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3rd Quarter 2009

**CAZ CORNERSTONE PORTFOLIO
Quarterly Update**

During the third quarter of 2009 the markets continued to surprise the world with their strength. Major stock market averages rallied by more than 14%, and we saw very few down days during the quarter. Behind the scenes of this rally we heard news headline after headline that told us “things are not as bad as they were a few months ago.” That “less bad news” was all that was needed for many investors to decide that risk taking was warranted, and risky assets of nearly all types did well during the quarter. As has become somewhat commonplace, the riskier the assets, the faster people seem to want to pile in and drive prices higher. At this point, the S&P 500 has now rallied from the March 9 low of 667 to more than 1,070. This is an increase of 60% from the lows! What could possibly be driving this massive move?

Cash and Career Risk

Simply stated, the first 30% of this rally has been a return to rational thought. Stock prices never belonged at the extreme valuations experienced in early March. So the first move off the lows was very expected as “the world did not come to an end.” The next 15% in the move seems to have been driven by the expectations that the recession will end and growth will return to the world economies. That leaves the final 15%, which is most of what was experienced in the third quarter. We believe that a great deal of this final leg has been driven by “Cash and Career Risk.” We have commented on this several times in the media, but to elaborate here, cash is truly “burning a hole in people’s pockets” right now.

The first reason people don’t want to hold cash is because no one is paying them anything to hold it. As a general rule, bank deposits pay less than 1%, U.S. Treasury securities of a short-term nature pay less than that, and even long-term fixed income instruments with decent safety will pay less than 4%. The second reason some investors cannot stand to have cash in their pocket is the greed factor. When the market is rallying, the average investor does not like the fact that other people are making money when they are not. This is especially true for the investor that panicked out of their stock holdings late in 2008 or early 2009. Now they have the incredible dilemma of when to get back in and being afraid of making the same mistake twice. These emotional forces are incredibly powerful and drive some people to actually fear missing the profit more than they fear losing money. As a result, they buy stocks, and in many cases, they actually go for the riskiest securities they can find to try to “catch up” with the rest of the world. Evidence of this abounds especially with the money flowing into emerging market stock mutual funds.



Career risk is an incredibly powerful motivator of human behavior. No one likes the idea of risking their job and not being able to care for their family. In some cases, people will do almost anything to keep their job or make more money. The economy is suffering the dramatic consequences of behavior driven by fear and greed in the last bull cycle. Unfortunately, this conduct is abundant in the financial profession. Sometimes greed is the driver and people make poor decisions or rationalize questionable behavior in the name of financial gain. Other times, the fear of losing their job causes people to “look the other way” or simply “go along to get along.”

Today this behavior is very visible in the money management world where investors simply take way too much career risk if they miss this move. It is very difficult for a money manager, mutual fund manager, stockbroker, financial planner, etc., to tell a client that they lost money. No one wants to deliver that news to a client. What is worse, though, is to have to tell that client that they lost money when the market went down and then they did not make much back when the market rallied. That is the double whammy and a conversation that nearly every professional is going to seek to avoid. This desire to avoid a difficult situation, and possibly the termination of one’s employment, is one of the main factors that causes the “herd mentality” to be so prevalent on Wall Street. Stated another way, it is much safer to be wrong in a crowd than to be wrong all by yourself. This is why “everyone” said internet stocks deserved to trade at insane multiples and “everyone” said 105% home financing for people that could never afford the payments made sense. Rational thought just leaves the building sometimes because of the emotions of fear and greed.

Today, there is a LARGE contingency of investment professionals that simply are petrified of missing this move. They know that if the market goes up and they don’t participate in the rally, they will get fired. That simple! And oh, by the way, anyone want to guess how easy it is to find a job in the financial services world right now? There’s not much hiring going on in Wall Street; let’s leave it at that. Therefore, if a manager is sitting with cash and it is dragging down their performance, they are going to spend it. They are going to spend it in such a way that will allow them to, hopefully, catch up to everyone else. We believe this is a MAJOR factor in the market right now and why nearly every dip is being bought by investors who are looking for opportunities to get in at cheaper prices. This momentum can last for quite awhile and can go farther than one might expect. However, there is a very true Wall Street adage that says, “stocks always go down a lot faster than they go up.” The reason is very logical—fear is a greater motivator than greed. Let there be no mistake, a lot of these investors who are chasing stocks because they feel like they have to have some exposure will sell quickly and aggressively when stocks start to have a sustainable leg down.

Introducing the Scale

It is appropriate at this point to introduce the “CAZ Scale” (Scale). Over the last decade we have used a lot of analogies to communicate where we stand on the risk/reward prevalent in the world. Whether it be “what time is it in Central Park,” or “what inning in the game are we in,” we try to help investors get a glimpse of our world view with visuals that many can understand. Well, we have decided to hone in on a single visual that can be used over and over. This is the CAZ Scale. This Scale is designed to give our readers a very quick view of where we stand on the risk/reward provided by risk assets. The results of our analysis will determine how comfortable we will be allocating capital to assets that have risk associated with them. The Scale has a range of 1 to 5. If the Scale is a 1, we are very concerned about the world and the outlook for investment assets. On the other extreme is a Scale rating of 5.



If/when the Scale reaches a 5, we are going to feel the risk/reward is heavily skewed to reward risk taking.

As one would certainly expect, on March 2, when we e-mailed all clients with the “Buying Opportunity of this Generation, Part II,” we were at a 5 on the Scale. As this market has continued to rise dramatically, we have gradually reduced our rating on the Scale. We have said it many times: as things become cheap, we become more bullish; and as things become expensive, we become more cautious. In March we felt the market was capable of rallying 50% over the next 3-5 YEARS! Well, it accomplished that price objective in less than 6 months! **As a result, we are more cautious than we have been in a very long time. The Scale is now at a 2.** Does this mean the market is going to go down right away? Of course not, but what it does mean is that we feel the market has more downside risk from this point than upside opportunity, at least over the next year or so.

Complacency Has Returned

There are dozens of reasons we can state for our cautious stance. Just a quick glance at a few: stubbornly high unemployment, no real recovery in business outlook/spending, the coming problems in commercial real estate, the incredibly high debt level in the U.S., the expectations that personal taxes are going to increase sharply in the next few years and geo-political instability that could flame up at any time. To be totally fair, things are getting better, and there has been the largest governmental stimulus effort in U.S. history thrown at the problem.

What concerns us is the level of complacency and belief that things are going to get better simply because “they always do.” The reality could be a different story, and while the economy is going to recover, it is going to do so at a slower rate than historically has been the case. That fact warrants a reconsideration of the fact patterns of the past and should cause adjustments to the expectations for the future. The majority of people simply seem to be so driven by “Cash and Career Risk,” as outlined above, that they are investing based on “hope,” not on facts.

As a result, we are cautious and the Scale is at a 2. Investors should be diligent to make sure they are comfortable with their current asset allocations. As a result of stock prices going up so much and bond prices/cash staying relatively flat, allocations are now VERY different than they were six months ago. The ride higher has been a lot more fun than the flip side, but we don’t want to get caught being complacent. We ask that you work with us to analyze your situation and make proactive decisions that will prepare you for the future, whether the markets continue to rise or pull back.

We are very excited about several new initiatives in our firm that will be rolled out in the very near future, and we feel confident that they will benefit you as our client. We truly appreciate your loyalty and look forward to seeing you very soon. Don’t hesitate to let us know if there is anything we can do for you.

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer