

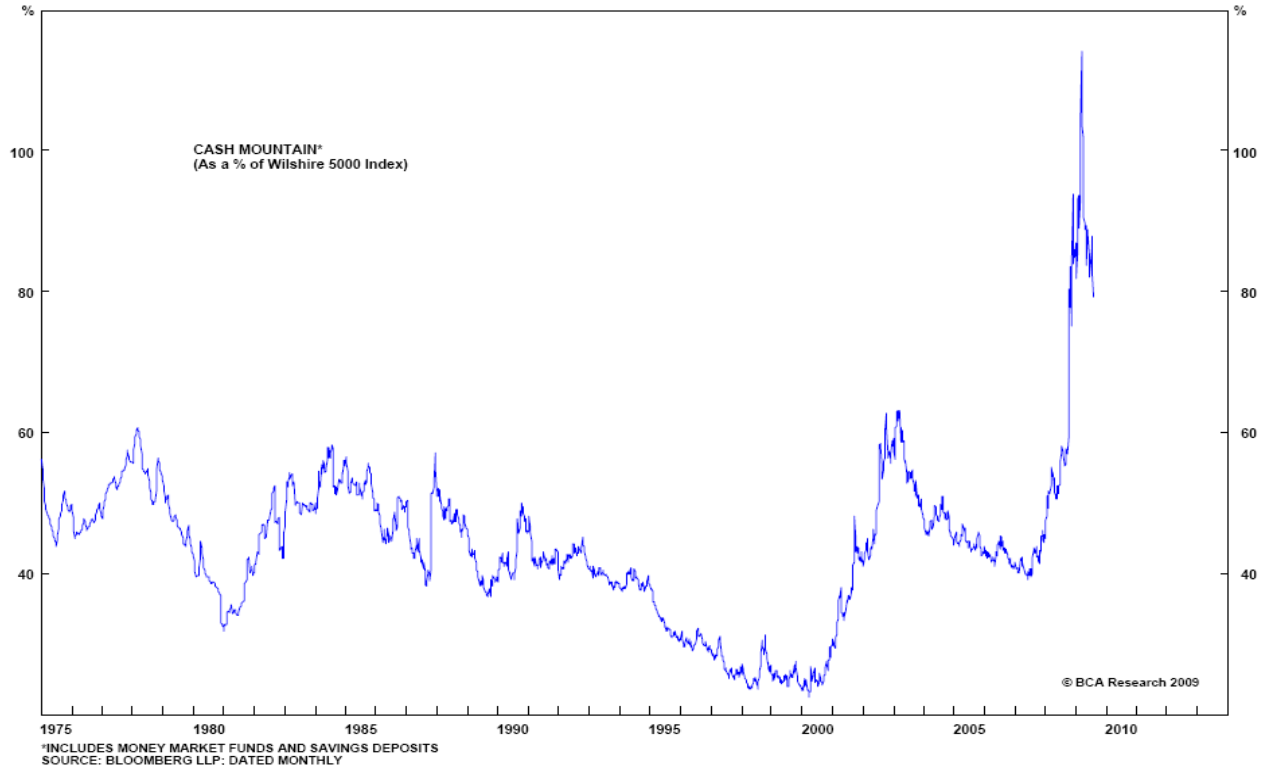
Erring on the Side of Caution

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The recent rally in the equity markets and the narrowing of spreads in fixed income instruments came in three stages: relief, fear, and hope.

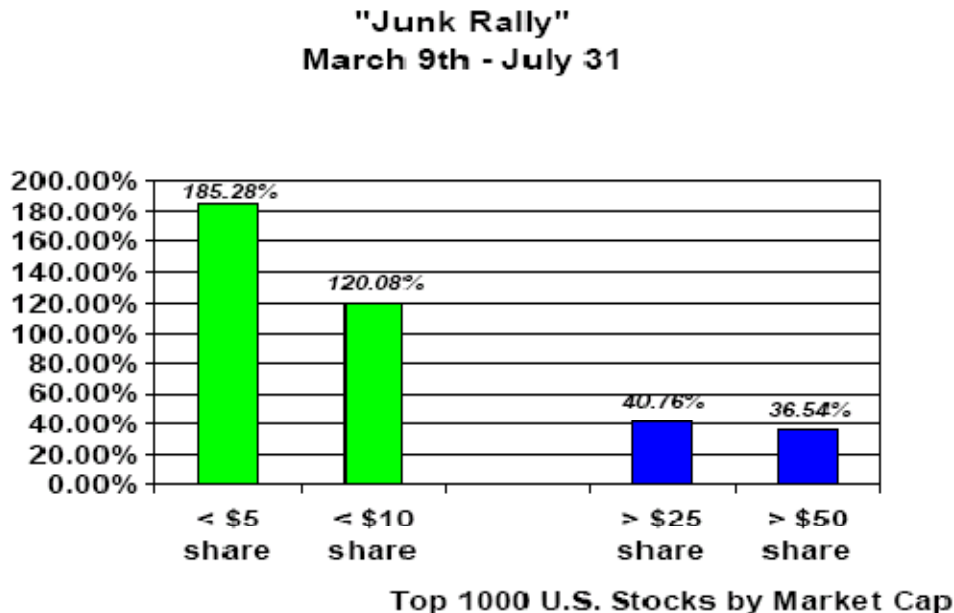
Relief: January and February of 2009 was rife with speculation that the U.S. economy might be entering the next great depression. There was talk that the United States would become “the next Japan”, experiencing years of zero growth and deflationary pressure. Investment time horizons went from five, seven, or twenty-five years to extremely short-term points of view. Panic was in the air. Investors had trouble withstanding the pain and raised immense amounts of cash in the midst of capital destruction. The following chart tracks cash (money market funds, savings deposits, etc.) as a percentage of the Wilshire 5000 Index. Over the past 35 years, cash averaged roughly 40% of the index. It peaked at approximately 118% in February of 2009. Please see the chart below.



Relief came as central banks around the world pumped tremendous amounts of liquidity into the global economies, backstopped distressed financial institutions and implemented countless plans to stimulate spending and growth. As these programs gained traction, the prospect of a systematic meltdown began to subside.

During this period of panic last fall and winter, fundamentals detached from capital markets pricing. The securities of good, bad, and ugly companies all traded lower without regard to their financial strength or market position (please see our strategy essay “Two Important Decisions We Must Make” dated 05/16/2009. It can be accessed at www.masseysquik.com under the Investment Strategy tab). In early March, brave investors purchased securities at fire sale prices, putting cash back to work. Markets around the world began to experience upward momentum.

Fear: The fear of being invested turned into the fear of missing the boat. Each upward move created more demand, pushing stock prices higher and narrowing the historically high spreads between the yields on corporate and municipal bonds versus U.S. Treasury securities. In the midst of this rally, an interesting phenomenon took place. Lower quality, lower priced shares rallied significantly more than higher quality, higher priced stocks. Stocks priced at or below \$5 were up 185.28% between March 9th and July 31st. Stocks of companies that were trading at \$50 or higher only rallied 36.54% during this period of time. Some refer to this as the “Junk Rally”. Fundamentals detached again from equity pricing. Higher quality companies were not necessarily rewarded for running great businesses. The following chart illustrates this point.



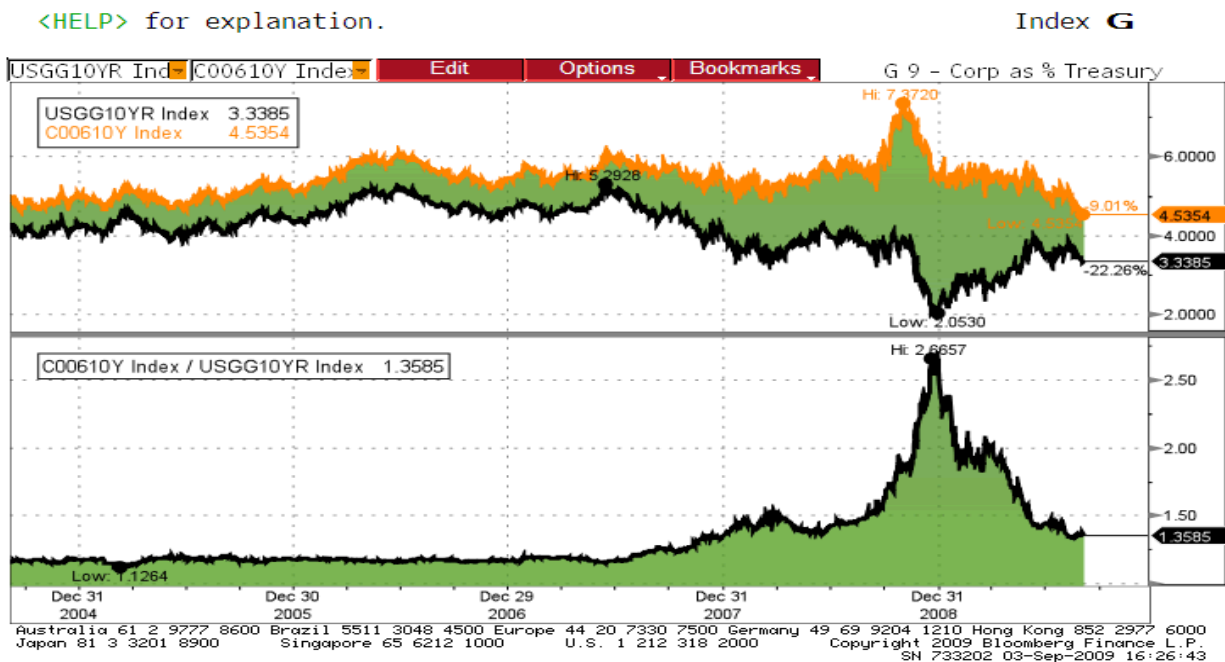
Hope: The most recent leg of the rally was based around the hope that the worst was over and economies would soon emerge from recession and begin to grow again. There were two important data points investors pointed to that brought them hope. The first was the

perception that the Chinese economy was beginning to turn. During the first quarter of 2009, China went on a buying spree of oil, copper, aluminum, steel, and other basic commodities. This left the impression that they were poised for economic growth. Rather, we believe this was a brilliant investment decision on behalf of the central bank, stockpiling inflation-sensitive assets at low prices. Rather than use their cash surpluses to add to their immense portfolio of dollar-denominated fixed income, they filled their coffers with inflation-sensitive assets, offsetting a potentially weaker dollar and future inflation. It was brilliant, but was not an indication of renewed economic growth.

The second important data point came during the most recent release of quarterly earnings. More than 75% of S&P 500 companies beat their forecasts. This too was viewed as a ray of hope, but when one digs deeper it is difficult to find a company that experienced revenue growth. Top line results were disappointing. Better earnings came from lower cost structures, not growth in the business. Layoffs, cost cutting, and inventory reduction helped the bottom line, but one must wonder if this is a temporary phenomenon.

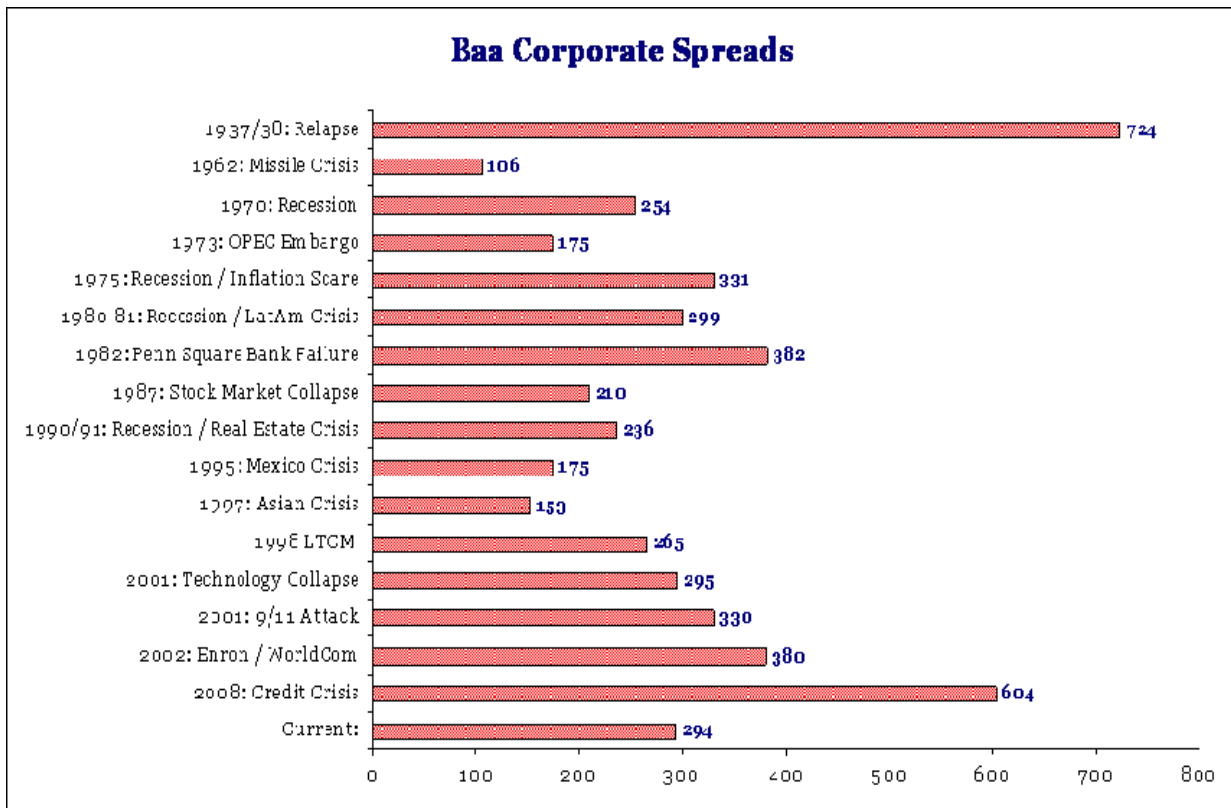
Fixed Income Markets Tell a Different Story

Like the equity markets, fixed income was under extreme duress in the fourth quarter of 2008. The following chart tracks the spread between 10-year investment grade corporate bonds and 10-year treasuries. The historically high spreads peaked in December.



The spike in yield spreads was a direct result of the rush toward liquidity. With the Fed keeping short-term rates at near zero, while pumping tremendous amounts of liquidity into the system,

investors rushed back into corporate and municipal bonds, bringing yield spreads down from their historic highs. The relief, fear, and hope rally in equities was mirrored in the fixed income markets. However, the bond market is telling a different story than the stock market. The following bar chart tracks 10-year Baa spreads over 10-year Treasuries at various crisis points. Spreads peaked at 604 basis points over Treasuries in December of 2008. They are currently trading at 294 basis points, similar to other “crisis points” like the recessions experienced in 1970, the early 80’s, and 1990/1991. Today’s yield spreads are in line with those experienced during the collapse of Long Term Capital Management in 1998 and the technology meltdown of 2001. Today, bond investors are demanding a higher risk premium, indicating their uncertainty about an economic recovery. There is a tremendous amount of refinancing that will have to take place over the next several quarters. The window is open for top-tier credits; it is beginning to open for lower quality issuers. We believe that spreads will begin to widen out again at all points of the credit quality curve. Bonds have moved too far too fast. It’s time to shorten maturities.



Weighing the Positives And Negatives

As economies begin to bottom out, there are always conflicting signals that investors must interpret. Investors also shift their time horizons after taking a real bruising. They think shorter term. With no clear path ahead, who's to say we couldn't experience another round of discomfort. Here's how we view the landscape:

Positives

- It's tough to swim against the tidal wave of liquidity, stimulus programs, and essentially free money that the Central Banks have provided. Their actions brought a degree of confidence back to markets.
- Despite the demise of a number of financial institutions, large banks are on stronger footing. TARP and the Temporary Loan Guarantee Program bought enough time for the survivors to work through the worst of their problems. Systematic risk was averted.
- The recession is beginning to moderate. While the economy remains in the deepest slump since the Great Depression, year over year comparisons are beginning to look better. Orders for durable goods and existing home sales both showed positive growth in July.
- The Term Asset-Backed Securities Loan Facility (TALF) has brought much needed liquidity back to the securitization markets.
- As corporations sought to cut costs, inventories declined substantially. Expect to see inventory restocking create some positive economic momentum.
- The significant rally in stocks from their March lows has dampened the "fear factor" investors were experiencing.
- There is still an immense amount of cash on the sidelines.

Negatives

- Home prices are still significantly off of their highs. Foreclosures are commonplace. There is a massive amount of shadow inventory on the sidelines as people wait for a price rebound to sell their homes. The negative wealth effect of the housing market will be felt for years to come.
- Economic stimulus programs, like incentives for first-time home buyers and cash for clunkers, have created some economic activity, but they represent a temporary fix. How will consumers act when the government stops subsidizing them?
- A secular change is taking place. Keeping up with the neighbors is gone. Consumer behavior will trend towards careful and necessary consumption. Households are still repairing their balance sheets as they bear the scars of the wealth effect caused by lower home prices and the deterioration of retirement savings.

- Unemployment remains high. It is unlikely that corporations will rebuild staff quickly. Where will the jobs come from? Entrepreneurs will emerge from the ranks of the unemployed, but it will take time for new businesses to gain traction. Many will fail.
- Commercial real estate is still in the early stages of decline. Rents, even for the most attractive locations, are falling significantly. Real estate owners face refinancing risk. Capital will become more expensive, if available. The necessity to refinance will mark real estate assets to their true valuation levels.

It's the Levels

The Financial Times of London published an excellent editorial by Mohamed El-Erian, Chief Executive and co-Chief Investment Officer of Pimco, on September 28, 2009. The editorial quoted Mervyn King, the Governor of the Bank of England who stated: "It's the level, stupid – it's not the growth rates, it's the levels that matter here." In other words, the absolute levels of income, wealth, debt, and unemployment, not just the rate of change, are what matters today. El-Erian pointed out "The outlook for major countries will continue to be driven by the levels of key variables, not their rate of recovery." Let me attempt this analogy: Think of the economy as a glass of water. Two and a half years ago the glass was full (a robust economy). The level of water in the glass dropped because of the emergence of a deep recession. Contributing factors to this decline were consumer indebtedness, a significant decline in home prices, the banking crisis, a lack of credit availability, and high unemployment. We may start to see positive year over year comparisons in these key variables, but it will take significant progress on all fronts to fill the glass again. In this environment of hope, even negative news takes a positive twist. On September 30th, it was announced that the United States gross national product declined by .7% in the second quarter of 2009. The market's first reaction was to bid stock futures higher. Gee, it wasn't as bad as the previous quarter's decline. What we need is real growth – "escape velocity" as Larry Summers, Director of the National Economic Council, terms it. It's the levels, not the growth rates, which really matter here. Capital markets are pricing in a "V-shaped" recovery. We just don't see it yet.

How to Approach Investing in the Current Environment

While the market could climb a wall of hope for a while longer, we feel like we are entering a no man's land where the risks and rewards force investors to choose between hazard and capital preservation. That being said, we will emerge from this recession. It will take time, and time is one of the most important factors in asset allocation. Looking three to five years out, it is likely that stock prices will be higher than where they are today. But investors' patience has frayed. This psyche may feed upon itself if the news turns disappointing again.

One of our other key concerns is inflation. The amount of public debt outstanding has grown rapidly. All of this wonderful liquidity that helped pull us from the depths of investment hell will have consequences down the line. Several years out, assuming we are in a healthy economy again, what interest rates will investors demand for the wave of debt that has been issued? Will the Fed be forced to rapidly raise rates to head off the inflationary pressures caused by excess liquidity?

Side by side with equities, the bond markets have had quite a run too. Corporate spreads have tightened and the dearth of new issuance in the municipal bond market has put downward pressure on rates. This appreciation is most evident in the high yield (junk bond) market where significant rallies have taken place and questionable new issues are coming to market. The following chart illustrates the rally in the Barclay's Capital High Yield Bond ETF. Again, too much too soon.



Courtesy Bigcharts.com

Balancing long-term goals after significant rallies in the equity and credit markets is a difficult task. We view our clients as owners of irreplaceable capital. One of the first rules of investing is that “you make money by not losing it”. So, absent clear signals of a real recovery, we’re erring on the side of caution. The following is a summary of our thinking on various asset classes:

- We remain overweight long/short equity and long/short credit.
- We are using structured notes on the S&P 500 with downside buffers to maintain exposure to the equity markets. (Although this is a somewhat complicated strategy for

investors, we would be happy to describe the advantages and disadvantages of using this vehicle as part of your overall portfolio.)

- While underweight developed international markets, we are seeking ideas for how to protect portfolios from a weaker dollar.
- We are urging our fixed income managers to shorten duration and increase credit quality.
- We are seeking an entry point for asset classes that protect portfolios against inflation.
- We are seeking the right entry point for emerging market equities, especially Asia and Brazil.
- We will be significant buyers of US equities on any meaningful pullback.

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“Risk is a choice, rather than a fate.”

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