



O'BRIEN MANAGEMENT QUARTERLY REVIEW

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Economic Overview

By: Mary Jo English

Director, Investment Research & Strategy

The U.S. government's massive fiscal stimulus plan and the Federal Reserve and Treasury stabilization plans have slowed the deterioration of the U.S. economy and reopened many portions of the financial markets. Time, most likely years, will be required to heal the improved but still ailing economy and financial markets. Major current economic and financial market ills that will take time to cure are declining consumer spending, falling home prices, a frozen securitization market and deterioration in the commercial real estate market. Of these, the most important economic growth factor is consumer spending. Consumer spending will decline relative to its levels earlier this decade due to rising unemployment, declining household net worth and increases in savings rates. While positive economic growth will certainly return, perhaps as soon as the 2009 third quarter, the reduction in consumer spending will likely result in tepid growth. The recovery will be slow and sub par relative to previous cycles.

To the good, businesses and consumers are much less fearful now than they were at the heart of the crisis. Inventories need to be rebuilt, and that will boost growth this year. Auto sales, home sales and retail sales have stopped cliff diving. Stock prices staged an impressive rally during the second quarter, up about 30% from their March lows. The power of the stimulus package has begun to impact GDP growth, adding 3% to second quarter 2009 growth and 3 to 4% to third quarter growth. In a typical recession, two key drivers stimulating recovery are resumption of consumption and a rebound in residential investment. After this "Great Recession", it is unlikely that either of these will roar back for years.

U.S. consumer net worth has contracted a stunning \$14 trillion over the past two years. Unemployment figures continue to increase. Home prices are still falling. Understandably, consumers are saving more and spending less. This is prudent financial discipline. However, U.S. consumer spending is 70% of the U.S. economy, and the extent to which the consumer refrains from spending will influence the strength of future economic recovery.

Headlines highlighting rising unemployment can't help but dampen consumer spending. Unemployment is nearing 10%. It is a lagging indicator, and it will get worse even as we generate positive GDP growth later this year. In the past 18 months, 6.5 million jobs have been lost. Another million are projected to be lost before the end of the year. The unemployment rate has doubled since 2007, which makes this the most costly recession in terms of unemployment rate increases in post-World-War II history. Wages are falling. The length of the average workweek has declined to 33 hours, which is the shortest average workweek on record. Individuals are being forced to work reduced hours or are taking unpaid furloughs.

On average, national home prices have fallen over 30% from their peak. Estimates include another 5 to 15% decline in average national home prices. This would bring the ratio of home-prices-to-home-rents and home-prices-to-family-income more in line with historical norms. That said, prices could overshoot on the downside, as an increasing number of foreclosures depress prices and beget even more foreclosures. However, recent home sales data do suggest that demand is stabilizing, an encouraging sign.

The increasing numbers of job losses and a loss of net wealth have forced consumers to increase savings. May's savings rate reached 6.9%, up from 1.4% in September 2008. Consumers still have too much debt. At the end of March, total U.S. household debt as a percentage of disposable income fell to 120%, which is the lowest it has been since 2004, but still well above the 1995 level of 83%. As potential consumers repair their personal balance sheets by increasing their savings, their consumption will be less.

Although there are signs that the worst is over for the housing market, the fact that the consumer's ability to borrow has been compromised and that their net worth has been slashed leads one to believe that, unlike in past economic recoveries, the consumer is unlikely to help return the country to robust growth in the near term. We are likely to see 1 to 2% growth in the next several years rather than the 3.5% growth levels earlier this decade. This is one of the reasons that we are cautious on the near to medium term outlook for the equity market.

Another lingering concern affecting the financial markets is the state of the securitization markets. The asset-backed securitization market provides crucial liquidity to the financial system. Securitization is the process of bundling a number of loans into a "pool" and then selling pieces of that pool to investors. The mortgage market illustrates a good example of the process of securitization. A bank provides a homeowner a mortgage. Most likely, that mortgage does not stay at the bank, but is packaged together with other mortgages, sliced and diced, and then sold to outside investors. The process of packaging and selling this mortgage together with others allows the bank to obtain cash and make new loans. Similar securitized pools can be structured using auto loans, equipment-lease loans or credit card loans.

The securitized market suffered a near-death during the financial crisis. Banks did not lend and investors were reluctant to make purchases from these pools. There are hopeful signs that the asset-backed securitization markets are reviving with help from the Fed's Term Asset-Backed Securities Loan Facility (TALF), and a number of deals have been completed this year. This is important because these pools are key lenders to the economy. William Dudley,

President of the New York Federal Reserve Bank, recently stated, "Prior to August 2007, as much as 60% of private credit creation in the U.S. was not held on the books of depository institutions but was instead distributed onwards through the asset backed security markets into the so-called 'shadow banking system.'" It remains to be seen if the government-aided TALF will provide merely a temporary fix or if it will successfully bridge the gap to the return of a healthy, vital and self-sustaining securitization market.

It has often been cited that the commercial real estate market is the next shoe to drop in the financial crisis. Banks have drastically reduced lending to finance shopping malls, hotels and office parks. The securitization market, described in the paragraph above, also was a key source of funding for the commercial real estate industry, and it dried up during 2008. Billions of existing commercial mortgage loans on properties will mature this year, and there is fear that refinancing the loans will be difficult. Commercial property values have plummeted in various areas of the country over the past two years, and interest rates on the \$3.4 trillion existing commercial real estate loans are high. It has been difficult for developers to take on new loans at the higher rates that take the full risks into account. We are seeing increasing defaults in this market, and, as vacancies increase and rents decrease, defaults are likely to get worse. The TALF also will be applied to the commercial mortgage backed securities market this summer, and it is imperative that this program ease pressure on the commercial real estate market.

The financial crisis has stabilized with help from the stimulus plan and some creative liquidity plans from the government. The economy should return to positive growth this coming quarter. But there are a number of outstanding risks to a recovery. Consumer spending is likely to be measured and plodding for the near future due to unemployment concerns and losses of net worth. The securitization markets need to function again as they are a key lubricant to the movement of money in our financial system. And the commercial real estate market deterioration, which has been referred to as a "ticking time bomb," will need to be diffused. Mitigating these risks will take time and sacrifice. To us, this argues for being cautious in setting return expectations and structuring your portfolios.

Market Update

By: Allison S. Gates

Investment Research Associate

On the whole, the second quarter of 2009 was a much needed bright spot in an otherwise rather grim 12 month period. Stocks, bonds, and alternative assets all posted positive returns during the quarter. This evidence points to a welcome development -- investors may be regaining a semblance of their appetite for risk.

The equity market made up serious ground during the second quarter of 2009. As is expected when investors are regaining their speculative appetites, the most volatile stock categories posted the highest returns. Emerging markets stocks are considered the riskiest asset category, followed by developed international markets, and finally domestic markets. Returns followed suit. The MSCI EM measures emerging international markets and surged 35%; the MSCI EAFE Index measures developed international markets and gained 25%; and the S&P 500 Index grew about 18%. Within the domestic stock market, performance also increased with risk. The most volatile domestic category, small-cap value, was the top performer, followed by mid-cap stocks and, lastly, large-cap stocks. This theme held true in alternative assets also, with the riskiest assets, commodities and REITS, beginning much-awaited comebacks at plus 14% and 26%, respectively.

O'Brien Management clients with equity exposure took part in the global stock market rise. Our main Emerging Markets fund, Lazard Emerging Markets, gained nearly 37%, while our aggregate developed international markets holdings increased by almost 33%. Our aggregate small-cap holdings posted a 23% gain, while mid-cap and large-cap grew at 20% and 18%, respectively. In both the large- and mid-cap areas of the market, value slightly outperformed growth. Despite the recent rally we remain cautious. From our perspective, there is still considerable uncertainty regarding the health of financial organizations and how long and severely the credit crunch will continue to affect the real economy.

The fixed income market, as measured by the Barclay's Aggregate Bond Index, returned 2% for the quarter, reflecting the movement of credit spreads toward more normal levels, again indicating investors' reborn appetite for risk. A performance highlight from the beginning of the year has been the Vanguard Short-Term Investment Grade Bond Fund, which continued its forward momentum, gaining just above 6% for the quarter. Year-to-date this fund is up more than 8%, a stunning showing for a short-term bond fund. This performance has been driven by the decrease in spreads between short-term corporate bonds and Treasuries, reflecting improved confidence in the corporate bond market.

In the coming weeks clients may notice changes in the developed international portion of their portfolios. Our investment committee has recently approved two actively-managed international funds, Dodge & Cox International and Harbor International, to replace the international indexes that we bought as part of our tax-loss selling in October 2008. These names may sound familiar but we went through a rigorous evaluation to re-approve them. In order to approve a fund, we do extensive research, including comprehensive data analysis and a lengthy interview with the fund's portfolio management team, to discern whether or not the fund meets our criteria. We feel confident in the long-term investment strategies of the managers running these funds and their prospects for outperforming the index and their peers. We will be making trades gradually to replace your current developed international holdings with these two recently-reviewed funds.

We are committed to managing our clients' portfolios prudently according to individual portfolio objectives. We will continue to monitor the market landscape and take advantage of the opportunities that, in our view, have the greatest reward given appropriate risk levels.

The O'Brien Management Investment Committee

Mary Jo English, Chair Allison Gates Lauren Gibbons Cindy Kuppens Ted Martin Marc O'Brien Lis Zimmerman