



Investment Perspective & Analysis

Third Quarter 2009

September 30, 2009

SUMMARY & HIGHLIGHTS

- Economic recoveries never occur in straight lines and never happen as fast as investors would like. Even though the stock market has skyrocketed in the past seven months, the underlying economy is going through the fits and starts of an uneven recovery.
- Economists are predicting economic growth to materialize in the third quarter when it is expected that GDP will grow in excess of 3%. By comparison, second quarter GDP was recently revised to indicate that the economy declined a mere 0.7%, better than the estimated 1.2% decline.
- The equity markets continued to rally into the third quarter as better than expected earnings and signs of a stabilizing economy pushed stock prices higher. The S&P 500 gained 15.6% during the quarter, giving the index a 19.3% return for the year-to-date period ending September 30th.
- To maintain the recent rally in stock prices it is necessary for companies to show improved revenue growth. As companies begin to announce third quarter earnings results over the coming weeks, investors will focus on signs that demand is picking up and revenue growth is beginning to accelerate.
- The U.S. faced the possibility of deflation for the first time since the early 1950s, a threat that has prompted the Federal Reserve to keep interest rates near zero. Bond yields remain exceptionally low with the 10-year Treasury currently yielding about 3.20%. It appears the bond market is anticipating a slow economic recovery, contradictory to the quick recovery the equity market seems to expect.
- Fixed-income securities underperformed equities in the third quarter of 2009 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy has bottomed.

GENERAL OVERVIEW

U.S. Economy

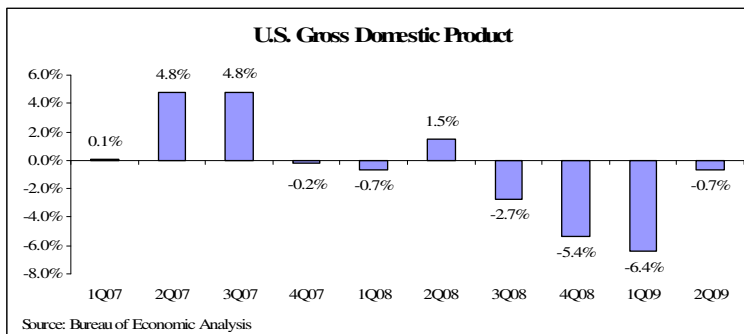
Economic recoveries never occur in straight lines and never happen as fast as investors would like. Even though the stock market has skyrocketed in the past seven months, the underlying economy is going through the fits and starts of an uneven recovery. Now that the fear of a depression has subsided, the worry turns to finding the bottom of the economic contraction. Most economists agree the bottom was reached earlier this summer. In addition, many feel it will prove difficult to achieve the economic growth rates experienced in recent years after the excesses of the past are wrung out of the system. It is one thing to avert a financial meltdown (accomplished through swift government intervention, vast amounts of debt and programs aimed at a rescue and/or stimulus). It is quite another challenge to get the economy expanding again. This is especially difficult given the multiplicity of

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problems such as the excessive amounts of debt and risk that were used to create this mess. Even though the equity markets by their swift and uninterrupted rise since March have anticipated a recovery, it is far from a “fait accompli” at the present time.

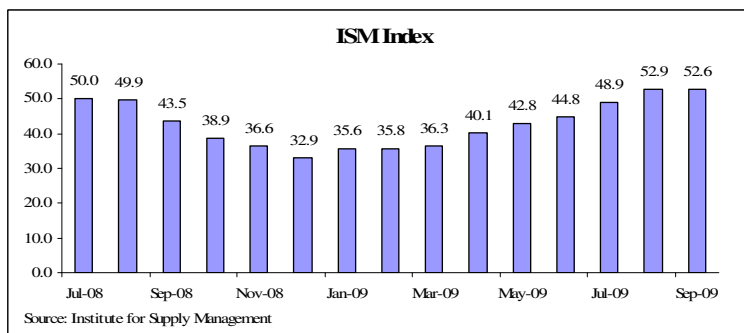
Economists are predicting economic growth to materialize in the third quarter when it is expected that GDP will grow in excess of 3%. By comparison, second quarter GDP was recently revised to indicate that the economy declined a mere 0.7%, better than the estimated 1.2% decline. This offers evidence that the economy is healing, but data maybe skewed by government programs such as “Cash for Clunkers”.

A better gauge of activity will come when fourth quarter GDP is released early next year. Currently, the economy is heavily subsidized by low interest rates, heavy support for banks and the government’s many stimulus programs. A number of economists are looking for growth in 2010, but the bears say it remains to be seen if sustainable growth can occur independent of government support programs. Without more lending from banks, especially to small business, orders and revenue growth will be constrained.



There are other signs of improved economic activity. The residential real estate market is showing early indications of a rebound in home prices and a rise in sales activity. The industrial and manufacturing sectors are still anemic, but experiencing a modest increase in orders and backlogs. Some improvement in manufacturing output has been seen recently as inventories, which have been worked down during the economic slowdown, required replenishment. Companies are still very cautious about the future, showing few signs of increasing capital spending. However, there is hope that companies will have to upgrade productive capacity and technology in order to remain competitive, reinstating equipment replacement programs that have been put on hold during the downturn. As an example, there is talk that many companies are waiting for the release of Microsoft’s new Windows 7 before upgrading their computers.

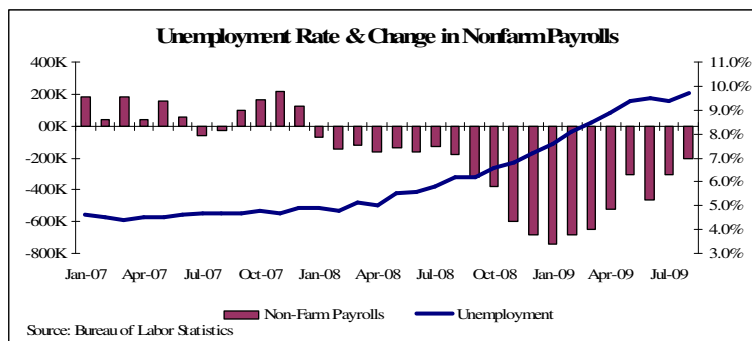
Another indicator of manufacturing activity is the ISM Index which fell to 52.6 in September (down from 52.9 in August), but is still above 50, indicating growth. This is up significantly from December 2008 when the index hit 32.9. Also, the Index of Leading Economic Indicators for August was up 0.6% and has consistently improved over the last four months. The indices that track the transportation of raw materials and other goods have seen some incremental improvement over the past few months as well.



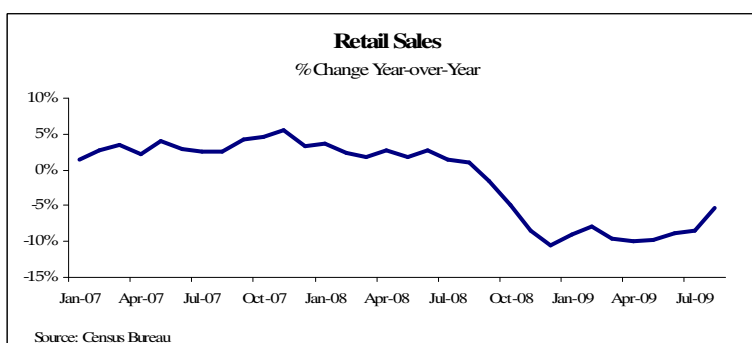
The American Association of Railroads recently reported that U.S. freight carloadings were down double digits for the 10th straight month, declining 16.4% year-over-year in August. However, this was the lowest percentage decline since February. Freight carloadings are generally a good indicator of economic activity since many raw materials are transported by rail.

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Improvement in the job market is another key to sustainable economic growth. Recently, the Labor Department reported the unemployment rate increased to 9.8% as 263,000 jobs were lost in September. A total of 7.2 million jobs have now been lost during the economic downturn. While the loss of jobs continues, the rate of decline in is slowing from a high of 741,000 per month in January. It also must be remembered that employment is a lagging indicator of economic activity, but at the same time the most politically charged. If there is to be another dose of economic stimulus – it's too early to tell right now – it should focus on job creation.



Related to job security is consumer spending. The trend in consumer spending has been slow or negative since the financial and housing crisis began in December of 2007. Without job growth, it is difficult to see a meaningful uptick in consumer spending. In prior years, this was facilitated by a robust lending environment that made credit easily available to those using inflated home values as collateral. Currently, mortgage lending is tight and limited to those consumers with high credit scores looking for a moderate loan-to-value as there are few buyers for mortgage backed securities, except for the Federal Reserve (which has purchased over \$1.2 trillion in mortgages this year). A good indicator of consumer activity is retail sales which declined 5.3% year-over-year in August. It is generally predicted that holiday sales this year will show little growth over last year's contraction. Retail sales have been anemic throughout 2009 and will continue to be pressured by high unemployment and an increase in the personal savings rate. The economic crisis has changed the spending patterns of consumers from one based on "want" to one based on "need."



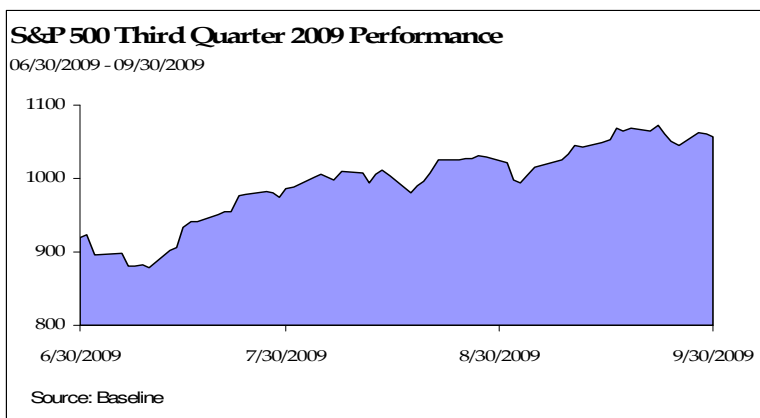
Looking ahead, it is difficult to see where domestic economic growth will come from. There are plenty of headwinds to keep the stock market on the defensive; however, the major equity indices are up over 50% since the March 9th lows. What is more difficult is to develop a bull case for the economy that would support current stock market valuations. We see only a few possible scenarios: strong leadership from emerging market countries that will enhance production capacity and satisfy a growing middle class that will be the new consumers while U.S. demand remains soft. As stated before, capital spending could provide a key to sustained equity prices and economic growth. If corporate CEOs become more constructive and loosen their purse-strings, this could unleash strong forces for growth and production. Once again, if this phenomenon is to materialize, credit sources must be made available to allow the financing of this growth. With banks undercapitalized, it is difficult see how credit growth will improve. All in all, we are not hopeful that the U.S. economy can make a swift recovery to previous "normal" economic growth levels. This is why Mohamed El- Erian, Co- CIO at PIMCO, has coined the phrase the "New Normal" that describes slow economic growth and low returns on capital for the foreseeable future. We are adjusting to that vision.

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EQUITY MARKET OVERVIEW

Equity Market Performance

The equity markets continued to rally into the third quarter as better than expected earnings and signs of a stabilizing economy pushed stock prices higher. The S&P 500 gained 15.6% during the quarter, giving the index a 19.3% return for the year-to-date period ending September 30th. The index is now up a staggering 56% since the March 9th lows.



Economic indicators such as slowing job losses and signs of a pick up in manufacturing helped investors gain confidence in an economic recovery. The idea that the recovery might be more of a “V-shaped” rather than “U-shaped” has taken hold and improved the tolerance for risk. The “fear of losing money” has been replaced with the “fear of missing the rally” as those who took defensive positions in cash and government securities at the beginning of the year have begun to allocate more capital to equities. A lot of faith has been placed in the government’s ability to stimulate growth. With stock prices at current levels, more than just economic stabilization is needed to extend the rally in equities. Further signs of improvement and the ability of the economy to sustain the growth as the government disengages from its stimulus programs is crucial to staving off a correction in the equity markets.

Second quarter earnings results helped extend the rally in stock prices as many companies beat expectations and provided signs that the economy was stabilizing and not on the drastic decline experienced in the first part of the year. While much of the upside in earnings was the result of better than anticipated cost cutting, the general consensus among management teams was that there are incremental signs of improvement. This contrasts with the fourth quarter of 2008 and the first quarter of this year, when demand for many goods and services virtually disappeared. However, cost cutting has its limits. To maintain the recent rally in stock prices it is necessary for companies to show improved revenue growth. As companies begin to announce third quarter earnings results over the coming weeks, investors will focus on signs that demand is strengthening and revenue growth is beginning to accelerate. Without such signs, it will prove difficult to maintain stock prices at current levels.

After a dismal start to the year, all the major U.S. indices performed exceptionally well in the third quarter following the solid second quarter performance. Small cap stocks led the way during the quarter as measured by the Russell 2000’s return of 18.9%. However, the other domestic indices were not far behind. The Nasdaq continued to outperform on a year-to-date basis, returning 34.6%. As in the second quarter, international equities outperformed domestic equities as measured by the MSCI-EAFE and MSCI-Emerging Markets Indices. Emerging market stocks have rallied 61.2% year-to-date after a -54.5% return in 2008. Investors have flocked to emerging market stocks on the belief that there are better overall economic growth prospects in those countries.

Equity Performance	1Q09	2Q09	3Q09	YTD*
Dow Jones Industrials	-12.4%	11.9%	15.7%	13.4%
S&P 500	-11.0%	15.9%	15.6%	19.3%
Nasdaq	-3.1%	20.1%	15.7%	34.6%
Russell 2000	-15.4%	20.2%	18.9%	21.0%
Wilshire 5000	-10.7%	16.2%	15.8%	20.1%
MSCI-EAFE	-13.9%	25.4%	19.5%	29.0%
MSCI-Emerging Markets	0.5%	33.6%	20.1%	61.2%

*As of September 30, 2009

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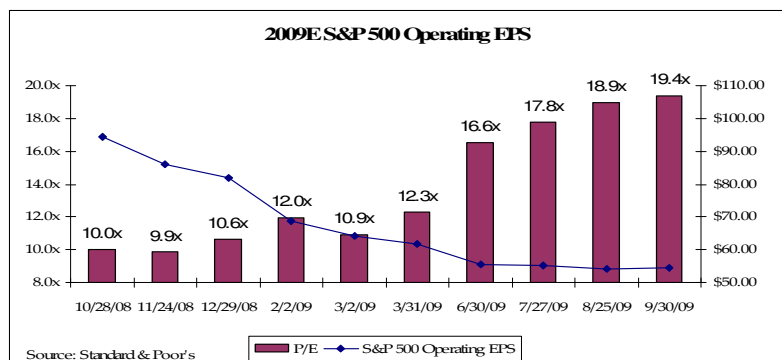
The financial sector continued to outperform in the third quarter gaining 25.1% followed by industrials and materials with returns of 21.1% and 21.0%, respectively. While the rally in stock prices over the past seven months was broadly based, the “risk trade” gained momentum during the quarter as investors piled into those stocks that experienced significant sell offs at the beginning of the year. Names such as Gannett, Hartford Financial Services and Tenet Healthcare more than doubled in just the third quarter, while many well known stalwarts such as McDonald’s and Wal-Mart that held up well during the downturn were virtually flat. On a year-to-date basis the technology sector continues to lead the way gaining 44.8%. The sector has benefited by not seeing the first quarter declines that other sectors experienced as well as the anticipation of accelerating earnings as the economy improves.

S&P 500 Sector Performance	1Q09	2Q09	3Q09	YTD*
Consumer Discretionary	-8.6%	17.7%	18.9%	27.8%
Consumer Staples	-11.3%	8.9%	10.5%	6.7%
Energy	-12.1%	10.1%	9.5%	5.9%
Financials	-29.5%	35.1%	25.1%	19.2%
Health Care	-8.5%	8.3%	8.9%	7.9%
Industrials	-21.8%	18.0%	21.1%	11.9%
Information Technology	3.7%	19.4%	16.7%	44.8%
Materials	-2.8%	15.5%	21.0%	35.9%
Telecom Services	-8.5%	1.9%	4.0%	-3.1%
Utilities	-11.9%	8.8%	5.0%	0.7%

*As of September 30, 2009

S&P 500 Earnings

2009 estimates for S&P 500 earnings have stabilized over the past few months at \$54. This is down significantly from estimates in the \$100 range around this time last year. The stock market rally has pushed the P/E to 19.4x which looks rather expensive. Many now question how much higher the market can go given the lofty valuation. Some investors are looking to 2010 to explain that stocks are actually not overpriced given an estimate of \$74 which equates to a P/E of 14.4x, a valuation level that is in line with the historic average.



The argument then turns to whether or not it is feasible for earnings to grow 35% to \$74 in 2010 given an economy that’s being supported by government spending and an unemployment rate that continues to move higher. As we move into the end of the year, companies will begin providing further guidance on the outlook for 2010 which may signal if a 35% earnings growth rate is achievable in 2010.

BOND MARKET OVERVIEW

Bond Market Performance

The U.S. faced the possibility of deflation for the first time this year since the early 1950s, a threat that has prompted the Federal Reserve to keep interest rates near zero. Regional Federal Reserve Bank Presidents Janet Yellen of San Francisco, James Bullard of St. Louis, Richard Fisher of Dallas, and Charles Evans of Chicago, have expressed concern in past weeks about the possibility of declining prices. According to Bloomberg News, “While the economy contracted 2.7 percent during the 1953 recession, it shrank 3.8 percent in the current recession, the most since the 1930s. Economists at New York-based JPMorgan Chase & Co. and Goldman Sachs Group Inc., the

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second- and fifth- largest U.S. banks by assets, say there's so much deflationary pressure coming from excess labor and plant capacity in the economy that the Fed won't raise interest rates until at least 2011." Bond yields remain exceptionally low with the 10-year Treasury currently yielding about 3.20%. It appears the bond market is anticipating a slow recovery, contradictory to the quick recovery the equity market seems to expect.

Fixed-income securities underperformed equities in the third quarter of 2009 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy has bottomed. Credit spreads tightened over the past three months even as more money flowed into Treasuries despite the record level of auctions.

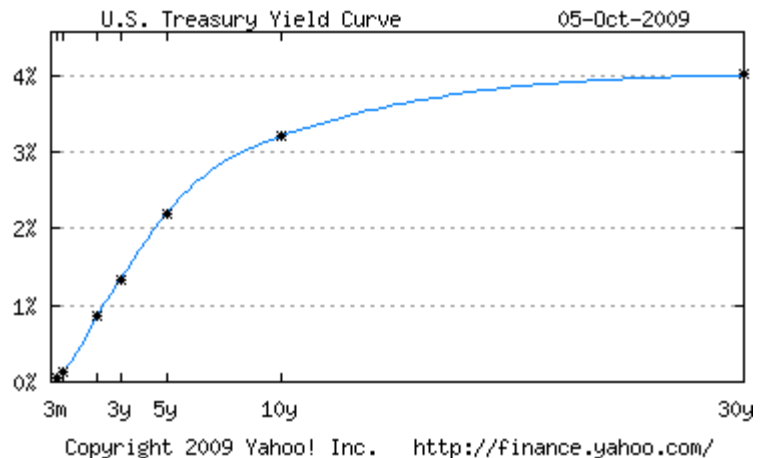
Bond Market Performance	1Q09	2Q09	3Q09	YTD*
90 day T-bills	0.1%	0.1%	0.1%	0.2%
10 year T-notes	-2.8%	-6.3%	2.7%	-6.5%
Corporates	-1.9%	9.4%	7.9%	15.8%
Agencies	-0.7%	0.7%	4.4%	4.4%
GNMA Bonds	2.3%	0.3%	2.7%	5.4%
TIPS	10.9%	1.2%	5.7%	18.7%
High Yield Bonds	7.1%	26.2%	15.4%	56.0%
Municipal Bonds	4.9%	2.4%	8.2%	16.2%

*As of September 30, 2009

Hi-Yield bonds gained 15.4% for the quarter outpacing all other categories as the risk premium for those bonds decreased. At the end of 2008 we told you about three schools of thought on why Treasuries are expensive relative to inflation and to an expected onslaught of supply to finance the growing federal deficit. Now it is largely believed that good relations with foreign nations and increased buying from sovereign wealth funds has kept Treasury auctions running smoothly and yields low.

Yield Curve

The yield curve as seen in the graph to the right could retest the May lows in both short and long term interest rates. Long rates have moved down over the last three months signaling investors' waning concern about the future prospects of inflation. However, the Treasury and the Fed are trying to keep rates down as many see low interest rates as the engine for pulling the economy out of a recession.



Credit Spread (10 year)

The Credit Spread (U.S. Treasuries vs. Corporates), a good measure of fear, reached a twelve month low in September 2009 at 132 basis points having contracted during the third quarter. Over the past year spreads had moved to as wide as 361 basis points during the credit crises.

Junk Spread (10 year)

The Junk Spread (U.S. Treasuries vs. High Yield Corporates), a good measure of risk premium or the amount of additional return necessary to accept significant default risk, reached a twelve month low of 444 basis points near the end of the third quarter. Since the peak in spreads at 1116 basis points in December of 2008 spreads have moved back toward historical norms.

Municipal Spread (10 year)

The Municipal Spread (U.S. Treasuries vs. Municipals) has been bouncing back and forth between positive and negative territory this quarter currently at a positive 32 basis points. After the meltdown in 2008 it shot to a high of

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240 basis points in mid-December. Since then it has dropped precipitously to as low as -42 basis points as fears of potential municipal bankruptcies have been assuaged by the Federal stimulus and early market recovery.

TIPS Spread (10 year)

The TIPS Spread (U.S. Treasuries vs. TIPS), a good indication of inflation expectations, was at a high of 210 basis points in June of 2009. Over the past twelve months we have seen it go negative during the market downturn and then recover in early 2009. Now standing at 180 basis points, TIPS are still reflecting moderate inflation expectations.

WEALTH MANAGEMENT CORNER

Private investors should be aware that a new opportunity exists in 2010 that would allow an individual, with over \$100,000 in modified adjusted gross income, to convert an existing traditional tax deferred IRA to a tax free Roth IRA. Up till now, this option was available only to individuals making less than \$100,000. This means that higher income individuals (Schwab recommends those with income of \$100,000 to \$250,000) can choose to make this conversion. By taking advantage of this program, your assets will be in a vehicle where they can accumulate, appreciate and be withdrawn tax free. There is, of course, the need to pay the tax that is due when funds are converted to the Roth IRA. Thereafter, however, a more flexible, less restrictive, vehicle will be available. A Roth conversion is best suited for investors who meet the following criteria:

- Likely to be in the same tax bracket or higher in the future
- Will not need to withdraw the money for ten years
- Have cash on hand to pay the income taxes due at the time of the conversion

In addition, a conversion to a Roth IRA is a good estate planning tool as the taxes will be paid by you and your heirs will have access to the funds on a tax free basis, over their lifetimes, without minimum distribution requirements.

If you have an interest in developing this strategy further, you should consult with your tax advisor and contact the Ridge office for a more detailed discussion and the development of a specific conversion plan.

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