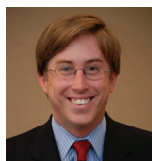




CAVANAUGH  
CAPITAL MANAGEMENT

# A Balanced Approach for Long-term Investors

Fourth Quarter  
2009



## The 2000's—The Times That Tried Investors' Souls

By Taylor Graff  
Senior Associate

It is difficult to remember that this past decade began with unparalleled optimism. Globalization, increased productivity from technology, and capable monetary policymakers had combined to create the "Great Moderation" in economic volatility. For nearly 20 years, interest rates were falling, inflation was moderating, the dollar was steady, and the U.S. economy and stock market had experienced unprecedented and consistent growth. Financial markets were boring, pleasantly boring.

But all good things must come to an end and the end was not pretty for financial markets. This decade experienced two brutal bubbles – technology stocks and housing. Each caused a recession and a severe bear market in U.S. equities and credit. Overall, the U.S. stock market had its worst decade since the Civil War.

See our website ([www.cavcap.com](http://www.cavcap.com)) for a full analysis of the decade's biggest stories in the financial markets, including a timeline of events, and a historic look at the first decade of the 21<sup>st</sup> century.



## My Discussion with Treasury Secretary Geithner

By Tom Graff  
Managing Director

On November 2, I had the opportunity to join seven other informal financial writers in a round-table discussion at the U.S. Treasury Department. I was invited in regards to my work on TheStreet.com. Several senior Treasury officials attended, including Secretary Geithner. The purpose of the meeting, initiated by the Treasury, was to improve access to their department for non-traditional writers. There were no presentations or opening remarks. It was simply an open discussion of whatever topics the small group, most of which were also financial professionals, wished to address.

Many topics were tackled during the two hour meeting, including:

- The bank stress tests formulated by the Treasury and conducted by the Federal Reserve,
- TARP—Treasury reiterated several times their desire to get out of their investment in banks, and
- "Too Big to Fail".

Further details of the meeting, and additional topics discussed, can be found on CCM's website, [www.cavcap.com](http://www.cavcap.com).

## Dear Client

By James Dugan  
President &  
Chief Investment Officer



Our research indicates that the U.S. should see solid growth in 2010, spurred by capital expenditures by business and industry. However, for growth to be sustained a revived consumer sector is necessary. For that to occur, job growth is required.

In our 3Q 2009 newsletter, we wrote "the unemployment rate, currently at 9.8%, will continue to rise above 10.0% into 2010." The unemployment rate reached 10.2% for October, but came down to 10.0% for November. While the jobless rate ticked down slightly, net job losses continued.

So when will jobs rebound? Some good news may be on the horizon. Temporary workers may be the canary in the coal mine for permanent jobs. They are the first to be let go when business activity decreases, and when business picks up, a company will hire a temporary worker before taking on the added cost of a permanent hire. After seeing a loss of nearly 1 million temporary jobs from January 2007 to July 2009, the data shows increases in each of the four most recent months.

Should temporary job growth herald an increase in permanent payrolls, it is likely that the positive jobs momentum will continue. Our research shows that in 11 of the 15 post-war economic recoveries, once job growth started, the number of jobs was higher six months later. When taking measurements 12 months after an upturn in employment, payrolls were higher in 13

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## EQUITIES, COMMODITIES, & REITs MARKET REVIEW

### Bull market continues into New Year

Financial markets cooled off somewhat after sizzling returns during the second and third quarters. The bull market was fueled by continuing improvement in economic indicators and corporate earnings but the question remains as to whether or not the market and the economy will be able to continue improving without the aid of fiscal and monetary stimulus.

- For the third straight quarter, REITs and Emerging Markets were the top performers.
- In October, the S&P 500 suffered its first losing month since February, but bounced back in November and December for a strong 4Q return.
- From March to December, the S&P 500 rose 51.7%, the best 10-month gain since 1936.
- U.S. stocks outperformed international stocks as the dollar strengthened modestly and the U.S. outperformed the rest of the G7 nations.
- Greece and Ireland had the worst performance worldwide as whispers of a national default started.
- Commodities had a surprisingly strong quarter considering the dollar strength. Commodities typically perform poorly when the dollar strengthens.

### Equity Index Returns (%) As of 12/31/09

Index	QTR	YTD
S&P 500 Index (large-cap U.S.)	6.04	26.46
Wilshire 4500 Index (small- and mid-cap U.S.)	4.91	37.46
MSCI EAFE Index (international - developed)	2.18	31.78
MSCI Emerging Market Index (international – emerging)	8.55	78.51
DJ Wilshire REIT Index (real estate)	9.18	28.46
S&P GSCI Commodity Index	8.42	13.49

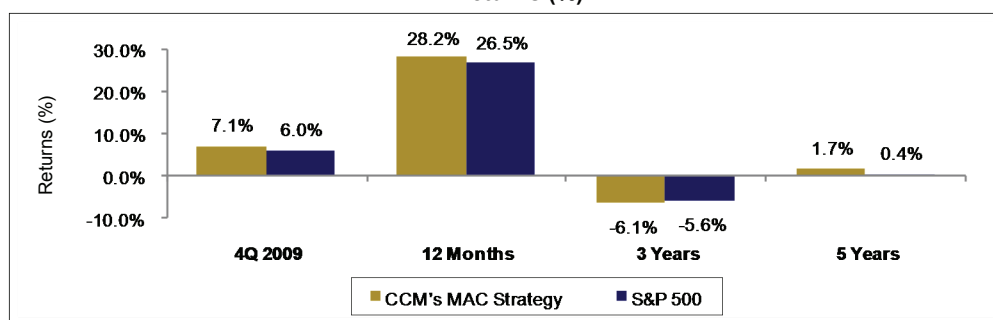
Source: Bloomberg

## MULTI-ASSET CLASS (MAC) STRATEGY

The MAC strategy ended 2009 with a 7.1% return in Q4, beating the S&P 500 by 1.1%\*. REITs and commodities both outperformed the S&P 500 which propelled the MAC's strong performance. REITs benefited from continued improvement in credit markets and general economic recovery while Commodity returns were driven by mounting inflationary pressures. For the year, the MAC outperformed the S&P 500 by about 1.8%\* driven by the strong performance of Emerging Markets, Small-cap stocks and REITs.

The big question for next year is how the world economy will recover after the worst recession in decades. Will monetary and fiscal policymakers tighten liquidity too quickly and choke off the recovery? Or will easy money last too long, causing inflation? CCM believes diversification is the most effective way to keep your portfolio prepared for any scenario while still providing the return potential to meet long-term goals.

### CCM's MAC Strategy\* vs. S&P 500 Returns (%)



\* Multi-Asset Class strategy (MAC) returns based on Dow Jones Total Stock Market Index (U. S. Equities), MSCI EAFE (Developed International Equities), MSCI EM (Emerging Market Equities), S&P GSCI (Commodities) and Wilshire REIT indices. Performance does not reflect the effect of trading, management, and/or ETF fees. Past performance does not guarantee future results. All returns greater than one year are annualized. The above statistics do not reflect allocation to U.S. Fixed Income which may be added depending on a client's tolerance for risk and/or income needs.

## FIXED INCOME SECTOR RETURNS

### Fixed Income Returns (%) As of 12/31/09

Index	Duration	Yield	QTR	Last 12 Months
Treasury <sup>1</sup>	5.13	2.46	-1.30	-3.57
Agency <sup>2</sup>	3.26	2.29	-0.03	1.95
Credit <sup>3</sup>	6.16	4.51	1.03	16.04
MBS <sup>4</sup>	3.57	4.15	0.57	5.89
Barclays Capital Aggregate <sup>5</sup>	4.57	3.68	0.20	5.93
High Yield <sup>6</sup>	4.30	9.06	6.19	58.12
Merrill Lynch 1-12 Year Municipals <sup>7</sup>	4.13	2.49	-0.24	7.643

- Treasury interest rates moved rapidly higher as evidence of a stronger economic recovery emerged. The 10-year Treasury yield rose 54bps from 3.30% to 3.84% during the quarter. The 2-year yield also moved higher, although only by 20bps from 0.95% to 1.14%. Both are at or near 6-month highs.
- Mortgage-backed securities outperformed Treasuries primarily due to the lower average duration for the sector. The Fed remains the primary buyer of MBS.
- Investment-grade corporate bonds had another strong quarter. The benchmark spread vs. Treasuries fell from 198bps to 157bps according to Barclays Capital, with almost all the gain coming in December. Although this a strong performance for corporate bonds, it is the smallest spread decline in three quarters.
- High-yield performance was strong, especially considering weakness in Treasury bonds. The Barclays High Yield index returned 6.19% during the quarter.
- Following the record-setting rally of 4.55% in 3Q 2009, the municipal market took a breather in 4Q

<sup>1</sup>Barclays Capital Treasury Bond Index; <sup>2</sup>Barclays Capital Agency Index; <sup>3</sup>Barclays Capital Credit Index; <sup>4</sup>Barclays Capital MBS Index; <sup>5</sup>Barclays Capital Aggregate Index; <sup>6</sup>Barclays Capital High Yield Index; <sup>7</sup>Merrill Lynch 1-12 Year Municipal Bond Indices

as the ML 1-12 Year Muni Index closed the quarter with a relatively benign return of -0.24%.

- Municipal bond yields showed some resistance to following Treasury yields higher in December. For the quarter, flat municipal bond returns compared favorably to the negative returns experienced in U.S. Treasuries.
- Demand continued to dominate supply in the muni market as mutual fund inflows remained robust, while taxable Build America Bonds (BAB) cut almost 30% of tax-exempt supply from the market.

## FIXED INCOME PORTFOLIO ACTIVITY

### TAXABLE BOND PORTFOLIOS

- Reduced interest rate risk, particularly by reducing the average maturity of Treasury positions within portfolios. While the exact timing and magnitude of an increase in interest rates is difficult to determine, we believe the risk/reward favors a defensive rate posture.
- Made extensive use of liquid bonds within spread sectors, especially certain taxable municipals and corporate bonds, to improve income generation.
- Remained underweight MBS vs. other spread sectors. The Fed has purchased more than 100% of the net issuance of MBS in 2009, but their purchase program will end in 1Q 2010. While we do not expect the Fed to be selling MBS immediately, the lack of Fed demand should push MBS spreads wider in 2010.

### ENHANCED CASH PORTFOLIOS

- Continued to utilize 1-2 year bonds in lieu of shorter securities. While the time for Fed hikes may be moving closer, it is not imminent. There remains

very little downside price risk in these bonds relative to the extra yield garnered.

- Continued to add to GNMA Project Loan positions with 0-2 year average lives. These securities are directly backed by the U.S. Treasury, but still carry yields above 2%.

### MUNICIPAL BOND PORTFOLIOS

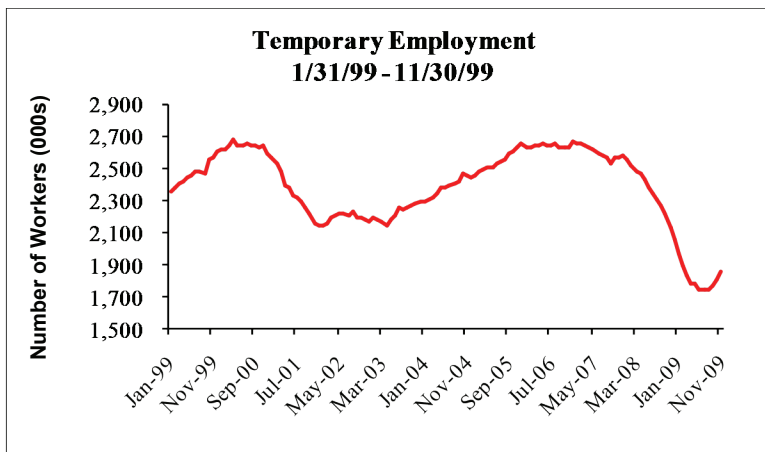
- Took profits in short-term Agencies that were added to municipal portfolios during 3Q 2009, as after-tax yields on these Federally taxable bonds normalized to levels that could be achieved through conventional tax-exempt munis.
- Shortened duration in intermediate municipal portfolios by selling tax-exempt bonds in the "belly" of the curve (4yr – 6yr maturities). High quality tax-exempts with maturities inside of 6 years continue to trade at significantly overvalued levels, relative to maturity matched Treasuries.
- Maintained a modest overweight to BBB-rated municipal credits which provided portfolios with a yield advantage versus the ML 1-12 Year Muni Index.

## Dear Client

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instances. The conclusion – when jobs turn positive, it is very rare to see a double dip decline.

While this analysis does not give any indication of the magnitude of job growth, it should signal a higher probability of Fed action in the near term. Currently, the expectation is that the Fed may start raising rates in the second half of the year. It is likely that yields will be higher on all types of bonds this time next year. We have already begun to reduce the interest rate risk of the portfolios under our management. In 2009, the formula for success was to own bonds other than Treasuries; 2010 may be more of a challenge.



The equity market should continue to grind higher in 2010. There may be a correction as Fed policy changes, but there is a long way to go (about 300 basis points) before Fed policy becomes restrictive. REITs and commodities should continue to advance and may provide a measure of protection if there is a surge in inflation.

While it can be a difficult exercise to predict the course of markets, it may be more speculative to predict the actions of government. However, we already know that income taxes are going up at the end of 2010 as the Bush tax cuts roll off. With mid-term elections this coming year, it is unlikely there will be Federal tax initiatives prior to November. However, we would not be surprised to see the creation of a new “millionaires” tax bracket with the marginal rate moving close to 45%. This may give political cover to raise tax rates across the board by a modest amount.

While private payrolls have declined by 4.0 million over the past year, the number of government employees has remained static. State and local governments are hungry for revenue. It should be expected that tax rates and fees charged by municipalities will also increase.



*A Balanced Approach for Long-term Investors*

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*Cavanaugh Capital Management (CCM) is an independent registered investment advisor. CCM specializes in active fixed income and passive equity strategies. If you would like more information about the firm, or its investment strategies, please contact Director of Marketing Doug Hinton at 410.769.6115 or [dhinton@cavcap.com](mailto:dhinton@cavcap.com). You may also visit our website, [www.cavcap.com](http://www.cavcap.com).*

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