



## First Quarter 2010 Summary & Commentary

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*“I have no idea what the stock market will do next month or six months from now. I do know that, over a period of time, the American economy will do very well and investors who own a piece of it will do well.”*

Warren Buffet in an interview on CNBC, Friday October 10, 2008

### *We welcome the first quarter of the new decade*

After the market rollercoaster of 2008 and 2009, the first quarter of 2010 has been blessedly uneventful by comparison. The equity market, as measured by the S&P 500, posted a gain of 5.4% in the first quarter, the best start to a year since 1988. In 2009 the market lost 11%, and in 2008 the S&P 500 shed 9.4% in the first quarter respectively. As of the end of Q1 2010, we have experienced four consecutive quarters of positive market performance. It has been a while since that could be said. In spite of a good first quarter and four consecutive positive quarters, the market is still 25% below its all-time high as measured by the S&P 500, and there continues to be a cloud of uncertainty over the market and the economy that is making many investors nervous.

It is said that the market climbs a “wall of worry,” and it appears this market is currently doing just that. Daily we hear the on-going debate of whether or not we are in a recovery mode, and if so, is it sustainable or is this an economy that is functioning largely on government stimulus. There are three primary assessments of the economy currently. First is the camp that believes the economy is in a classic “V recovery” coming out of a recession. Then there are those who see the economy currently in the left side of a “W recovery” with the risk of a double dip. Finally there are those who believe we are in a “Square Root” recovery where we are currently experiencing growth out of the recession and that will be followed by a longer period of slow, sub-par growth.

### *Economic Review*

Looking back at March of 2009, we see a market that was priced for another Great Depression. Headlines of “Dow 5000?” in the Wall Street Journal and “Holding on for Dear Life” in Time magazine were not uncommon. Consumer and investor sentiment was low. Banks had been bailed out. Bank stress tests were coming and nobody knew what the results would be. There was talk of nationalizing some banks. The auto industry required government support. Unemployment was high and going higher. The residential real estate market was in trouble and the commercial market was showing signs of similar problems. All we needed for the market to bottom was a catalyst. In hindsight, we were given several. The end of mark-to-market accounting, the much anticipated Federal government Stimulus Bill and a Federal Reserve willing to print money created an environment for a market recovery. Positive technical indicators for the market were in place, but the fundamentals of the economy were still very depressed. At the end of the day it came down to one question:

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“Were we headed for another Great Depression or would we get something less severe?” In the end the market was pricing in a worst case scenario and we got something better.

As the equity markets moved higher in Q1, we saw leadership continue to be in the smaller capitalization, lower-quality names. Large cap, higher-dividend paying companies continued to lag smaller cap issues. Higher beta, more risky stocks outperformed for the quarter. We continue to see corporate America deleverage and create a less risky profile. Revenue and company profits continue to increase as companies make money and take advantage of greater operating leverage, reduced financial leverage, lower interest and borrowing costs and lower employment costs.

### *Review of 1<sup>st</sup> Quarter 2010*

Index	Q1 Performance %	Description
Dow Jones Industrials	4.8%	Large Cap Stocks
S&P 500 Index	5.4%	Large Cap Stocks
NASDAQ Composite	5.7%	Large Cap Tech Stocks
Russell 1000 Growth	4.6%	Large Cap Growth Stocks
Russell 1000 Value	6.8%	Large Cap Value Stocks
Russell 2000 Growth	7.6%	Small Cap Growth Stocks
Russell 2000 Value	10.0%	Small Cap Value Stocks
MSCI EAFE	0.9%	Europe/ Australasia/ Far East
MSCI Emerging Markets Equity	2.5%	Emerging Markets
Barclays U.S. T-Bill: 3 Month	0.0%	Short-Term Bonds
Barclays U.S. Aggregate	1.8%	US Government Bonds

*Data obtained from Deutsche Bank Securities, Inc.*

### *The fundamentals continue to improve*

Economic reports continue to be somewhat mixed but are overall positive and supportive of a recovering, sustainable economy. The global economic recovery has been led by the emerging markets followed by the United States, while Europe has lagged. In the United States corporate profits, profit margins, cash flow and revenues are all moving higher. Company balance sheets are in “very good” condition and getting stronger as companies pay down debt and lock in their long-term cost of capital at low rates in the bond markets. We saw strong revenue surprises to the upside during Q1 and it appears that we are headed for a strong earning report in Q2. GDP continues to expand. On April 2, the Labor Department reported that March payroll numbers increased by 162,000. This number included 48,000 temporary workers hired by the U.S. Census. Consumer confidence and spending rose. The Institute for Supply Management (ISM) reported that both the manufacturing and non-manufacturing indices rose to 59.6 and 55.4 respectively. A reading above 50 signals expansion. This was the eighth month in a row of expansion for the manufacturing index and its best reading since July 2004. Factory orders rose as corporate America continued to restock inventories. It was the sixth straight monthly gain for factory orders. Productivity is above average and capacity utilization is still low. The combination of inventory restocking and productivity growth will support the growth of the economy. With corporate cash flow running near record highs and earnings strong, businesses will likely increase corporate spending which will be supportive of the economic recovery. We continue to have an accommodative interest rate policy from the Federal Reserve, and the most recent Federal Open Market Committee (FOMC) minutes continued to include the “extended

period” language. With low short-term interest rates, the yield curve has continued to steepen, a sign of economic recovery.

Outside the United States, we see relatively robust growth in China and other emerging economies. These countries carried manageable levels of consumer and sovereign debt into the recession as compared to Europe and the United States. This has provided these governments with greater monetary flexibility and less debt, giving them ample capacity to boost private consumption and finance fiscal expansion.

### *Causes for Concern*

Even with stabilization and growth of the global economy, we still see things that cause us concern. Sovereign debt concerns in Greece and other European countries have the markets on edge. While we have seen the leading economic indicators increase over the past 12 months off very depressed levels, it appears now that the increases are slowing and the indicators may be peaking. The lead time on these indicators can be 6-12 months, so we see room to grow. We will begin to see the Federal Reserve continue to move towards ending some of its quantitative easing. Mortgage rates have moved up in the past week as the Fed stopped purchasing mortgages. As other programs are wound down, we will have to watch and see if this budding economic recovery is sustainable. Bank credit and lending continues to be constrained at both the consumer and the corporate level. The economic and market recovery needs credit and lending to continue and become sustainable. While the Federal Reserve seems to be in no hurry to raise rates and squelch recovery, credit demand from the U.S. government to finance our growing deficits may have a “crowding out” effect and put upward pressure on interest rates. Whether or not we have turned the corner on unemployment is yet to be seen. We still have a U-3 unemployment rate of 9.7% and the U-6 rate still lingers around 17%. Looking at the consumer, deleveraging continues and, although the consumer savings rate has decreased slightly and consumer spending seems to be increasing, we see a consumer who is still grappling with a combination of possible foreclosure, unemployment or under employment and stagnant wage growth. These factors do not combine to create a positive situation for potentially 70% of GDP growth. Fiscal stimulus by the Federal Government has been intense and has helped to get the economy moving. However, demographics only compound the problems at the federal level, since the retiring baby boomers will continue to put stress on government programs such as Social Security and Medicare. Health Care Reform will also present a new set of challenges as it is ultimately implemented and paid for. The bottom line is that we have unsustainable federal spending and deficits that need to be addressed sooner rather than later. Additionally, state governments are running significant deficits and have significant unfunded liabilities in the form of retiree medical and pension costs. These issues point to a simple fact; higher taxes are coming. We believe it is a safe bet that that Bush tax cuts will sunset and we will see higher taxes on the wealthy in 2011. Additionally, we will see higher Medicare taxes and a new 3.8% tax on capital gains, dividends, interest, rents and royalties for individuals making over \$200,000 (or couples above \$250,000) in 2013 as part of the recently passed Health Care Reform legislation. Finally, residential real estate continues to struggle to find a bottom as foreclosures and short sales put downward pressure on values.

### *Where do we go from here?*

In the short term, we feel the economy will continue to grow and the recovery will be sustainable. Longer term, we see slower, sub-par growth. Continued deleveraging at the individual and government level, increased taxes, higher interest rates, higher government entitlement costs and more government involvement all draw upon

resources in the economy. We would recommend that new money be deployed into the market using a dollar cost-averaging discipline due to the massive run up in the stock market in the last 12 months.

On balance, we share Warren Buffet's mid-term positive outlook. This is because we see many of the positives that drove market optimism two years ago are still in place. Among these, the continued emergence of a global middle class in developing countries like China, Brazil, India and Turkey. This educated middle class will continue to provide growth to the global economic recovery that will benefit everyone. We see a domestic economy that is benefiting from the global recovery and will continue to do so. We are still in a period of low interest rates that will allow consumers, corporation and the government to restructure and strengthen their balance sheets. As we continue to move into 2010, we are focused on several key issues in the management of our client portfolios. First is a focus on quality. We believe that larger capitalized, high-quality companies with global exposure will be rewarded as the recover continues. Second is to look to dividends. Historically dividends have made up 40% of the total returns of investing in stocks and also help to provide stability through market turbulence. Given that we have to expect continued volatility, we work to identify your individual cash flow and liquidity needs and make sure that we have adequate amounts to address those needs in short-term, safe investments. Lastly, we always recommend sticking to the plan we have developed with you. Should your situation change or if you have concerns about your current portfolio, please call us so that we can set up a meeting to review your situation. Our goal is to prudently structure your investable assets and have them grow in a predictable manner despite the headwinds we may see ahead.

We want to thank you again for the opportunity to serve you and your families and to have the opportunity to work with you.

Best wishes!

*Accounting, legal and reporting practices in foreign countries may be different than in the U.S. Potential political or economical instability presents risks, as does the fluctuation in currency exchange rates, as well as the possible imposition of exchange control regulation or currency restrictions that could prevent the conversion of local currencies into U.S. dollars.*

*The unmanaged indexes represent general markets and are for illustrative purposes only. They do not reflect the performance of any security. One cannot invest directly in an index.*

*This commentary should not be considered individual investment advice; you should consider your individual investment objectives and risk tolerances as well as meeting with your financial professional before making any financial decisions.*

## Appendix A

Beta - The tendency of a security's returns to respond to swings in the market.

- Beta = 1 – moves with the market
- Beta >1 – more volatile than the market (example – Beta = 1.2 – moves 20% more than market)
- Beta <1 – less volatile than the market (example – Beta = 0.80 – moves with the market 80% of the time)

Dollar Cost Averaging - The technique of buying a fixed dollar amount of a particular investment on a regular schedule regardless of the share price.

Example: You decide to purchase \$100 worth of XYZ each month for three months. In January, XYZ is worth \$33, so you buy three shares. In February, XYZ is worth \$25, so you buy four additional shares this time. Finally, in March, XYZ is worth \$20, so you buy five shares. In total, you purchased 12 shares for an average price of approximately \$25 each.

Please note that dollar cost averaging does not assure a profit, may not protect against loss and involves continuous investments in securities regardless of fluctuating prices. You should consider your financial ability to continue purchases over an extended period of time.

### Fixed Income Definitions

High Yield Bonds - Also known as "junk bonds." A high paying bond with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating of 'BBB' or lower from S&P, and 'Baa' or lower from Moody's.

Investment-Grade Bonds – “Investment Grade” is a rating that indicates that a municipal or corporate bond has a relatively low risk of default. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade.

Municipal Bonds - Also known as a "muni." A debt security issued by a state, municipality or county to finance its capital expenditures. Municipal bonds are exempt from federal taxes and from most state and local taxes, especially if you live in the state in which the bond is issued.

General Obligation (GO) Bonds - A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

Build America Bonds (BABs) - Taxable municipal bonds that feature tax credits and/or federal subsidies for bondholders and state and local government bond issuers. Build America Bonds (BABs) were introduced in 2009 as part of President Obama's American Recovery and Reinvestment Act to create jobs and stimulate the economy. BABs attempt to achieve this by lowering the cost of borrowing for state and local governments in financing new projects.

## **Understanding Bond Prices and Interest Rates**

Bonds provide an element of stability that offsets some of the volatility of stocks. However, they are vulnerable to economic changes that can undermine their value.

The biggest economic threat to bonds is rising interest rates. If you own a bond and interest rates go up, the value of your bond on the open market, with few exceptions, will go down.

Of course, if you plan to hold the bond to maturity the value of your bond doesn't change because interest rates change. You'll still get the amount promised when you bought the bond, all other things being equal.

## **Equity Definitions**

Emerging Markets - A nation's economy that is progressing toward becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

Emerging markets generally do not have the level of market efficiency and strict standards in accounting and securities regulation to be on par with advanced economies (such as the United States, Europe and Japan), but emerging markets will typically have a physical financial infrastructure including banks, a stock exchange and a unified currency.

Large Cap Stocks - A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization." Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Mid Cap Stocks - A company with a market capitalization between \$2 and \$10 billion, which is calculated by multiplying the number of a company's shares outstanding by its stock price. Mid cap is an abbreviation for the term "middle capitalization".

Small Cap Stocks - Refers to stocks with a relatively small market capitalization. The definition of small cap can vary among brokerages, but generally it is a company with a market capitalization of between \$300 million and \$2 billion.