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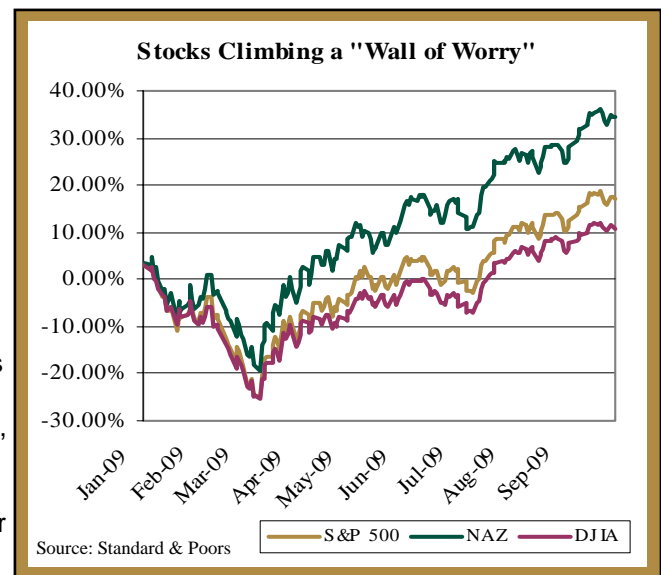
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The Quarter in Review

Markets continued to climb a “wall of worry” during the third quarter as both equity and fixed income markets delivered impressive gains. The rally that began in March for stocks gathered momentum during the summer months with the Dow Jones Industrial Average delivering its best quarterly performance since 1998 and its best third quarter since 1939. The S&P 500 Index, after seven straight months of gains, is up nineteen percent for the year and fifty-six percent from its March lows, yet still thirty-two percent below its October 2007 high. All areas of the fixed income market also posted respectable gains for the quarter, the biggest coming from the high yield arena – the lowest credit quality issuers affectionately referred to as junk. Similarly, the best returns in the stock market during the past six months have come from the areas historically categorized as high risk or high beta. Morningstar did a study segmenting returns between different types of stocks over this period. The results concluded that “distressed” stocks rose twice as much as “speculative growth” stocks and four times as much as “classic growth” stocks. As is often the case, when an appetite for risk returns to the financial markets, it is the most speculative areas that initially deliver the greatest rewards.



Concerns over the health of the economy and the consumer were overshadowed by better than expected earnings results and economic data. As companies released earnings results in July and August, nearly seventy-five percent reported results that beat expectations. In September, FOMC Chairman Ben Bernanke declared that the weight of the evidence is suggesting the recession that began in December 2007 is “very likely over”, and that the economy is stabilizing. Economists are apparently in agreement with this assessment as consensus estimates from a recent *Wall Street Journal* survey call for GDP growth of 2.5 percent in the second half of 2009 and 2.8 percent growth in 2010.

Merger and IPO activity has reappeared and helped to fuel some of the recent stock market gains. The volume of IPO activity offerings exploded in the third quarter with over \$5.5 billion raised versus \$2.3 billion in the entire first half of the year. A resurgence of mergers and acquisitions are making headlines as several companies have announced significant transactions. Amongst the major announced deals were: Kraft offering to buy Cadbury, Dell buying Perot Systems, Xerox bidding for ACS, and Comcast in talks to buy up to half of NBC Universal. While skeptics may argue that these are acts of desperation in an otherwise stagnant environment, we view these developments as not only a sign of good management during difficult times, but also a sign that companies are seeing value, opportunity, and light at the end of the tunnel. Corporate America has clearly gained some confidence in the outlook. The volume and magnitude of these types of deals would have been unthinkable this time last year.

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Trick or Treat in October?

There is a wide divergence of opinion from pundits predicting the direction of the economy and the financial markets in the coming months. Some say the stock market has gotten ahead of itself and that we will ultimately retest the lows seen March. Others believe the recession is over and consumers will respond positively as the economy continues to improve. As investors continue to sort through the questions and headwinds we are faced with, there is also the fear that surrounds the month of October. It is often cited as a precarious month for stocks due to memories of the significant market crashes in 1929 and 1987.

According to *cnbc.com*, the top three (and five out of the top ten) one-day percentage declines for the Dow Industrials have all transpired in October. Recently, large one-day declines occurred in October during both 1997 and 2008, and bears have been prognosticating that this year will offer a similar result.

Despite these interesting factoids, the reality is that historically October

	Avg. Gain	% of Time Index Up	Avg. Gain Following Up Sept.
DJIA (since 1896)	0.21%	59%	1.49%
S&P 500 (since 1928)	0.27%	59%	1.90%
NASDAQ (since 1971)	0.31%	53%	1.22%

Source: CNBC.com

is not that bad of a month for the markets. As Mark Twain so eloquently penned in his 1894 novel *Pudd'nhead Wilson*, "October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February." As can be seen in the table, fears surrounding the month may be overblown. The month has actually delivered gains on average, and does even better following a positive September. There are inherent risks to investing in stocks yet they are oblivious to our position on the calendar.

As we get through third quarter earnings season, investors will be focused on the quality of earnings, company's future guidance, and evidence of increasing revenues not simply cost-cutting to achieve results. If the last two quarters were a guide, we should expect that companies will continue to beat lowered expectations. The market is no longer "cheap" after recent gains. The S&P 500 currently trades at an elevated twenty times current year earnings and approximately sixteen times 2010 earnings estimates – in-line with historical averages. That said, we believe it is a market of stocks not a stock market and companies with high quality earnings will be rewarded in this environment. For sure, we expect volatility will remain part of the "new normal" until fears subside and ultimately confidence is restored. For stock prices to continue their ascent the market needs to continue seeing positive signals and not data that is simply less worse than expected. We continue to focus on strong companies that are efficient users of capital, have proven management teams, competitive advantages, and growth potential that are operating in industries that matter. Companies meeting these criteria will continue to provide value to shareholders as we emerge from this downturn.

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