2nd QUARTER 2009

The stock market, as represented by the S&P 500 Index, is still in the process of forming a bottom. From its high of 1565 on October 9, 2007 to its current closing low of 676 on March 9, 2009, the S&P 500 Index was down - 56.78%, excluding dividends. Of course, that is assuming the March 9, 2009 current low of 676 on S&P 500 Index 676 and 6547 on the Dow Jones Industrial Average were indeed the lows . . . they may not be. Historically, bear markets typically end after a double-bottom. In other words, a bottom is established and that bottom has to be retested over several months to see if that bottom holds*, i.e.,* the double-bottom. If that bottom doesn't hold, then a new bottom must be established and the double-bottom process begins again. This is what happened after it appeared that 754 on November 20, 2008 was the low for the S&P 500 Index. But it wasn't. However, from the November 20, 2008 low, the stock market staged a 24% rally, excluding dividends, to January 4, 2009 when, unfortunately, the rally failed as a new low was reached on March 9, 2009 at S&P 500 Index 676. Therefore, the double-bottom (retesting) process now starts over again at 676 on the S&P 500 Index. Let's hope this last bottom successfully retests and holds. If it doesn't, please know that we will take an even more defensive position.

Waiting for the Next Bull Cycle

There are only two kinds of cycles – it's either a bull or a bear. You have to be in one or the other. Since we've been in a bear cycle (and we're still in one, in my opinion) the next cycle will be a bull. Historically, after severe bear cycles like this one, the subsequent bull cycles have been powerful. However, no one can predict exactly when a new bull cycle will begin, how powerful it may be, or how long it will last.

For instance, consider the worst five bear cycles since the October 29, 1929 market crash that began the Great Depression and the subsequent bull cycle that followed each one. Please note these total returns do not include any dividends.

1. October 29, 1929 to June 14, 1932 – over 32 months, the stock market lost -84.76%. However, in the middle of the Great Depression, the market experienced a bull cycle of + 137.32 over 35 months from its June 1932 bottom to its peak on May 18, 1935.

2. The current bear cycle is the second worst bear cycle in terms of total return loss since the Great Depression. As stated above, from its high of 1565 on October 9, 2007 to its current closing low of 676 on March 9, 2009, the S&P 500 Index was down - 56.81. It remains to be seen what the next bull cycle will bring in terms of total return.

3. March 24, 2000 to October 9, 2002 – over 31 months, the stock market lost – 49.10%. However, the subsequent bull cycle saw the market go up + 101.50 over the next 60 months to its peak on October 9, 2007.

4. January 11, 1973 to October 3, 1974 – over 21 months, the stock market lost - 48.20%. However, the subsequent bull cycle saw the market go up +73.14% over the next 24 months to its peak on September 21, 1976.

5. March 14, 1937 to April 18, 1938 -- over 13 months, the stock market lost - 45.39%. However, the subsequent bull cycle saw the stock market go up + 32.15% over the next 7 months to its peak on November 12, 1938.

Important Takeaway: Bull cycles always follow bear cycles. Again, I am not predicting how much the stock market will go up, nor am I predicting when it will happen. What I can predict with certainty is that we will have another bull cycle sometime and investors must be patient and wait for it.

"Never play poker with a man named Slim. Never buy a Rolex from a man who is out of breath. And never get your investment advice from someone who is yelling."
--- George Will, commenting on Jim Cramer of CNBC's Mad Money

Moves in Our Model Portfolios

As you have seen by the several confirmations you've been receiving recently, I've made several moves in our model portfolios. In fact, I have made more trades in the last 12 months than I did during the entire five-year bull cycle from the October 2002 bottom to October 2007. These trades have helped our three model portfolios (Conservative, Balanced and Growth) fare much better relative to their benchmarks since this bear cycle began in 18 months ago in October 2007.

We currently have an over-weighted position in the Money Market (cash) in all three models. However, as you have seen by the confirmations you've been receiving, I've also been deploying small amounts into various sector Exchange Traded Funds (ETFs) that *move opposite* of their respective sectors. As of this writing, all of those positions have been closed. They were short-term trades that provided somewhat of a cushion against this continuing bear cycle.

I will continue to be nimble and choosy as we continue to navigate our way through this bear cycle. Please call me if you would like more specifics on how these trades have affected your account(s).

Recession vs. Stock Market

On Monday, December 1, 2008, the National Bureau of Economic Research (NBER) officially stated the U.S. economy has been in recession since December 2007. NBER is a private group of leading economists who are charged with providing starting and ending dates for recessions. Unfortunately, it usually takes almost a year after a recession begins for NBER to actually have enough data to declare a recession.

While the economic news will continue to be rough for the next several months – job losses, lower corporate earnings, consumer sentiment, etc…, according to Minneapolis, MN market research firm, The Leuthold Group, the stock market historically starts its recovery phase three to five months before the economy starts its way back. Let's hope history repeats itself.

Recessions are typically defined by employment numbers and negative gross domestic product (GDP). Non-Farm payrolls (jobs) have been steadily falling since December 2007. As of the February 2009 Non-Farm Payroll Report, job losses are close to 3.8 million since December 2007. For Q4 2008, GDP is expected to be the worst since the 1980-81 recession.

But as we have discussed many times in your reviews and in this newsletter, recessions and the stock market don't always walk hand-in-hand. Consider this: the U.S. economy has experienced nine recessions (including this one) since 1950. Amazingly, of those nine recessions, the stock market actually gained in value in five of them. That's right. Stocks gained in value from the recession peak to its bottom in five of the nine recessions since 1950.

Another interesting behavior of the stock market during these nine recessions since 1950 is how the market rallied while the recession was in full force. For example, during the 1973-75 recession that lasted 16 months, the stock market rallied 38% as that recession raged on. The 1981-82 recession also contained a stock market rally of 40% right when the economic news was at its worst.

No one knows exactly when this bear cycle will end. But again, the good news is that bull cycles always follow bear cycles. Investors who have panicked at these lower levels and sold may regret it, in my opinion, as I believe it may be too late to sell at these levels in the market. Several studies (including a Dalbar study cited on Page 3) have shown how many investors sell at the wrong time – and I believe this may be the wrong time to completely bail out. Unfortunately, many of these same investors typically buy back in after a new bull cycle is in full force. That strategy, in my opinion, is not the most efficient way to make money in the stock market.

So please be prepared as I expect more bad economic news well into the summer in 2009. However, I also believe there will be little sprinkles of good news along the way, too. But do not panic when you hear the bad news as history shows by the time the economic news is at its worst, the stock market may be well on its way to recovering.

"Markets can remain irrational longer than you can remain solvent."
-- John Maynard Keynes

Buy-and-Hold Isn't Working

One of the biggest arguments among market academics is whether investors are better off buy-and-holding stocks for the long term -- or -- investing based on the prevailing trend and cycle. One of the leading proponents of buy-and-hold is Professor Jeremy Siegel of The Wharton School and author of the classic book, *Stocks for the Long Run*. In his best selling book, Siegel analyzed 200 years' worth of U.S. market returns and concluded that patient, consistent investing in stocks over a long period is the most effective strategy for wealth creation among regular investors.

Buy-and-hold is a strategy adhered to by several big name investors. Wally Weitz, a value-oriented manager who oversees some $3 billion, recently stated "If you're going to have a stock portfolio, if you can't stand either financially or emotionally to have it be down 50% at some point, you shouldn't be in the stock market." Vanguard founder John Bogle is another buy-and-hold proponent and has stated that "It's one thing to get out of the market at the perfect time -- how many people can do that? But it's quite another to get back in at the perfect time. You've got to be right twice."

But here are the facts: First, the S&P 500 Index is now over 50% off its October 2007 highs. Second, the last time the S&P 500 Index hit 676 (the March 9, 2009 low) was September 12, 1996 – almost 12 ½ years ago. And, for the 10-year period of March 9, 1999 to the March 9, 2009 low, the total return, excluding dividends, was a terrible - 36% for the S&P 500 Index.

As you know, none of my model portfolios have ever used a buy-and-hold strategy for any lengthy period. While I respect Sigel, Weitz, and Bogle for their investment prowess, the last 10 years shows that always using a buy-and-hold strategy hasn't worked well for many investors. Plus, studies show many investors don't follow the buy-and hold strategy with conviction anyway. A recent study from Dalbar Research called "Quantitative Analysis of Investor Behavior" showed that during the 20-year period from 1988-2007 the average stock investor earned an annualized return of just 4.5% versus the S&P 500 Index's 11.8% annualized return, excluding dividends. Why? The study found that many investors chase performance, as well as sell (and buy) at the wrong times.

Professor Siegel has recently had to defend the buy-and-hold strategy. He said in a recent CNBC interview "So we've had a bad ten years. Does that mean we're now going to have another bad ten years? The history of the market is precisely the opposite. If you have a bad ten years, you're likely to have a good next ten years."

I do agree with Siegel there. With P/E Ratios (valuation levels) of stocks now back at 1990 levels, it's my opinion the next ten years, on a probability basis, may be better than the last ten years – but that isn't guaranteed. But even if we do have great returns for the next ten years, as Siegel suggests, it still doesn't mean, in my opinion, that investors should always use the buy-and-hold strategy. And when you consider the S&P 500 Index is now almost half of what it was 9 years ago in March 2000, excluding dividends, I think it's safe to say that buy-and-hold has not been an effective strategy during the early 2000s.

So, does buy-and-hold ever work? Yes, in my opinion, a buy-and-hold strategy may be effective in a secular bull trend – like from August 1981 to March 2000 -- a tremendous secular bull trend. Unfortunately, I do not believe we are in a secular bull trend right now – we're still in a secular bear trend that began in March 2000. Therefore, I don't believe buy-and-hold is a good strategy until this secular bear trend is over.

The good news is that even during secular bear trends, the stock market, as shown on Page 1, may stage several strong rallies. However, be aware that once these bull cycles are over, investors exclusively using a buy-and-hold strategy may eventually give those bull cycle returns back. Therefore, it's my opinion an active strategy is needed -- which is what you are paying me to do. While it's unfortunate my three model portfolios have absorbed a large part of this latest bear cycle, over the long-term, we have been able to capitalize on the bull cycles and we have minimized our exposure to the bear cycles.

Key Factors to Improve Economic Outlook

1. Taxpayers will see more cash flow ($65 per month) in their paychecks thanks to reductions in their individual tax rates.
2. Interest rates are still low which may allow for more consumer borrowing after confidence is restored in the banking system.
3. The Federal Reserve's monetary policy is still quite stimulative.
4. Infrastructure spending on projects should create more jobs and economic activity.

"You try to be greedy when others are fearful, and fearful when others are greedy."
-- Warren Buffett

Newsletter Summary

- Historically, bear markets typically end after a double-bottom. Since the November 20, 2008 bottom of S&P 500 Index 754 did <u>not</u> hold, it now remains to be seen whether the March 9, 2009 low of 676 on the S&P 500 Index will be now be the ultimate low in this bear cycle. It's my opinion we will need to see another retest, or double-bottom, of the March 9, 2009 low. Should that retest not hold like the November 20 did not hold, be assured we will again have to take some defensive measures.

- The good news about bear cycles is they eventually end and are subsequently always followed by bull cycles. Bear cycles and bull cycles always alternate. However, no one can predict exactly when a new bull cycle will begin, how powerful it may be, or how long it will last. Historically, severe bear cycles like this one have been followed by powerful bull cycles. But again, while I'm not predicting how much the stock market will go up or when it will happen, I can say that we will have another bull cycle.

- As we wait for the next bull cycle, you can see by the many confirmations you've been receiving that I have been playing defense as this bear cycle rages on. Our three model portfolios (Conservative, Balanced and Growth) have fared much better relative to their benchmarks because of these recent moves. Currently, we are over-weighted in the Money Market (cash) in all three models. I've also been using some of our money market reserves to purchase various sector Exchange Traded Funds (ETFs) that move opposite of their respective sectors. As of this writing, all of those positions have been closed. I will continue this strategy until I believe we are within a range of the bottom.

- For the rest of 2009, I expect the economic news to continue to be rough, although I also expect some positive news to start surfacing as well. Job losses and the unemployment rate are expected by many economists to continue getting worse before they get better. But as we have discussed many times in your reviews and in this newsletter, recessions and the stock market don't always walk hand-in-hand. So do not be alarmed as you continue to hear and read about more bad economic news well into 2009. Please note that history shows by the time the economic news is at its worst, the stock market may be well on its way to recovering.

- The buy-and-hold strategy has long been touted by many stock market academics, including Professor Jeremy Siegel of The Wharton School, Vanguard founder John Bogle, and value investor Wally Weitz. However, buy-and-hold is now being questioned by many investors as the S&P 500 Index is now over 50% off its October 2007 highs. In addition, on March 9, 2009 when the S&P 500 Index hit 676, the last time it was at that level was September 12, 1996 – almost 13 years ago. In fact if you go back 10 years to March 9, 1999 to the March 9, 2009 low, the S&P 500 Index had a total return of - 36%, excluding dividends. As you know, none of my model portfolios have used a buy-and-hold strategy 100% of the time. So in my opinion, investors have every right to question whether buy-and-hold is a suitable strategy for them. Will buy-and-hold ever work again? Perhaps, but it may not be until the current secular bear trend that began in March 2000 ends and new secular bull trend begins.

As always, if you ever have any questions or concerns about your account(s) or what I am doing, please call me.

I appreciate your business and your friendship.

- - - Matt Montgomery

Newsletter Sources and Disclaimers

CNBC, November 2008
http://research.stlouisfed.org/fred2/
http://us.ishares.com/home
http://www2.standardandpoors.com
U.S. Department of Commerce: Bureau of Economic Analysis
U.S. Department of Commerce: Bureau of Economic Analysis
U.S. Department of Commerce: Census Bureau
U.S. Department of Commerce: Department of Labor Statistics

Index Disclaimers:
* An Index is a portfolio of specific securities (common examples are S&P, DJIA, NASDAQ), the performance of which is of10 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
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.Newsletter Disclaimer

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