SARGENT BICKHAM LAGUDIS

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Market Commentary and Review

"Alexander Hamilton started the U.S. Treasury with nothing, and that was the closest our country has ever been to being even." – Will Rogers

SUMMARY:

Nearly every asset class had high returns in 2009 – recovering from the historic fall in 2008.

The economy is recovering from recession, but is likely to grow slowly and unemployment will stay stubbornly high.

Earnings are expected to grow by 30% or more in 2010. Valuation is no longer cheap, but remains in the fair value range.

Inflation and interest rates will remain low this year.

Tax policy and planning is in chaos.

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Dear Clients and Friends,

It seemed more useful to let January pass before writing this letter. That way all the prognosticators have already prognosticated, and the coast is clear to make our own 2010 predictions. Plus, we have a month of data to work from. Pardon our tardiness. As usual, we begin by summarizing returns from previous periods:

	Jan 2010	1 Year ending 12/31/09	5 Years ending 12/31/09	10 Years ending 12/31/09
Large Cap U.S. Stocks	-3.6	26.4	2.0	-9.6
Mid Cap U.S. Stocks	-3.2	37.6	16.0	80.9
Small Cap U.S. Stocks	-3.1	25.9	6.2	23.9
Nasdaq 100	-6.5	54.7	16.8	-48.5
Foreign Stocks – Developed Countries	-5.1	27.0	17.3	61.1
US Bonds	1.4	5.9	25.8	80.0
Emerging Markets	-5.1	68.9	100.3	135.5
REITs	-5.4	30.5	-5.6	146.7
High Yield Bonds	0.2	37.6	24.3	64.0
Commodities	-7.9	20.1	10.2	50.9
SBL Alternative Assets Group (11 Fund Avg.)	-1.3	21.1	43.2	127.8
60/40 Balanced Index	-1.5	20.1	15.2	29.8
Gold	-1.3	24.0	145.0	373.4

** Returns are from ETFs/Index funds and sometimes averages of multiple funds with similar objectives. Will differ from other published index returns. 5 and 10 year returns are cumulative.*

This has been one of the most interesting and volatile 10 year periods on record; and one of the worst for large cap common stocks. As shown above, the S&P 500 lost 9.6% cumulatively. One analysis by a Yale professor concludes it was the worst decade in almost 200 years for stocks. Part of the reason for this is the arbitrariness of the calendar; but it nonetheless underscores the difficult environment over the last decade.

What happened over the last 10 years, and what can we learn from it to help us in the future? Read on and we will try and pass along what we have learned from this tumultuous decade.

It is easy to be confused today, for this is a complex time that is different than anything seen. We have never seen a financial and economic bust such as the one we just had. We have never had two great asset bubbles break in the same decade. Any forecaster that pretends to tell you with certainty what is going to happen should be ignored.

1999 ended two of the best decades in history for common stocks. Returns averaged over 18% for the 1980s and 1990s. In hindsight it is easy to see a bubble had formed. Even at the time there were many, including us, that recognized the technology bubble. Very few, however, could have predicted the degree that technology stocks would fall and take the rest of the economy with them. We believed the dot-com stocks could disappear and there would be little impact on the real economy. What we missed was the amount of "funny money" floating around that was making its way into real companies for advertising, mergers, and sales of equipment and services. In this period the funny money came from ridiculously priced IPOs.

The technology bubble led to overvaluation in nearly all stocks. The S&P 500 began the new decade priced at about 33 times earnings, so it was mathematically predictable that a reversion to the mean would lead to sub-par returns. Additionally, the attack on the World Trade Towers in September 2001 led to a real recession, and was the precursor to two wars – Iraq and Afghanistan.

Valuation is not only a math function; it is also a long-term sentiment indicator. As investors are confident in the future, they are willing to pay more for it. When they doubt the future, they will only pay for current earnings, but when they are confident they will look longer term. During the recession and lead up to the Iraq invasion, investors became increasingly cautious. By 2003, the market had fallen 50% from its peak and earnings had risen, so valuation had reached attractive levels. The P/E was down to 15x. The subsequent five years enjoyed relatively decent economic and earnings growth and the market rose in line with earnings.

But, the period will be remembered for the real estate bubble that grew out of both excessive liquidity and a lack of decent regulation. This bubble began unraveling late in 2007 but did not become a full fledged crisis until the fall of 2008. Once again, we recognized the real estate bubble long before it popped and avoided any investments that we thought might be affected. But again, we did not see the amount of funny money that had made its way into the economy. This time the funny money came from structured financial products tied to the housing market and was leveraged over and over again. The popping of the housing bubble was even more devastating because of its far reaching nature for both the financial system and the real economy.

So what are the main lessons from these two great financial disasters? First and foremost, keep your eye out for funny money. It has a way of distorting prices and economic activity. Second, do not underestimate the degree to which a small problem can become a bigger problem. Third, develop some guidelines to keep yourself grounded. Here are ours:

- The economy. Growing or not?
  - While there are many leading indicators to watch, monetary policy is possibly the most important.
- Earnings growth.
- Inflation and interest rates. Falling is generally good, rising is bad.
- Valuation.

This is why every week we go through the same routine at our investment committee and research and debate these four cornerstones. Let us look at each in turn.

The economy has now grown for two consecutive quarters*, and while this does not by itself define the end of the recession we believe we have exited the recession.* Housing indicators have improved, exports are benefiting from a weak dollar and strong growth in emerging markets, inventories have gotten to extremely low levels relative to sales and have to be re-stocked, and while the consumer is weak she is not completely dead.

Monetary policy is stimulative, and only $250 billion of the $750 billion stimulus bill has been spent. There is much criticism leveled at the Federal Reserve, the Administration, and the Congress, and some (but not all) is justified; but it is hard to believe the economy does not grow with all this money thrown at it.

On the other hand, with unemployment and underemployment at 10% - 20%, and consumers fully levered and undercapitalized, we cannot expect a robust recovery. Furthermore, the history of the banking crises is i) greater public indebtedness just as we are experiencing now; and ii) an extended period of sub-par economic growth and elevated unemployment. Finally, the banking system is no longer in critical condition, but banks are not making loans – no matter

what they are saying in the newspapers. Our conclusion is to expect a slow but growing economy.

Earnings will grow by 30% or more *in 2010 versus 2009.* Earnings estimates may be too high, but consensus earnings call for 2010 S&P 500 earnings of $75 versus $55 last year. And, early (too early in our opinion) estimates for 2011 call for another 20% growth in earnings. Earnings are critical. The experience of Japan warns that low interest rates are not enough to propel stock prices if the economy and earnings stagnate. In Japan, earnings collapsed during the past two decades and the stock market is still 75% below its 1989 peak.

Inflation and interest rates are a hotly debated topic currently. Most of our clients are concerned that the unprecedented liquidity by the Fed, and the spending by the government will inevitably lead to inflation. On the other hand, some economists argue that deflation is the more likely outcome. Their case is based on the history of over-indebtedness and major economic contractions. According to Lacy Hunt at Hoisington Investment Management, the trillions of dollars of monetary stimulus are being offset by the writing down of bad debts and declines in asset prices. The growth of the money supply over the last 12 months is only 3%, and has slowed to zero in the last six months. At this rate, it would be rational to expect GDP to fall and inflation to be quiescent.

We question this conclusion on one issue. We think money supply is low because banks are not lending, meaning the velocity of money is low. This could change and it may be difficult for the Fed to withdraw liquidity fast enough to stop an inflationary spike if velocity changes quickly.

Ultimately, we agree with the low inflation crowd. With unemployment at 10% and excess capacity everywhere in the world, we do not see generalized inflation. What we may see is something different, such as inflation in certain commodities that have supply constraints. Oil is the most obvious, but it might also include industrial metals such as steel, copper, or aluminum. There will also likely be a general decline in the dollar, especially against some of the emerging markets such as China. In this case, there will be import inflation.

Generally, long-term interest rates follow inflation. Therefore, we do not expect rising rates until inflation returns. However, we think there is a caveat. Investors require a risk premium for holding a long term asset. This risk premium includes not only the risk of inflation, but also the risk of default. While we think the risk of the U.S. Government defaulting is virtually zero, the perceived risk of default or of unsound monetary policy has increased. We would not be surprised, therefore, to see long term rates rise by 1/2% to 1%.

There is no simple and universally accepted way to value the stock market. *The Economist* magazine recently titled their magazine with "Bubble Warning" and went on to claim the market was 50% overvalued on the "best long term measure". Poppycock. There is no best long term measure. We love *The Economist,* but they missed the mark on this one.

The most commonly used measure of valuation is the price-earnings ratio. But this measure has many flaws. Should you use last year's earnings or next years? Operating earnings or reported earnings? Some analysts smooth the cyclicality of earnings by taking an average of the last 5 or 10 years. Then, there are other measures of valuation such as the ratio of prices to book value, the dividend discount model, and various yield comparisons between stocks and bond investments.

We ran into this problem early in this company's history. Many different analysts, all as smart as rocket scientists, came up with completely different answers from seemingly the same data. So, we developed our own model. It is not the most sophisticated, but it is consistently applied and we have used it for almost 20 years. It has been a useful tool, especially at market extremes.

The model compares P/E ratios on forward and trailing earnings to historical averages. It also uses a modified dividend discount model, and incorporates the Fed Model that compares the earnings yield on stocks to the yield on Treasury bonds. Finally, it adjusts for the level of interest rates and inflation, which have historically been the most important factor in the direction of the market. This model says today's market is fairly valued.

As stated above, the P/E ratio is the most commonly used measure, probably because it is the easiest to calculate and understand. We have printed the table in the past that shows that the lower the inflation rate, the higher the average P/E. The central tendency of the multiple should be around 16 – 19x. Today, the market is trading at 14x S&P 500 2010 earnings estimates. We believe this is reasonable given the economic uncertainties, and will even be cheap if the economy and earnings continue to grow in 2011.

Strategic Allocation Decisions

We began raising our equity weightings in the spring, again in August, and again in the 4th quarter. We now are targeting equities at 100% of normal long-term averages in our models. For bonds, we have moved to underweighted targets of 75% to 80% of normal. The Alternative Assets & Strategies Group is targeted at 6% to 13% for most clients. Each portfolio will differ, but we use models to guide our decisions. In addition to increasing equity allocations generally, we also moved to increase sectors more economically sensitive such as industrials, technology, and small and mid cap stocks. Anticipating the dollar will remain weak for some time, we also increased foreign mutual funds both in developed countries and emerging markets. These are all continuations of changes we began during the last six months of 2009.

The correction we witnessed in January has not changed our view. The market was overdue for a pullback from a technical standpoint. In fact, we predicted it in our newsletter last fall. We try not to let short term swings overly affect us. We will monitor market movements closely to glean any information we can from trends and relative strength of the market sectors.

U.S. Stocks

As previously discussed, our valuation model now shows the market at fair value. Interestingly, the best value can be found in the largest of the blue chip companies. The "Mega Caps", the top 50, have median P/Es of 14x vs. 15-16x for the next 2,950. We have recently (4th quarter) increased our small and mid cap holdings, but this was from significantly low levels. Blue chips still represent the majority of our U.S. holdings.

For simplification, we are combining the small and mid cap sectors for reporting. We still analyze mutual funds or other managers based on their more specific peer groups, but for allocation decisions we prefer the flexibility of moving within a broader category. Mid/Small caps are targeted at 5% to 12% for balanced portfolios.

We are re-introducing an "Opportunistic" category to our portfolios. Classifying assets and strategies is more art than science, and it is a process that continues to evolve. Our current goal is to separate more aggressive strategies that are highly correlated to the stock market from the Alternative Assets & Strategies Group.

Investment Grade Bonds

There is no change in our view about bonds. Returns last year were better for all categories of bonds than Treasuries. The U.S. Aggregate index was up 5.9% while the Treasury index was down 3.5%. Longer term Treasuries fared even worse, falling 21%.

Going forward we continue to expect sub-par returns from investment grade bonds. Yields are in the 3% to 5% range, and while we believe the Fed will keep interest rates low for the next six to twelve months, there are increasing risks of rising rates in the future. Rising rates causes bond prices to fall, so total returns over the next few years are likely to be in the low single digits. If the economy falters, or if there is another crisis, then high quality bonds will again do their job of providing safety, liquidity, and income; so they remain an important allocation for most of our clients. But, on a comparative basis we expect them to under-perform.

Alternative Assets Group:

Over the last 12 months this strategy returned between 16% and 20% in client accounts, depending on the exact mix and timing. On a risk adjusted basis, this has been an excellent strategy since we began defining it as a separate investment category in 2001. Cumulatively, since 2001 an unaudited composite of this strategy gained 51% versus only 0.7% for the S&P 500.

The focus of our investments in this strategy is likely to change in 2010. During 2008-2009 the allocation was used primarily as an alternative to equities, but this year it is serving as an alternative to bonds. We are changing the mix slightly, therefore, to target a lower risk profile.

There continues to be interesting new mutual funds created that replicate strategies previously only available to large institutions. One such strategy is called a beta replication fund. The idea is to capture the common risk factors or "betas" of a broad group of hedge funds by using futures contracts and other instruments. They are designed to provide investors with the diversification benefits of hedge funds with lower fees, liquidity, and more transparency – exactly what we are attempting with our strategy. For individual investors or institutions, it would usually require minimum investments of millions to access this strategy, but we can invest in an institutional mutual fund with an aggregate investment of $100,000. This is just one example of the products our clients have access to that they otherwise would not be able to invest in.

***Model Equity**: Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account closed the gap and beat the S&P 500 for 2009. It gained 28.1% vs. 26.4%. The 4th quarter saw an 8.4% gain vs. 6.0% for the S&P. We have now outperformed the S&P 500 in 6 of the 7 years since we began measuring performance in 2003, and the cumulative gain is 72.6% vs. 45.5%. An outperformance of 27.1%.

For the year, outperformance came from nearly every sector but especially from energy, utilities, and financials. Technology, up 48%, was nevertheless an underperforming group. The S&P technology sector was up 61%.

As we enter 2010 our positions are the same. We are positive on industrials and energy. We think a weak dollar will help companies with global sales. We also believe the demand for resources such as energy, food, and water will be an important investment theme for years to come.

Foreign Equities and Fixed Income:

According to *The Economist*, Europe will grow this year at 1.2%, Japan at 1.5%, and Canada at 2.4% - all slower than the U.S. The developing countries will grow much faster. China is estimated to grow at 8.6%, India at 6.3%, and Brazil at 3.8%. The U.S. estimated GDP growth is 2.7%. So, the emerging countries are more attractive from a growth point of view.

Further, according to The Leuthold Group, a quantitative research firm, the U.S. ranks 38th of 45 countries in terms of valuation. They use a weighted ranking of price-earnings, price-book, price-cash flow, and yield. We have less confidence in this ranking than if we did it ourselves, but we have not been able to find a reliable source of data for foreign markets over the years; and we have confidence in Leuthold's disciplined methodology.

Finally, they are more attractive from a debt point of view. According to PIMCO, the world's largest bond manager, the gross level of public and private debt is shown in the following table:

Country	2009 Total Debt (% of GDP)
India	129
Brazil	142
China	159
Canada	259
Germany	285
United States	300
United Kingdom	466
Japan	471

The conclusion is obvious, but comes with its own set of risks. Growth, leverage, and valuation is better outside the U.S. – especially in the emerging markets. But, developing markets are by definition undeveloped. That means there will be periodic negative surprises. Political and / or financial instability will occur. We will have to accept and try to manage the inherent additional volatility of these markets in order to capture their higher growth potential.

Financial Planning

We predicted in the last newsletter the next 16 months would likely be one of the most tumultuous for tax planning anyone has ever seen; and thus far we have been proven correct. We were shocked there was no compromise to extend the estate tax law, so we have entered 2010 with a 0% tax rate on estates. The problem is that few believe the law will remain the way it is. It is expected that Congress will re-write the law and make it retroactive to 1/1/10; but there are some who believe that is unconstitutional. What happens to those people (or more specifically, to their heirs) who died in January? How should they file?

Also, some estate plans may unintentionally disinherit a surviving spouse. It is common for married couples to use estate tax funding formulas in their estate plans to place the maximum amount of assets not subject to the estate tax into a Trust, often to benefit children. The remaining assets go to the surviving spouse. But this year, there is no limit on assets that pass to heirs, so all the client's assets might automatically move into the Trust and the surviving spouse would get nothing.

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The following table summarizes the past, present, and future of wealth transfer taxes as the law is currently written:

	2009	2010	2011
Estate tax exemption	$3.5M	-0-	$1M
Maximum tax rate	45%	0%	55%*
Gift tax exemption	$1M	$1M	$1M
Maximum gift tax rate	45%	35%	55%*
GST tax exemption	$3.5M	-0-	$1M
Maximum GST tax	45%	0%	55%

The problem is that nobody knows whether the law will be changed, and if so, when or how. We do not recommend you contact your lawyer to change your will... yet. Wait until we get something from Congress. If you are particularly worried about your situation, call or email Gary at Gary@SBLfinancial.com or Viktoria at Viki@SBLfinancial.com .

As we previously reported, there are changes to Roth IRAs this year that present opportunity for some clients. Gary has written a detailed paper on the topic to help clients determine if it is beneficial to them. If you are interested, please call Bailey and request a copy. It can also be viewed in the market news section of our website.

Company News:

Now in our third decade of serving clients, we finished 2009 very strong. Despite the wrenching bear market, SBL finished the year with more clients, more assets, and our staff intact. Our assets under management totaled about $700 million at year end, making us one of the largest independent wealth managers in Colorado. Brad Bickham, CFA, CFP® and Meagan D'Angelo, CFP® were listed as "Best Personal Wealth Managers" in the September issue of Denver's *5280* Magazine.

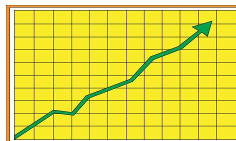
Bill Gross, the "Bond King" at PIMCO, wrote in his last newsletter: "If an investment manager and an investment management firm proved to be good stewards of capital markets during the turbulent but vapid 'aughts', they may be granted a license to navigate the rapids of the 'teens', a decade likely to be fed by the melting snows of debt deleveraging, offering life for unlevered emerging and developed economies, but risk and uncertainty for those overfed on a diet of financed-based consumption". That's a mouthful, but we would like to think our success is due to the discipline and hard work we have put into being good stewards of our clients' capital over the last decade; and we are determined to do an even better job over the next decade.

We would like to recognize our custodial partners, Schwab, Fidelity, and TD Ameritrade for their financial strength and quality of service to our clients during the crisis.

Within the company, we are happy Meagan has returned from maternity leave. And, during the 4th quarter we completed a business plan review that should put us on a solid footing for the future. We are committed to remaining an independent, profitable company that provides a valuable service to our clients, and is a rewarding place to work for our employees and principals. We have implemented a new profit sharing plan for employees, and are focused on bringing additional resources to provide the highest level of wealth management services to our clients.

We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow so we can keep adding resources to provide you with the best possible service and performance. If you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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