O'Brien Management
INVESTMENT STRATEGY & MANAGEMENT

O'Brien Management Quarterly Review

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Economic and Market Overview

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The first quarter of the year ended with glimmers of hope that the worst of the financial crisis is behind us. The recent bounce in the stock market and the uptick in commodity prices are viewed by some as a sign that the global economy is poised to begin a recovery by the end of 2009. In the past few weeks there has been a growing appetite for risk as evidenced by good demand for emerging market equities and junk bonds, two of the worst performing asset categories in 2008. At its low in early March, the broad equity market was down 25% from the beginning of the year. It has since rallied by over 20%, one of the quickest moves ever recorded.

There are several reasons for the change in investor psychology. Recent data releases indicate that the rapid pace of deterioration in economic activity is slowing from the levels recorded at the end of 2008 and earlier this year. Sales of both new and existing homes, though still at low levels, are now above their extreme lows. The same is true for auto sales. Industrial production and retail sales figures have also shown modest improvement. The recently announced plan by the Department of Treasury, the Public-Private Investment Program, which is intended to help rid the banks of their toxic assets, was initially being viewed as a positive for the market. In contrast to the skepticism that met previous plans put forth by the Obama Treasury, this plan was seen as a way to improve price discovery for distressed assets. Also, there was relief that the new administration was not going to rush in and nationalize major banks. The recent G-20 summit of world leaders, hough lacking in any major pronouncements, was not marked by public discord, which too has added to the positive tone of the stock market.

While the stock market's recent performance is encouraging it is too early to say whether it is a bear-market bounce or the beginning of a more sustainable move. There is reason to be cautious. Market volatility is down from the extremes at the height of the crisis when Lehman Brothers went under, but remains well above long-term historical averages and is an indication of system imbalances and investor angst. Also, the rally in the stock market has not been accompanied by a significant improvement in the credit markets. The flow of credit is certainly better than last fall when credit extension came to a virtual standstill; however, we are far from normal with credit conditions remaining tight for many companies. Credit quality spreads, both for investment grade bonds and low quality bonds, have compressed slightly from their widest levels reached last November but remain multiples above what we think of as typical. Critical to the smoother flow of credit is finding a solution to cleaning up bank balance sheets. The Treasury's recent proposal, as mentioned above, is a good step forward but it is still unclear whether it will be successful in attracting the necessary private capital. The longer it takes to solve the banking crisis the longer and deeper the economic contraction.

This economic downturn is very different from most postwar recessions. Once the trough is reached, the recovery could be muted and drawn out before the economy achieves its full growth potential. Most business cycles come to an end because the Federal Reserve raises interest rates and thus slows demand in an effort to ward off a rise in inflation expectations. Today's situation is much different and reflects the bursting of a massive credit bubble after the household sector went on a prolonged debt binge financed by an increasingly-leveraged banking system. Households are in the midst of paying off this debt. The process of reducing debt to more manageable levels relative to personal income will take time. As a result, the attendant increase in the savings rate can be expected to slow the snap-back in consumption that is typical of other recoveries. Also hindering a recovery this time around will be the ability of bank lending to support growth. Funds from various government bail-out programs are only replacing lost bank capital, not increasing it. Banks' weakened financial conditions will shrink their abilities to make new loans as the economy emerges from the recession.

We are in the beginning stages of comprehensive reform of financial market regulation. The era of financial liberalization or pro-market ideology has ended. In hindsight our system was too fragile, too vulnerable to shocks. More checks and balances on risk taking will be put in place. Balkanization is one way of describing the architecture of the current system of financial regulation. The patchwork of regulatory agencies at the federal and state level must be modernized to reflect evolving financial products and the globalization of financial markets. Consideration is being given to making an independent institution, possibly the Federal Reserve, responsible for monitoring financial institutions whose failure could have a destabilizing impact on the economy. A primary goal of consolidating and streamlining regulatory oversight is to make our economic and financial system less pro-cyclical so that it dampens, not amplifies, future booms and busts.

What impact will government intervention have on future economic growth and financial asset returns? Will stricter limits on leverage and increased oversight result in less volatile markets, but at the expense of potential economic growth? If so, what does that say about future equity returns relative to what investors have come to expect in the past? In this new era, these are some of the questions we will be contemplating to help us determine the appropriate asset allocation and investments for our clients.

Index Performance		
Stock Indexes	**Q1 2009**	**One Year**
S&P 500 (Large U.S. companies)	-11.01%	-38.05%
Russell 2000 (Small U.S. companies)	-14.95%	-37.50%
MSCI EAFE (Large Foreign companies)	-13.85%	-46.20%
MSCI Emerging Markets	1.02%	-46.90%
Bond Indexes		
Lehman Aggregate (U.S. bond market)	0.12%	3.13%
Lehman Investment Grade Corporate	-1.93%	-6.63%
Lehman High Yield	5.98%	-19.30%
Lehman Municipal	4.23%	2.27%
3 month Treasury bill	0.16%	1.61%
Alternative Asset Indexes		
Lehman U.S. TIPS Index	5.52%	-2.04%
Dow Jones-AIG Commodity Index	-6.36%	-45.54%

Portfolio Review

By Brandon Auger, CFA
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Investors were taken for another wild ride in the first quarter of 2009. Dour economic news and bearish sentiment pushed the domestic equity market to fresh lows by the middle of the quarter. However, in early March, stocks began a dramatic comeback that pushed prices almost 20% higher in just a few weeks. The rally, in which all major segments of the equity market participated, was mostly fueled by a slew of moderately positive economic news and by the release of a new government plan to rid banks of toxic assets.

Despite this positive development, stock prices are still down for the year. We remain cautious in putting new cash to work in the equity market and will maintain a defensive posture until we see more clarity in the economic outlook.

The bond market posted modest gains during the quarter, providing a slight cushion for our clients' portfolios. The *Vanguard Short Term Investment Grade Fund* returned 1.6%, outperforming other investment grade bond funds because of the significant yield it offers, coupled with minimal exposure to interest rate risk. Our core bond holding, the *Pimco Total Return Fund*, was up almost 1.0%. Dislocations in the bond market persist and continue to present significant opportunities in high quality short-term corporate bonds. With yields to maturity of approximately 7% we are being well-compensated for the unlikely risk of a significant increase in default rates.

In the Alternative Assets asset class, Treasury Inflation Protected Securities (TIPS) were a positive contributor to client portfolios as they gained sharply in March. Near the end of the quarter, the Investment Committee decided that the rally in the TIPS market was excessively enthusiastic and that it was prudent to sell the *Vanguard Inflation Protected Securities Fund* in order to lock in the substantial gains. At some point we will reinstate our TIPS position, as TIPS are a unique diversifier and a solid inflation hedge. However, we will wait for a more advantageous price. In the meantime, we are evaluating options in which to invest the trade's proceeds.

Though the final three weeks of the quarter provided some reprieve to investors, it is likely that the market will continue to gyrate as it seeks fair value. Our Investment Committee will remain vigilant in searching for attractive investment opportunities in this murky economic environment. It is hoped that the government's plans to stabilize the markets and the banking system will gain traction and generate newfound optimism for the U.S. and global economy.

Changes Affecting Taxable Accounts

Last fall we took losses in most taxable accounts, resulting in many clients realizing considerable tax credits. To do this, we sold out of actively managed equity funds and simultaneously reinvested in passively managed index funds of similar make up. We planned to reinvest in our actively managed equity funds in the New Year and have begun this process in the mid- and small-cap categories. It has always been O'Brien Management's belief that, over the long-term, clients will benefit more by holding actively managed funds as opposed to passively managed funds. The advantages to holding actively managed funds may be even greater now, because it is in times of great volatility that active managers may particularly add value. Managers of active funds have complete control over what their fund holds on a day to day basis. Passive fund managers, on the other hand, must replicate stock indexes and, like the indexes, be fully invested in a fixed mixture of stocks. When market conditions are such that prices may not be indicative of true value an active manager's judgment can prove quite beneficial. We will continue this passive to active shift in the large-cap and international areas.