

For the second quarter in a row, the S&P 500 generated a return of nearly 16%. The solid returns for the past two quarters helped erase the negative first quarter 2009 return, and brought the S&P 500 Index to a gain of 19.3% for the year. As difficult as the last year has been, it is worth noting that the S&P 500 Index is up over 28% from this time last year.

The rally took off in March, as panic and despair dominated the thoughts of investors and Americans prepared for the “Great Depression II.” As a glaring testimony to the inherent difficulties of market timing, a magnificent bull market followed, resulting in a rally of nearly 60%. In recent weeks, we’ve watched the Dow reach the 10,000 level and Fed Chairman Bernanke declare an end to the recession.

Put simply, we have seen this rally because economic data, earnings and credit markets have all improved more than expected. In terms of economic data, green shoots turned into green stalks as metrics continued to show progress. Although some areas remain challenging, most economic factors continued to exceed expectations in the third quarter. In fact, the theme of the third quarter could be “better than expected.” Factors contributing to the market’s rebound included the following:

- Last quarter, 72% of the companies in the S&P 500 reported earnings higher than analysts’ estimates, marking the highest reading in several years.
- The Fed signaled it would keep its target short-term interest rate low for “an extended period,” while continuing its program to purchase more than \$1 trillion of mortgage bonds to lower the cost of home financing.
- Monetary policy remained extremely supportive for the financial system. Despite the lingering effects of the financial crisis, the financial system backdrop continued to enjoy broad-based improvement.
- The yield curve remained extremely steep. Steep yield curves provide a favorable backdrop for bank lending profitability because banks are typically able to borrow (attract deposits) at lower short-term rates while making loans at higher long-term rates.
- Spending continued as part of February’s \$787 billion U.S. government stimulus legislation, including the “cash for clunkers” program that boosted auto sales.
- Businesses found easier and cheaper access to credit.
- Despite large government deficits and money supply growth, which kept concerns alive about future inflationary impact, actual inflation remained muted.
- Oil and gasoline prices remained mostly flat during the quarter, up significantly from the beginning of the year but still far below mid-2008 peak levels.
- The U.S. housing market exhibited several signs of stabilization.
- Policy stimulus, both in the U.S. and abroad, remained supportive of growth amid low interest rates and heavy government spending.
- Growth in large developing countries, including China and India, reaccelerated and provided a boost to global trade.

“The problem with socialism is that eventually you run out of other people’s money.”

Margaret Thatcher
Prime Minister of
the United Kingdom
from 1979 to 1990

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As you can see, the list of positive economic factors that aligned in the third quarter were numerous. Although we are cautiously optimistic, it is important to be mindful that no recovery occurs unabated. There will inevitably be fits and starts. Markets do not advance in a straight line, and there will be pullbacks on the road to higher eventual levels. However, looking forward, we see continued signs of improvement and data which may serve as an impetus for further advances such as:

- The 3.5% rise in Q3 GDP announced this week was the first positive number in a year, and the fastest growth in two years. This exceeded economist's estimates of 3.2%, again keeping with the theme of economic numbers coming in "better than expected." This marks a solid return to positive growth after a full year of consecutive declines. We feel this serves as an unofficial confirmation that the longest and deepest recession since the Great Depression has ended. While investors have anticipated the return of GDP growth for some time, confirmation of growth in the 3% range is likely to be a surprise to some. Investors who have not yet acknowledged the economy is on a path towards recovery may be swayed after this GDP report.
- More than 80% of S&P 500 companies that have reported third-quarter results have beaten analyst earnings estimates, exceeding the record pace of 72% for the period ended in June. If this were to hold throughout the duration of this earnings season, it would be the best number in almost twenty years.
- Leading economic indicators continue to signal that the economy is exiting the recession. Economic indicators that are considered "leading" are the most helpful to investors because they tend to do a better job of identifying future economic trends. For the second straight month, eight of 10 components of the Leading Economic Indicators index rose on a six-month basis.
- Despite the hand-wringing, the weak-dollar is not all bad. Since 2003, dollar weakness has gone hand-in-hand with equity rallies. Because nearly 50% of revenues for S&P 500 companies come from abroad, dollar weakness actually boosts earning of large, U.S. multinational corporations through increased competitiveness and positive currency translation effects, as foreign revenues are converted into a greater number of shrunken dollars.
- In August, retail inventories fell for the thirteenth consecutive time for a cumulative decline of 15% since last summer. To put the drop in perspective, retail inventories have never before fallen more than three months in a row. This is actually good news, because these inventories will need to be replenished. Looking ahead, restocking inventories should further boost growth in the fourth quarter of this year and the first quarter of next year.
- Federal stimulus will contribute to growth through the first half of next year too, mostly thanks to money allocated, but not disbursed in 2009.

Yet for all this good news, there seems to be an increasing amount of skepticism regarding the sustainability of this rally. Contrary to what you may think, a certain amount of skepticism is actually a good thing. Extreme optimism and pessimism tend to characterize market tops and bottoms, and cause emotional investors to commit the cardinal sin of "Buying High and Selling Low." Time and again, we've seen the market overshoot in both directions, while in reality true fair value lies somewhere in the middle.

As famed value investor Sir John Templeton once said, "Bull markets are born in despair, *grow amid skepticism*, mature in optimism, and die amid euphoria." In Wall Street terms, this is often described as "Climbing the Wall of Worry," which occurs when markets rise in the face of negativity. The idea is that when skeptics abound, it means that equities are still somewhat "unloved" or out of favor. As such, there are plenty of investors who have not yet "bought into" the rally. As a result, prices are often reasonable,

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allowing for more generous returns. In addition, when these skeptics eventually come around, it provides an added tailwind to push up stock prices.

The stage is being set for this exact scenario to play out. The evidence of negative retail investor sentiment is demonstrated unambiguously via the sheer hoard of cash on the sidelines. Investors placed \$1.45 trillion in U.S. money market funds in 2007 and 2008 during the worst financial crisis since the Great Depression. Cash in money market accounts alone has swelled to a remarkable \$3.5 trillion. According to recent data compiled by the Federal Reserve, a broader measure of reserves that includes cash, bank deposits, and money market funds has climbed to \$9.55 trillion. That's enough to buy every single company in the S&P 500!

These high cash levels suggest that many individuals remain skeptical about investing in stocks, which is often seen as a positive sentiment indicator for contrarian investors. As the stock market rallied in recent months, a very large percentage of assets remained parked in money market funds. The stock market is up 58% since its most recent March 9th low, while the absolute level of assets in money market funds fell only about 8%. A good chunk of the recent decline in money market funds (as a percentage of stock market capitalization) was due to the market going up, not investors rushing back into the market. This illustrates that many investors either were late to the party or didn't fully participate in this vibrant rally.

Given the severity of the ongoing recession and 2008 market decline, it may take longer than in the past for many shell-shocked investors to consider reallocating to stocks. Still, the cash stockpile on the sidelines remains larger than it historically has been which means that it would only take a relatively small percentage of investors reentering the market to provide a significant boost to stock prices.

History also has proven that deeper recessions are followed by stronger recoveries. Economists often call this the "Rubber Band Effect" because, like a rubber band, the more the economy is pulled in one direction, the harder it will "snap back" in recovery.

Since 1945, there have been four major recessions during which the U.S. economy shrank by more than 2.5%. Each time, the ensuing rate of growth during the first two to four quarters of recovery was vigorous, averaging 6-7% on an annualized basis. Even if we examine the Great Depression, the historical pattern remains consistent. From 1929-1933, the economy contracted by a stunning 27%. However, in 1934, as the economic recovery took hold, growth reached nearly 11%.

Conversely, "mild" recessions have tended to be followed by "mild" early-stage recoveries. The last two recessions (1990-91 and 2001) were the tamest economic contractions on record, and the subsequent rebound in economic growth averaged a more tepid 2% during the first year of recovery. Thus, when economic recessions have been deeper and more severe, the early stages of the subsequent recovery have been stronger.

The 2007-2009 recession (assuming Mr. Bernanke is correct) will have been the longest and most severe since World War II. However, a recent survey of economists showed their expectations for growth rates were almost exactly in line with the rate of recovery that has typically occurred after "mild" recessions. In other words, current expectations are that this extremely severe recession will be followed by a "mild" early-stage recovery, despite the fact that this has not happened in the modern history of the U.S. economy.

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Another area where we look to history as a guide is valuations. When looked at on the basis of price-to-earnings, price-to-book value and price-to-sales ratios, valuations appear to be supportive of further equity market gains. S&P 500 stocks are now selling for about 15 times expected operating earnings for 2010. This is by no means excessive given currently low inflation and interest rates, as the average price to earnings ratio in similar environments over the last 50 years has been in excess of 18 times earnings. According to data compiled by Bloomberg, the S&P 500 index trades for 2.17 times book value, which is 33% below its 15-year average. Likewise, the index fetches 1.15 times sales, 22% less than its average since 1993.

Further, large-cap stocks appear to be significantly undervalued relative to their small-cap brethren. On a trailing basis, the S&P 500 is trading at a P/E of 19, while small-cap stocks (as measured by the Russell 2000 index) have a negative P/E of -126! Yes, that is a minus symbol. That's because small stocks, in aggregate, have actually lost money over the last twelve months. If we look forward, large stocks are selling at a P/E of 15 times next year's estimated earnings, while small-caps are trading at 26 times. That means, in times of uncertainty, investors are paying nearly twice as much for more uncertainty. We think that is unlikely to persist.

There is no doubt we are confronting many challenges, and there are many battles to be fought. Government intervention and regulatory risk continue to create uncertainty. And eventually, when the Fed must remove accommodative monetary policy by increasing interest rates, history tells us a small correction could follow. But history also tells us that investors who stay the course following the first hike are rewarded with positive equity returns more than two-thirds of the time over the following year, by an average of nearly 9%.

The downside of skepticism is that it is often accompanied by volatility. We do not see this going away in the short-term, and corrections are likely along the way. But when this occurs, it is important to remember that the reward for this volatility is great, and is the primary reason that stocks have the best long-term track record of any asset class. This is supported throughout history. Jeremy Siegel, finance professor at Wharton and acclaimed author of one of our favorite books "Stocks for the Long Run," penned an article in Financial Times recently which clearly illustrated the long-term advantages of equity investing. The following is a brief excerpt:

"The recent bear market has been particularly painful for stocks investors, beginning only five years after the vicious 2000-2002 bear market. For the ten years ending last December, stocks have offered a negative 3.15 per cent real return for US investors, constituting the fourth worst ten year period since 1871. This had led many to question whether the mantra "Stocks for the Long Run," is still right for investors.

But a look at history shows that recent experience is not uncommon and excellent returns are available to those who survive such rough patches. Since 1871, the three worst ten-year returns for stocks have ended in the years 1974, 1920, and 1978. These were followed, respectively, by real, after-inflation stock returns of more than 8 per cent, 13 per cent, and 9 per cent over next ten years. In fact for the 13 ten-year periods of negative returns stocks have suffered since 1871, the next ten years gave investors real returns that averaged over 10 per cent per year. This return has far exceeded the average 6.66 per cent real return in all ten years periods, and is twice the return offered by long-term government bonds.

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Strong future returns also followed poor returns if one extends the analysis to the worst-performing of all 127 10-year stretches since 1871. Without exception, for each ten-year return that fell in the bottom quartile, the following 10-year period yielded positive real returns and the median return exceeded the long-run average.

Stocks also swamp the returns on fixed-income assets over the long run. Even with the recent bear market factored in, stocks have always done better than Treasury bonds over every 30-year period since 1871. And over 20-year periods, stocks bested Treasuries in all but about 5 per cent of the cases...

...Bill Gross, the head of PIMCO, has joined other pessimists by claiming the US economy is headed for a "New Normal," which he describes as slower economic growth and limited stock returns. This prediction is based on lower spending by American consumers who are unwinding from the excess leverage built up over the past decade.

But these predictions fail to take into account that it is world economic growth, not only US growth, which will dictate future stock returns. Every dollar of US international indebtedness is matched by a dollar of assets abroad. S&P 500 companies now obtain almost 50 per cent of their revenue outside the US and that share will most certainly rise as growth in the emerging nations continues to outpace that of the developed world...

...The recent behavior of stock market prices sheds some light on a phenomenon which has long puzzled economists: why do stocks over the long run yield so much more than bonds? The pain that investors often suffer, such as in the recent bear market, forces many to forsake equities altogether. This drives stock prices down and enhances their future returns. Equities offer investors excellent returns to those willing to accept the market's volatility."

As our clients and readers of our newsletters are well aware, we at Bowling are firm believers in the long-term advantages of equity investing. We continue to be supportive of Professor Siegel's work and applaud his efforts.

We have included an exhibit titled "Excess Annualized Return over Benchmarks." This exhibit illustrates the difference ("excess return") between the return of Bowling's Large Cap Core/Value composite and that of the S&P 500 and the Russell 1000 Value indices. We think it is worth noting, and it is certainly something we are very proud of. We are very pleased that we have been able to add value on behalf of our clients, which, in the end, is our mandate.

Thank you for your interest in Bowling Portfolio Management. If you would like to discuss our comments, or if we can be of assistance to you in anyway, please call our office and ask for Ed Rountree, CFP, Vice President at 513-871-7776.

Excess Annualized Gross Returns Over Benchmarks

Bowling Portfolio's Large Cap Core/Value Strategy



	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	15 Years	20 Years
Bowling Portfolio's Large Cap Core/Value vs. S&P 500	3.29%	2.77%	2.45%	3.26%	3.45%	4.28%	2.34%	3.30%
	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	15 Years	20 Years
Bowling Portfolio's Large Cap Core/Value vs. Russell 1000 Value	7.70%	6.48%	4.89%	3.38%	2.68%	1.54%	1.45%	2.70%

Data as of 09/30/09.

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. These gross composite returns are calculated on an asset-weighted basis and include transaction costs and the reinvestment of dividends and income. The S&P 500 Index and the Russell 1000 Value Index are unmanaged asset-weighted indices of large U.S. based companies which include income but do not include expenses. Past performance is no guarantee of future results. For additional information, contact Bowling Portfolio Management LLC at 513-871-7776.

Annualized Gross Returns Over Benchmarks

Bowling Portfolio's Large Cap Core/Value Strategy



	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	15 Years	20 Years
Bowling Portfolio's Large Cap Core/Value	22.55%	-4.14%	-2.98%	4.28%	9.31%	4.13%	9.96%	11.30%
S&P 500	19.26%	-6.91%	-5.43%	1.02%	5.86%	-0.15%	7.62%	8.00%
Russell 1000 Value	14.85%	-10.62%	-7.87%	0.90%	6.63%	2.59%	8.51%	8.60%

Data as of 09/30/09.

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The Bowling Large Cap Core Value Composite

BOWLING PORTFOLIO MANAGEMENT LLC LARGE CAP CORE VALUE COMPOSITE ANNUAL DISCLOSURE PRESENTATION

Year	Gross Of Fee Return	Net Of Fee Return	S&P 500 Index	Number of Portfolios	Annual Composite Dispersion	Composite Assets End of Period (\$Millions)	Percent of Firm Assets
1998	16.60	15.12	28.58	499	2.86	243.2	73.9
1999	19.09	17.63	21.04	544	5.05	286.4	78.7
2000	0.44	-0.75	-9.11	589	5.38	313.9	83.4
2001	-1.99	-3.13	-11.91	610	3.46	314.0	82.3
2002	-20.37	-21.28	-22.07	458	1.89	183.7	66.5
2003	27.83	26.54	28.68	343	1.38	202.9	66.1
2004	19.05	17.85	10.88	398	1.37	233.4	75.6
2005	15.01	13.88	4.91	472	1.14	311.1	78.1
2006	15.85	14.79	15.80	541	1.12	392.3	75.0
2007	12.72	11.71	5.49	613	1.20	460.7	75.7
2008	-38.36	-38.95	-37.00	528	1.08	242.0	65.4
Cumulative*	1,095.24%	830.27%	488.18%	* Cumulative and annualized performance is calculated since inception (01/01/88) through 12/31/08.			
Annualized *	12.54%	11.21%	8.80%				

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

Bowling Portfolio Management LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

1. Bowling Portfolio Management LLC ("Firm") is an investment management firm serving both tax-exempt and taxable clients, offering a variety of investment management strategies. The Firm is an SEC-registered investment adviser and is dedicated to the practice of professional investment management. Bowling Portfolio Management, Inc. was founded in 1982 and began managing equity accounts January 1, 1988. Effective July 1, 2001, Bowling Portfolio Management, Inc., became Bowling Portfolio Management, an independently operated division of The Renaissance Group LLC ("Renaissance"). Effective December 31, 2004, Bowling became a stand-alone entity and was no longer a division of Renaissance. The composite of Large Cap Core Value portfolios was created July 1, 1994.

2. The Large Cap Core Value Composite includes the portfolios of all clients, whether taxable or tax-exempt, for which the Firm has full discretionary authority to manage in a diversified portfolio of large cap equities. Portfolios below \$50,000 are excluded from the composite. Beginning January 1, 2002, all fully discretionary, Large Cap Equity portfolios participating in a wrap program were excluded from the Large Cap Core Value Composite and included in the Large Cap Equity Wrap Composite.

3. Performance results are calculated both gross and net of management fees. Gross returns include the reinvestment of income and are gross of the firm's management fees; they are reduced by transaction costs and administration fees. Net returns reflect the deduction of the Firm's management fees. Additional information regarding policies for calculating and reporting returns is available upon request. The fee schedule is as follows: 2% of the first \$500,000, 1% of the amount above \$500,000, and a flat 1% on all accounts above \$1,000,000. Varying terms may be negotiated. Performance is expressed in U.S. Dollars. After-tax results will vary from the returns presented here for those portfolios that are subject to taxation.

4. Annual composite dispersion is calculated using the asset-weighted standard deviation of gross results for those accounts in the composite for the entire year.

5. The benchmark for the Firm's Large Cap Core Value Strategy is the Standard & Poor's 500 Index which is an asset-weighted index of large U.S. based companies that includes income but does not have any expenses. Prior to September 30, 2005, presentations included the Standard & Poor's 500/Barra Value and the Standard and Poor's 500 indices. The Standard & Poor's 500/Barra Value is no longer included in the presentation as the index is no longer available.

6. A complete list and description of the Firm's composites is available upon request. From January 1, 2005 through January 1, 2008, the composite was named the Large Cap Equity Composite. Prior to January 1, 2005, the composite was named the Large Cap Value Composite.

7. The Firm's compliance with the GIPS standards has been verified for the period January 1, 2006 through June 30, 2009 by Ashland Partners & Company LLP and for the period January 1, 1988 through December 31, 2005 by Deloitte & Touche, LLP. In addition, a performance examination was conducted on the Large Cap Core Value Composite for the period January 1, 2006 through June 30, 2009 by Ashland Partners & Company LLP and for the period January 1, 1988 through December 31, 2005 by Deloitte and Touche, LLP.

8. For all periods presented, the composite contains non-fee paying accounts. The percentage of composite market value of these non-fee paying accounts is less than 1% at the end of each period listed, 1999 through 2008.