July 2009 – Recovery Comes From Action Not Hope

Hard times are still here but they won't last! Today there are tremendous opportunities for investment. Real estate values have generally retreated to prices near to what they were ten years ago and, in some cases, below that. Other alternative investments may be attractive as their owners are being forced to sell. Shares in great companies can be purchased at a fraction of what they were selling for two years ago. What we need now is for our economy to start to grow again.

Over the past nine months, there have been unprecedented actions by governments around the world to stimulate the world economy. In the United States we have seen the Troubled Asset Relief Program (TARP), President Obama's American Recovery and Reinvestment Act of 2009 and over a trillion dollars in various interventions by the Federal Reserve Bank. Most economists agree that we should see a return to economic growth by 2010 or maybe sooner. However, these vast amounts of money injected into the system carry a risk for higher inflation in the future, and in and of themselves, will not produce a sustained recovery. Higher employment, more consumption and more capital investment are needed.

We believe stock portfolio management is best compared to the S&P 500 index since this is a broad measure of overall U.S. stock performance. On September 30, 2007 the S&P 500 was at 1,547. On June 30, 2009 it was at 919 – a decrease of 40.6%! While the S&P did recover somewhat in this second quarter, it needs to go up about another 70% to be back to where it was on September 30, 2007.

So what do investors do now? We save and invest so that we can help our families, help others and help ourselves by maintaining and improving our living standards. We all must re-evaluate our risk tolerance and investment goals (growth, income and preservation of capital).

The problem with investment goals is that they are conflicting. Generally:

- The greater the return, the higher the risk.
- Stocks, including preferred stocks, are riskier than bonds.
- Treasury bonds and tax free bonds pay less than corporate bonds of a similar maturity.

We must also keep in mind that credit risk is real and destroys returns. So while the current yield on a corporate bond may look very attractive, bankruptcies may change returns dramatically. Just ask a Chrysler bond holder.

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Many investment experts believe that history repeats itself and that future long-term results should be similar to past long-term results. We believe this too. So back to the central question: How do we recover?

If the S&P has to gain 70% to get back to its value on September 30, 2007, then consider the attached Exhibit, **Returns and Risks**. As you can see, if we have returns similar to current and expected returns, it could take years to recover. Also, any given security has either a low return or inflation and credit risk. As noted, high-yield securities generally have high risk. Just a few defaults can lower total returns or even result in more losses. In the current difficult economy the critical decision is how to allocate your portfolio between preservation of capital and growth.

> **Preservation of capital** – We believe that in this portion of your portfolio little risk should be taken. Accordingly, short-term securities of the highest quality and Treasury Inflation bonds are the best choices.
>
> **Growth** – We believe a diversified portfolio of stocks gives the best long-term returns commensurate with reasonable risks. Real estate and other alternative investments can also provide growth, but these generally have more illiquid markets, can be complex, and have high on-going costs and transaction costs. Risks of such assets are often understated by sellers or misunderstood by buyers.

Remember long-term is relative. A thirty year old has a different investment horizon than a seventy year old. In a June 15, 2009 article in *Time* magazine, Justin Fox concluded his article on different investment returns as follows: “Stocks are still the best investment for the long-run. But maybe not for your long-run.”

In a different, more liquid environment, economic strategies can and should change. When interest rates are higher for high-quality fixed income securities and the chance of high inflation seems remote, then more of an allocation should be made to such securities.

In spite of all the talk about “change”, we do not believe the long-term fundamentals of economics and investments have been altered. What is required now is for all of us to actively and realistically review our investment goals in line with our own time horizon, risk tolerance and personal values and make adjustments to fit those parameters. Passively hoping that things will be all right is not an option. Stated another way: Hope is not a strategy. As always we are happy to review your investment plan to be sure it meets your needs. Although these times have been difficult for us all, we believe a tailored investment plan should achieve the desired results and more peace of mind.

Returns and Risks

Type of Security	Market Rates[1]	Estimated Years to Recovery[3]	Inflation Risk	Investment Risk
3 mo. Treasury	0.16	325	low	none
1 yr. Treasury	0.70	75	low	none
5 yr. Treasury	2.59	20	medium	none
30 yr. Treasury	4.36	12	high	none
5 yr. AA Corporate	3.29	16	medium	low
30 yr. AA Corporate	5.85	9	high	low
	Estimated Returns[2]			
High-Yield Corporate	11.00	4.83	high	high
U.S. Large Cap Stocks	9.00	5.83	low	low
U.S. Small-Mid Size Cap	9.25	5.67	low	medium
International Developed	9.25	5.67	low	medium
International Emerging	10.25	5.17	low	medium
Private Equity	10.00	5.25	low	high
Real Estate	7.25	7.25	low	high
Hedge Funds	7.75	6.75	low	high
Commodities	7.00	7.50	low	high

[1] Source Charles Schwab, July 1, 2009, 10:24 AM EST

[2] JP Morgan Asset Management, Long-term Capital Market Return Assumptions as of November 30, 2008

[3] Years at the Estimated Return Rate to recover the decline from September 30, 2007 through June 30, 2009.

Note 1. Inflation is uncertain. The judgment of Inflation Risk and Investment Risk is the opinion of Callahan Advisors. Investment Risk, which can be thought of as combining market risk and bankruptcy risk, can be lowered through diversification.

Note 2. Total return is affected by taxes, fees and transaction costs.

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