HORIZON ADVISORS

On the Horizon

Fall 2009

Resumption of our "Quarterly" Newsletter

This current issue of our newsletter, for the Fall of 2009 follows our Fall 2008 issue, which we published in late September of last year. Our last edition was issued in the aftermath of Hurricane Ike and the coincident meltdown in the credit and equity markets. You may recall that Lehman Brothers failed on the same weekend that Ike plowed into the Houston area. While the disruptive effects of the hurricane were temporary, the effects of the market decline and the blow to investor confidence have lingered on. Thankfully, as we first noted in our "Hopeful Signs" communication in March, we believe that we are beginning to "see some light at the end of the tunnel" and are all too happy to return to some sense of normalcy.

It's hard to be philosophical, however, when your hair is on fire, so we suspended production of our newsletter while focusing on caring for our clients and their portfolios. Like many of you, we recognized that it's times like this that make you question everything. As we have marched through the recent unpleasantness, we have devoted our time and effort to supporting our clients and double checking our process and procedures. We've read voluminous written commentary about the crisis and how to respond to it – trying to ensure that we can answer our clients' questions, but more importantly, making sure that we do what is right in our investment process. All of this effort and research has reaffirmed our belief that the best course of action remains a long-term, disciplined approach to investing. In addition, we remain committed to our comprehensive service approach. Finally, we are pleased with the significant rebound in the financial markets enabling our clients' portfolios to begin a recovery from the historic declines of the past year.

Thank you all for your trust and confidence.

COLLECTED THOUGHTS

"The function of economic forecasting is to make astrology look respectable." – John Kenneth Galbraith

What Now?

The abject fear of the fall of 2008 and the spring of 2009 has given way to a sizable rebound in both the equity and bond markets. At the depths of the market contraction, investor fear coupled with the losses resulting from the credit meltdown, pushed stock valuations to unsustainable lows. Times like these (when investors are *least* likely to favor stocks) are the times when patient, long-term oriented investors achieve their best returns. This has certainly been the case since March 9th. Stocks have moved higher as investors realized that there were great companies available at fire-sale prices and the overall markets have returned to some sense of rationality. Chris Davis, one of our recommended managers recently said, "You make most of your money in bear markets; you just don't realize it at the time."

Since the markets reversed course in early March they have risen dramatically. Through the end of July, the S&P 500 index has increased by 46% and there has been a marked improvement in the credit markets as well. This increase has allowed us to breathe a little easier (although there is still a great deal of uncertainty about the economy both domestically and internationally). While we remain in a prolonged recession, it appears that we've seen the worst, and we expect that circumstances should gradually improve.

In the wake of the rescue of the financial system that began last fall, we have seen massive governmental intervention in the markets. While we do not yet know the effect of all of these steps, we do have some expectations, in light of the effort.

We expect rising interest rates. Last year marked the beginning of the end for the historic low interest rates that businesses and consumers have enjoyed for many years. The credit crisis and the rapid deleveraging which began last fall has reduced the availability of credit in general and has resulted in increased scrutiny of the credit quality of borrowers. As the credit markets have contracted, well capitalized lenders can now cherry pick their prospective borrowers and can earn higher rates for extending credit.

In addition to tighter and more expensive lending policies in the private sector, the US Government's economic rescue efforts and aggressive program expansions have led to a substantial increase in government borrowing. This increase will add pressure on the interest rates that the government must pay to borrow money. This will result in higher borrowing costs for businesses and individuals as they have to compete with the government for their borrowing needs.

We expect higher US taxes. Congress and the Obama administration are wrestling with the details of a massive expansion of the federal government in healthcare, education, and energy. The recession has also resulted in severe budget shortfalls at state and local levels for most of the country. Since the cost of the economic stimulus, proposed new federal programs, and nationwide budget deficits must eventually be paid, the prospect of higher taxes (at both the state and federal level) appears unavoidable. While we're not certain what shape tax increases will take, we're highly confident that higher taxes are on the way for most taxpayers.

We expect higher than normal inflation. The US government has embarked on an ambitious and expensive agenda, attempting to soften the blow of a severe recession and in the next step, vastly expanding government programs. This has resulted in the most aggressive expansion of fiscal and monetary policy in the US since World War II. This leaves open the possibility that the stimulus from an increased money supply will lead to a period of rising inflation as more dollars are made available to compete for goods and services.

Our hope is that the reins of monetary policy will remain in the hands of the Federal Reserve Chairman Ben Bernanke. Mr. Bernanke has indicated his intent to take the necessary monetary and fiscal steps to minimize inflation. However, it's far from clear exactly what steps to take, or that our government will have the political will to restrain credit during a period of economic recovery. It's our expectation that efforts to time the removal of fiscal stimulus will be moderately successful, but not perfect, leading to rising inflationary pressure down the road.

Market Review—A Retrospective Look

The following table shows market index returns for 2009 through July 31st, trailing 12-months and past 3 years.

Index (Through 7/31/2009)	YTD	1-Year	3-Year
S&P 500 TR (Large Stocks)	10.97%	-19.96%	-6.16%
EAFE TR (Int'l Stocks)	15.19%	-22.60%	-5.57%
Lehman Bond Aggregate	3.54%	7.85%	6.52%

The past two years have been like a blur with the seemingly endless stream of unexpected events followed by terrible market returns and historic volatility. Taking a closer look at what has happened, we believe it is helpful to think of this crisis as a series of events defined by five distinct phases.

The following is our attempt to deconstruct the events and markets of the past two years. To do this, we have divided the period from July 2007 to July 2009 into what we consider to be five defining time periods and the events or circumstances which led to the market's performance in each period. We've labeled these phases as *Weakening Economy*, *Financial Crisis*, *Wholesale Panic*, *Less Bad*, and *Recovery*. By segmenting the entirety of the market crisis into a definitive series of events, we hope to provide some context for our cautiously optimistic expectations for the future.

Weakening Economy (July 2007 - February 2008) - In the summer of '07 the market received its first hints of trouble as sub-prime mortgage defaults began to mount and measurable damage began to appear on bank balance sheets. During this phase, problems manifested themselves in somewhat predictable ways. The housing market softened, construction related spending declined, and job losses began to swell in housing and financial related businesses. On the surface, these seemed to be the normal consequences of a long-overdue real estate correction. The expectation was that the real estate market would eventually stabilize, default rates would decline, bank write-downs would end, and the economy would get back on track within a year, give or take.

Financial Crisis (March 2008 - December 2008) - The expected stabilization did not materialize and, over time, more and more problems appeared in the financial system. Then, in March of '08, the Treasury Department hastily arranged the shotgun marriage of Bear Stearns to JP Morgan. This "rescue" gave the market a false expectation that major financial institutions would be saved by the federal government if they were in danger of collapse. After a rocky summer, this notion of safety was shattered when September brought about the unexpected collapse of Lehman Brothers, followed closely by the sale of Merrill Lynch to Bank of America, and massive bailouts of Fannie Mae, Freddie Mac, and AIG. This combination of events and the resulting liquidity crisis brought the global financial system to the brink of collapse. If not for an enormous intervention by the Federal Reserve and the Treasury Department, grave consequences seemed sure to impact the global economy.

Wholesale Panic (January 2009 - March 9, 2009) - The worst financial crisis since the 1930's had shaken investor confidence to the core. Popular opinion held that the future of the economy remained very dim. Discretionary spending came to a standstill causing GDP growth to slide thereby accelerating job losses. Very little was required to further unnerve the capital markets, setting the stage for full-blown capitulation. Enter the newly elected presidential administration boasting an aggressive shift in policy which fueled a cascading erosion of confidence in the economy and the new leadership. These fears reached an apex when newly appointed Treasury Secretary Timothy Geithner made (at a time when crystal clarity was needed) a woefully vague announcement about the Treasury's plan to stabilize the financial system. Wholesale panic ensued and many investors sold into the freefall hoping to salvage whatever value they could from their devastated portfolios.

Less Bad (March 10, 2009 - June 2009) - The beginning of this phase was marked by a new (and now very specific) announcement by Treasury Secretary Geithner that stress tests were planned for the major banks to gauge their health, with the promise that the government would do whatever was necessary to help them regain their strength. Banks began to raise private capital and required relatively little help from the government to pass the stress tests. The financial system was officially pronounced healthy. We then began to see economic data for the first time in months that suggested the freefall was ending. Things were not necessarily getting better; they were just getting worse at a much slower rate. With stocks battered down to their lowest level since 1996, a renewed appetite for risk returned to the market, and the market responded with a powerful rally. Investors who gave into their fears and sold during the panic, have since learned that the temporary security of being on the sidelines was a steep price to pay once the market began to move upwards.

Recovery (July 2009 - ?) - We are now hopeful that the final stage of recovery has begun. This newest phase will be characterized by data that is actually improving rather than getting worse at a slower rate. There are already tangible signs that this is occurring. For instance, we are finally starting to see an uptick in home prices, there was an improvement in the most recent employment report, and banks are paying back their bailout money to the government. There is even a possibility for a relatively rapid (or V-shaped) recovery. Business inventories are very lean suggesting it will be hard for producers to meet increasing demand without rehiring workers and ramping up activity. In addition, the steep decline in spending has created a backlog of demand that may surge, once confidence returns to consumers and businesses.

We continue to believe that long-term investors will be rewarded for remaining patient and staying in the market regardless of the specific timing of the eventual recovery. Stocks were not particularly expensive when the bear market began, and, as of July 31, it will take an additional 57% rise in the S&P 500 to get back to the previous high. We believe that the many tools the Federal Reserve and the Treasury now have at their disposal have effectively eliminated the risk of a systemic failure of the financial system. Thus, we are left with the relatively mundane task of muddling through a cyclical recession. As we mentioned previously, concerns still loom such as higher interest rates, rising taxes, and inflation. But America has overcome these problems many times in the past only to emerge each time more prosperous than ever before.

Thank you very much for your continued confidence in our service and advice. If you have any questions, comments, or would like to schedule some time to come by and review your goals and objectives, or to just visit, please call.

Manager Spotlight—Janus Mid Cap Value

A recent addition to our recommended portfolio of funds is the Janus Mid Cap Value Fund which is managed by the Janus subsidiary Perkins Investment Management (PIM) which is located in Chicago, Illinois. PIM invests in companies defined as "mid cap." Mid cap companies are typically companies that have matured beyond the stage of a start up, but have not yet grown to a level that would make them a household name.

PIM considers their strategy to be a classic value approach. PIM is not interested in buying "distressed" companies; instead the management team aims to buy good, stable companies that others overlook. PIM also searches for stocks in out of favor industries which are trading at a discount. PIM, additionally, likes to see strong fundamentals and significant insider ownership. Their research team routinely meets with the management of the portfolio companies and rely on strict fundamental research to select their holdings. The goal for the portfolio is to participate when the market is rising and preserve capital when the market is going down.

The portfolio managers of the Mid Cap Value Fund are Tom Perkins and Jeff Kautz. Tom Perkins has over 30 years of investment experience. He worked for many years at Kemper Financial and Alliance Capital before joining his brother, Robert Perkins, at PIM in 1998. Tom has a Bachelors degree from Harvard. Jeff Kautz began his career as a market maker on the Chicago Stock Exchange for the GVR Company and joined PIM in 1997. Jeff has a bachelor's degree in mechanical engineering from the University of Illinois and an MBA in finance from the University of Chicago. In addition to co-managing the Mid Cap Value Fund, Jeff also serves as PIM's chief investment officer.

Over many years, PIM has built a solid reputation as a leader in value investing. The Mid Cap Value Fund boasts an impressive long-term track record versus their peers and the Russell Mid Cap Value index. Their conservative style has caused them, at times, to underperform in up markets. The tradeoff, however, has generally resulted in superior performance in down markets. We will continue to monitor the process and performance of this fund to assure it delivers the quality we expect for our clients.

Disclaimer: This manager (Janus / Perkins Investment Management) is responsible for managing one or more investments recommended in the past by Horizon Advisors. A complete list of all investment recommendations Horizon Advisors has made in the past 12 months is available upon request.

COLLECTED THOUGHTS

"We should be careful to get out of an experience only the wisdom that is in it— and stop there; lest we be like the cat that sits down on a hot stove-lid. She will never sit down on a hot stove-lid again—and that is well; but she will also never sit down on a cold one anymore." – Mark Twain

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