All Star Quarterly

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2011 - 3rd Quarter Review and Preview

Bob's Corner

2008 Again?

After a very hard quarter, I just want to reassure all of you that this is not another 2008 in our minds. How do we know? Consumer savings rates are up to 4.9% from a low of 2.1% in 2008. Consumers have also decreased their debt as a percentage of household income from 14% to 11%. From Sept 08 to Sept 11, P/E ratios are down from 22.5x to 13.7x. This market is cheaper than anytime in the last three recessions.

What we need is U.S. governance and the global powers to make some decisions quickly and with authority. If that happens, the market is a great buy!

Uncertainty Abounds but Patience and Discipline Will Prevail

Market Overview

Overview

An old saying in the investment world suggests "the market hates uncertainty." As the third quarter unfolded, that old adage appeared to be confirmed. Uncertainty spread across the financial world. Would the potential default by Greece's government become another "Lehman-like" event? Would sluggish growth in the U.S. economy lead to another recession? Can corporate earnings hold up in the current environment? These and other questions are clearly weighing heavily on investors.

The quarter began with all eyes focused on Washington and the debt ceiling debate. Shortly after it was partially resolved, Standard & Poor's downgraded U.S. government debt from AAA to AA+. This reflects ongoing concerns about long-term debt issues facing the federal government, and a real long-term resolution continues to be a political hot potato. Europe is struggling to resolve its own debt issues and an eventual default or restructuring of Greek debt looms over the market.

As these events swirled, the already slow recovery in the U.S. economy stalled. All of these factors contributed to a market correction in the third quarter affecting nearly every asset class except the dollar and U. S. Treasuries. Despite these problems, the U.S. still maintains its "safe haven" status in the eyes of global investors, as individuals, corporations, and countries continue to flood to the U.S. treasury for a safe investment.

The high level of uncertainty surrounding these events led us to raise cash levels across our portfolios to offset market volatility. We have maintained equity positions that offer the most attractive long-term growth potential and bond holdings that are best-positioned from a credit and yield standpoint. We want to be able to manage through this period and plan to maintain a more conservative posture until more clarity is evident in the economic and financial outlook.

There is a positive development from the events of 2011 – the market appears to have already priced in a recession. Stock valuations are cheaper than what they were during the last three recessions. If economic growth remains slow or even if we enter a mild recession, stocks may still have the potential to rise.

Economy

The 3rd Quarter

Fears about the threat of a looming recession were fanned by reports this summer that 1st quarter economic growth as measured by Gross Domestic Product (GDP) was downgraded from an annualized rate of 1.9% (in initial estimates) to just 0.4%. That was followed by 2nd quarter growth of approximately 1.0% (annualized). In the first half of 2011, the economy grew at less than half the rate of growth seen in 2009 and 2010.

Underlying signals in the economy were also weak. The ISM Manufacturing Index barely grew in August. Even worse, production, new orders and backlog components all declined, an indication of slumping demand for manufactured goods. The ISM Service Sector Index grew at a respectable rate, but here too, the backlog component declined, another leading indicator of slower future demand for services.

Over the last two months businesses have cut back on hiring plans. Earlier in the year, the economy added jobs at a rate of 200,000 per month, but that slowed to zero job growth in August. Unemployment remains above 9%. The weak job market appears to be contributing to a continued slump in housing, as median home prices fell another -5% in August.

Inside...3rd Quarter Review and Preview Continued...Performance Summary

There are bright spots. Healthy corporate profits allowed business spending to jump by 6%. Consumer spending also held up reasonably well with 2% growth, although that is down from the pace set earlier in 2011. Inflation remains mild, with both the Consumer Price Index and the Producer Price Index up just 2.5%. In recent months, energy prices have declined significantly, helping to temper inflation concerns and keep more money in consumer pockets.

Looking Ahead
Forecasts for economic growth have been revised downward due to trends that have emerged in recent months. The consensus economic forecast is for growth to finish out the year at 1.5% and continue in the 1.5% to 2.0% range in 2012. The economy may be approaching a “fork in the road.” Either it will continue to muddle through with slow growth or it could dip back into another recession. Should a recession occur, it would likely be mild and short. We believe this to be true because both housing and employment markets are already struggling and aren’t likely to get dramatically worse, even if a recession occurs.

A strong recovery will require more robust job growth. The Obama administration proposed a new $450 billion jobs bill to promote hiring, but it remains to be seen if it can pass through a combative Congress. The Federal Reserve has committed to maintaining low interest rates into 2013. Even if fiscal and monetary stimulus are limited, the business cycle eventually will run its course, and if nothing else, we believe the economy will nurse itself to health over time.

Bond Market

The 3rd Quarter
Despite global debt problems and the S&P ratings downgrade of debt issued by the Federal government, U.S. Treasury securities fell to record lows yet still retained “safe haven” status for investors. All other segments of the bond market struggled during the quarter as uncertainty rose.

U.S. Government bonds gained 5.9% during the 3rd quarter. Treasury Inflation Protected Securities (TIPS) rose 4.5% and long-term government bonds returned an astonishing 23.9% during the period. Their performance illustrated investors’ growing risk aversion. Returns may have benefited as well from the Fed’s unprecedented announcement that it planned to maintain its zero interest rate policy for two years, and its implementation of a program to purchase more long-term Treasuries in an effort to support economic growth.

All credit-related bond sectors experienced weaker performance during the quarter. Investment-grade corporate bonds gained 3% while corporate high-yield bonds fell -6.1%. Emerging market bonds declined -8.9% as the dollar rallied against most other currencies. As you may remember, a strengthening dollar has a negative impact on returns of foreign holdings.

Looking Ahead
The rally in Treasuries has been so significant in recent months that any upside potential seems marginal. The 10-year Treasury currently yields near 2% and fell to a record low 1.69% during the quarter.

More attractive yields can be found elsewhere in the bond market for those willing to accept some risk. Corporate high-yield bonds again pay more than 8%, emerging market debt yields are near 6% and investment-grade corporate bonds yield 4.5%. While yields widened and prices declined during the 3rd quarter for all non-Treasury sectors, the credit quality of these sectors did not fundamentally change. Corporate and high-yield default rates remain very low at 2%. Corporate cash levels are at record highs. Even emerging market debt is originating mostly from countries with large budget surpluses and much more favorable balance sheets than the U.S. and Europe.

Although non-Treasury securities have performed poorly in recent months, they appear to offer the greatest potential going forward for bond allocations. Investors will have a difficult time getting ahead over the long-term with a 10-year Treasury note that pays a 2% yield. In our estimation this is not enough to even keep pace with a modest rate of inflation.

Domestic Stock Market

The 3rd Quarter
Stocks sold off across the board in the 3rd quarter in reaction to a number of negative headline events. The Russell 3000 Index fell -15.3% during the period. However, across industry sectors, performance varied widely.

Utilities, Consumer Staples and Technology stocks held up the best during the quarter. Utilities gained 0.4%, Consumer Staples lost -4.9%, and Tech stocks fell just -8.0%. This reflected the continued consumer demand for basic products and strong cash positions for most technology companies. The situation was dramatically different for cyclical stocks. Financials fell -23.1%, Materials stocks dropped -25% and the once hot Energy and Industrials sectors declined -21%.

Investors demonstrated a preference for more established stocks. Large-cap stocks, with a return of -14.7%, significantly outperformed mid-cap stocks -18.9% and small-cap stocks -21.9%. Growth stocks were more resilient than Value stocks, with a return of -13.9% vs. -16.6%. This could be credited primarily to the relative strength of technology stocks.

Performance Update

Market Index	3rd Qtr	YTD	1 Year	2 Years	3 Years	5 Years
DJ Industrial Average	-14.90	-9.49	0.88	5.82	1.72	-0.63
S&P 500	-13.87	-8.68	1.14	5.56	1.23	-1.18
Russell 2000	-21.87	-17.02	-3.53	4.57	-0.37	-1.02
S&P Mid-Cap 400	-19.88	-13.02	-1.28	7.83	4.05	2.20
Russell 3000	**-15.28**	**-9.90**	**0.55**	**5.63**	**1.45**	**-0.92**
S&P Global BMI	**-17.95**	**-13.87**	**-5.73**	**1.84**	**1.73**	**-0.74**
MSCI EAFE	-19.01	-14.98	-9.36	3.25	-1.13	-3.46
MSCI Emerging Market	-22.56	-21.88	-16.15	0.4	6.27	4.87
NASDAQ	-12.70	-8.33	2.96	7.68	5.93	2.23
Barclays High Yield	-6.06	-1.39	1.78	9.80	13.83	7.08
Barclays Aggregate Bond	3.82	6.65	5.26	6.70	7.97	6.53
Barclays Credit Index	0.94	4.19	2.92	6.81	10.17	6.24
Barclays Government Bond	5.85	8.11	5.58	6.27	6.43	6.56
Barclays Corporate Bond	3.03	4.19	4.56	8.05	11.74	6.72

Looking Ahead

One of the most encouraging stories of the year relates to corporate profits. So far in 2011, profit growth is 13% higher than a year ago. Investors will closely monitor 3rd quarter earnings reports that will begin to be released in October. The issue is whether companies can continue to generate strong earnings growth or if the weaker economy begins to take its toll on corporate profits.

Even in this struggling economy, companies are in a far healthier financial position today than they were in 2008. Most have lower levels of debt and more cash on hand and their stocks offer more attractive valuations (from a Price/Earnings perspective) than at anytime during the last three recessions. Large-cap stocks appear to be the best positioned thanks to their ability to pay attractive dividends and generate significant revenues from faster-growing overseas markets.

International Markets

The 3rd Quarter

As bad as the quarter was for U.S. stocks, things were even worse overseas. European debt woes persistently weighed on market sentiment during the period. The slowing global economy became a threat to growth in booming emerging market economies like China, though these countries continued to be in better economic shape in the near-term compared to developed markets like the U.S., Japan and European countries.

The S&P Global Broad Market Index (ex-U.S.) declined -18.0% during the period. The MSCI EAFE Index, representing developed foreign markets, fell -19.0%. Emerging markets were harder hit, as the MSCI Emerging Markets Index lost -22.5% in the 3rd quarter.

Not surprisingly, given the debt crisis, Europe was the hardest-hit region, with markets across the continent dropping -22.6%. By contrast, Japan, facing its own economic challenges but showing signs of rebounding from March's earthquake and tsunami, lost just -6.4%.

Looking Ahead

Long-term growth prospects in emerging markets remain solid. Emerging markets have represented one of the best-performing asset classes over the past decade, with average annual returns in excess of 16%. The outlook for the next decade remains favorable given demographic trends that are leading to an emerging middle class in many developing countries. While they are subject to more volatility than developed markets, emerging equity markets are the best buy value to growth and tend to have more upside potential when fear is not the dominant emotion affecting investors.

Japan appears poised for a modest recovery from its natural disaster. While many fear a recession overtaking Europe as fallout from its debt crisis, that doesn't appear to be a certainty. Valuations of stocks in developed and emerging markets are extremely attractive from an historic perspective, particularly considering that the average dividend yield on international stocks exceeds 3%.

SUMMARY

We reduced equity positions and raised cash to moderate the impact of these volatile markets. But we are maintaining our positions in stocks and bonds that represent sound, long-term values. We expect to add a couple of flexible and tactical style managers to our portfolios, which should put us in a position to re-enter the markets as quickly as possible when market conditions improve.

Although the economic outlook may remain fuzzy, investors should remember that stocks have the ability to perform well even if the economy is struggling. If you focus on equities that offer good value, when fear is taken out of the equation, you will be positioned to benefit when markets recover. Equity markets around the world will recover. The big question is when.

Patience and discipline will prevail!

Discipline, Not Fear, Is Necessary in Uncertain Times

Global stock markets tumbled in the third quarter as political uncertainty, lowered growth expectations, and a defensive consumer all played a part in why investors ran from equities these last three months. Many investors are **fearful** that they may lose even more of their money and some have even moved all of their retirement assets to cash or gold. There is no denying that the average consumer in the United States has a difficult road ahead and that there continues to be many unanswered questions about U.S. economic policy and deficit reduction. At All Star Financial we employ a disciplined investment process that has been successful over the long-term.

Harvey MacKay recently penned a column in the Star Tribune that encouraged people to be fearless in times of uncertainty and distress. He noted many companies that were started during a recession including McDonald's, General Electric, and Disney. It takes confidence and discipline to succeed during these times of instability. We have been conducting due diligence on a variety of funds and asset classes and we are looking to buy securities that are undervalued relative to alternatives and history. We maintain that there are attractive opportunities in the global stock market even with the uncertainty that hangs over these companies.

It is important to understand that the economy and the market do not always operate hand-in-hand. One shining example of this is the relationship between the University of Michigan Consumer Sentiment Index and the Stock Market. As the table below illustrates in recent decades, when consumer sentiment reaches extremely low levels the subsequent 12-month return of the S&P 500 Index has been markedly positive.

Consumer Sentiment Bottom	S&P 500 Return for Next 12 Months
2/28/1975	22.2%
5/30/1980	18.1%
10/31/1990	29.1%
3/31/2003	32.8%
10/31/2005	14.2%
11/30/2008	25.4%
9/30/2011	???

From 2/28/1969 to 7/31/2011, when the University of Michigan Consumer Sentiment Index is below a 66 reading (we are currently at 59.4), the Dow Jones Industrial Average has averaged a 14.4% gain over the next 12 months.

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