ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

January 2010

Economic Conditions & Market Outlook

The transition to a New Year is traditionally filled with individual resolutions and investment forecasts for the twelve months ahead. Both of these endeavors are about as equally unlikely to be accurate prognosticators of the actual outcomes that follow in the upcoming year. Case in point, the percentage of individuals who actually lost the ten pounds they resolved to lose last year is probably about the same as the percentage of Wall Street watchers who predicted last January that the Dow Jones Industrial Average would finish 2009 at 10,428, nearly 19% above the prior yearend's close. The S&P 500 Index registered a similar upside move, wrapping up the calendar year over 23% higher than where it started.

One shouldn't be too harsh on the mistaken market mavens since the first quarter of 2009 was anything but an illustrious start for the year to come, with both investor confidence and market uncertainty plummeting to new depths. Even by mid-year, the number of managers certain that a major market correction was forthcoming, with perhaps even a retest of the Dow's 6,547 low, was far more abundant and vocal than any dissenting voices suggesting that the equity markets might continue to plod upward throughout the remainder of the year.

Which market forecasters were right this time and which ones were wrong is somewhat immaterial because every scenario will have its fair share of each. The most important lesson investors should learn from last year's manic market is one that has remained consistent in our firm's ongoing investment strategy; specifically, that it is futile to attempt to accurately forecast future movements in the market given the vastness and variability of the potential influencers involved. A far better alternative than trying to predict where the markets might go is to manage money by vigilantly responding to invariably changing conditions in ways that incrementally enhance portfolio return and control portfolio risk relative to defined, quantifiable benchmarks.

We have diligently applied this active management approach since the inception of the firm in 1998 and it has consistently added significant upside value and downside risk control to client portfolios. Sadly, others have not been so fortunate. Despite the stock market suffering two monumental declines during the past ten years, many so-called experts still offer the same tired advice of "just riding it out, stocks will always come back". This is simply not true and we have unfortunately seen the disastrous impact of such misbegotten management.

While portfolio performance can vary notably based on the starting and ending date of the timeframe measured, the returns of equity indices during the past decade provide a stark illustration of this misplaced guidance. The Dow Jones Industrial Average entered the new millennium on January 1, 2000 with a value of 11,497 and ten years later closed at the 10,428 level noted above, a dismal -9.30% decline. However, that would have been stellar compared to the results earned by 'riding it out' in either the S&P 500 Index or NASDAQ Composite, which provided investors 'returns' of -24.10% and -44.24% for the ten year period. Translate those negative percentages into actual dollars lost and the life-changing impact becomes apparent.

Unfortunately, for many investors this delusion continues as less-than-forthright managers and fund purveyors pound their chests with seemingly stupendous one-year returns for calendar year 2009. To know the value of any investment return for any given period, it is critical to fully understand the context in which it was earned. For instance, while a portfolio gain of 43% may sound heady indeed; this is merely the return needed to simply break even from a 30% portfolio decline; slightly less than what the S&P 500 lost from September 30, 2008 to March 31, 2009, the worst of the recent market downturn. To represent the climb from the chasm you created as the total picture is disingenuous at best. Suffice to say, let the buyer beware…even more than the norm.

Most economists would readily admit that accurately predicting economic moves for any impending twelve month period is only slightly less perilous. While specific economic data and trends can provide a useful finger on the pulse of the economy's overall health, over-extrapolating individual econometric measures can be particularly risky during periods of economic transition, such as the current recovery from the so-called Great Recession. Likewise, the caveat that the economy and markets do not necessarily move in tandem has been oft-stated in previous *Investment Updates* and warrants mention again. Hesitant investors who remained on the sidelines waiting for clear-cut confirmation of an economic rebound learned that the hard way in 2009.

It is likely that mixed economic signals will remain the norm near term as the economy continues to regain its footing. On the positive side, recently released Commerce Department numbers showed factory orders rising in November at more than twice the expected rate and previously reported Commerce figures saw business inventories rising in October for the first time in 13 months. Both measures suggest that businesses suspect the nascent rebound in purchasing at both retail and corporate levels will grow. Many individual measures of economic activity should continue improving into early 2010, despite some doing so at a less than robust rate.

Housing and construction will continue to hopscotch their way toward eventual recovery but exactly when that will occur is anybody's guess. The stock market was buoyed mid-December when reports showed house construction and existing home sales rebounded more than expected in November and Commerce Department data showed increases in building permits, single-family home commitments, and apartment construction.

Yet, stocks stuttered earlier this week when information released by the National Association of Realtors appeared to contradict any hint of a turnaround by reporting that new house sales contracts dropped 16% from October to November, ending nine months of upward movement. Further review suggests that October's figures in this report were bloated by a rush of buyers looking to take advantage of the first-time homeowner tax credit before it was originally set to expire. This program's deadline was subsequently extended until Spring 2010, thus taking the pressure off new purchasers to act immediately but the market's initial response to seemingly negative news illustrates a general skepticism that the real estate corner has been turned.

Improvement on the employment front will continue to lag other indicators, which is no surprise. We have noted previously that by the time these numbers turn positive, the economy's overall recovery will have been well under way. As increases in production and inventory continue, jobs growth should inevitably follow.

A bigger concern is that the lack of a short-term jobs bounce will prompt poll-sensitive politicians to continue their stimulus spending spree unabated and potentially create even larger issues down the road via inflation and an ever-burgeoning federal deficit. Despite Federal Reserve Chairman Ben Bernanke's assurance that his hand is on the brake of the Fed's easy money engine to apply when needed, the political will of elected officials to tighten spending has been sorely lacking for years. We are less than optimistic that fiscal restraint will make a reappearance anytime soon given the current administration's expressed commitment to 'spend their way to prosperity'. In spite of having serious concerns about the government's unbridled largess, the problems that may result will be problems for a future day and do not weigh on our near-term investment decisions.

Despite the current lagging employment numbers, both The Conference Board's Consumer Confidence Index and the Reuters/University of Michigan Consumer Sentiment figures continued an upward trend in December. While consumer sentiment indices do not always correlate well with actual consumer spending; retail sales measures showed strong momentum through the months of October and November, with December 2009's results likely to meet or exceed earlier expectations. Even modest gains would be a notable improvement over 2008 when December's sales dropped 5.6 percent, making it the worst holiday season in more than 40 years.

At the macro level, the final rendition of third quarter 2009 gross domestic product (GDP) was released in the last weeks of December and registered economic growth of 2.2 percent; a downward revision from the original growth estimate for the period but still solid confirmation that economic expansion had returned after four consecutive quarters of contraction. Analysts suspect fourth quarter 2009 GDP will come in near 4.0 percent when it is first reported on January 29 but we would not be surprised to see an even higher number. The economy took a veritable roller coaster ride in 2009, with the first three months logging the worst quarterly slide in GDP (-6.4 percent) in twenty seven years. The fear of a global financial apocalypse that contributed to last year's massive first quarter decline is gone, so some bounce back is not out of the question.

Contributing to the likely uptick in fourth quarter GDP was strong export sales of U.S. goods to foreign consumers due to a weaker dollar. The dollar's valuation dropped through the latter part of 2009, making stocks and commodities increasingly more attractive investments. For several months the stock market's daily ups and downs appeared to move in the exact opposite direction to the dollar's value change for that day. This inverse correlation trend was finally broken mid-December when gains in stocks occurred even as the dollar's value rose. We see this continued de-linking as an important transition for equities moving forward, since an improving U.S. economy will eventually result in rising interest rates and a stronger dollar as well.

Some of the stock market's upward movement in latter 2009 was driven by the lack of appealing alternatives in other asset classes. For example, investment grade bonds had already bounced back to normal pricing ranges by mid-year, leaving investors with potential return opportunities limited to the modest yields being paid. Similarly, the term 'modest' would be an overstatement when describing current money market yields, which are a fraction of what they were twelve months prior. As expectations for a return on assets gradually eclipsed fears of a financial collapse, more investors developed a renewed appetite for risk and stocks were the primary benefactor. Since investor liquidity remains relatively high, we suspect that upward pricing pressure from money returning to equities will continue to aid the stock market in early 2010.

Based on historic norms, larger businesses also have plenty of cash in the coffers. Company owners are facing the same low yields as everyone else and will eventually be itchy to deploy some of those dollars in ways that will better benefit their company and its investors. As the business environment continues to improve, this corporate cash can be used to increase production, hire people, enhance technology, and make acquisitions. Less likely options at this stage of a recovery are increasing stock dividends or initiating stock buybacks.

After a relatively uninterrupted ride since last April, stock prices will likely be subject to some choppiness in the ensuing months. Some of this may come from profit taking or portfolio repositioning; some may come from reported earnings surprises that are either above or below expectation. At any point in time, there seems to be opinionated debate as to whether the stocks market is 'over' or 'under' valued. We tend to dismiss such global generalizations and focus our evaluation by adding the simple qualifier, "Compared to what?" In our view, a stock's current valuation is dependant on many factors but the relative price to earnings (P/E) ratio ranks up near the top. A report of solid corporate earnings growth during the early part of 2010 will be important for any stock to maintain forward momentum.

As noted previously, some observers have been calling for a stock market correction of 10 percent or more ever since the market bottomed in March 2009; with the advantage being that if you continually argue that the market is going to correct, eventually you will be right. While certainly not outside the realm of possibility, we do not believe significant price consolidation is necessary for stocks to continue their upward trend.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- The ***overall target level*** for portfolio allocations was formally moved up to ***one step below maximum equity*** during the month of ***September*** and remains there today. This was not a full-step increase since most portfolios had already experienced ***notable appreciation*** and were intentionally not rebalanced back to target level. Since then, several individual issues and/or funds have continued to appreciate to the point where either ***additional profits were taken*** or their ***percentage exposure was increased***. The firm's ***active asset allocation*** and ***disciplined portfolio rebalancing*** methodologies continue to ***add significant value***.

• ***Diversification always is a priority*** but, as mentioned in the previous *Investment Update,* ***unique opportunities*** in asset classes and sector weightings will continue to be utilized to ***capture near term market appreciation.*** Portfolio exposure in ***Mid-Cap asset class, Technology sector, and Growth style*** equities was reduced closer to benchmark levels toward year end after all three had enhanced performance for the period. Just as we ***add or enhance exposure*** in securities/sectors that are ***positioned to appreciate,*** we also ***reduce or eliminate*** those that appear ***fully priced or disproportionately at risk*** via the firm's active ***sell discipline***.

At present, a ***slight overweighting*** versus benchmark is being maintained in the ***Energy, Healthcare, Pharmaceutical, and Utility sectors***. Stocks with *both* ***attractive fundamentals*** *and* ***appreciation potential over the next twelve months*** will take precedence for all but income-oriented portfolios.

• ***Short-term fixed income*** investment levels remain ***significantly below the norm*** due to low yields. Cash positions have been ***redeployed*** into ***high-quality bonds*** with slightly better yields, although individual ***bond availability*** has recently become ***more limited.*** Despite this, the ***average duration*** of bond portfolios is ***not being extended*** significantly because of the potential rise in interest rates relatively near term.

E. Jeffrey Roof