

Celebrating Our Second Decade of Providing Unbiased Financial Advice

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.”

Mark Twain

Upward Momentum Continues

Investors continued to regain confidence in the markets as third quarter gains surpassed all expectations. U.S. stocks, as measured by the S&P 500, experienced a third quarter gain of 16% bringing year to date performance to 19.2%. Results for developed foreign markets (EAFE) were even better as these stocks finished the quarter up almost 20% raising year to date performance to 32.5%. Emerging markets equities continued their sharp rally and are now up over 62% for the year. In the U.S. bond markets investment grade corporates earned a generous return relative to Treasuries and high-yield bonds turned in another stellar performance. High-yield bonds have actually outperformed the S&P 500 year to date.

We are encouraged about the performance of our models and managed accounts relative to benchmarks. Our active equity managers have done an outstanding job thus far of determining which companies would

benefit in this dynamic environment. Our bond managers continue to exceed benchmark performance with good security and sector selection, duration bet, and yield-curve positioning. Though improving, the direction forward for the economy and markets is still unclear so we are still underweight stocks and overweight non-treasury bonds. Focus is now being given to those positions where it may be time to harvest some gains and reallocate assets to undervalued areas or new market opportunities.

Today’s Economy

There is broad-based evidence of a recovery in the U.S. and global economies. Most economists are now calling for GDP growth in the U.S. for the third quarter, thereby technically ending the recession. Cost cutting efforts by corporations have resulted in positive second quarter earnings results and top-line revenue growth is anticipated with third quarter results. As of this writing, nearly 80% of the major companies that have reported profits for third quarter have beat projections. That puts this quarter on track to become one of the best since early 2004. More importantly, 61% of companies have reported better-than-expected revenue figures. One in five

companies managed to raise their forecast so far, which helps to lessen concerns about a double-dip recession once government aid is removed. Unemployment continues to rise and foreclosures are still climbing. Inflation is not a near term concern with high unemployment and domestic manufacturing at 68% of capacity.

Globally, emerging market (EM) economies have led the way out of this recession. In terms of GDP, EM economies account for seven of the top twenty countries, and represent the segment that is growing the fastest. China, with the aid of a \$580 billion stimulus program, has kept GDP growth above 6% and is forecasting 8-10% in 2010. India has been able to maintain growth at 5%. Nevertheless, there remains considerable uncertainty about the level of expansion we may experience in years to come. There are many divergent views and getting the big-picture economic view right will be critical to future investment strategies.

Challenges

Typically, the end of an economic downturn brings increased consumer demand, replenishment of inventories, and businesses begin to rehire staff. Historically, when the economy experiences a deep recession, the subsequent upside is marked by several quarters of strong GDP growth. However, this has not been a typical recession and we do not anticipate a long-term period of robust growth. The strength of the recovery is heavily dependant on the following factors.

- **Consumer Demand**

Consumer spending accounts for about 70% of U.S. GDP. We rely on consumers to drive demand through their willingness and ability to increase discretionary spending. From the peak October 2007 to March 2009, U.S. households lost almost 21% of their net worth, representing \$14 trillion. Households have curtailed spending and increased savings to begin the task of rebuilding their balance sheets. It will take years for consumer debt to reach sustainable levels and for vanished wealth to be restored.

News Notes

ISG hosted the 2009 Annual Meeting at Inverness Hotel on September 26th. This was our largest meeting ever with over 260 attending. There was great food and a chance to visit with friends, ISG staff and advisors. Principal Mike Dibala provided a great presentation on priorities in life and how the melt down of 2008 has impacted all of our lives.

Dr. Kishore Kulkarnia, professor of economics, provided a history of business cycles and a positive view on how Americans have a real skill for working through financial challenges with the most industrious, creative, and hard working workforce in the world. He, like all of us, stated he was not sure where the next financial breakthrough will be but he conveyed the utmost confidence that “we will work through this and be better for the experience.”

For those who attended, we thank you. For those unable to attend, we look forward to seeing you at next year’s event.

• Unemployment

Always discounted as a lagging economic indicator, employment has taken on a more important role in this recovery. Instead of the borrow and spend process adopted over the past several years, Americans must now actually earn money to spend it! Without sustainable, high-quality employment there can be little economic stability and only tenuous economic growth. The rate of growth in unemployment appears to be slowing but we are still losing a significant number of jobs. In any market downturn, companies scrutinize costs and become more efficient. In this recession, companies have reacted quickly to consumption decline and cut costs rapidly and dramatically. It is important to understand how well companies have positioned themselves to create earnings in a reduced demand environment. If costs are cut enough, profit growth will resume on lower levels of demand and hiring will occur. Increased foreign demand from countries such as China, Brazil, India, and Russia may also help replace some of the demand lost in the U.S.

• Housing

Home sales have strengthened thanks to low mortgage rates, depressed home prices, and tax credits for home buyers. However, this is still a very fragile part of our economy. The risk going forward is that the level of foreclosures will continue to run at very high levels as a result of the combination of high unemployment; a significant percentage of homes are now valued at less than mortgage balance; and a wave of Alt-A and Option ARM mortgage payment resets that will occur over the next three years resulting in large increases in monthly payments. Higher foreclosure volume will add to homes on the market putting further downward pressure on home prices. Home prices may decline into the first half of 2010.

• Government Policy

Government policies, or lack thereof, play a critical role in determining what kind of economic rebound we will have and the timing of a rebound. Policymaking also determines the environment we find ourselves in with global trading partners. The large government stimulus has triggered and supported economic activity. Cash for clunkers, the tax credit for new home purchases, Fed purchases of virtually all mortgages being written, and a surge of unemployment benefits have supported and stimulated demand. However, most of these programs have either expired or will unwind

soon. How issues such as health care, cap and trade, and potential tax rate hikes are resolved will also have an impact on future economic growth.

• Inflation

Over the past year, inflation has been a non-issue as we have actually experienced mild deflation. With both excess labor and manufacturing capacity, no strong pressures exist for an inflationary economy. Add weak consumer demand, and this combination suggests that we are more at risk of additional deflation in the near term. The Fed is keenly aware of the problems presented by an extended deflationary period and are focused on eventual re-inflation of the economy. The key will be to control inflation without igniting a period of hyper-inflation. The Fed must keep policy accommodative enough to sustain economic recovery, while providing reassurance that it will tighten when needed. Debate continues but many expect inflation to be materially higher in three to five years.

So Where Are We Headed?

The economy is now recovering and the risk of financial-system meltdown appears to be behind us. But there remains the important question of how strong the recovery will be and how long it can be sustained. Several scenarios are possible ranging from a double dip recession in 2010 or 2011 as government stimulus is removed and inventory restocking is complete to the optimistic potential of a robust recovery ensuing from strong business and consumer demand coupled with emerging markets growth. It is our view that a US economic expansion may be sustained but at a pace well below historical norms. We expect the U.S. economy to grow but take second seat to the consumption demand anticipated from emerging markets like China, Brazil, and India.

The markets will provide opportunity but it will require a greater understanding of global conditions and governmental interactions. Long term, 3 to 5 years, we expect equities to outperform non-equities but will continue near term to add value by capitalizing on inefficiencies in the bond markets. We have added a global bond fund to our core non-equity holdings. Global exposure has also been increased with the addition of a global asset allocation fund with the ability to hold a combination of company stock, debt, currencies, or precious metals based on current market conditions. As long as significant valuation differences exist value will be added using active management. We are constantly assessing other investment strategies that will result in overall long-term out performance and stay focused on making the best decisions for our clients. Though complex and challenging, we think the road ahead will provide us with considerable opportunity.

Portfolio Revisions and Comments

1. We recently removed Brandywine Blue from our core holdings and replaced it with Ivy Asset Strategy. Asset Strategy is a world allocation fund actively managed with allocations to global equities & debt, foreign currencies, & precious metals.
2. With spreads on High Yield bonds now narrowed to 50% of their March 2009 values and performance of core holding Eaton Vance Income Fund well over 35% year to date, we elected to harvest gains and sold all positions in this fund. It has been replaced with Templeton Global Bond Fund. This fund is a world bond fund with active positions in under priced bonds with price appreciation potential. At least 80% of the fund is in government or government agency bonds.