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Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended December 31,2009

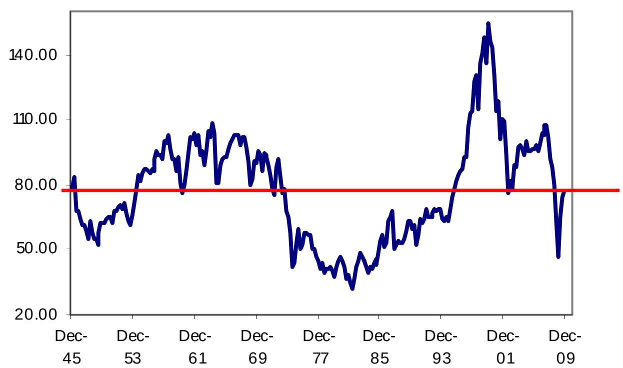
What Is Valuation Saying?

Most valuation methods are based on comparisons of stock prices with profits or earnings. As the price-earnings ratio of stocks goes up, stocks are viewed as pricy. If it goes down they look cheaper. Most of these models use earnings from a single year.

The problem with this approach is that earnings are volatile. In a year when earnings are temporarily depressed, stocks look expensive. When boom times come along, temporarily over-inflated earnings make stocks look cheap. What investors need is a basis for valuing stocks which is more stable than earnings.

One simple method for valuing the overall market is to compare the price of the S&P 500 Index to the size of the U.S. economy. The logic here is that, over time, profits should rise or fall with the economy. Additionally, fluctuations in the Gross Domestic Product (GDP) are relatively small compared to the wild swings which earnings experience. This valuation method is analogous to a price-sales ratio for an individual stock.

The S&P 500 closed the year at 1115. GDP in the last year was $14.45 trillion. 1115 divided by 14.45 equals 77.1, a number which is meaningless by itself but very useful for comparison purposes.



STOCK VALUATION IS BACK TO AVERAGE

Doing the same calculation for each quarter since World War II yields the chart displayed on this page. This shows that about 50% of the time since 1945 stocks have been more expensive than right now and about 50% of the time they have been cheaper.

Interestingly, this chart suggests that stocks were quite expensive in late 2007, when the market peaked. Price-earnings ratios at that time, however, were not at alarming levels. The reason for the disparity was that profit margins had temporarily risen to record high levels, making stocks look deceptively cheap. The price-GDP model gave a better picture and indicated that the market was expensive.

"...the easy money has already been made in the current bull market."

If the model is correct, stocks right now are neither cheap nor expensive. This suggests that the easy money has already been made in the current bull market. Additionally, with GDP expected to grow at only an average historical level of 3-4% in 2010, it suggests that meaningful advances in the stock market will depend on a continuing rise in economic expectations from the current level.

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Is There A VAT In Our Future?

Appearing on the Charlie Rose show on October 5th, 2009, U.S. House of Representatives Speaker Nancy Pelosi asserted that, to help the U.S. address its fiscal responsibilities,"it's fair to look at" the VAT as part of an overhaul of the nations tax code.

The Value Added Tax or VAT, which first appeared in France in 1954, is similar to a national sales tax. Like a sales tax, it is a tax on goods and services. The VAT is a tax on consumption, and is therefore regressive, unlike our income tax. The VAT differs from a sales tax in that it is not directly charged to the consumer at the time of a purchase. Instead, the tax is assessed at each stage in the production of a good or service in proportion to the value which is added by the manufacturer or service provider. The result is that retail prices of goods and services would rise by the total tax accrued during their production. Foreign purchasers of goods and services for which the price includes a VAT are usually eligible to receive a rebate.

About 90 countries now use a VAT, including countries in the European Union, Brazil, Canada, China, India and Russia. Rates range from about 15-25% but are often

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VAT: continued

lower for some items deemed to be essential. Goods and services produced in VAT countries are priced 15-25% higher for domestic buyers, although tourists are often eligible for a rebate.

In 1965 before the VAT was introduced in the EU, total taxes paid represented 27.7% of Gross Domestic Product (GDP), about what we paid in the U.S. in 2006. Today, the tax burden in the EU is 39.8% of GDP. Clearly, the VAT is a powerful tool for generating tax revenue.

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In the third quarter of 2009, Chinese consumers bought more computers (7.2 million) than Americans (6.6 million). This year they are expected to buy more autos.

Why The Price of Gold Is Rising

The price of an ounce of gold has more than quadrupled from $260 in early 2001 to $1,100 today. Over the same period the S&P 500 index had a total return near zero. This is very unusual. Over the long term stocks have dramatically outperformed gold. Even now, gold is only marginally above the peak price it reached in 1980 while stock investments have grown in value 18 times.

It is often said that a rise in the price of gold is a harbinger of inflation. Still, after a nine year rise in gold, inflation is still tame. It's also fair to point out that the previous gold peak in 1980 was soon followed by a rapid decline in the level of inflation.

Gold can be used as money. During times of war or social upheaval people have often abandoned paper money in favor of gold. We all are familiar with the phrase, "as good as gold". The gold standard, which the U.S. abandoned in 1971, required that currencies be backed by gold held by the government.

Gold is a commodity, and as such, is subject to the laws of supply and demand. The supply of gold is fairly constant, with mines adding only a small percentage to the total each year. Demand comes from the jewelry industry, the dental industry and investors, from coin collectors to central banks. Most of these buyers are either small or have a consistent need for gold. Central banks are the major exception.

Central banks hold monetary reserves in the form of gold and other secure financial assets (e.g. U.S. Treasury bonds) to back the value of their currencies, which are otherwise backed only by faith in the government. While developed nations such as the U.S. and Germany have up to 2/3rds of their reserves in gold, developing nations like Brazil (0.5%), Russia (4.7%), India (6.4%), and China (1.5%) have a much lower percentage. As those nations grow to occupy a more prominent place on the world economic stage, it is natural that their governments would seek to increase their gold holdings over other less secure assets.

The rise in the price of gold is a consequence of the recent growth in importance of emerging nations. That it may indicate declining faith in paper currencies or a coming bout of high inflation is also possible, but difficult to prove.

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On the last day of 2009, the Obama administration pledged to back mortgage giants Fannie Mae and Freddie Mac, no matter how big their losses in the next three years.

40% of the revenue of S&P 500 companies comes from foreign sources but only 11% of U.S. GDP comes from exports.

The Bottom Line: 12/31/2009

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1115	26.5%
Small company stocks *(S&P Small Cap Index)*	333	25.6%
Short term interest rates *(3 Month T-Bill Yield)*	0.04%	From 0.1%
Long term interest rates *(10 Year T-Bond Yield)*	3.8%	From 2.2%
Inflation *(Consumer Price Index)*	217.3	1.9%
Energy *(West Texas Intermediate Crude Oil)*	79.36/bbl.	78%
The economy *(Inflation adjusted GDP)*	$14.5 trillion	-2.7%

QUOTABLE

"It's difficult to make predictions, especially about the future"

Neils Bohr, Woody Allen and others

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