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The following contains a brief discussion from our Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane. Mr. Crane offers some insight on the equity markets.

MARKET OVERVIEW

In our Market Perspective this past February, we lamented the bear market we were experiencing, but in our outlook we tried to gauge what could go right. Our outlook proved fitting. It is important to remember that equity markets are leading indicators, but that they also tend to overshoot reality at both optimistic and pessimistic extremes. The first few months of 2009 were examples of each phenomenon.

The economic reality was bad — growing unemployment, a lack of credit available to consumers and businesses, and plunging confidence — but the selling pressure and sentiment on Wall Street were even worse. Even some of the most stable, long-term investors were shaken out of the market. In a word: capitulation. And with it came a bubble in low-risk or risk-free assets, like cash and U.S. Treasuries.

Market bottoms require capitulation, but they also require incremental good news, or sometimes just news that is less bad. In March and April, corporate earnings were not as grim as most had expected. In fact, because many companies cut costs and were managed for a severe slow down, sales figures were down, but profitability did not necessarily suffer.

Better than expected corporate earnings, combined with incrementally less bad economic news and an oversold market set the stage for an impressive rally. From the March 9 lows through June 30, 2009, the S&P 500 was up 36.88%. Consumer Discretionary, arguably the sector with the most negative sentiment early on, quickly became the best performing as Wall St. realized the world wasn't coming to an end.

OUTLOOK

It is easy to draw parallels and compare market cycles and business cycles, and those comparisons are a worthwhile exercise. The belief is that if you are able to determine where we are in the cycle, then there is an unofficial, unwritten playbook upon which portfolio managers rely. The textbook solution is to buy defensive stocks like Healthcare and Utilities as the economy weakens, then as the business cycle turns more positive, one should shift into early cyclical stocks such as Transports and Consumer Discretionary, and so on.

Rather than refer to the cliché, "it's different this time," I would propose that it's different every time. The challenge is to figure out *how* it's different. The depth and the duration of this recession have been more severe than any in recent history, and it is reasonable to assume that our recovery won't necessarily unfold in the same manner either.

While a resumption in consumer spending has bailed us out of economic slowdowns in the past, this time it is not likely to return to the same levels. That is OK. The U.S. savings rate has been anemic for years, as we were collectively consuming beyond our means. The long-term outcome is perhaps a healthier consumer, but our economy's bounce back may not be quite as dramatic.

Oftentimes, the solution to one economic crisis leads to the creation of the next. The unprecedented fiscal stimulus and subsequent budget deficit are due to become the next economic burden. The massive government spending

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could also lead to inflation. As the market begins to worry about inflation, interest rates will trend higher — as they already have. With the government's burgeoning debt, the costs to finance it will only grow.

That being said, Q1 2009 results revealed a surprise. The seriousness of the economic slowdown had been heavily advertised and broadcast. While that in itself surely contributed to its magnitude, it also caused companies to prepare for it. Reductions in headcount, expenses, inventory and the like enabled many companies to maintain very healthy levels of profitability. Our belief is that from a macro economic standpoint the worst is behind us, but that there will be struggles ahead. Those struggles may serve as a cloud over equity markets. But we also believe that there will be bright spots. The best managed companies, the market leaders, those with a competitive edge should continue to grow, and in some cases take market share as weaker competitors fall by the wayside. As a result, we believe that investment strategies that seek high quality growth companies should excel.

To the average person this distinction might sound contradictory, but as portfolio managers, much of our job is differentiating between *good companies* and *good stocks*. Sometimes those that are regarded as the "best" companies won't necessarily have the best performing stocks, usually because their stock price already reflects all the good fundamentals. In fact, there are times when the "worst" companies — those with shrinking businesses, on the verge of bankruptcy, and so on — can be top performers because their stocks had been massively oversold. However, we believe that time tends to diminish this spread. In the short run, bad companies can be good stocks, but eventually, quality wins. As you know, we focus our efforts on those higher quality companies, and in particular the ones that are growing the fastest.

I believe there are two relevant points to be made. First, an analogy: just as there can be a good stock where there may not be a good company, there can be a good stock market where there is a weak economy. Companies that have prepared themselves for a slower economy and tighter credit should outperform, and may benefit from gaining ground against weaker competitors.

Second, in March and April we saw a dramatic low quality bounce, as the companies that were hardest hit on the way down saw more relief in percentage terms. We believe that phenomenon is not sustainable. Now that the market has bounced, and hopefully put in a bottom, the next focus will be on asking "what next?" The answer may be in finding companies that can actually generate organic revenue growth. The market does not have the luxury of a global growth tailwind. Achieving real growth will be difficult, but for those that are able to do so, there will likely be great rewards.

Ryan Edward Crane

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