MISSION®
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY

Second Quarter 2009

Investors experienced a feeling of whiplash in the second quarter. Equity markets that were pummeled in the first quarter came roaring back in the second. As measured by the S&P 500, common stocks rose by 15.9% in the June quarter after falling by 11% in the prior period. Nonetheless, the key equity index was down 26.2% from its level of June 2008.

Bonds exhibited similar patterns but over slightly different time frames. Long U.S. Treasury bonds, which were up a powerful 23% in the second half of 2008, retreated by 12.3% in the first half of 2009. Junk bonds, on the other hand, having plunged by 25.2% over the final two quarters in 2008, roared back by 30.4% in this year's first half. To demonstrate the return of risk appetites, one need only examine the performance of the worst of the worst. Bonds of companies with one foot scarcely out of bankruptcy were the best performers in recent months, experiencing bounces of over 50% from their former decimated values. Such gargantuan rallies notwithstanding, most investment assets remain far below their values of just two years ago.

Fear of massive losses has quickly morphed into fear of being left behind by rallying markets, especially in the riskiest sectors. Much of the fault for this phenomenon lies with the consulting fraternity who led clients away from the concept of investing and toward the process of benchmarking. As a result, increasing numbers of investment managers have abandoned traditional, more patient investment approaches in the quest for quarterly performance. Consequently, many impatient investors have abdicated the search for real, absolute value. Even during periods of severe overvaluation, managers settle for what they consider attractive *relative* value resulting in the vast majority of investors and investment managers remaining relatively fully invested at all times.

At Mission, we have argued against the practice of benchmarking and buy and hold investing for decades. This first decade of the new century has provided compelling evidence in support of our approach. With just six months remaining in the first decade, most stocks show negative returns for the century-to-date. A fifty-fifty stock/bond mix would be up about 20% cumulatively from January 1, 2000. In the same time period, our clients for whom we have complete asset allocation responsibility have earned about 60% before fees. (Fees vary based on portfolio size.) While we have largely avoided the effects of this decade's two major bear markets, we have found enough investments with positive returns to outperform almost all managers in a very difficult environment.

While we did buy a few stocks near the March market bottom, in retrospect we did not find enough in light of the second quarter's strength. Instead we used the quarter's rally to sell a number of stocks that had deteriorated fundamentally in the preceding few months and which we had earmarked for sale on an anticipated bounce-back. We are left with a minimal equity position, which will cost us short-term performance if the second quarter rally persists.

Earlier in the year we indicated in our seminars and writings that we anticipated a strong rally this year but that we had no strong feelings about when or at what level it would commence. Because we believed there to be a reasonable possibility of a major market meltdown should monetary authorities lose control of investor confidence, we were more cautious than usual, in hindsight a judgment error. It's important to remember, however, that this is a probability business, not a certainty business, and one can never afford to be heavily exposed to a true market meltdown.

Where does that leave us today? We are somewhat agnostic about whether the second quarter rally will continue well into the latter half of the year. Much may depend upon the government and monetary authorities' ability to boost and maintain investor and consumer confidence. The jury is certainly out on that point.

From a fundamental perspective, the equity market is not cheap. Price to book value, price to dividends and most other valuation measures are well below the extremes of the past decade, albeit still above normal. Because of massive write-downs in the fourth quarter of 2008, corporate earnings for the past year are negligible, and the S&P price to earnings ratio is off the charts. While there is ample talk of "green shoots" and other hopeful signs, no one really knows when earnings will begin to grow steadily. Even if the Standard & Poor's forecasts for earnings prove accurate -- and most earnings estimates now are guesses -- the price to earnings ratio at year-end 2009 will be in the 30's. That's extremely expensive.

Of course, we have no way of knowing how the domestic and world economies will progress. The government is attempting to rescue major institutions, forestall the logical consequences of the greatest real estate collapse in more than 70 years and simultaneously stimulate the bullish instincts of both consumers and investors. While it is unknowable whether they will ultimately be successful, success is far from a sure thing.

When stocks are historically expensive, and economic prospects are murky at best, any stock market rally, especially one already up by 40% from its lows, falls in the high risk category. Rallies, of course, can take on lives of their own and can last as long as investor enthusiasm is sustained. Such price gains may, however, be taken back very quickly if insufficient fundamental support undercuts that investor enthusiasm. Consequently, we are not chasing this rally, and we expect eventually to be able to add stocks with growing earnings at attractive prices.

In the meantime, we found a profitable opportunity in the fixed income market. Despite historically high spreads of corporate and municipal yield over U.S. Treasuries, we have resisted that temptation. We expect a series of high profile defaults in both the corporate and municipal markets, which may lead to a further expansion of spreads. We're keeping our powder dry in those areas for now. We did, however, take advantage of the rapid run-up in rates on 10 year U.S. Treasury notes. In early June we purchased that bond for our fixed income and controlled-risk, strategic allocation clients at a yield of 3.98% after it had risen from 2.08% just six months earlier. We had no predetermined time frame for the trade, but we anticipated that a normal correction from that rapid rise would see the yield drop back into the 3.25% to 3.50% range. If it took place in a six to eighteen month time frame, we would earn a high single digit to low double digit return. Befitting the volatility that has characterized many markets recently, it happened much faster than we had anticipated, and we closed the transaction just four weeks later in early July at 3.33%. (Remember that prices and yields move inversely, and that as yields decline prices rise.)

As markets move into the second half of 2009, our clients' portfolios are up comfortably for the year to date, and we are in a very liquid, conservative position. That leaves us able to respond quickly and prudently to market environments that could change very rapidly and unpredictably. While there may be opportunities to make significant profits in the quarters and years ahead, there exists the very real potential to lose vast amounts of money over that same time period as well. As we continue to face a period of great economic stress, it is highly unpredictable how investors and markets will respond. We strongly urge investors to value absolute returns over relative returns and to build flexibility into their investment programs rather than to retain the fixed asset allocation, buy and hold approaches that have become so popular in recent decades.

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