global demand is still dependent on government support, and public largess has papered over old problems while creating potential new asset bubbles. Property prices are still falling in more markets than they are rising and, despite a dramatic relaxation of accounting rules (bad assets are not being re-

flected at their true values), banking stresses still persist. Moreover, for all the talk of saving and deleveraging, American household debt, relative to income, is only slightly below its peak, and remains some 30% above the level of a decade ago. At the same time, our nation's federal debt has increased by close to \$2 trillion. Of course, it goes without saying that high unemployment (near 17% by some measures) remains a strong headwind, particularly to our 'consumer driven' economy.

One cannot be an observer of financial markets and economic trends without contemplating the unprecedented events of the past two years. **While sound minds can agree or disagree philosophically as to the merits of policy responses, it is indisputable that direct government involvement in the economy has escalated to new and previously unimaginable levels.** Money has been flowing from the government into the private sector, primarily to stabilize the financial system, and the results to date have yielded some success. However, there is a cost to these actions in the form of immense government debt expansion, more restrictive regulation, higher tax rates, and the real risk of accelerating inflation, to name a few. In addition, a 'socialization of risk' mentality has entered into the financial markets, as the government has adopted a 'too big to fail' strategy with respect to certain companies and industries. Ironically, this expectation of a government backstop, together with unusually low short-term borrowing rates, has encouraged fresh risk taking in the financial markets that could fos-

ter a repeat of the damaging investment scenarios of the recent past.

**In sum, perhaps the most critical issue going forward is whether the balance between the private sector (highly profitable and efficient over time) and the public sector (terribly inefficient and unprofitable) has shifted to the point where the natural growth rate of the US economy has been reduced. The answer to this question will not be fully determined for some time, yet will greatly influence investment returns for years to come.**

### Expectations For 2010

Needless to say, these are challenging times. Typical of a post-bubble credit collapse, the range of outcomes in the markets and economy is quite large. **Markets around the world have rallied mostly because interest rates are exceptionally low and liquidity is plentiful.** Moreover, history shows that sharp economic rebounds follow sharp declines, and the market may be anticipating such a result. There are two main schools of thought as to where the economy is headed: 1) that GDP will bounce back strongly because that is what always happens, as pent-up demand powers the economy forward, and 2) that a restrained rebound will occur as consumers save more and spend less, and credit availability continues to be tight. In the near term, there may be a meaningful pick-up in demand, if for no other reason than to refill inventories. Moreover, we know that 2010 is an important election year, and policies will be oriented to improve

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US economic figures and, specifically, to reduce unemployment. This means additional government borrowing and spending, again, factors that support the concept of a ‘liquidity driven’ bull market.

**Beyond the short term, however, lie some potentially troubling pitfalls unless our national priorities and policies change dramatically.** Indeed, time will tell whether the problems that created the dire circumstances of 2008-2009 have been resolved, or rather only been obfuscated or moved. The shift of crushing debt loads from the private to the public sector is one such example. At this time, most investment observers advocate policy shifts including greatly reduced government spending and borrowing, encouraging global trade and avoiding damaging protectionist agendas, and promoting constructive regulatory reform, to name a few. Actions such as these would go a long way toward restoring the financial health of our country. Left unchecked, however, the path we are on is unsustainable. Paul Volcker, one of the single most responsible economic leaders in America over the past 50 years, said recently that the financial system had a breakdown and became dysfunctional, that the “American political process is about as broken as the financial system”, and that major reforms are necessary. Warren Buffet concurred by stating, “we cannot keep running fiscal deficits like we are currently without having a lot of consequences over time...if you keep flooding the world with your debt and people see your fiscal policies are sort of out of control,


they’re going to get less and less and less enthused about your debt.”

Where does all of this leave us as investors? We must accept that underlying financial conditions, while improved from one year ago, remain difficult due largely to very high debt levels worldwide. Consequently **the risk of economic shocks will continue, and investors should be positioned to ride through those events.** That does not mean to totally avoid risk, rather to understand and be comfortable with the risks assumed in one’s investments. **We believe more than ever that emphasizing quality, liquidity, and value in our client’s portfolios will stand the test of time in this challenging investment environment.**

Specific to the stock market, with speculative companies having led the 2009 rally, it seems reasonable to expect that investors will favor high quality stocks this year, whether the economy and earnings are strong or not. **While current equity valuations are generally full, and reflect optimism over improved profit growth, we remain optimistic with respect to the long-term business strength and earnings leverage now inherent with many of the highest quality companies.** They offer better risk/reward scenarios, often pay healthy and even rising dividends, and maintain balance sheets that allow investors to sleep well at night.

With regard to bonds, while they continue to play the important role of providing portfolio stability, there is only modest value offered at currently low

yield levels. **We believe the combination of the all out effort by the Federal Reserve to revive economic activity through suppressed interest rates, together with the humongous amounts of government directed fiscal stimulus, creates a recipe for resurgent inflation and higher interest rates.** It is true that, for the moment, the weak economy has created excess production capacity and low wage pressures, key factors that have kept inflation levels modest. However, the rapid growth in money supply, lofty commodity prices, and weak currencies (with the US dollar among the weakest), are powerful signals that inflation will likely be problematic for investors. Our bond holdings should be of high quality with relatively short maturities. The near term cost of this conservative position is a modest reduction in current income. The long-term benefit, we believe, will be avoiding sharp security price declines and the opportunity to reinvest at higher yield levels. Admittedly, the crystal ball is foggy as to when yields will rise, though that timing is clearly tied to the strength of the economy.

**In closing, 2009 marked Lodestar’s twentieth anniversary in business. We don’t know where the time went, but whether we have had the privilege of working with you for one year, all twenty, or somewhere in between, we are deeply grateful for your trust and support. Have a safe, healthy and happy 2010!** 

## Managing Director Profile



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Peter W. Flanzer  
Managing Director

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Peter joined Lodestar in 2002 after serving as a Principal with another Chicago-based investment advisory firm. For over 20 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.

Peter can be reached at 312.630.9666 or at [Peter@ldstr.com](mailto:Peter@ldstr.com).

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## Market Snapshot - December 31, 2009

<u>Equity Indices</u>	<u>Quarter</u>	<u>YTD</u>	<u>Interest Rates</u>	<u>12/31/09</u>	<u>12/31/08</u>
S&P 500	6.04%	26.47%	5-Year Tax-Exempt AA	1.70%	2.59%
Dow Industrials	8.09%	22.64%	5-Year US Treasury Notes	2.71%	1.54%
NASDAQ	6.91%	43.89%			
Wilshire 5000 Index	5.51%	27.09%	<u>Commodities</u>		
			Gold	\$1100.00	\$869.70
			Oil - WTI (\$/Barrel)	\$79.36	\$44.60

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**“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*

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