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Financial Market Commentary 1st Quarter 2009

Summary

April 22, 2009

The first ten weeks of 2009 were about as bad an opening to a year as investors have ever experienced. The S&P 500 was down more than 24% at the close on March 9th, and investor sentiment was awful. The government reported a 6.2% decline in GDP during the 4th quarter of 2008, the worst quarterly contraction since the Depression. Few expect the 1st quarter of 2009 to be much better. All of this produced the intense fear we started to see at the end of February. As is often the case, however, when investors are feeling the worst the bottom is very close. The combination of a slight improvement in retail sales and the government's financial and regulatory assistance to the banking sector produced a nice rally that has continued in to April.

That said all of the major averages declined last quarter. The S&P 500 Index fell 11.0%, the Dow Jones Industrial Average plunged -12.5%, and the NASDAQ Composite was down a modest -3.1%. The Russell 2000 small company index did the worst, losing -14.9%. International markets were even more unkind to dollar-based investors; the EAFE index was lower by -14.6%. In terms of sectors, only precious metals gained. Health care and technology didn't lose much, in fact the latter vaulted into positive territory April 2nd. On the other hand, financial and industrial stocks continued to struggle. The real estate sector was by far the worst performing sector, losing a staggering -29%.

Bonds managed to eke out a small gain (0.1%) on average. Efforts to stimulate the economy created inflation fears, increasing the appeal of inflation-protected treasury securities (TIPs). There was also somewhat of a rally in the higher risk corporate bonds that lost so much in 2008. Rising interest rates made long-term treasury bonds (2008's best performing sector) last quarter's worst sector of the bond market. International bonds declined as the dollar rebounded.

Activity

We continued the process of making portfolios more conservative while raising the income component of portfolios such that they can recover quicker in an environment where stocks tend to struggle. With the economy recording GDP declines it hasn't seen in over 70 years, we don't feel that we can depend on capital appreciation. This strategy change involved reducing the overall weighting in stocks and using mutual funds that employ cash as part of their investment strategy. We have also started to use a managed futures fund in some portfolios because they have very little correlation to the stock market. Also, we have hedged our most conservative portfolios by putting a modest

allocation into the Federated Prudent Bear fund, which actually rises when the stock market falls (note that these last two strategies are only available at TD Ameritrade). For more aggressive investors, we made adjustments within our stock and bond positions to increase exposure to better performing sectors such as high yield. Our move into high-yielding oil & gas tanker stocks has also been successful. These moves have enabled us to post significantly lower losses than might have been expected given the performance of both the domestic and international stock indices.

Performance

Our flagship CSFC Balanced Model Portfolio declined a little more than -4% in the first quarter of 2009 Vs. the Standard & Poors loss of -11%. We continue to see the positive impact of the changes we made in your portfolios last October. While we are pleased that our loss ratio is approximately one-third of the S&P 500 losses we continue to strive towards positive returns!

Outlook

The Federal Reserve, Congress, and the Obama Administration have a tough choice right now. If they allow banks and other financial institutions that have made very poor decisions to fail, they run the risk of a significant deflationary contraction. Alternatively if they come to their rescue with the cash necessary to preserve and restore those companies they saddle taxpayers with a huge bill (and worse, allow those most responsible for the mess we are in to largely escape any consequences). We started the quarter talking about holding people responsible, but the markets clearly did not like that. When government focus shifted from “who’s to blame?” to “how much do you need?” stocks certainly responded, but we are not comfortable that this decision is good in the long-term. If one of my children wrecks my car, do I run right out and buy them a new one to drive? The powers-that-be have a delicate balancing act to perform and there are going to be times that they need to disappoint the markets. That fact is one of the reasons why investors need to continue to be careful.

The bigger reason not to get carried away with this rally is that the underlying market assumption is that the nadir of the recession was in the January-February time period, and we are going to see the rate of decline slow until the fourth quarter whereupon the economy is going to show positive growth again. The problems with that assumption are two-fold. It is one thing to presume you are going to transition to recovery within a year if the economy is only barely contracting. For example, during the 1990 recession we never saw GDP contract more than -3.0% (4th Q-90) on a quarterly basis. During the 2000 – 2001 recessions we never saw GDP contract more than -1.4% (3rd Q-01) on a quarterly basis. Contrast that with the -6.2% GDP fall during 4th Q-08.

Secondly, the term recession implies a cyclical imbalance of resources, labor, and/or credit. As such, recessions are usually “fixed” within a couple of quarters by alleviating the imbalance and then lowering interest rates. On the other hand, when speculative markets collapse (as has just happened on a global

scale) even interest rates near zero tend to have limited effect. Japan has still not recovered from the bursting of its stock and real estate bubble in the late 1980s despite interest rates less than 1%. If consumers have high debt levels and they do not have either income growth or asset growth to help them manage that debt, they can't increase spending no matter how low rates are. In other words, this isn't a recession.

The bottom line is that we believe we are going to trade in a range that is well below the 2007 market highs for quite some time. There will be occasional rallies and occasional sell-offs as investors get encouraged about the prospects for recovery and then are disappointed as economic activity fails to live up to those hopes. We are very close to the center of the range between where the banking crisis became acute in early October and the height of Depression fears in March. That seems about right.

Commentary

The last seven months have been one of the toughest stretches today's investors have ever had to go through. Prices have swung wildly, but mostly to the downside. At times investors have been left wondering if there was any investment left that could be counted on. It has been a very stern test of our psychological fitness to be investors, and it revealed to some that they were more suited to being savers –that is, to accepting a lower fixed return in exchange for the knowledge that their principal was guaranteed. After all, investing involves foregoing that guarantee on the hopes that you can earn a higher return through appreciation and/or a higher dividend. Both approaches involve risk. Investors risk loss of principal, while savers risk loss of opportunity and potential purchasing power due to inflation.

We believe that one of the big reasons some people fare poorly as investors is that they equate value (what something is worth) with price (what it is selling for right now). Price can be extremely volatile, while value is usually not. For example, if the price of your home declines by 35%, you don't think to yourself that you better sell it before it becomes worthless. You know your home is never going to be worthless because there is value in its ability to provide shelter, comfort, entertainment, etc. that others would be willing to pay for. Yet last month more than one person was of the opinion that bonds and stocks were soon going to be worthless! It was as though an art collector discovered one of her paintings was a forgery and began to fear that they all were. What we are saying is that there is inherent value in stocks and a bond which makes them much more like a home than a piece of artwork. Bonds are an obligation of the issuer. In the worst case (bankruptcy), bondholders are creditors and have a claim on the assets of the issuer.

Stocks carry more risk because they are not obligations, but they represent the physical assets of a company (including its cash, receivables, and marketable securities), its products and patents, and the knowledge and creativity of its employees. That is very seldom worth nothing.

Unfortunately, when people are unsure of the value of something, they tend to rely on price. Moreover, since a rising price in many areas (art, for example) implies quality and desirability and a falling price the opposite, we naturally tend to avoid things we cannot value that are falling in price.

Investing is therefore an act of faith that either you or the professional you hire to invest on your behalf has some understanding of the value of what you are invested in (note: there are those that buy and sell purely based upon the direction of the price. They are traders *not investors*). Great investors learn to embrace volatility because on those occasions when meaningfully price movement above or below their value present opportunity to either buy sell. It takes patience, fortitude, and humility to be an investor. Patience, because good decisions are almost never rewarded instantly; fortitude, because it is very difficult to hold your conviction when price is moving against you; and finally humility, because you are going to be wrong some times and you need to be able to take a loss and move on.

To be honest, very few investors have all of these attributes. For them there are three decent options: one, find someone you trust (in good and bad markets) to invest for you; two, index your investments and accept the return of the index (however good or bad that might be); three, accept your limitations and become a saver (which is ultimately a lot cheaper than pretending you can handle volatility when you can't). At Capital Strategies we believe we are good investors. What we are especially proficient at, however, is evaluating other investment managers. We can identify great mutual fund managers and then put together a diversified portfolio where each sector is managed by the most skilled managers available. Furthermore, we are able to help you, as our clients make the tough, non-emotional portfolio decisions that most investors have trouble with during periods of euphoria or fear. There is nothing wrong with being a saver if you cannot tolerate the volatility inherent in the stock and bond markets. **You just don't want to make that decision at the bottom of the market.**

We are grateful that you have placed your trust in us. We will continue to work very hard to determine the value in the investments we make for you. This is not to say we won't occasionally be wrong, or that the markets won't test our patience and fortitude as well. We believe that our track record has shown that we can continue to be effective investment managers on your behalf. We will continue to preserve value first and grow your portfolios second. We have reduced the risk in your portfolios and will continue to do until the risk-reward trade-off is favorable.

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