

Quarterly Review

The first quarter of 2009 kicked off with two historic and coinciding events: (1) the inauguration of Barack Obama, the first African-American president, and (2) the Dow's largest inauguration-day drop (-4.01%). Once the dust had settled, the charts for the Dow, S&P and NASDAQ ended the quarter looking roughly like the southern border of Texas. This was appropriate since market performance was "all hat and no cattle" (specifically no Bull).

The across-the-board losses which battered the markets during the second half of last year continued into the first quarter of 2009, as the four major asset classes, namely, stocks, bonds, commodities and real estate, all finished lower for the quarter (see Figure 1). In fact, stocks—despite staging a mini-rally at the end of the three-month period—closed lower for the sixth consecutive quarter. There was one "silver" lining in the cloud that hung over the markets: metals. Gold, silver and copper all closed higher.

So, now we know where we are, but where do we go from here and how do we get there? As always, we will evaluate and select the right mix of investments (stocks, bonds, commodi-

ties, cash, etc) to help our clients meet their individual financial goals. Given the track record of these asset classes over the last several months, the key is to determine what percentage of each is needed to arrive at the proper allocation. One of the key pieces to the puzzle will be bonds, so let's take a closer look at this critical asset class.

PERFORMANCE OF SAMPLE INDEXES 1ST QUARTER 2009	
Standard & Poor's 500	-11.7%
Merrill Lynch Investment-Grade Corporate Bond Index	-1.4%
Dow Jones All Equity REIT Index	-31.6%
Dow Jones/AIG Commodity Index	-6.4%

Figure 1

The Case for Bonds

Bond Basics

Let me preface this article by saying that bond decisions, like all our investment choices, are made based on the best interest and long-term investment goals of the individual client. As an asset class, bonds have many unique characteristics that make them an attractive part of any asset allocation.

First, it's interesting to note that the bond market is the largest securities market in the world. Also, the variety of bonds to choose from is almost limitless. Bonds vary by issuer (Federal governments and agencies, states and municipalities, corporations, etc.), interest rate and yield, maturity, terms and purpose. In addition, and perhaps most importantly, bonds can be subject to the vagaries of rating agencies such as Moody's, Fitch and Standard & Poor's

which can greatly affect their value.

From an investment perspective, bonds typically have an inverse relationship to stocks. Unfortunately, as we've seen recently, bonds can move in concert with stocks. In fact, the two often have an adversarial relationship. When stocks are going up equity investors espouse their superiority to bonds, but when stocks are on the decline bond buyers decry the inherent risk and uncontrollable volatility of equities. As with most investments, the truth (careful selection of investments that best meet the needs of clients) lies somewhere in the middle (see Figure 2).

Another traditional characteristic of bonds is their reputation as a safe haven. With the exception of Treasuries, that has not been the case during this crisis. One reason for this is that investors have called into question the issuers ability to repay the debt. This is

Stocks vs. Bonds
Significant Periods When Bonds Bested Stocks
1803 to 1871 → 68-Year Period
1929 to 1949 → 20-Year Period
1968 to 2009 → 41-Year Period

Figure 2

true for corporate as well as municipal bonds. While there is some expectation that this will change as Federal support of issuers and new budget programs begin to take effect, it remains to be seen when and how effectively these expectations are met.

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Corporate Bonds: The Next Equity?

Like many analysts, we expect the overall corporate bond market to perform favorably in 2009. As corporate balance sheets improve, investors will be more willing to assume the risk presented by bonds. Also, to improve their balance sheets corporations will continue to cut costs which could make bonds a viable substitute for dividend-paying stocks.

Finally, it is likely the Fed will continue borrowing to fuel the various stimulus programs its funding making corporate bonds a more attractive alternative to treasuries. The key to taking advantage of this improvement is identifying which sectors are best positioned to successfully raise capital in the credit markets. Once we've identified the sectors we think will be the best performers, we utilize Exchange Traded Funds, or ETFs, instead of buying individual bonds. ETFs help us manage risk and are often more liquid than individual issues.

TIPS on Investing

As we've stated previously in this publication, we never attempt to predict the future and that includes the future path of inflation. We do, however, take inflation into account when constructing portfolios. The best example of how we try to hedge against inflation is the use of Treasury Inflation-Protected Securities or TIPS.

TreasuryDirect, a service of the Treasury Department, defines TIPS as marketable securities whose principal is adjusted by changes in the Consumer Price Index (CPI). With inflation (a rise in the index), the principal increases. With a deflation (a drop in the index), the principal decreases. TIPS pay interest every six months, based on a fixed rate applied to the adjusted principal. Each interest payment is calculated by multiplying the adjusted principal by one-half the interest rate.

The relationship between TIPS and

the CPI affects both the sum you are paid when your TIPS matures and the amount of interest that a TIPS pays you every six months. TIPS pay interest at a fixed rate; however, because the rate is applied to the adjusted principal interest, payments can vary in amount from one period to the next (inflation causes the interest payment to increase while deflation causes the interest payment to decrease). At the maturity of a TIPS, you receive the adjusted principal or the original principal, whichever is greater. This provision protects you against deflation.

It's true that TIPS provide a safe way to help protect against the potential negative effects of inflation and deflation. But TIPS are government-issued bonds and therefore subject to movements in the overall Treasury market. For this reason, we will never be overly aggressive with TIPS in our portfolios. They are simply another vehicle for ensuring our clients achieve their long-term investment goals. To limit risk and ensure liquidity, we use TIPS ETFs instead of individual bonds.

Municipal Bonds

While similar to corporate bonds in many respects, the ability of municipal bonds to offer tax-exempt income set them apart from their brethren in the fixed-income world. Also, the complex trading network (thousands of traders nationwide) and diverse make up of issuers (states and territories, cities, towns, counties, various agencies, etc.) in the municipal bond market add to its singular nature.

As with corporate bonds, there is some concern among investors about the ability of municipal issuers to repay all interest and principal in full and on time. Investor fears may be warranted as many local governments—especially in hard hit states like California, Florida and Michigan—face severe financial downturns. But unlike corporate bond issuers, issuers of municipal bonds often have access to local tax revenues to

repay obligations. And, defaults on municipal bond issues are very rare.

Because of their special tax considerations, munis role in portfolio construction differs from other asset classes. When deciding whether a municipal bond is right for a client, we look primarily at the Federal tax implications rather than state and we typically recommend munis for clients at or above the 25% percent Federal tax bracket. Also, in most cases munis work best for clients who rely on income from their portfolios for day-to-day expenses. Finally, while munis differ considerably from other fixed-income securities, the due diligence required to decide which bonds to choose remains the same.

As with corporate bonds and TIPS, we invest in municipal bonds through the use of ETFs. Owning ETFs instead of individual issues helps reduce risk and preserves liquidity. The latter is important for portfolio construction because it allows us to easily reallocate funds if necessary. (The loss of Bear Stearns and Lehman Brothers as well as the scaling back in market presence of Merrill Lynch and UBS greatly affected liquidity of individual municipal bonds).

Conclusion

Bonds, like other asset classes, can be an important part of a larger investment strategy. Whether or not we add bonds to a portfolio depends on the long-term investment goals of the client. If we decide that bonds should be part of a portfolio, we participate using an appropriate ETF. ETFs offer lower cost than mutual funds, greater diversification than individual bonds, and liquidity.

"I don't think there is any other quality so essential to success of any kind as the quality of perseverance. It overcomes almost everything, even nature."

Birds of a Feather (The Value Trap/Averaging Down)

The Value Trap

There has been a lot of talk recently about how beaten down some sectors (homebuilders, financials, etc.) are leading to the belief that stocks within those sectors are unusually cheap. The appearance that stocks in these sectors with low P/E ratios or book value are “cheap” is what is known as the “Value Trap.”

Warning to all investors new and experienced: value trap does not mean value stock! Yes, some stocks *look* cheap, but what is their real value? To find out you have to look beyond P/E ratio and book value to the underlying fundamentals.

What does the company’s business plan look like? What is the nature of their competition? What are their prospects for growth? If you can’t answer these and other questions in a

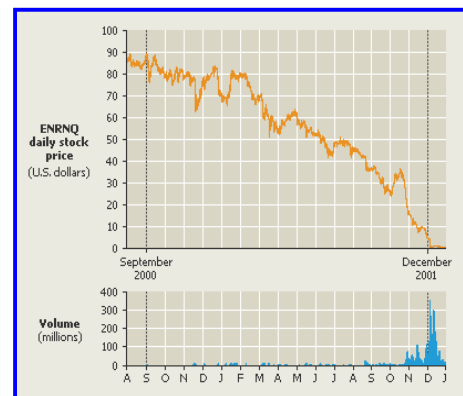
positive manner, stay away from the stock. Otherwise, you may end up in the Value Trap.

Averaging Down

As first cousin to the Value Trap, the process of averaging down attempts to take advantage of “cheap” stocks in an effort to lower the average cost of shares in a certain stock.

The process refers to buying additional shares in a stock at a lower price than you originally paid under the assumption that lowering the *average* cost of the stock position is necessarily a good thing. That may be true if the underlying fundamentals (there’s that word again) of the stock remain attractive. But if a stock is going down there must be a reason and it’s not always a good one. Increasing your position in a stock on the way down is

risky for the simple reason that it could go to zero (see Enron chart below). Also, you could face unfavorable tax consequences if you sell some of the shares because the IRS doesn’t recognize “average” cost for tax purposes. Generally, you would be better off to buy a different stock that is fundamentally sound and fits into your overall investment plan.



2008 Reader's Choice Awards—Best Financial Advisor

Fed Policy, Exports and Inflation

We’ve all seen media reports about the Fed “printing money” and lowering interest rates—effectively to zero—in an effort to spur economic recovery and control inflation. But what are the practical implications of Fed policy? One way to answer this question is to look at the impact of Fed policy on the value of the dollar and how that affects imports and exports.

In response to the current financial crisis, the Fed used several policy tools to improve the flow of credit into the economy and improve liquidity. These tools included lowering interest rates, direct lending to a wider variety of so-called “counterparties” and the purchase of agency and treasury securities. When these policies were implemented or expanded, the dollar increased in value as global investors sought a safe

haven against economic and sociopolitical troubles. During the rally, the dollar climbed to two-year highs against many currencies; however, the rally was temporary.

As the value of the dollar rose, imports from Europe and Asia initially became more affordable for U.S. consumers (conversely, the cost of U. S. exports went up thus increasing the trade deficit). But as the Fed lowered interest rates to near zero and small signs of an improving global economy began to show, the dollar lost some of its allure as a monetary safe-deposit box.

As a result, the dollar began to slide in value against the currencies of trading partners in Europe and Asia making their exports more expensive. This, of course, led to a smaller-than-

expected narrowing of the trade deficit. And ‘round and ‘round we go.

So where does this financial merry-go-round lead us? These swings in the value of the dollar vs. other currencies demonstrate that the global economy continues to be weak. Growing U. S. deficits will likely weigh on the dollar but sluggishness in Asia and an ongoing slump in Europe should keep it from falling too dramatically. This should keep import/export prices on somewhat of an even keel and lessen the chance of inflation.

All of this leads us to an incontrovertible conclusion: the global economic recovery will be slow and uneven.

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Inside the Company and In the News

As mentioned in the March 2009 issue of *The DLB Bulletin*, we are exploring ways to improve our investment process through better evaluation and understanding of risk tolerance. Focusing on this critical element of portfolio construction will help ensure we meet the financial goals of our clients. To this end, we will begin implementing a new questionnaire that takes a more holistic approach to evaluating a client's ability to assume risk. Rather than focusing on a client's *experience* with investing, this questionnaire asks clients about their attitudes, values and experiences regarding risk and its relationship to portfolio construction. We will begin sending the questionnaire to all our clients within the next few weeks.

CFA Magazine, March/April 2009 – David L. Blain was interviewed for an article regarding the use of exchange traded funds as part of an overall hedging strategy in portfolio management.

New Bern Sun Journal, February 9, 2009 – David L. Blain commented on the psychology of investing during turbulent economic times.

NAPFA Advisor, February 2009, "In the Limelight" – David L. Blain was recognized for his contributions to various finance-related publications during the 4th quarter of 2008. These include bloomberg.com, *BusinessWeek* magazine, *CFA Magazine* and *InvestmentNews*.

BUILD • PRESERVE • ENDOW

Wealth Manager

D. L. Blain & Co., LLC was named one of *Wealth Manager* magazine's Top Dogs for 2008. This annual list of the country's top wealth managers is based on average assets under management.