Economic Update

Broadleaf Partners, LLC

Changing Seasons
March 11, 2010

Two months ago, we published an update titled Shifting Gears. In that update, we emphasized our conviction in the durability of the current recovery and our view that the economy would likely shift gears as 2010 progressed. Generally speaking, we've had the view that the economy will be stronger than the stock market in 2010, which is the exact opposite of what occurred last year.

What we did not discuss is what this might mean from a portfolio strategy perspective. In client portfolios, we have been shifting gears a little more actively in anticipation of changing economic seasons.

Those that have followed our firm know that we compare our selling discipline to taking care of a garden. Weeding out bad stocks, pruning healthy ones, and transplanting names as seasons change are all necessary to maintain the vitality of the overall portfolio.

I would emphasize that these changes aren't indicative of a shift in our bullish stance, but simply a recognition that certain economic sectors tend to do better than others during different stages of the economic cycle. With the engine revving at the red line after an incredible acceleration off year ago lows, it is now time to downshift, grab the next gear, and experience a different kind of torque.

We generally categorize the stages of the economic cycle in four basic buckets - early expansion and recovery (accelerating growth), late expansion (normal growth), early contraction (soft landing), and late contraction (recession.) While all economic cycles don't necessarily include all four stages, they often do.

Since March 9, 2009, a tad more than a year ago, the economy began what we can now safely label its early expansion or recovery stage. In the most recent quarter, gross domestic product grew nearly 6%, a significant improvement from last year at this time when it was declining at a similar rate and it felt like we were in a spiraling free fall. As is often the case, the stock market moved well in advance of improving economic news, and the S&P 500 is now up 72% from its lows, with most of the gains coming in the earlier months of the recovery. (The Broadleaf Growth Equity portfolio is up 90% over the same time period. [i])

We now believe that the economy is moving past its early recovery phase and into its late expansion mode where growth still occurs, but at a slower and more sustainable pace. How long this phase of the cycle lasts and at what rate of growth it settles is subject to considerable debate, but generally speaking, stock market gains tend to follow a similar trend of moderation.

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We would be the first to point to easier monetary policy as a significant factor in turning the economy around one year ago. With many worldwide economies now back on track, several international monetary policy boards have already started to raise rates to keep inflation from becoming a problem. It is not unreasonable to expect the Fed to eventually follow suit.

What is different about our Fed, however, is its dual mandate. Not only is the Fed accountable to price stability, but it must also act in a manner conducive to full employment. Our Fed has likely been slower to reverse course as compared to its global counterparts because of this dual mandate.

With the unemployment rate now officially ticking down from its highs in the 10% vicinity, the likelihood of a reversal in Fed policy measures increases as the voice of inflation hawks grow in relation to those most concerned about jobs. What constitutes "full employment" is subject to considerable debate, but given the recent change in trend, the likelihood that we're now moving on a path towards "fuller" employment seems more likely than one in the other direction.

I would reiterate, however, that just because the Fed starts raising rates, doesn't necessarily imply that the stock market will quickly fall apart. As we wrote in our last update, Fun with Charts, history suggests that a stable pattern of economic growth tends to have a greater influence over stock market returns than Fed policy moves during later stages of an expansion. While the stock market may pause as it digests the change in policy direction, the durability of economic growth will likely play the greater role in determining the medium term outlook for the stock market.

We are well aware that no two economic cycles are the same; each one has its own nuances and yet at the end of the day, most still rhyme. In this recent version of the nursery tale, the recovery appears textbook, while the downturn was not. The verdict is still out on how powerful and durable the last two stages will be. We know that growth will slow to a more sustainable pace, but we don't know what that pace will be. Two, three, or four percent? Only time will tell.

To prepare for the change in economic seasons, we have slowly and steadily been pruning the gains we've enjoyed from the sectors that did the best during the economy's bleakest winter months and have been transplanting seeds to those areas most likely to thrive as summer arrives.

Summer, as any Ohioan would care to admit, can't come soon enough.

Kindest Regards,

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[i] *Portfolio performance reflects Broadleaf's Growth Equity Composite at the one year anniversary of the market bottom 3/9/09. All figures are shown net of actual fees. Any assumed fees have been calculated on a pro forma basis, reflecting the highest fee levels that Broadleaf would charge clients per our disclosures in Part II of our Form ADV.*

Results reflect the actual performance of Broadleaf's Growth Equity Composite. Performance data is shown net of advisory fees and trading costs. Broadleaf may charge different advisory fees to clients based on several factors, but primarily based on the size of a client's account. Broadleaf's basic fee schedule is available on its Form ADV, Part II. Results reflect the reinvestment of dividends and distributions, if any. Leverage has not been utilized. The U.S. Dollar is the currency used to express performance.

Broadleaf's Growth Equity Composite includes all fully discretionary accounts utilizing our growth equity style of investing, with a minimum initial account size of $100,000. (Prior to 6/30/2009, the minimum account size necessary for composite inclusion had been $250,000. Historical results have not been updated retroactively to reflect this change, but will reflect the change from 6/30/09 forward.) To be included in the composite, an account must have been under management for at least one full quarter. If a significant cash flow in an underlying composite account during the quarter causes it to deviate from our intended growth style, we will remove the account for the period in which the significant cash event occurred. A significant cash flow is currently defined as 10% or more.

Total firm assets at quarter end were $60.5 million. Prior to January 5th, 2005 the firm did not have any investment advisory clients. As a result, composite data prior to March 31st, 2006 only reflects the performance of Doug MacKay's personal retirement account.

The S&P 500 Index has been used for comparative benchmark purposes because the goal of the stated strategy is to provide equity-like returns. The S&P 500 is a broad based index reflecting the performance of the equity market in general. The stated S&P 500 return includes dividends. While we believe the S&P 500 is an appropriate benchmark to use for comparison purposes, it should be expected that the volatility of the Broadleaf Growth Equity Portfolio may be higher due to its concentrated nature.

The performance period highlighted reflects a period of only one year for both our portfolio and the index, following a period when the markets were under extreme duress. This period of time chosen is entirely atypical and has only been shown to illustrate the magnitude of the rebound. Such performance is not sustainable. You are further cautioned that information concerning comparative performance over this period of time may bear no relationship whatsoever to performance over a longer period. This information should not be regarded as in anyway representing the likely future performance of the portfolio in absolute terms or in comparison to the indices. Investment in securities, including mutual funds, involves risk of loss. Past performance is no guarantee of future returns.

Broadleaf Partners, LLC is registered with the SEC as an investment advisor. The firm maintains a complete list and description of composites, which is available upon request.