

1st QUARTER 2010

Although I will explain in more detail during your Annual Review, here's a brief explanation as to why your mailbox has been filled with so many trade confirmations over the past three months. The stock market, as represented by the S&P 500 Index, hit an intra-day low of 666 on March 9, 2009 -- its second secular bear trend major low since March 2000 (the first major low was the 768 intra-day low on October 10, 2002). From the March 9, 2009 low, the market has been in a classic bull cycle. However, like many bull cycles, the bulk of the gains came in the first few months. In fact, 87% of the gains (as of 12/31/09) occurred from March 9 to September 16 while the last three months account for only 13% of the gains. This has created a rather tight trading range for the market. So, you have been receiving a lot of many trade confirmations recently because I have been trading the upper and lower boundaries of the tighter range. While it's my opinion the market may have to catch its breath a bit before possibly moving up again in 2010, I believe this trading range strategy is necessary in the current environment. Again, I'll explain *why* in more detail when you come in for your Annual Review.

The Trend Has Not Been a Friend

You frequently hear me discuss how the stock market has historically moved in trends and cycles. I think it is now more important than ever to recognize where the market may be with respect to the current trend. Remember, trends are long periods of time where the stock market moves in one primary direction, either *up* or *down*. Up trends, also called secular bull trends, are when the stock market's highs go higher and the lows are higher. While there are short-term pullbacks (bear cycles), the long-term direction is still upward. However, in down trends, or secular bear trends, the stock market's highs get lower and the lows get lower. While there are short-term rallies (bull cycles), the long-term direction is still downward.

Since 1871, there have been 11 identifiable long-term trends -- five bull trends and six bear trends. So how does one know if the market is in a secular bear trend? Since March 2000, the stock market's highs have been lower and the lows have been lower -- which is what defines a downward, secular bear trend. Now there was a brief time in October 2007 when it appeared the bear trend may have ended as the March 2000 high was briefly taken out. Unfortunately, I believe it was just a head fake as the secular bear trend came back with a vengeance and the stock market fell to new bear trend lows by March 2009. Also remember that each trend has alternating cycles. Since 1871, there has been 77 cycles -- 38 bear cycles and 39 bull cycles (this latest cycle is the 39th bull). While no one can predict the ultimate bottom of the secular bear trend with 100% certainty, we have seen at least two major bottoms so far. Will there be more? No one knows for sure. But we have to consider that possibility and actively position our model portfolios accordingly.

Statistical Evidence the Secular Bear Trend May Still be Intact

Even with the recent market recovery, the major indexes are still a long way from where they were almost ten years ago on March 24, 2000 when the S&P 500 Index closed at 1,524 and the Dow Jones Industrial Average closed at 11,112. Where those indexes were then and now verifies the current secular bear trend, in my opinion. But there are other statistics as well.

David Rosenberg, the former Merrill Lynch strategist now at Gluskin-Sheff, recently suggested the secular bear trend may be far from over when he compared data from the last secular bear trend bottom in 1982 to the same data today:

- In 1982, the P/E Ratio bottomed at 6 and the dividend yield bottomed at 6%. Today, based on 2009's estimated S&P 500 Reported Earnings of \$44.50, the P/E Ratio is 25 and the dividend yield is 2%. None of the previous five historical secular bear markets since 1871 ended anywhere near today's P/E Ratio or dividend yield.
- In 1982, the Federal Reserve was reducing the money supply and lowering inflation. Today, it is just the opposite as the Fed has been printing massive amounts of money in order to re-flate the economy.
- In 1982, the Federal Debt-to-GDP Ratio was 35%. Based on 2010 projections, the Federal Debt-to-GDP Ratio is estimated to be 98% --- the highest since World War II.

- In 1982, de-regulation was the theme. Today, it is about re-regulation, government ownership, and too-big-to-fail.
- In 1982, the dollar was beginning its own secular bull market. Today, the dollar has been mired in its own bear market as current monetary policy has been making no attempts to protect the dollar's value.
- In 1982, income tax rates, capital gains rates, and dividend tax rates were declining. Today, I don't believe it's a question of *if* tax rates will rise – but *how much* they will rise.

Bottom Line: From a stock market point of view, I believe there is enough evidence to suggest, although not guarantee, that the stock market may not have bottomed. Yes, we have had a nice rally. But we have to respect history and that is why I am cautious about 2010. We'll discuss the strategies for 2010 in more detail at your Annual Review.

Been There, Done That

With the government spending money like there is no tomorrow, many believe it is necessary to "save" our economy. We've all heard how Mr. Bernanke is a student of the Depression in the 1930s. We've also heard how he is doing the opposite today of what was done then. I cringe whenever I hear that because it is not true. There was massive spending and it didn't work. After initially supporting a massive fiscal stimulus, here is what FDR's Secretary of the Treasury, Henry Morgenthau, said in 1939: *"We have tried spending money. We are spending more than we have ever spent and it does not work. I say after eight years of this administration, we have just as much unemployment as when we started and an enormous debt to boot."*

The Stock Market's Lost Decade

With the first decade of the 2000's now complete, many investors are disappointed at how the buy-and-hold strategy – a strategy that worked so well in 1980s and 1990s -- simply failed them over the past ten years.

How bad would a buy-and-hold strategy have been over the last ten years? Had you invested \$10,000 in the S&P 500 Index in March 2000, you would have around \$ 7,200 today, excluding dividends --- an approximate (- 28) percent loss over nearly ten years. While the stock market was up in 2009, there have always been rallies inside secular bear trends. Also, secular bear trends cannot end with a bull cycle. All five historical bear trends since 1871 ended with a bear cycle before an ultimate bottom was reached and a new secular *bull* trend began.

So if we are in a secular bear trend -- as I've been saying for several years now --- how does one make money investing in the stock market? First and foremost, I believe you have to be active and not rely on a buy-and-hold strategy. While a buy-and-hold strategy may work well *if* the long-term trend is bullish (like the 1980s and 1990s), it doesn't work well in secular bear trends. In my opinion, there are two primary ways to potentially make money in a secular bear trend:

1. You have to choose your entry points. For example, had you invested \$10,000 in the S&P 500 Index on October 2002 (the first secular bear trend low), you would have around \$14,000 today, excluding dividends --- an approximate + 42 percent gain as of 12/31/09. Good entry point. But what if you invested \$ 10,000 in the S&P 500 Index at the second bear trend high in October 2007? Today, you would have a little over \$ 7,000, excluding dividends -- an approximate (- 30) percent loss as of 12/31/09. Bad entry point.

2. You have to choose your exit points. There have been four major exit points since this bear trend started. Obviously, March 2000 was the first one. Other opportunities to have exited were Summer 2000, Summer 2007, and Fall 2007. A fifth potential major exit point, in my opinion, may be coming sometime in 2010. While I recognize that no one can sell at the exact tops or buy at the exact bottoms with absolute certainty, there are times during secular bear trends when you may need to be out of the stock market.

The primary focus for investing in a secular bear trend should be on avoiding losses rather than capturing gains. In other words, I believe *being out* of the market on the down legs and avoiding losses may ultimately be more important than *being in* the market on the up legs. So even the market rallied in 2009, it is no time to get complacent as the overall downward (bear) trend may reassert itself and pull back significantly.

Who Pays the Majority of Federal Income Taxes?

*"Should five per cent appear too small,
 Be thankful I don't take it all.
 Cause I'm the taxman,
 Yeah, I'm the taxman"*

--- The Taxman, written by George Harrison, from The Beatles *Revolver* album, 1966

As many of you know, I'm a numbers and stats geek. There is a huge debate going on in Washington about exactly who will pay for all of this massive spending coming out of Washington. President Obama campaigned in 2008 that he would only raise taxes on people making over \$250,000 – the top 3% of income earners. But will that be enough? It will certainly be an issue in the mid-term 2010 elections later this year. So I wondered . . . will increasing income taxes on only the top 3% -- people making over \$250,000 -- be enough to stem our bloating deficit, fund our entitlement programs like Social Security and Medicare, fund the stimulus packages, the bailouts, Afghanistan and Iraq, and potential health care reform?

I don't think so. Take a look at who actually pays federal income taxes in America.

- Of the 307 million people living in America, only 151 million (almost one-half) are "taxable units."
- Of the 151 million "taxable units", about 78 million (almost one-half) will not pay one dime in federal taxes in 2009. Nothing. That means the other 87 million people will pay the entire \$ 1 trillion of federal income taxes expected to be collected in 2009. So out of every four people living in America, one person pays 100% of the federal income taxes for the other three. Twenty years ago in 1990, it was one out of three, according to www.taxfoundation.org.
- The IRS estimates that the top 3% of income earners in America (people making above \$250,000 per year) will pay 64% of all federal income taxes in 2009. People making below \$250,000 per year will pay the other 36%.

Now I'm not talking about "fairness" here -- I'm talking simple math here. I just can't see how it won't take more income brackets than just the top 3% to help pay for the massive financial obligations being piled up right now and in the future.

Important Reminder: Tax Reports for 2009 included in 4th Quarter Performance Report

For those of you with non-IRA accounts, please remember the two important tax documents you will need for your 2009 income taxes ---- the **Dividends and Interest Report** and the **Capital Gain and Loss Report**. Both of these reports will be included in the 4th Quarter Performance Report you will receive very soon. This is the report you get every quarter with all of the colored graphs. Please make sure you pull these two reports from your 4th Quarter Report to give to your tax preparer.

Short-Term Yields Are Disappointing

When I came into this business almost 28 years ago in 1982, interest rates were 18%. Today, interest rates are near 0%. Amazing. With such a large position in "cash" right now in our models, I am frustrated with the low interest we're getting on our "cash" – and CDs and U.S. Treasuries aren't much better. The last time I had this much in "cash" was January 2000 when the money market rate was 5.25%. So what can we do to get more interest on our "cash" position while, at the same time, not risk principal? What about bonds? Recent reports show a huge inflow of money into bond equivalents in 2009. The poor interest rates being offered on cash equivalents have basically forced people to take their cash equivalents and buy bond equivalents to get more yield. This concerns me. Do you remember what happened to bonds in 1994 when the Federal Reserve raised interest rates six times in one year? Bond values got whacked. Remember, the price of a bond acts inversely to interest rates. When interest rates rise, bond values go down. When interest rates go down, bond values rise. With today's interest rates at basically 0%, it's obvious we can't go any lower – so the next direction is up. Sure, you may get a nice bond yield – but in my opinion, if the Fed raises rates, your principal may be at risk depending on the bond type and duration (length of time). But no one knows exactly when the Fed may start raising rates. 3Q GDP was positive and 4Q GDP may be positive as well. If the economy continues to improve, the Fed may raise rates. If the economy weakens again, the Fed most likely will not raise rates and bonds may still be attractive. In that case, I will consider a high quality "bond" equivalent to possibly get more yield. But right now, I am not ready to do that yet in our models until we get more vision on the economy.

Is it Different This Time?

A recent book from Princeton University Press called *"This Time is Different: Eight Centuries of Financial Folly,"* shows that throughout world history, rich and poor countries alike have been lending, borrowing, crashing – and recovering – their way through a wide range of financial crises. The book cites how the experts always claim during these crisis times that, *"This time is different."* What do we hear today? The same thing. As the book points out, today's economic and political events are really no different than what has happened before in other countries. Sure, the *details* may be different, but history shows the markets still react the same way. It's not different this time. While I understand how easy it is to get caught up in the daily news, the bigger picture is more important. So if you're worried about your money, the stock market, the economy, what is going on in Washington, or overseas -- give yourself a break. Turn off Fox News and CNN. All they seem to do is give you the bad news anyway because that's what sells.

While I recognize this has been a somewhat gloomy newsletter, please know I am actually quite optimistic about the future and how we're going to navigate through the remainder of this secular bear trend. Here's the good news -- *every* secular bear trend in history has been followed by a secular *bull* trend. Of course, no one knows exactly *when* that will happen -- but it will happen at some point. Until then, we will continue to be active in our portfolio models.

Annual ADV, Part II Offer

Pursuant to the SEC Brochure Rule 204-3, the Investment Advisors Act of 1940, advisors are required to offer a copy of their ADV, Part II to every advisory client on an annual basis. Please send me a written request if you are interested in receiving an updated copy of Matthew Louis Montgomery's Form ADV, Part II.

As always, please call me if you have questions or concerns. I appreciate your business. If you haven't sent back the information I need for your Annual Review, please do so as soon as possible. I look forward to seeing you!

--- Matt Montgomery

Newsletter Sources and Disclaimers

CNBC, December 2009

<http://research.stlouisfed.org/fred2/>

<http://www2.standardandpoors.com>

Mauldin, John, Millenium Wave Investors

www.IRS.gov.

www.taxpolicycenter.com

<http://www.bloomberg.com/apps/news>, December 4, 2009

U.S. Department of Commerce: Bureau of Economic Analysis

U.S. Department of Commerce: Department of Labor Statistics

U.S. Department of Commerce: Bureau of Economic Analysis

www.taxfoundation.org www.usgovernmentspending.com/downchart

David Rosenberg, Gluskin-Sheff, www.tradersnarrative.com, November 2009

Index Disclaimers:

* An Index is a portfolio of specific securities (common examples are S&P, DJIA, NASDAQ), the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indexes are un-managed portfolios and investors cannot invest directly in an index. Past performance is not indicative of future results. The Wilshire 5000 measures the performance of all U.S. equity securities, and so serves as an index of all stock trades in the U.S. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents 98% of the investable U.S. equity market. ** Past performance is not indicative of future results.

Benchmark Disclaimers:

The Conservative Model Benchmark: 35% 30-Day Money Market Yield Index; 35% Barclays Aggregate Bond Index; 30% S & P 500 Composite Index, excluding dividends. This portfolio focuses on protecting the principal within the portfolio from loss of value. Income generated by the portfolio is of secondary concern. The Balanced Model Benchmark: 20% 30-Day Money Market Yield Index; 20% Barclays Aggregate Bond Index; 60% S & P 500 Composite Index, excluding dividends. This portfolio is designed to provide both current income and growth of portfolio assets and has moderate risk. An equal emphasis is placed on both earning current income and asset growth. The Growth Model Benchmark: 10% 30-Day Money Market Yield Index; 10% Barclays Aggregate Bond Index; 80% S & P 500 Composite Index, excluding dividends. The assets used are generally more risky. The majority of the assets do not pay current income as their primary purpose is strictly capital appreciation. Some of the assets are very volatile and often a loss of capital may be experienced.

DISCLAIMER

In general, the bond market is volatile, bond prices rise when interest rates fall, and vice versa. The effect is usually pronounced for longer term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Technical analysis and resulting conclusions and observations are based upon historical patterns. In effect, TA is a study of probabilities. What has happened 75% of the times in the past does not mean it will ALWAYS recur in the future. It logically follows that historical precedent does not guarantee future results. Investors should be aware that there are risks inherent in all investments like fluctuations in investment principal which may result in a loss of principal. Bear in mind that there is no guarantee that any specific goal will be met. Past performance is not a guarantee of future results. Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal, or investment advice. Although the information has been gathered from sources believed to be reliable, please note that individual situations can vary therefore, the information should be relied upon when coordinated with individual professional advice. Securities offered through Royal Alliance Associates, Inc. Member FINRA/SIPC. Investment Advisory Services offered through Matthew L. Montgomery, DBA Montgomery Financial Designs, a registered investment advisor not affiliated with Royal Alliance Associates, Inc.