



Answering Your Questions May 20, 2009

A few of our friends and clients have been asking specific questions on our views of the market in recent days. We thought we'd share our responses.

1.) Given the market correction, do you perceive securities and other market instruments are at bargain prices? If so, where are the bargains?

From a statistical point of view the market doesn't look cheap, but that assessment is based on cyclical lows in earnings estimates which will work their way higher over time. The 666 low on the S&P 500 in March was likely discounting an environment of rampant bankruptcy while now, after a strong run, it may simply be discounting a "less bad" scenario.

There are bargains if you are willing to look out two to three years, where gains could be significant from here. Right now, we are most interested in later stage cyclical stocks in the materials, energy and industrial sectors. As the recovery gains traction, the recent out performance of early cycle plays in the financial and consumer discretionary sectors should begin to fade just as the economy shifts to second gear and these later stage cyclicals begin to shine.

Consumer staples stocks are clearly in the bargain bin, but theory suggests the area may face performance headwinds as money flows into areas more leveraged to economic improvement. We believe, however, that this theory may be put to the test in this cycle as consumer staples stocks could be unique beneficiaries of a weakening dollar in the face of relative strength overseas.

2.) Given the significant impact of the economic outlook (perceived or real) on the markets, what is your perspective on the state of the economy?

We are seeing signs that things have stabilized, a sentiment shared by many corporate managements during this earnings season. At some point, however, the markets will need more than "less bad" results to make additional progress. But "less bad" is an important first step. Having been through a hurricane, companies can now assess the damage and begin the rebuilding process on firmer ground rather than sand that may still be shifting.

Sentiment plays a huge role in determining the state of the economy in the extreme short run. After a nice bounce, moods are understandably better across many measures of consumer sentiment, but it remains fragile. Investor

sentiment, on the other hand, remains bearish by historical standards, rivaling lows only seen once in the last forty years of bear market rallies. While a 10-20% pullback from here wouldn't be unprecedented, it is doubtful that we'll revisit the old lows in the face of such bearish sentiment. Bull markets invariably climb a wall of worry and we still have far more worry than jubilee.

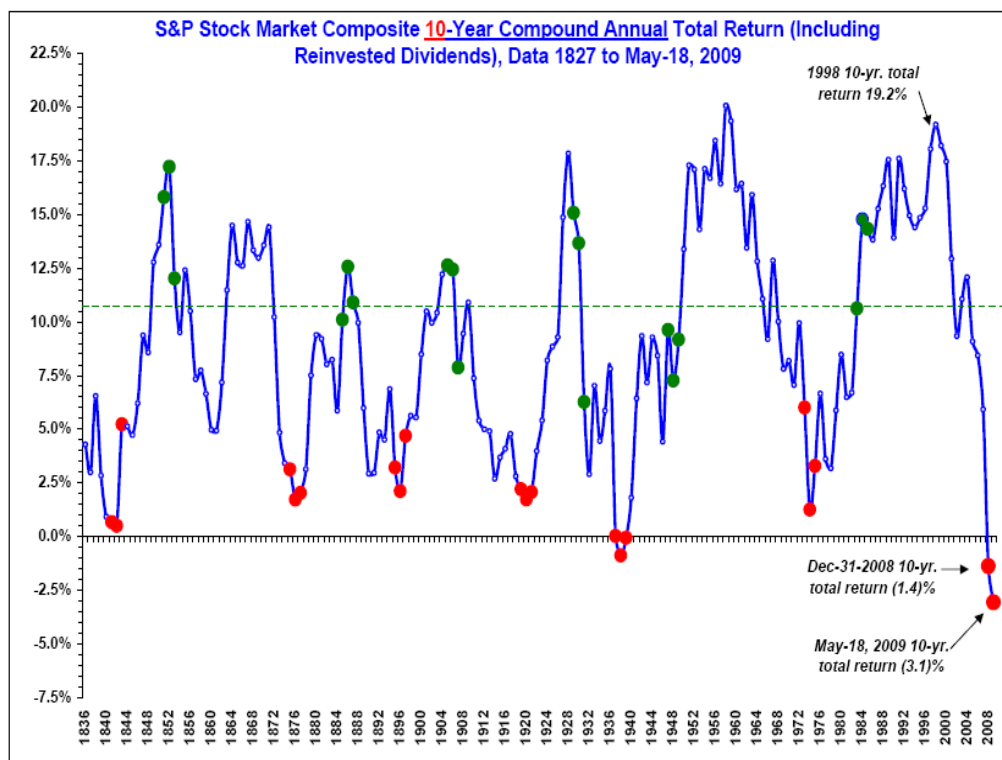
On the political front, conservatives are up in arms over the rise of big government, but liberals aren't entirely to blame as the trend clearly started during President Bush's last year in office. While I am conservative, I believe the minority party is beginning to sound fatalistic, which has dangers of its own. Things aren't likely to be nearly as bad as the extremes of either party might suggest, even though these voices will always be the loudest.

We'll get through this; we always do.

3.) What is your recovery plan to address these historically low returns?

Ten year rolling average rates of returns on large cap stocks have never been as low as they are today even going back to the Great Depression.

Unless this is really the end of the world, forward ten year rates of return could have significant upside. Today's prices may be an incredibly compelling buying opportunity for today's long term investors.



I would also note that "buy and hold" investing is now disdained worldwide. Even Warren Buffet has taken shots lately. Ditto with the "it's different this time mantra". I hear alot of that these days.

When an investing style or economic sector becomes universally loved or despised, an impending inflection point is often close at hand. History teaches that it can pay to go against the grain during points of both maximum pessimism and maximum greed. The key lies in finding the courage to act.

4.) What single most significant change have you made to your own personal investment philosophy and how have you incorporated this change, or will you incorporate this change, in your personal investments?

After the tech wreck earlier in the decade, we adopted a selling discipline which we compared to caring for a garden. Regular pruning, weeding and transplanting of investment holdings based on relative performance criteria and changing economic seasons has served us well.

More recently, we've recognized that the greatest gains in the portfolio have tended to come from the names that are most universally out of favor, a characteristic that may be unique to extreme environments. This has caused us to take a closer look at similar areas of opportunity, not only within the portfolio, but outside of it as well.

Every morning, we review the performance of our holdings on a year to date basis and off the lows in both November and March. We've been quicker to prune gains, but have also been quicker to hold or add to names under pressure.

Historically, we've invested in bonds when clients need income or would like to achieve some level of downside protection. Since corporate bonds don't usually provide downside protection, we've tended to stick with government debt when fixed exposure in a portfolio is desired.

Given the recent downturn, I would be more inclined to have a fixed income component in almost any portfolio, including my own. Hundred year floods do occur and one must have the liquidity to survive. You also can't take advantage of buying low if you have nothing to sell high.

5.) This rally seems crazy and has nothing to do with earnings. What am I missing?

While it may be true that "less bad" isn't the same as "good" it is still an important first step in the healing process. As mentioned in our answer to question two, First Call earnings estimates have been trending up for the first time in quite awhile.

It is important to recognize that the market discounts improvements in earnings ahead of their actual occurrence just as it discounts deteriorating earnings ahead of their actual occurrence. There are certainly false positives on both sides, but in

all cases, stocks end up moving up or down in advance of the fundamentals. In this sense, there is nothing unusual about the current situation even though it may seem disjointed.

In our last update, we closed with a comment on religious faith, defined as being sure of what one hopes for and certain of what one cannot see. The greatest blessings often come to those who move ahead of the crowd, when the evidence for such belief isn't always clear. Investing may be similar.

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