

An Eye Towards the Future With Knowledge of the Past

Stembrook Investment Commentary – May, 2009

Over the past 18 months, financial markets around the world have endured a profound downturn caused by overly stimulative monetary policy, lax regulation, easy credit and in some cases, outright fraud. More recently, we have seen a resurgence in share prices as confidence in an economic recovery has tentatively materialized. As the investment landscape changes with great speed and scale, it is my intention to keep you up to date on new developments and to let you know how we are positioning your portfolios to both protect capital and take advantage of the opportunities that such volatility can create. This commentary will attempt to outline the causes of the financial turmoil, highlight a number of key factors in our investment thesis and explain how we are positioning portfolios with an eye towards the future.

Key Culprits of Financial Turmoil

The following timeline provides a brief, high-level view of what happened during this financial crisis. While the whys and hows of this financial downturn have been widely covered in the press, I believe it is instructive to look back at what happened, in part to create a clearer picture of the way forward. There is plenty of blame to go around, but a few key contributors are:

- Cheap and abundant credit make real estate an attractive investment
- Sub-prime borrowing expands due to increased securitization, reduced lending standards, and lax regulation
- Real estate mania drives up demand and prices
- Eventually sub-prime borrowers start defaulting, causing prices of residential real estate and securities backed by such real estate, to decline. Mortgage banks soon begin to falter
- Lenders are reluctant to fund (even healthy) companies' short-term operations via short-term paper, for fear of not getting their money back
- Money markets freeze up, leaving money market funds with less liquid paper and rising redemptions
- Investment banks (e.g. Bear Stearns, Lehman Brothers) hold securitized mortgage loans on their books and are forced to recognize losses as the value of these loans declines
- Banks and hedge funds are forced to sell to raise capital and pay out redemptions
- Capital starved banks stop lending to businesses and consumers
- Economic growth plummets and unemployment soars
- Federal government provides massive amounts of stimulus to support banks and to maintain orderly markets

Drivers of Return

At a time when asset prices are so volatile, it is helpful to remember the factors that ultimately drive prices. This knowledge provides a sense of investment direction when our horizon is obscured by financial storm clouds. Financial markets depend upon two variables for their ongoing health and growth: **corporate profits, and trust**. Corporate profits are used by companies to fund future projects, to make interest and principal payments on bonds (fixed income), and dividend distributions on stocks

(equities). Trust in the system and in underlying companies' ability to deliver, determines how future profits are valued by market participants. Currently, both are in short supply.

Corporate profits, the quantifiable part of the equation, will, after a painful period of restructuring and asset write downs, rebound. Before that happens it is likely that more individual companies will fail, more bond issuers will default, and more workers will lose their jobs. In many cases, companies that emerge from the turmoil will be stronger and more profitable organizations. This survival of the fittest mechanism is the cornerstone of capitalism, and while capitalism is not a word much in favor right now, it is ultimately what will put straight what has been terribly twisted.

Trust provides the foundation of well functioning capital markets. The word credit is, in fact, derived from the Latin word *credo*, which roughly translates to "I trust you." Trust is the component of returns driven by individual's visceral response to information. It is the primal emotions of fear and greed that underlie market sentiment. In financial terms, it is a discounting mechanism that increases and decreases the perceived value of future corporate profits. Given all that has happened, it will take some time for investors to regain their confidence in markets and the financial institutions that support them, but it will happen.

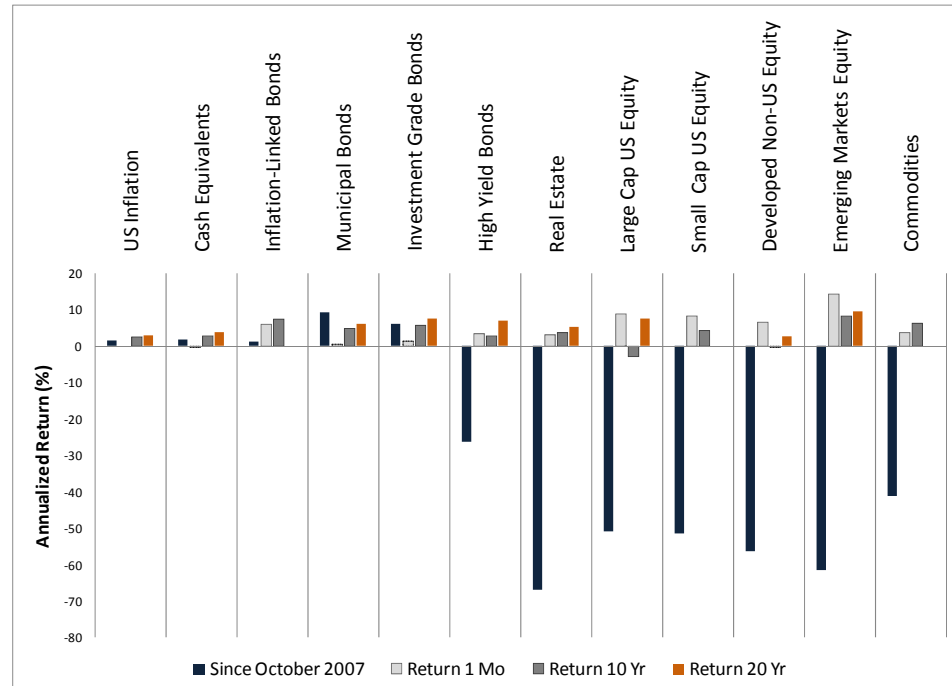
Market Returns

As is shown in Chart 1, many markets around the world are off more than 50% from their highs. At the same time, fundamental measures continue to point to lower valuations and thus higher expected future returns. The price-to-book value (see Chart 2), which measures equity prices versus the book value of

underlying company assets, is currently hovering near 1.5 times, below its post-war average of two times book value. This is one of many indicators of a market that has priced in significant bad news.

The recent rally in stock prices has been considerable, with the S&P 500 up more than 30% at the time of this writing. That is a large

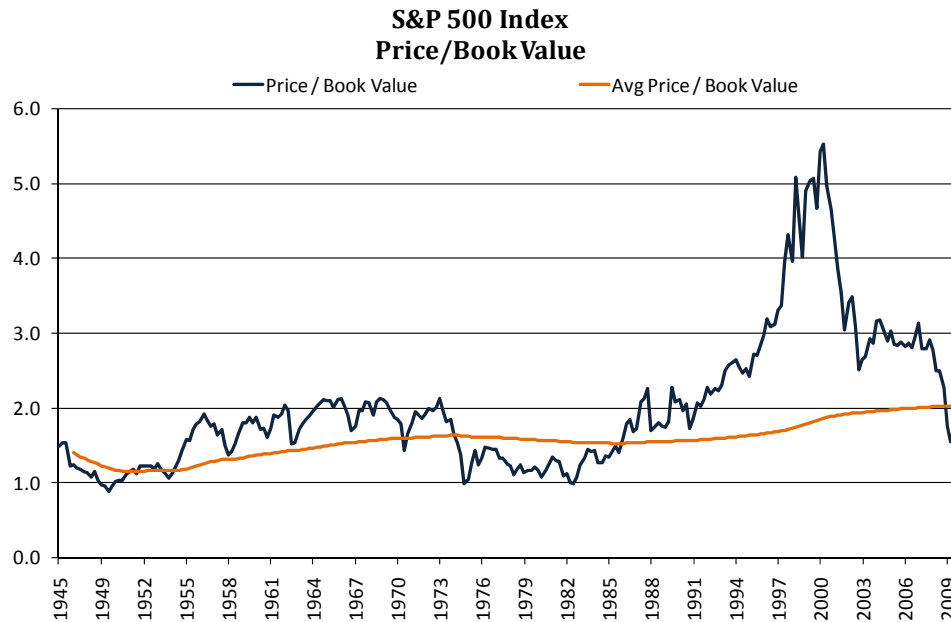
Chart 1 – Global Market Returns as of 3/31/2009



Source: Thomson Financial, Stembrook Research.
 Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index.

gain, but it should be remembered that a 30% gain is required to make up for a 15% loss, and markets are off more than 50% in many cases. This implies that we require a gain of 100% to bring us back to pre-recession highs. If history is a guide, we should expect significant volatility to persist and should remain skeptical that we are out of the woods, just yet.

Chart 2 – Market Valuation



Source: S&P, Stembrook Research

Government Stimulus

The US federal government is bound and determined to jumpstart the economy in an effort to avoid a protracted drop in economic output. To that end, the government has applied a level of stimulus more than three times larger than that provided in the 1930’s. Table 1 outlines U.S. recessions since 1929 and shows the

Monetary and Fiscal policy responses to each. The magnitude and speed of today’s response is nothing short of breathtaking. This action should stimulate growth, but is bound to have large unintended consequences in the future. One such consequence is the likelihood of higher inflation in

Table 1 – Massive Federal Stimulus

U.S. Recessions				Stimulus as % of GDP		
Peak	Trough	Length (months)	Decline in real GDP	Monetary	Fiscal	Combined
August - 29	March - 33	43	27.0%	3.4%	4.9%	8.3%
May - 37	June - 38	13	3.4	-	2.2	2.2
November - 48	October - 49	11	1.7	(2.2)	5.5	3.3
July - 53	May - 54	10	2.7	-	(1.4)	(1.4)
August - 57	April - 58	8	3.2	-	3.2	3.2
April - 60	February - 61	10	1.0	0.7	1.0	1.7
December - 69	November - 70	11	0.2	0.3	2.4	2.7
November - 73	March - 75	16	3.1	0.9	3.1	4.0
January - 80	July - 80	6	2.2	0.4	1.1	1.5
July - 81	November - 82	16	2.6	0.3	3.5	2.8
July - 90	March - 91	8	1.3	1.0	1.8	2.8
March - 01	November - 01	8	0.2	1.3	5.9	7.2
December - 07	?	15	1.8	18.0 *	11.9 *	29.9
Average		13	1.8	1.6	3.1	4.6

*Estimated

Sources: Grant’s Interest Rate Observer, Federal Reserve, Congressional Budget Office

future years. The market impact of fiscal stimulus will be a focus of our research as we attempt to capitalize on the dislocations and mispricings that will likely occur in the future.

Investment Planning Remains a Critical Component to Success

Every one of our clients entered this downturn with an investment plan. That plan considered investor's ability to take and withstand risk. In that regard, our investment planning placed clients in the proper strategies, thus allowing each to stick with their investments through the tough times. A key tenet of investment planning is to only invest what you don't need in the short run, thus avoiding the need to book those losses by dipping into principal during the downtrend. This ability to remain patient preserves buying power in the portfolio for the eventual rebound.

Our Holdings

While a number of our positions performed well on a relative basis, that is cold comfort in a generally down market. We avoided some of the worst markets, and have begun buying in some of the most beaten down areas where risk premia are at or near historic highs.

Our holdings in **Developed Non-US Equities** underperformed US stocks mostly due to a very strong dollar. International stocks are priced in foreign currencies, as the dollar strengthens and foreign currencies inversely weaken, the dollar value of our holdings declines by a corresponding amount. Our contention is that over the long-term, investors should avail themselves to the half of companies in the world not domiciled in the US. This has proven to be a successful strategy in the past, and in a world comprised of increasingly global enterprises, will likely be successful in the future. We continue to hold international equities as a core position in our portfolios.

Our long-term investment in **Alternative Energy** related companies was hit hard by the combined forces of plummeting energy prices and falling economic output. The steep drop in the cost of energy has reduced the economic viability of new technologies in the short run. However, we continue to hold this position based on the thesis that over time, political pressure and pricing dynamics will ultimately drive further innovation and significant growth in a relatively young market.

Emerging Market Equities were also held as a very small percentage of the portfolio at the beginning of the bear market, given their high historical valuations. We have added to this position over time as prices have fallen, and have benefited from the recent strength in this market. Emerging markets should continue to benefit from the secular trends underlying their growth, but will continue to provide a bumpy ride.

Real Estate, as represented by REIT's, was underweighted in the portfolio prior to the market downturn. This decision was driven by data pointing to overvaluation. We have begun to increase our real estate position as valuations have improved, but this asset class still faces deeply rooted fundamental challenges.

We held no **Commodities** in the portfolio as we entered the downturn, but over the past few months, we have begun building a position and have benefited from the recent bounce. We contend that commodities, the raw materials of productive economies, will necessarily rebound as financial conditions around the world eventually improve. Commodities also tend to serve as an inflation hedge. We believe that over the long-term, commodities will provide both improved diversification and enhanced returns.

Selective positions in **Treasury Inflation-Linked Bonds** fared well during the financial storm. A few months ago, breakeven inflation rates – or the market’s expected inflation rate – moved to historically low levels in anticipation of the short-term deflationary pressures of a slowing economy. However, longer-term these securities provide a hedge against the deleterious effects of rising inflation.

High Yield Bonds were underweighted as their spreads to treasury bonds were at historic lows prior to the downturn, signaling very high valuations. As spreads widened to normal levels we began to move back into high yield, only to see spreads widen (and prices fall) further. After this historic widening, we again increased our exposure and have seen significant value added to the portfolio in the last few months from these investments.

High quality **Investment Grade Bonds** in the form of Corporate, Government and Agency bonds in tax-exempt portfolios and Intermediate Term Municipal bonds in Taxable portfolios combined with an overweight in **Cash Equivalents** have served as a strong mooring in a very rough market. While U.S. Treasury bonds appear fully valued, we continue to believe that significant value exists in high grade corporate bonds.

With the tremendous destruction of equity and credit values over the last 18 months, we acknowledge that risk remains high and the future uncertain. However, we believe that debt and equity of many companies are trading at fundamentally attractive levels and should provide solid returns for long-term investors. That said, it is essential for each individual to review their own financial situation and assess if the risk level of their portfolio remains appropriately calibrated to their personal circumstances. While we have great confidence that ultimately the economy will grow again and equity prices will normalize, the duration and severity of this recession, and corresponding weakness in equity prices, is difficult if not impossible to predict. Therefore, it is imperative that all investors evaluate their near-term liabilities and confirm that they are adequately matched with assets of an equivalent duration. We stand ready to assist you in this effort and encourage you to call with any questions or concerns.

Stembrook will continue to manage your assets in-line with your long-term objectives as outlined in your *Stembrook Strategic Investment Plan*. The return oriented portion of the portfolio (risky assets) will be positioned so as to take advantage of both long-term secular trends as well as short-term dislocations in prices. The short-term portion will be managed with an eye towards safety and meeting your immediate income needs.

As always, I thank you for your continued confidence in Stembrook, and I look forward to speaking with you soon.

A handwritten signature in blue ink, appearing to read 'Peter D'Agati'.

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Important note regarding Stembrook's capital market expectations.

The capital market expectations developed by Stembrook Asset Management are estimates of both a central tendency of asset class behavior and a probable range of asset class behavior over a long-term horizon. These estimates are one of many inputs used in the portfolio construction process, and should not be used independently. These expectations should not be construed as the returns that will be achieved, but merely those that may be achieved if certain assumptions hold true. Also note that each client's portfolio may differ given specific goals and constraints applied to the portfolio construction process.

Additional information is available upon request.