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Q3 2009 Quarterly Report
For Public Release

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Two Up Quarters In A Row!

A Second Up Quarter After Six Down Quarters In A Row

The third quarter of 2009 saw a second consecutive strong period for equities after six quarters of negative returns in global stock markets that began in Q4 2007. Stocks rose sharply in the period with the S & P 500 returning 15.6% and the EAFE Index 18.8% (large cap international developed markets). Bonds also did well posting a return of 3.3% (US Intermediate Gov./Credit).

The result of this strength is a slate of year-to-date returns that are +20% to +30% for equities and bonds between +14% on the high side and -8% for the weakest (long term US government bonds).

The economy continues to shed jobs and look anything but strong. This is no surprise given the timing of the stimulus package passed by Congress. We are only in the first third of the actual spending of stimulus funds. We should begin to see increased impact in the remainder of 2009 and into early 2010. We continue to expect an economic growth spurt in the second half of 2009 well into 2010.

Whither the Market?

Anyone watching the action of US and international stock markets recently was likely in awe at the strength. As this is being composed, the S&P 500 is at 1068, up from its low of about 670 in February! That is an increase of 60%. Impressive.

How does the nearly unprecedented rise in the market square with an economy that (at least to many laid off workers) looks anemic at best, even after factoring in the likely surge due to stimulus expenditures? It seems to us that one of two things is possible or perhaps some of each:

Possibility **number one** is that the economy is rebounding more dramatically than is visible in the current data. This idea is supported by the increase in commodity prices (which have rebounded smartly) but is undermined by the strength in bond prices which have been rising (normally a sign of economic weakness). Given that US consumers are not spending with abandon, as they had been up until a year ago, one wonders where hidden economic strength might be coming from?

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Two Up Quarters In A Row! (cont.)

A sound recovery must be built upon a societal change from consuming more to saving and investing more. Consumer credit has contracted and saving has turned positive in the past year. These are good signs for the long term but do not support rapid economic growth in the near-term.

In this regard one wonders what our leaders are thinking when they promote increased consumption (cash for clunkers)? More consumption and debt increases economic activity in the short-term but longer term it saddles US consumers with more debt. How is that a good idea?

The underlying question is whether US Consumers have gotten the message that they need to rebuild their balance sheets through increased saving and investing? The market's rise above reasonable valuations might be a big bet by investors that consumers will go back to their spend-thrift ways any minute (perhaps holiday shopping?)!

Possibility **number two** (as an explanation of stock market strength) is that the productive economy has too much capacity and not enough demand, meaning that it cannot absorb all the cash being invested in the economy (or *thrown at it* by the federal government!) . If true, it suggests that the stimulus cash and bailout money is flowing into financial assets rather than productive assets. More demand for financial assets will cause financial prices (stock prices) to rise. Unused capacity statistics (currently lots of it), unemployment numbers (rising) and tax receipts by state and local governments (falling) support this possibility.

So which is it?

As usual it is not obvious to everyone. The smart analysts we follow (those that saw the 2008 financial collapse coming) are uniform in their view that possibility #2 is the most likely explanation. If so it is troubling as the stimulus money is simply inflating another bubble in stocks. Is our memory that short? Or maybe it is different this time? Or maybe we are simply not seeing something?

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Risk

As we have pointed out repeatedly over the years it is not risk that is the problem; it is the intensity of the consequences of risks realized that matter. If we look at these two possible explanations for market strength, what risks are there?

If there is hidden economic strength that we don't yet see, the result will be more growth and higher corporate earnings producing rising stock prices and a likely increase in inflation expectations. However, currently the bond market (particularly TIPS – inflation protected bonds) is suggesting that the demand for money is weak and that inflation is expected to decrease not increase. The risk is therefore an unexpected increase in the demand for money (government debt plus private and corporate borrowing) that will fuel a rise in interest rates and prices. Last quarter we suggested that there would be more growth than the consensus at that time expected. In recent weeks however consensus has caught up with and now exceeds our expectations.

The consumer holds the key. If families decide that they must borrow and spend rather than save and invest (the long term trend behavior in the US) then near-term economic activity will surge as consumers buy relatively scarce goods (inventories are low) driving prices higher despite high unemployment and unused capacity. This is a real risk, the consequences of which, if realized, would be intensely damaging to the US economy (another consumption bubble followed by collapse) in the intermediate to longer term. We must bring our spending and saving into balance or we will be much poorer as a nation. Prosperity does not come from borrowing and spending, rather it derives from saving and investing (actually a balance between both). There is no free lunch.

The net of all this is that we think the greater risk with the most intensity is likely to be renewed economic weakness as the stimulus impact begins to wear off. Sharply lower stock prices are the likely outcome. We are cognizant of the possibility that near-term, consumers may spend more thereby adding fuel for faster growth. This would likely result in higher stock prices.

Two Up Quarters In A Row! (cont.)

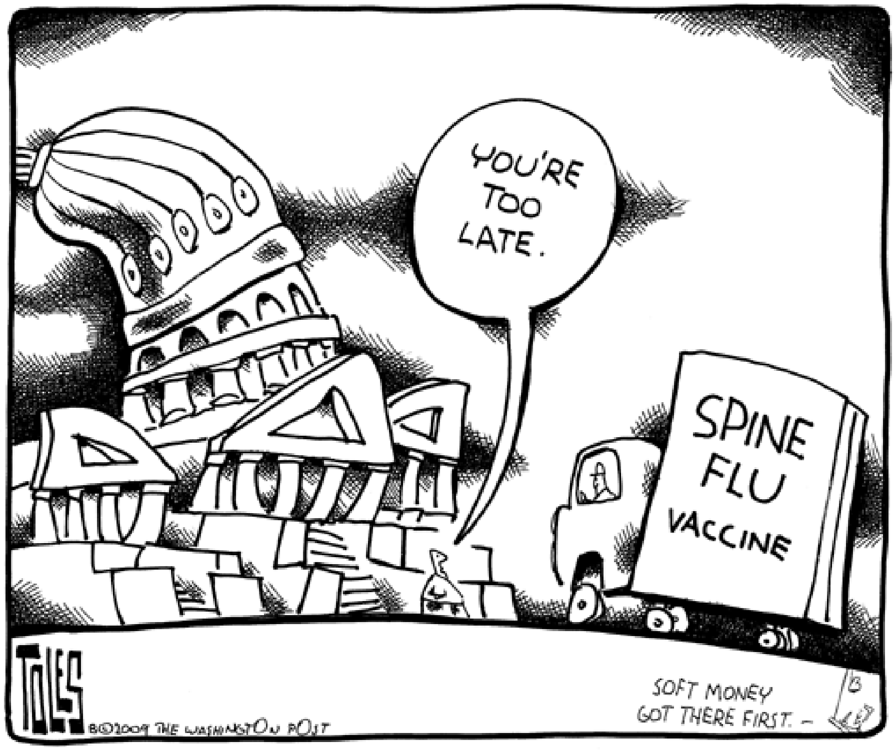
<u>Outlook</u>

In our last report we said,

"In 2005 – 2008 we were outside the mainstream by being cautious about equities. We continue with our non-consensus posture in suggesting that equities, private equity and high-yield bonds will produce double digit returns on an annualized basis over this period. Opportunity knocks."

This recovery in stock prices has discounted seven years of growth at 8% in just six months! We are now on the other side of consensus. <u>Having been more optimistic in March we are now more pessimistic than consensus</u>. Our investment program will reflect this view going forward.

We have begun to hedge our bets and modestly reduce exposure to equity risk and delay new equity position purchases. If we are incorrect in this judgment we think it will be for a short period of time. Overall equity exposure is large enough to have benefitted from this run-up and we hope to make sure the accrued benefits do not disappear.



The following pages have our graphical view of the important factors effecting of economy (and above is one slight "dig" on our political leaders!).

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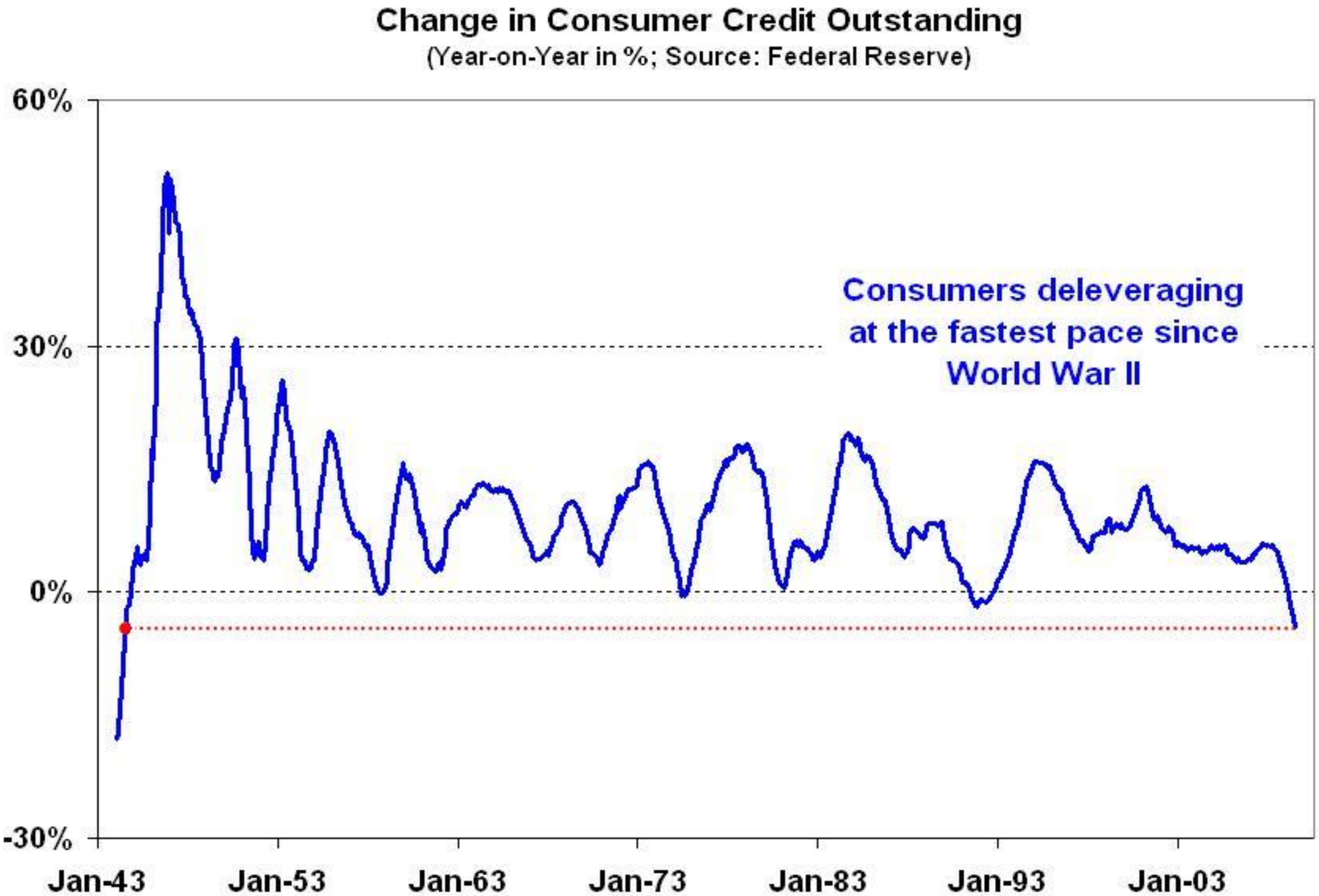
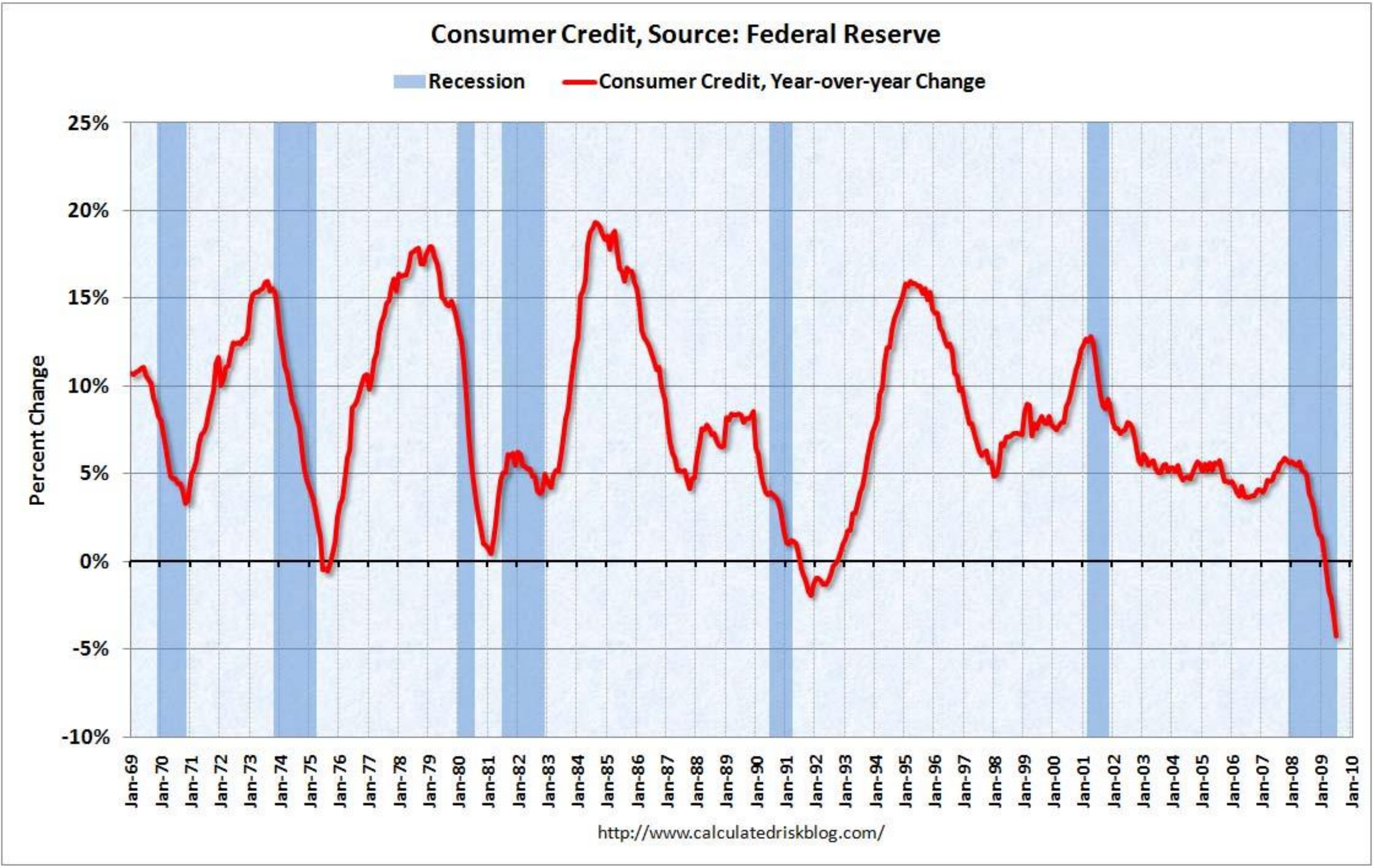
Consumer Credit – Then & Now



Consumer Credit & Recessions



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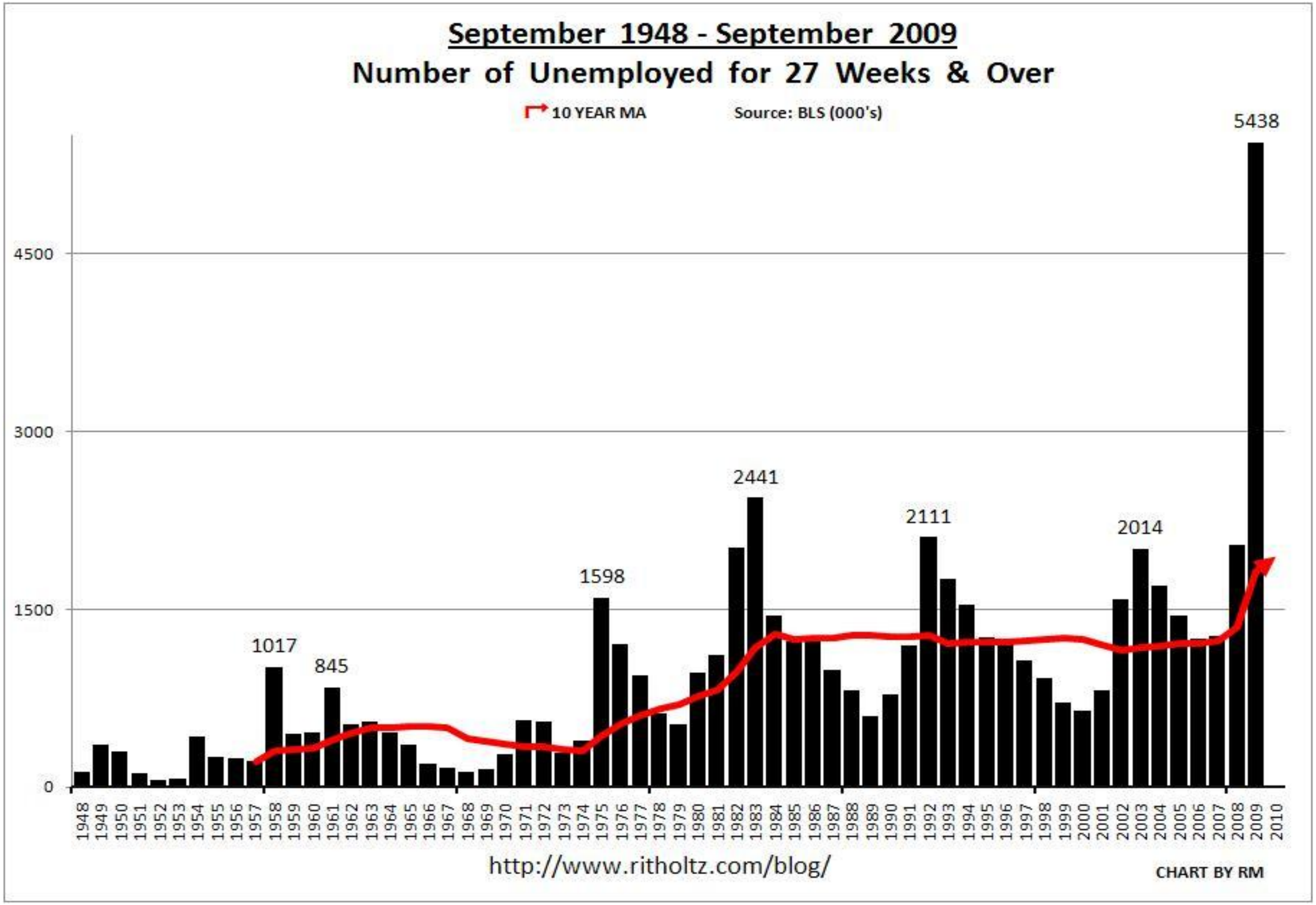
Consumer Deleverage & Retail Sales

Chronic Unemployment – Further Pressure



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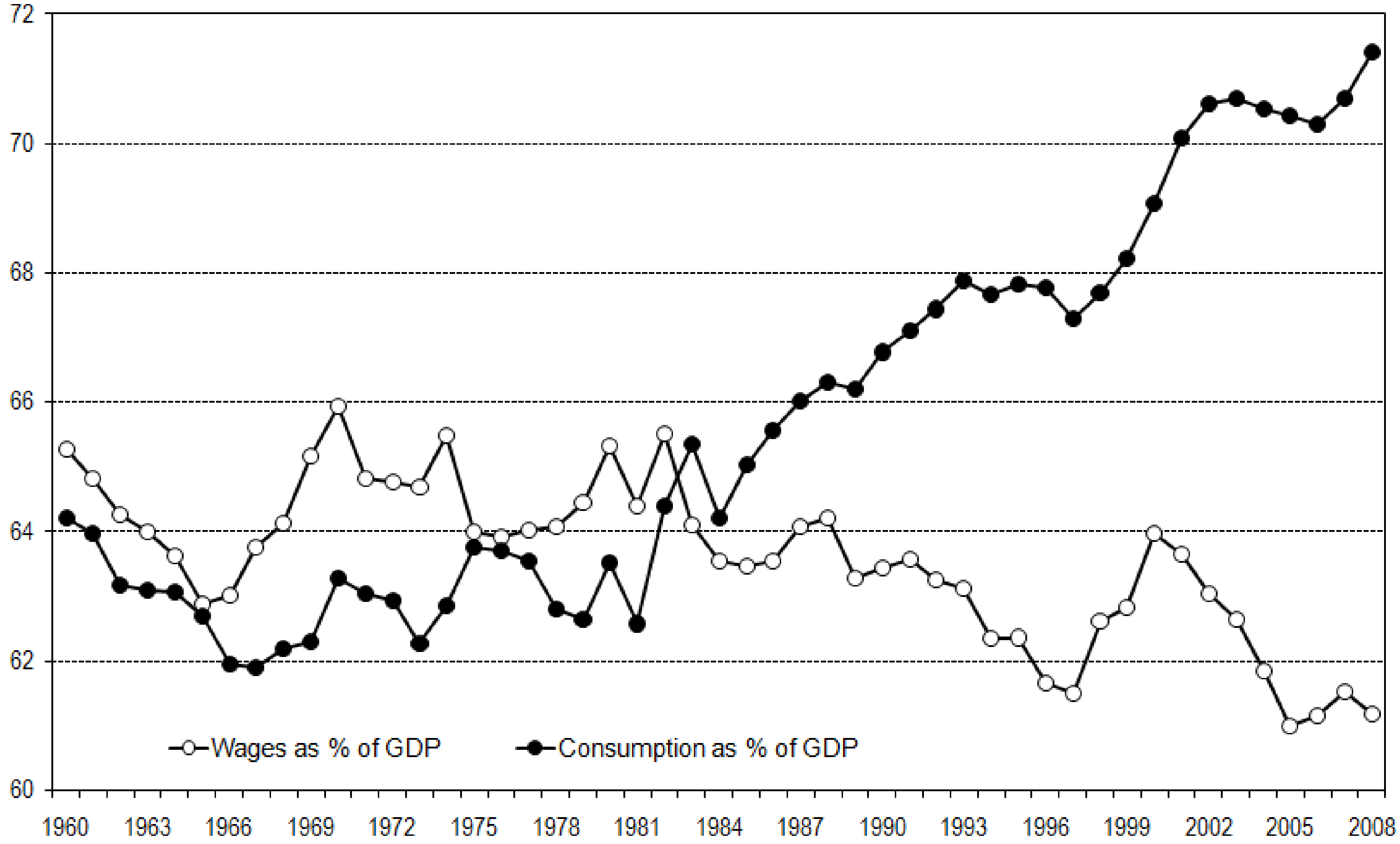
Consumption Gap & Stagnant Wages



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MARKET RETURNS

Asset Class	Q3 2009	YTD	One Year	Three Years	Five Years	Ten Years
Large Cap US Stocks: S&P 500	15.6%	19.3%	-6.9%	-5.4%	1.0%	-0.2%
KLD Social 400	19.0%	28.7%	-6.2%	-8.3%	-1.2%	
Small Cap US Stocks: Russell 2000 Index	19.3%	22.4%	-9.6%	-4.6%	2.4%	4.9%
International Developed Market Stocks: MSCI EAFE	18.8%	25.5%	0.0%	-6.3%	3.3%	0.3%
Emerging Market Stocks: MSCI Emerging Markets	20.1%	61.2%	16.2%	5.5%	14.5%	8.9%
Intermediate Bonds (Barclays Intermediate Gov't/Credit)	3.3%	4.9%	10.0%	6.2%	4.7%	5.9%
High Yield Bonds (Barclays High Yield)	14.2%	49.0%	22.3%	5.3%	6.1%	6.3%
Money Market Funds (3 Month T-Bill)	0.0%	0.1%	0.4%	2.6%	3.0%	3.7%
TIPS (Treasury Inflation Protected Securities)	3.1%	9.5%	5.7%	5.6%	4.8%	7.5%
Citi Non $ World Government Bonds	7.3%	6.7%	16.1%	10.2%	7.1%	6.7%
Barclays Municipal Index	7.1%	14.0%	14.9%	5.1%	4.8%	5.8%
Commodities: Dow Jones Commodity Index	4.3%	9.1%	-23.7%	-4.9%	-0.7%	6.3%
Real Estate: MSCI US REIT	34.6%	17.9%	-28.2%	-12.7%	1.3%	9.4%

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BENCHMARK'S CLIENTS RESULTS

	3rd Qtr	YTD	1 Year	3 years (3)
Benchmark composite (2)	5.6%	9.8%	3.5%	4.6%
Blended Market Index (1)	11.4%	15.5%	0.8%	-0.8%

Footnotes:

1. *Blended Market Index is a default 60/40 = Large Cap US - 35% DS400, Large Cap Intl-15% EAFE, Small Cap -10% R2000, Bond - 30% Barclays Intermediate Gov/Credit index, Cash - 10% 3 month t-bill*

2. *The Benchmark Asset Managers LLC Client Composite is the total time-weighted return (cap weighted), net of fees, of all client portfolio's managed by Benchmark Asset Managers LLC. Returns are calculated monthly. Before January 2008 returns were calculated quarterly.*

3. *Annualized*