BOWLING
PORTFOLIO MANAGEMENT LLC

# Q1 MARKET REVIEW AND ECONOMIC OUTLOOK 2009

*"The nine most terrifying words in the English language are, 'I'm from the government and I'm here to help."*
Ronald Reagan
40th President of the United States of America
(1911-2004)

It is conventional wisdom on Wall Street that a new bull market cannot begin until there is a final capitulation and investors sell most or all of their stocks in an emotional panic. The March 6th intraday low of 666 on the S&P 500 marked a breathtaking 56% decline from the high set in October, 2007. Since then, in the midst of widespread skepticism, we have rallied nearly 30%, with only brief pauses for air. Within the quarter, the equity market had a steep decline into early March but rallied 17.9% from its March closing low to the close of the quarter. When all was said and done, the equity market as measured by the Standard & Poor's 500 Index finished the quarter down 11.0%.

We are encouraged by the current stock market rally which has carried us over 30% higher from the March lows. However, we know that the bottoming of markets, as well as economies, is a process, not a singular event. Markets don't recover in a straight line. There will be fits and starts under even the best of circumstances. Fortunately, there is growing evidence of the beginning of a break from the stagnation that has paralyzed the economy and markets since last September. Most importantly, there are some indications of a slowing in the pace of the economic decline. The sheer magnitude of global policy initiatives has been staggering as government authorities attempt to transition from being reactive to proactive. The markets seem to be buying into the notion that these policies will soon gain some traction and that there's some light at the end of the tunnel. There is, of course, no way to know when this bear market will end, but if the sum of the damage is any indication, we should be fairly close.

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It strikes us as fitting that Spring is an appropriate time for investors to begin to feel more optimistic about the future. Despite the continued drumbeat by the media on the dire economic conditions (job losses, rising unemployment, increasing mortgage and credit card delinquencies, home foreclosures, etc.), there are indications that the winds of change are blowing. Chairman of the Federal Reserve Bank, Ben Bernanke, recently said the "green shoots" of an economic revival were already evident. The economic rate of decline for many parts of the economy has been slowing. The bad news is getting less bad. The operative words these days (with apologies to English teachers) are "less worse." These subtle economic improvements are often easier to see in the rear view mirror than through the front windshield, but many indicators are showing early signs of leveling out or are declining at a slower pace.

So, you may ask, "What are these 'green shoots' of economic spring growth?" We offer the Following for consideration: the credit markets have improved significantly since freezing up last fall. Lower energy and commodity prices have reduced pressures on the U.S. consumer. Consumer confidence is beginning to improve. In the months ahead we should begin to see the positive effects of the stimulus bill. Tax refunds are up 15% over last year. This is the largest increase since 2002. Fiscal stimulus always acts with a lag, but the initial stimulus moves made last year may be bearing fruit in the form of budding growth.

Additionally, housing prices appear to be stabilizing in some markets. There is a large amount of refinancing activity in residential real estate. With mortgage rates at all time lows, borrowers who can qualify are aggressively acting to lower their payments. Unemployment remains high, but this tends to be a lagging economic indicator, and generally does not peak until well after an economic recovery has begun.

We are even seeing a pickup in some leading indicators such as retail sales, existing home sales, and the stock market. Auto sales are increasing modestly. Manufacturing orders are increasing across the globe, and inventories are decreasing providing the need to restock at a future date. It is unfortunately true that global industrial production has plummeted, meaning goods are not being manufactured. However, going forward, increased manufacturing will be needed to restock inventories. This will fuel increased job growth. That is how a recession comes to an end.

While marginal improvements in some economic data could well prove to be temporary, we believe the much greater likelihood is that the economy is entering the first phase of recovery. We believe the economy is currently in the process of transitioning from a period of active contraction to a period of easing decline. There is little debate that the economic data will continue to be quite dour, and we have certainly not yet seen the depths of negative economic data points. However, the exercise of measuring economic activity in prior periods is by its very nature backward-looking. Many widely followed economic indicators such as unemployment are lagging indicators. In fact, the economy often turns the corner by the time lagging indicators show improvement.

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Governments around the world have directed massive amounts of stimulus at the crisis and remain committed to doing so until credit markets thaw meaningfully and leading economic indicators turn up decisively. Even though it took the politicos too long to recognize the severity of the situation, they have subsequently taken significant meaningful steps over the last couple of months. Since mid-2007, there have been over 500 stimulative policy announcements. Nearly 90% of these have occurred in the past 6 months. Despite all of the discourse to the contrary, the widespread fears of repeating the terrible policy blunders that exacerbated the Great Depression are simply unfounded. In fact, as a result of these policy measures, a number of hopeful signs of a moderating of this global recession have surfaced over the past month. We're encouraged. Cautiously.

The most profound challenge in the immediate future continues to be the need for government to enact policies which promote financial stability, foster economic growth, and fight price deflation. Given the tenuous positive changes we have begun to see in some economic data, we believe this recession is likely at or near its point of maximum contraction. If this proves to be correct, the second half of 2009 should be marked by signs of increasing economic stability, which will lay the groundwork for economic and capital market expansion, and the eventual resumption of economic growth.

As usual, and as our long time readers have come to expect (at the ever-present risk of being perceived as Pollyannaish), we would like to share with you the following points which are supportive of our guarded optimism:

•Symptomatic of the extremes in investor sentiment, cash positions are at record highs and are currently earning paltry returns. According to Ned Davis Research, Money Market Fund assets now represent a staggering 40% plus of the total value of the U.S. stock market. This is the highest level ever. What is even more awe inspiring about that figure is it does not include cash that has been stored at low interest rates in bank accounts, checking accounts and CD's. Nor does it take into account the immeasurable amount of money investors have thrown at Treasury instruments, some yielding near nothing. When taken as a whole, the aggregate amount of assets effectively "hidden under the mattress" surely exceeds the total aggregate value of every single share of every single stock on every one of our exchanges. That is a lot of dry powder. As confidence builds, and investors seek higher rates of return, some of this money will inevitably be reallocated to equities. This will be the fuel for the next bull market. This is not so much an "if", but a "when."

•Equity valuations range from moderate to "downright cheap". Consequently, valuations should not be a hindrance to either a continued rally or the start of a new bull market. Most valuation tools suggest stocks are at least moderately undervalued. Here are a few of them:

# FIRST QUARTER 2009 MARKET OUTLOOK

1) The market's fourth quarter annualized free cash flow yield was over 6% versus its long term average of around 3%. This is a 50% plus discount to average market cash flow valuations. In fact, the free cash flow yield is at historically high levels in most markets around the world. However, it is highest in the U.S., which may suggest the domestic market offers compelling value compared to its international peers.

2) The median price/earnings ratio for the 3000 largest U.S. stocks since 1972 is 14.8. The price/earnings ratio currently stands at about 11. Again, this is a substantial discount to its historical average.

3) Yale's Robert Shiller has calculated historical price/earnings ratios using "normalized" earnings per share. In this approach the earnings used to calculate the ratio are the average earnings over the previous ten years. This helps to smooth the extremes of earnings cycles, and is a very conservative approach. Using this definition, the current S&P 500 price/earnings ratio is around 13. This suggests upside of over 30% if the market mean reverts to its long term average (since 1926) of 17.

•According to The Leuthold Group, the S&P 500's ten-year total return ending March 6, 2009, was negative 4.4% per year, or a cumulative loss of 36.3%. It was the worst ten-year stretch in U.S. stock market history, including the Great Depression. Valuations ten years ago were extremely high and sentiment approached exuberance. Today, valuations are low and sentiment is dreadful. History shows repeatedly that low returns follow high valuations and grand expectations, and high returns follow low valuation and pessimistic expectations. The table below depicts the ten-year annual compound returns for stocks following the fifteen worst ten-year periods in the U.S. history. It is worth noting that none of these 10 year periods with negative returns was followed by a subsequent 10 year period with negative returns. Never. In fact, the lowest subsequent ten-year annualized return was 7.2% per year and the highest was 15.58% per year. We believe the next ten years will fall into this range.

| Past 10 Years | Past 10 Yr Annualized Return | Next 10 Years | Next 10 Yr Annualized Return | Total Compound Return |
|---|---|---|---|---|
| Q2 1929 to Q2 1939 | -3.65% | Q2 1939 to Q2 1949 | 8.62% | 128.54% |
| Q1 1929 to Q1 1939 | -2.79% | Q1 1939 to Q1 1949 | 9.12% | 139.36% |
| Q3 1929 to Q3 1939 | -2.74% | Q3 1939 to Q3 1949 | 7.74% | 110.79% |
| Q1 1928 to Q1 1938 | -2.54% | Q1 1938 to Q1 1948 | 11.76% | 203.87% |
| Q1 1930 to Q1 1940 | -1.42% | Q1 1940 to Q1 1950 | 9.65% | 151.31% |
| Q2 1930 to Q2 1940 | -1.42% | Q2 1940 to Q2 1950 | 12.19% | 215.88% |
| Q4 1928 to Q4 1938 | -0.65% | Q4 1938 to Q4 1948 | 7.21% | 100.63% |
| Q3 1928 to Q3 1938 | -0.10% | Q3 1938 to Q3 1948 | 8.12% | 118.31% |
| Q3 1930 to Q3 1940 | 0.18% | Q3 1940 to Q3 1950 | 12.57% | 226.85% |
| Q4 1927 to Q4 1937 | 0.20% | Q4 1937 to Q4 1947 | 9.61% | 150.39% |
| Q4 1929 to Q4 1939 | 0.23% | Q4 1939 to Q4 1949 | 9.09% | 138.67% |
| Q2 1928 to Q2 1938 | 0.44% | Q2 1938 to Q2 1948 | 9.52% | 148.39% |
| Q3 1964 to Q3 1974 | 0.49% | Q3 1974 to Q3 1984 | 15.58% | 325.30% |
| Q1 1931 to Q1 1941 | 0.71% | Q1 1941 to Q1 1951 | 14.47% | 286.14% |
| Q4 1964 to Q4 1974 | 1.24% | Q4 1974 to Q4 1984 | 14.76% | 296.23% |
| | | AVERAGE | 10.67% | 182.71% |

The Leuthold Group - March 2009

## FIRST QUARTER 2009 MARKET OUTLOOK

For investors who are capable of patience, and with a long term horizon, we see very attractive stock valuations which we believe may occur only once in a lifetime. We remain convinced that adhering to a strict investment discipline during the inevitable challenging times is the right course of action. Diversification, sector neutrality and stock selection are paramount. We believe now, more than ever, that a value-based equity investment strategy is the best way to approach long term participation in the U.S. equity market.

We always feel that it is part of our job to manage the expectations of our clients. Long term performance consists of many periods of short term performance. In some of these short term periods, the market is up and sometimes it is down. Likewise, there have been periods when our clients outperformed the market and periods when they underperformed the market. No manager will outperform the market in every time period. This is why we are consistently focused on outperforming the market over the longer time frames. As the chart below demonstrates, our Large Cap Core Value ("LCCV") strategy has handily outperformed the S&P 500, as well as the Russell 1000 Value Index, over the last 1, 3, 5, 7, 10, 15 and 20 years, as well as from inception of the strategy in 1988. This cumulative performance is after all fees and expenses

| | 1 Year | 3 Years | 5 Years | 7 Years | 10 Years | 15 Years | 20 Years | Since Inception |
|---|---|---|---|---|---|---|---|---|
| Bowling LCCV | -35.68% | -29.96% | -6.45% | -2.38% | 8.47% | 175.02% | 522.44% | 761.63% |
| S&P 500 | -38.09% | -34.28% | -21.66% | -20.36% | -26.25% | 136.52% | 319.11% | 423.30% |
| Russell 1000 Value | -42.42% | -39.45% | -22.36% | -15.58% | -6.05% | 154.61% | 340.68% | 483.32% |

*For Use Only in One-On-One Presentations

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***Bowling's composite performance results for the Large Cap Core Value Strategy include actual total returns for all non-wrap and fully discretionary accounts in this strategy above $50,000. Prior to 2002, the composite also included wrap accounts. These net-of-fee composite returns are calculated on an asset-weighted basis and include transaction costs and the reinvestment of dividends and income. The net-of-fee composite returns are after the deduction of management fees. The S&P 500 and Russell 1000 Value are unmanaged asset-weighted indices of large U.S. based companies which includes income but do not include expenses. Past Performance is not a guarantee of future results. Bowling Portfolio Management LLC claims compliance with the Global Investment Performance Standards (GIPS). Performance is expressed in US Dollars. For additional information, contact Bowling Portfolio Management LLC at 513-871-7776.**