

December 2009

In the Fall, market observers began to realize that the decade was going to end badly for investors. I didn't hear much talk of the "Lost Decade" in March. Undoubtedly, some were thinking about it, but few wanted to talk about it. From 1999 through 2008 the markets had done plenty to destroy confidence. Then 2009 started badly. However, on March 12 the market experienced a follow through day, a historically meaningful event, which, in past market cycles, has sparked a rally. This follow through day succeeded and a rally began. As always happens, savants were quick to cast doubt on the rally. "Just a bear market bounce," many said. "We're going to test the lows," said others. Each time the market paused, started a correction or some exogenous event took place that rattled the market, detractors evinced negativity. There was plenty to be unhappy about looking in the rearview mirror.

2009 was an unusual year in many, many ways. It marked the end of one of the worst bear markets since the Great Depression. The stocks that provided the best returns were those most severely thrashed in 2008 and early 2009, not quality stocks. Citi was 97 cents at its low and rallied 459%. Ford's low was \$1.50 and rallied 566%. Bank of America dropped to \$2.53 and rallied to \$19 in October 2009 for a gain of 566%. It looked, for a time, like the whole financial system might collapse. It certainly was subjected to plenty of stress testing. It was a bad year for dividends: many were cut, many more eliminated and no dividend stocks provided the cushion to stock price declines many had claimed they would. 2009 was also a bizarre year because many of the indicators that historically signal caution weren't followed by meaningful declines. No market setback exceeded 10%, despite the fact that heavy volume selling days piled up in May, July and September. In October the market stalled and traded in low volume. The explanation: funds had a good year and booked gains in October, content to sit on cash or hold, not increase positions. Individual stocks began bases, digesting gains.

One way that 2009 was not unusual is reflected in the superior performance during the first leg up from the bear market bottom in March. The Nasdaq zoom 81% from the March low through the end of the year. Historically, the first up leg after a bear market is the strongest of a bull run. 2009 was the best year since 2003. In 2009 major averages performed as follows:

Nasdaq:	+43.9%
NYSE Composite:	+24.8%
S&P 500:	+23.5%
Dow Jones:	+18.8%

Even though many Nasdaq stocks posted very good gains, quality stocks with superior earnings and revenue growth were not the leaders. Leaders were mostly beaten-down underperformers from the prior year. A strong and healthy market is led by quality stocks. It takes time to renew confidence lost in markets. 2009 was marked by a paucity of confidence and yet the markets continued to rally, climbing a wall of worry. Sellers appeared

whenever the market rallied. One prominent market letter writer, acknowledging this nervousness, notes that in January 2010 over \$10 Trillion of cash is in money funds. This does not include the substantial sums that have poured into bond funds. Investors have chased yields to historic lows, despite historically high deficits.

Looking at previous rebounds might be helpful in discerning what may be next. There have been seven bear markets comparable to the sharp 2007-09 decline. Each bear market was followed by a first leg, then a correction and a second leg up.

Dates	Index	Decline	Duration	1st Leg	Duration	1st Correction	2nd Up Leg
1901-03	DOW	-46%	29 mos.	+ 54%	7 mos.	10% (1 week)	+ 27% (4 mos.)
1906-07	DOW	- 49%	22 mos.	+ 71% (2/08)	19 mos.	27% (10 mos.)	+ 17% * (3 mos.)
1919-21	DOW	- 47%	22 mos.	+ 61% (8/21)	14 mos.	10% (1mo.)	+ 15% (4 mos.)
1924-32	DOW	- 89%	34 mos.	+ 101%	2 mos.	39% (6 mos.)	+ 122% (4.5 mos.)
1937-38 **	DOW	- 50%	13 mos.	+ 63%	7 mos.	24% (6 mos.)	+ 31% * (5 mos.)
1973-74	S&P500	- 50%	21 mos.	+ 51% (12/74)	7 mos.	16% (2 mos.)	+ 33% (12 mos.)
2000-02	NASDAQ	- 78%	31 mos.	+ 72% (3/03)	11 mos.	19% (7mos.)	+ 25% (4 mos.)
2007-09	NASDAQ	- 56%	17 mos.	+ 81% (3/09)	***		

* Failed to reach previous high

** Great Depression

*** Three of four averages yet to correct 10%

The data above appeared in the year end market wrap column in the January 4, 2010 edition of IBD.

So what do the data suggest may come next? First up legs are of varying, albeit short, duration relative to declines. First up legs can provide very meaningful returns, the smallest 54% and the largest 101%. The second biggest gain (+81%) occurred from the March 9 bottom through year end 2009. To capture such dramatic increases an investor had to have been ready to buy stocks when the turn came despite the overwhelming bad news and even though it was scary. Once the first leg run has begun, be ready to play defense. That means watching out for stocks that are failing to make progress or failing after breakouts. Beware of market distribution days piling up over a few weeks. The first leg up was so strong investor confidence grew that the second leg would be a replay of the first. The data suggest otherwise: second leg returns produce lower, although not insignificant, returns than the first and are shorter. So, keep second leg expectations modest. I remember the relief I felt in September 2004 when the market started rallying, a second leg up after a vigorous rebound in 2003 and a correction that lasted from March through September 2004. The second leg's end coincided with the end of 2004. Be alert for something new that could either extend or cut short the rally. For instance, before the 1937-38 bear market, the Dow Jones had always recovered the prior high during the second leg up. The year 1938 was the first time that did not happen and it has not happened since.

After a disappointing decade what might we expect in the immediate future? Excluding 1932 (the market fell 0.4%), returns on stocks have been positive the second year following a bear market. The average return is 15%. Steve Leuthold's Group analyzed the

worst rolling ten-year periods for the S&P 500 and found that stocks were positive the next ten years in all fifteen cases with an average annual return of 10.7%. And there is all that cash around.

Client account performance was good in 2009, beating many of the major averages. A new year is a good time to revisit strategy and goals. To that end I want to review the disciplines and practices I employ and the character of the stocks I select for portfolios. Stocks must be in top industry groups. Rapidly growing earnings and sales over both three years and recent quarters are critical selection criteria. It's even better if sales and earnings are accelerating. Management should have significant equity stakes in the companies they run. Management must efficiently employ company assets, that is, provide a high return on equity and high margins. Something new should be happening at the company, a new product or service, a new market, a previously unmet need or a new management. Cash flow must exceed reported earnings. Stocks selected must have strong relative performance. Better performing mutual funds should own shares. These are high expectation stocks and to continue rising in price they must continue to exceed expectations. Some do and some do not. When they don't, stock prices can drop quickly and by a meaningful amount, either diminishing gains or creating losses. Some prices recover quickly after a bad or disappointing quarter and some take a very long time to recover, if ever. The purpose of active portfolio management is to allocate funds to the most productive assets. To do that often means selling a stock that has disappointed and buying a better potential candidate. All stocks selected for inclusion in portfolios have the same potential based on their metrics. Some realize that potential and some do not. Sometimes price declines are the consequence of a poor market and sometimes the fault lies with the stock itself. My purpose in explaining my process is to provide you with the opportunity to reflect on your goals and tolerance for risk and to ask questions about your portfolio so that you understand how your money is invested. If there is any aspect of your account that you would like to better understand, please feel free to call me.

Wishing you a very Happy New Year.

Sincerely,
John Preston
Senior Vice President