Portfolio Manager's
Quarterly Market Commentary
INCOME SOLUTIONS FOR THE FINANCIAL PROFESSIONAL

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ADVISORS ASSET MANAGEMENT

Fourth Quarter, 2009

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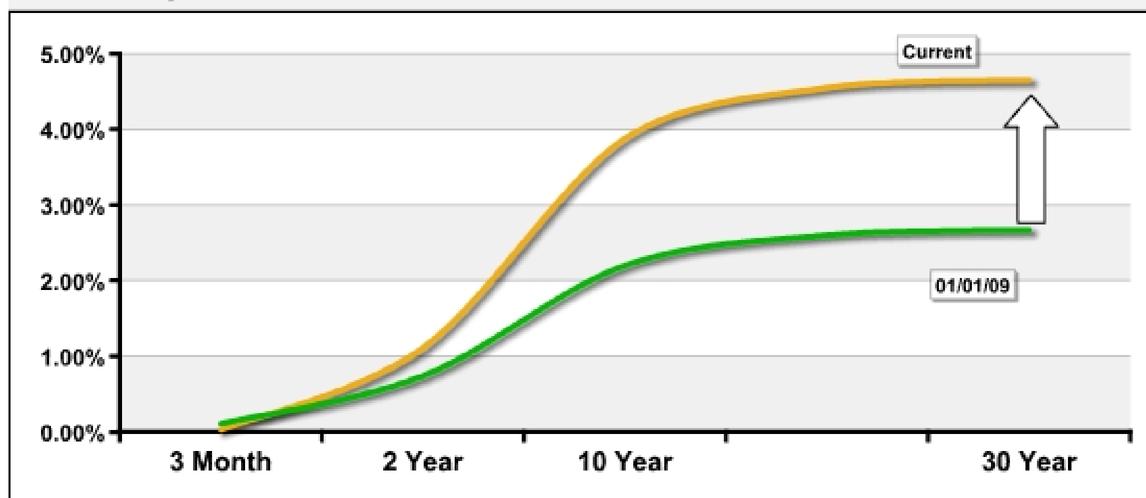
You couldn't help but feel good about the way 2009 ended up especially given at one point the S&P 500 was down 25% for the year and many believed Great Depression II was upon us. However, prospects of a return to growth (and later actual signs) propelled risk assets of all types off of their early March lows and it resulted in positive gains for the four major asset classes for both the fourth quarter and the year. The leader of the pack for the year was REITs, as measured by the MSCI U.S. REIT Index, which tacked on 8.91% for the quarter and 27.93% for the year; however, they still sit about 40% off of their February 2007 peak. Next in line were equities, as measured by the S&P 500, which gained 6.04% for the quarter and 26.47% for the year. That marks the third consecutive quarter of gains for the S&P 500 but it is the humblest gain of the run as the index gained about 15% in both the second and third quarter. Next in line were commodities, as measured by the Dow Jones – UBS Total Return Index, which gained 9.03% for the quarter and 18.91% for the year. Rounding out the asset classes was the Barclays Capital U.S. Aggregate Index, which returned a modest .20% for the quarter and 5.93% for the year. However, it should be noted that bonds began bottoming out in October of 2008 unlike the rest of the risk asset classes which did not bottom until March of 2009. Yet not all bond asset classes fared well as U.S. Treasuries posted their worst yearly performance since 1978 and were the worst performing sovereign debt market for the year as yields moved up considerably for the majority of the maturity spectrum.



On the short end we saw the 3-month U.S. Treasury move down slightly in yield by 6 basis points for the quarter. However, for the other maturities we saw the moves turn positive and increase in size as the maturity lengthened. The 6-month maturity moved up by 2 basis points for the quarter, the 1-year maturity moved up by 6 basis points, the 2-year by 19 basis points, the 5-year by 37 basis points, the 10-year by 53 basis points and the 30-year by 59 basis points. These moves caused the curve to shift up and become slightly steeper with the spread between the 10-year and 2-year maturity widening from 236 basis

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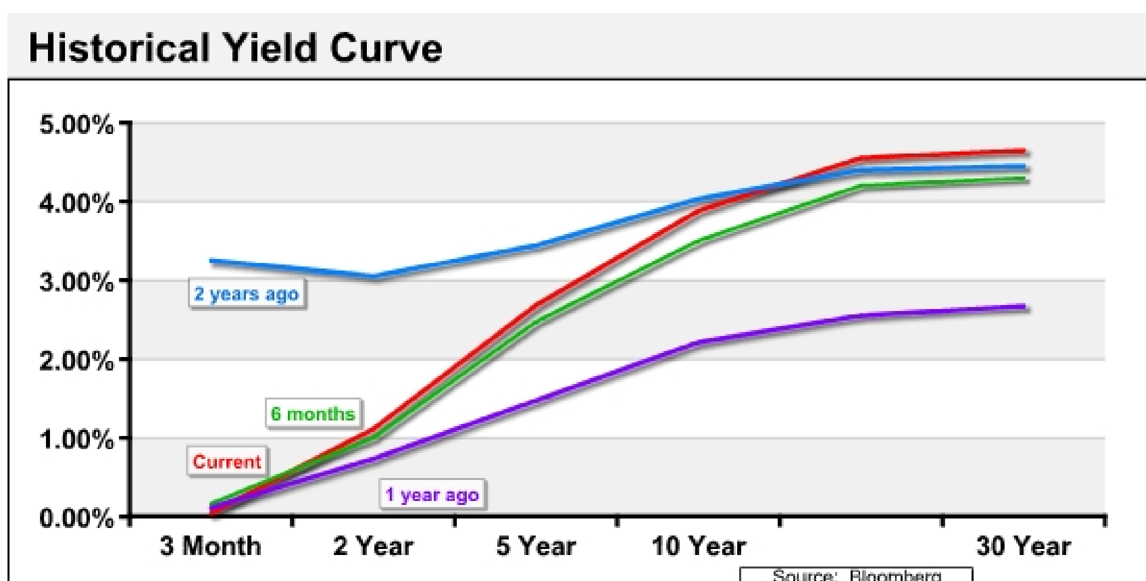
points at the beginning of the quarter to 270 basis points at the end. This spread is the highest since the Fall of 2003 which preceded four more years of economic expansion. For the year the shift up in yields was similar to the fourth quarter with the biggest gains coming at the 10 and 30 year maturities, which were up 162 and 197 basis points respectively. These large moves up in yield were a function of a number of things including anticipation of a stronger economy and a tremendous amount of new issuance by the U.S. Government. They are also indicative of a bubble that had formed in U.S. Treasuries near the end of 2008 that we have discussed in detail. Though we expect the yields on U.S. Treasuries to continue to move up in 2010 we don't expect to see the same magnitude of moves as we did in 2009.



For illustrative purposes only.

We discussed last quarter how we thought the U.S. economy had exited recession in June or July and the GDP report for the third quarter (+2.2%) now confirms that. Back in January of 2008 we felt that the U.S. economy would in fact resume growth in the second quarter driven by global government stimulus, low interest rates and pent up demand coupled with low inventories. Driven by these factors we have seen a vast improvement in the ISM measures of both Manufacturing and Non Manufacturing (services) activity, as well as improvements in retail sales, home sales and auto sales. In addition, we have also seen recent stabilization in the job market as well as stabilization (and even some slight increases) in home prices while inflation still appears to be held in check. We seem to get the most questions lately concerning inflation, so let's address that first.

As we discussed last time inflation was a topic that has been dominating headlines for quite some time. To review, we detailed that in the past how inflation has been driven by gains in wages, increases in home prices and tight capacity. We still do not see significant evidence of any of these; however, as perception sometimes can lead to reality inflation could become a self fulfilling prophecy. If enough investors become concerned about inflation and take positions in inflation sensitive commodities and securities this may cause a rise in the price of these commodities and securities and subsequently a rise in inflation. As we have proposed before we would recommend investors take a diversified position in a couple of asset classes that have historically provided some correlation to, or a hedge against, inflation. These include dividend paying equities, real estate and commodities (both the physical commodity as well as the producers).

Turning away from inflation we continued to see signs of an economy on the rebound. December's ISM Manufacturing Index came in at 55.9 (above 50 signifies expansion) which was much better than the 54.3 level expected and the highest reading since a 56.0 was reported in April of 2006. It should be noted it was also well above the 32.9 level it hit in December of 2008.

We have seen confirmation of these readings with an uptick in Factory Orders and Capacity Utilization. The latest reading on Factory Orders is +1.1% (after a cycle low of -6.5% in November of 2008) and the latest reading on Capacity Utilization is 71.3% (after a cycle low of 68.3% in June of 2008). Switching to the service side the ISM Non Manufacturing Index also came in above 50 (50.1) for December and also now sits well above its December 2008 level of 40.1. Unfortunately, these upticks have not been coincident with new hiring, but the data indicates that may not be far behind.

Unemployment now sits at 10.0% after hitting as high as 10.2% in October of 2009. However, we have started to see a moderation in Initial Jobless Claims and Continuing Claims as well as an uptick in the change in Nonfarm Payrolls that most likely indicates we are vey close to returning to modest job growth in the near future. The most recent reading on Initial Jobless Claims came in at 432 thousand which was much improved from the 674 thousand level reached in late March of 2009. In addition, it is approaching its 20-year average of 368 thousand. Continuing Claims was still a weak point at 4.981 million; however it was much improved from the 6.904 million it hit in late June of 2009 and has retraced about half the distance back to its 20-year average of 2.878 million. Productivity remains high which is one reason corporations have been able to refrain from hiring, and though we expect productivity to remain high, we think in order to significantly increase production from here corporations are going to need to add personnel which should lead to positive job growth by the end of the first quarter of 2010.

Another issue which affects almost everyone, housing, is also beginning to show signs of stabilizing. Based on The S&P/ Case-Shiller Composite-20 Home Price Index home prices hit bottom in April of 2009 and then rose month-over-month for five months in a row before remaining flat in October of 2009 (the index has a 2-month lag). The recent report of stagnation is a bit disconcerting and bears watching, but we all need to be reminded that recoveries don't necessarily have to occur in straight lines or without hiccups.

Outlook

A year ago we forecast a return to growth for the U.S. economy in the second quarter of 2009 due to the presence of global government stimulus, low interest rates and pent up demand coupled with low inventories. For the most part those factors are still in place and we think adding increasing consumer confidence with a stabilizing job market that the U.S. economy is on track to continue to grow in 2010, and most likely will even surprise slightly to the upside. Based on current estimates compiled by Bloomberg GDP for 2010 is expected to be 2.6%, and we believe it could end up in the 3-3.5% range. One thing has become clear over the last couple of years and that is it is easier to be negative than positive on the economy and it also appears to be the path of least resistance. However, the negative case often doesn't fully comprehend the power of the U.S. economy to recover and the resiliency of the U.S. consumer. Take autos for example.

It was widely reported that the "Cash for Clunkers" program (officially named Car Allowance Rebate System (CARS)) would artificially enhance sales in the short-term only to cause sales to dip back down again to lower levels afterwards as well as devastate the used car market. The program, which effectively ran from July 1st through August 25th, did cause a spike up in car sales with a subsequent hangover in September, however, car sales in December improved 15% year-over-year and sales in the fourth quarter showed a year-over-year improvement for the first time since the fourth quarter of 2006. In addition, the devastation to the used car market never materialized. We think this can also be extrapolated to the housing market. The tax credits for first-time home buyers have now been extended through April of 2010 (contract signed, purchase completed by June 2010) and they have also added a tax credit for other than first-time buyers. Couple this with mortgage rates well below long-term averages and prices depressed about 30% and we think the housing market can continue to pick up steam. Yet to be clear, we don't want prices to spike up, but to creep up, that way when mortgage rates rise in 2010 houses will still be affordable.

Clearly there are still many hurdles for the U.S. economy to navigate in 2010 including commercial real estate, healthcare, possible tax increases, questions concerning bank capitalization, unwinding of the Fed's $2.2 trillion balance sheet and mid-term elections in November. However, the U.S. economy has already fared much better than many had foretold. Given we still

have low rates, the majority of the $787 billion stimulus package still to come, pent up demand, and extremely lean and well capitalized corporations, we feel the U.S. economy can continue to expand in 2010 and into the foreseeable future; in the process surprising quite a few participants.

Peroni Method

A proliferation of bullish technical trends based on both price action and money flow behavior in the fourth quarter reinforced the progress of the stock market since the March 9th lows while also presenting an encouraging outlook for 2010. Broad and diverse sector leadership has been a consistent theme following the equity market bottom in 2002 and many of the sectors that propelled the market higher seven years ago remain largely intact. It is remarkable that instead of derailing much of the sector leadership in play prior to the financial-led decline, the dramatic downturn in 2008 may have actually bolstered appreciation potential in such areas as technology, healthcare, energy and manufacturing. This suggests that this bear market may have been an aberrant move within the context of a longer term bullish cycle. Although the fourth quarter did not sport dramatic accelerations in trading volume, net money flow actions continued to reflect favorable underlying accumulation. Preliminary data also indicates that retail investors may have begun to revisit equity opportunities.

The fourth quarter had its fair share of volatility, but pullbacks were limited in an uncanny manner to 50-day moving average levels. Buyers seemed more willing to participate on relatively shallow retreats suggesting heightened investor confidence and further technical evidence of an improving equity environment. The resulting formations in individual stocks are largely designated as 'cup and handle' patterns which have historically produced durable and sustainable price movements over many months. While the 'cup' represents the gradual transition from urgent selling to initial net buying, the 'handle' is the result of a primary breakout from that bottoming process. Often, a significant and longer-term advance begins after some secondary consolidation following these breakouts. The emergence of these advances above the 'handle' levels in the fourth quarter is a bullish development that may suggest the stock market is sensing economic improvement in 2010 that exceeds current consensus forecasts.

Commodities experienced expansive trading swings in 2009 but finished the year firmly. Oil rallied from yearly lows in the mid-30's, but struggled with resistance at the $80 area in the fourth quarter. Oil could face some further hesitation in the low 80's but I expect oil to reach $100/brl or higher this year. Since the 2002 bottom there has been a general correlation between the price of oil and the direction of the stock market. That correlation was tested by the financial crisis. Although stocks and commodities were broadly and adversely impacted by the bear market through much of 2008, both oil and various sectors that had led the market higher prior to the credit crunch bottomed successfully and essentially coincidently in early 2009. This persistent parallel suggests that the post 2002 stock market cycle, based on global industrial expansion, remains effectively in place.

Although investors may have shown improved acceptance in the fourth quarter that the market was in a recovery, volume trends suggest that sidelined cash (buying potential) remained largely untapped. Positive shifts in psychology certainly did little to ignite a buying flurry or produce an overbought condition. I believe this non-descript volume behavior presents a glass half full scenario where positive catalysts in early 2010 could have a big impact on the market. Merger and acquisition activity is expected to increase in 2010 which could spur increased speculation and attract money off the sidelines. I think another soft stimulus might be a dramatic increase in stock splits that could put numerous momentum stocks in leadership areas within reach of retail buyers. The year ahead is likely to favor a multi-cap investment strategy with a growth stock-picking emphasis. My 2010 DJIA target is 12,500 versus anticipated support near the 10,000 level.

Core Tax Exempt

The intermediate municipal bond market in the fourth quarter of 2009 was generally characterized by a partial reversal of the very strong total return in the July through September period. That strong return in late summer was prompted by steady demand for municipal bonds, heavy issuance of Build America Bonds (BABs), and reduced supply of traditional municipals. In October and November, a seasonal increase in traditional new issue municipal supply and reduced demand by individual retail investors caused municipal bond yields to rise. At the beginning of the fourth quarter, municipal bond yields were at or close to their historical lows in many parts of the yield curve. Given the arguably transient reasons for the late summer decline in municipal yields, it was not surprising to see investors "go on strike" to some extent regarding municipal bond purchasing for parts of the fourth quarter. These forces accounted for the very modest or even slightly negative total returns municipal's experienced last quarter.

The critical factors at work regarding the municipal bond market for all of 2009 would include generally strong investor demand, large issuance of Build America Bonds (BAB's), reduced supply of traditional municipal's, and a general shrinking of credit spreads and municipal/Treasury ratios, particularly since last Spring. All of these forces produced strong total returns for municipal bonds in various parts of the yield curve but particularly in the longer end of the maturity spectrum. The general shrinking of credit spreads and municipal/Treasury ratios since last spring constituted evidence of a gradual thinning out of the unprecedented levels of uncertainty that prevailed at the end of 2008. The current challenges to municipal bond credit quality are serious and we expect that headline risk will be with us for the next 12 months. We still believe strongly, however, that municipal bond issuers generally have self-corrective tools and powers to extricate themselves from the challenges they face. They continue to provide essential services and have exhibited a "staying power" historically that has made them relatively stable, enduring investments. We believe strongly that municipal bonds, among conservative investment alternatives, remain attractive for high net worth investors and that there continues to be value to unearth in the municipal market.

The past five years is an instructive period to examine investment performance since it is reflective of a full interest rate cycle. It has included both very positive and very negative interest rate environments and a variety of "in between" scenarios as well. Our consistent, balanced, investment grade, intermediate maturity approach to municipal portfolio management continues to be an important contributor to our long term performance through a variety of interest rate cycles.

Core, Core Plus and Credit Opportunities

Most major bond indices posted strong gains with the Investment Grade U.S. Corporate Bonds, as measured by the Barclays Capital U.S. Credit Index, posting 16.04% for the year. The bond markets saw continued tightening of spreads throughout the fourth quarter. As money came off the sidelines, pricing improved and spreads dropped across all ratings. Spreads fell on triple-A (AAA) paper by 14.9 basis points while triple-C (CCC) paper fell 233.5 basis points. Just in December alone the Investment Grade Credit Default Swap Index (CDX IG13) fell from 102.25 on December 1st down to 81.0 on January 5th.

The **Core Plus Strategy** saw both benefit from holdings in the financial sector. The preferred positions continued their momentum from the third quarter. The other financial positions were positive contributors during the quarter and we see the financial sector and financial preferreds remaining our top opportunities in 2010. Other corporate holdings such as communications, transportation and manufacturing contributed to gains during the quarter.

	4th Quarter 2009 Asset Allocation	1st Quarter 2010 Asset Allocation
Corporates	50%	50%
Mortgages	35%	25%
Treasuries	5%	5%
Agencies	5%	5%
Other	5%	15%

The calls for a second stimulus plan continued although only $249.8 billion of the $787 billion stimulus package has been paid out in the form of $92.8 billion in tax benefits, $65.8 billion in grants and loans, and $91.2 billion in entitlements. Mortgages posted positive returns during the quarter with mixed results across the various positions. The mortgage market still shows mixed signs with the disparity between bid and ask prices remaining. Overall mortgage metrics still remain strong as some of the efforts to stabilize the housing market begin to take hold.

Although our asset allocation did not change during the fourth quarter, we reduce our mortgage exposure from 35% to 25% and increased our Other asset allocation to 15% in January of 2010.

The **Core Strategy** was lead by the financials and the industrial sectors. The portfolio remains well positioned in financials and industrials that will benefit as the economy turns around in 2010.

The **Credit Opportunities Strategy** saw spreads tighten during the fourth quarter with double-B (BB) credits dropping 74 basis points, single-B credit dropping 140 basis points and triple-C (CCC) tightening by 233 basis points. Money came off the sidelines as investors sought better returns and increased their risk tolerance. The high yield market had a strong year in 2009 with the Barclays Capital U.S. High Yield Index posting a 54.78% gain.

The housing sector continued to stabilize. The industry has seen five months of home price increases while existing home sales, permits and housing starts have shown improvement. Bond prices firmed during the quarter allowing us to harvest some gains.

The fourth quarter brought some sense of completion to the restructuring activity in the portfolio. GM is moving into its post bankruptcy phase. Other plans received quick approval while some plans are still in the formulation stage with parties on both sides prepared to argue their case with the judge. In most cases the debt we held will be exchanged for some form of equity in the reorganized entity.

The returns on mortgage holdings in this strategy were mixed overall with several outliers on both the positive and negative side of the ledger. The mortgage drivers were slowed down during the quarter as the first time buyer tax credit was set to expire. It was subsequently renewed by the Administration.

We anticipate maintaining our exposure in the financial and material sectors as we feel these markets offer exceptional prospects in 2010.

See next page for important disclosure information.

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