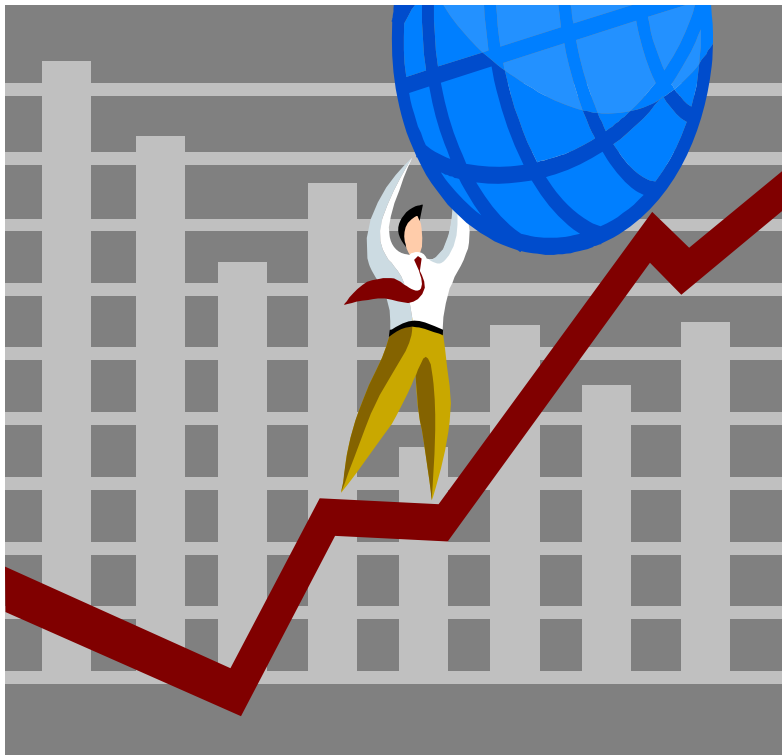


Morning Again

2009 Q3 Quarterly Commentary



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Markets have enjoyed a long, uninterrupted string of favorable economic reports. Over the past seven months (from March 1 through September 30), the S&P 500 has rallied over 45%. And if that weren't a big enough gain, emerging market equities rallied 83% during the same period. The financial and emotional devastation of last fall and winter now seems like a bad dream.

In April I wrote you that the S&P 500 could finish the year up 32%, or near 1200, based upon a historical analysis of the ISM Manufacturing Index. This was not my prediction, but I did argue that a strong finish this year for the S&P 500 was "not implausible and does give credence to the notion that the worst may very well be behind us." Today, it's much easier to believe this. And reaching 1200 is definitely achievable.

Good News: The End is Near!

It often happens that client questions stem from a news article they have recently read. That happened recently when two clients asked about the October 5th cover story in BusinessWeek headlined "Searching for True North". The article starts off: "Investment gauges are broken, market signals are mixed and money managers don't know where to turn." Doesn't that get your attention?

And if that weren't enough, the article goes on: "The sacred texts of investing need to be rewritten. It turns out that the so-called equity risk premium, the once sacrosanct belief that stocks perform better than bonds over time has been vastly overrated."

The authors reached that conclusion because earlier this year U.S. Treasury Bonds had outperformed the S&P 500 in the past ten- and twenty-year periods. They also wrote that U.S. Treasury Bonds beat the S&P 500 over a thirty-year period. Interestingly, however, our data does not show that.

I think that when the average investor reads such information, they will overreact and end up putting a higher allocation to "safe" assets in their portfolios, including a large over-allocation to U.S. Treasury Bonds - hardly a riskless asset class as you'll see below.

Instead of arguing that the world has changed forever, I think the BusinessWeek reporters should have gone back and examined the historical record more closely. They should have asked: "Have stocks in the modern investing era ever underperformed U.S. Treasury Bonds before this?" Had they done so, they would have found that stocks in fact have underperformed bonds in one other prior twenty-year period: the years 1929 through 1948.

The reporters then should have asked a most elementary follow-on question, "What were the twenty-year returns of stocks and U.S. Treasury Bonds in the twenty years succeeding that period, i.e. 1949 through 1968?"

The BusinessWeek reporters may not have examined the record, but I did. And the answer is, in the succeeding twenty years, stocks returned, AFTER INFLATION, a robust 12.7% per year. And U.S. Treasury Bonds? Their returns were a most dissatisfying minus 0.7% per year after inflation. ...Things that make you go "Hmmm..."

The reporters continue, commenting that the forty-year returns of stocks and U.S. Treasury Bonds (ending 2008) were basically equal. Calling stocks “a sucker’s bet”, they imply that while U.S. Treasury Bonds may not generally outperform stocks, they are a safer bet. Again, they needed to dig deeper.

Had the reporters pursued a more comprehensive analysis, they would have compared the worst forty-year period of stocks (ending 2008) to the worst forty-year period of U.S. Treasury bonds (ending 1980). What they would have found is that stocks were far safer, returning 413% or 4.2% per year after inflation. Bonds? Do you really want to know? The total return of bonds from 1941 through 1980 after inflation was minus 60% or minus 2.3% per year for forty years in a row! That doesn’t sound too safe.

Nuff said!

Inflation Likely to Emerge... Eventually

With all of the stimulus that has been pumped into the global economy (including quantitative easing in the U.S. and the U.K.) over the past twelve months, it is our opinion that inflation will make a comeback during this business cycle. In prior periods when excessive stimulus was introduced in the U.S. (during World War II and the Guns and Butter era of the late 1960s/early 1970s), inflation did emerge. Between 1941 and 1947 inflation averaged 8% per year. And in the years 1973-1981 inflation averaged 9% per year.

What this means is that we need to position our portfolios for inflation. And we have done just that since the beginning of the year, emphasizing small cap equities rather than large cap, commodities and gold, and general corporate debt rather than high quality corporate or government debt. Our exposure to emerging markets should help too as the U.S. dollar continues to depreciate against foreign currencies.

As I’ve written before, a beneficial side effect of inflation is that it discounts the real principal value of debt. What this means is the ratio of overall debt to income should fall, which would significantly improve credit markets and eventually create the underpinnings for a long, favorable business cycle.

But the return of inflation is definitely not a slam dunk. There is still the possibility of another asset markdown as happened last year if policymakers act too aggressively to “take away the punch bowl”. We don’t think this is likely to happen, but if it does, we would act to reduce exposure similar to what we did to weather the storm this past year.

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firm's management by reimbursing transfer fees and waiving commissions on electronic equity trades through June 30, 2010 for new-to-Schwab clients who open an account by December 31, 2009. This can represent significant savings.

So if you know of anyone who would benefit from Weyland's services, please have them give me a call at 877-433-8994 or e-mail me at bhenkel@weyland.com.

Bob Henkel
Chief Investment Officer

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