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2nd Quarter 2009

CAZ CORNERSTONE PORTFOLIO
Quarterly Update

Back Into "No Man's Land"

The markets experienced one of the best quarterly performances in history during the 2nd quarter. The rally from the March lows has been truly breathtaking, and April and May were joyful months after the horrific experiences of the preceding three quarters. In June, the market consolidated its gains and was basically flat for the month. The result was a rally in the S&P 500 of nearly 16%.

As we have discussed in several media outlets, the "easy" money has been made. The world was despondent in early March and had priced in a worst-case scenario. As a result, prices became so inexpensive that the opportunities were truly compelling. Now the market has rallied nearly 40% from the bottom, and valuations are back to "normal." From here, the markets are going to need to see real stabilization in the economy and corporate profits in order to make substantial gains from these levels. This is what we mean by "no man's land." The market is no longer ridiculously cheap, and it is not particularly expensive. There is not an "obvious" edge that one can derive simply from valuations at this point. This means that individual themes and individual news flow will drive the majority of value changes from these prices.

Silver Lining or Storm Clouds?

We are pleased with how the economy appears to have stabilized, and we do believe that we are no longer at the edge of an economic cliff. The likelihood of a major financial "meltdown" (worse than the one we saw in the fall) is probably very low at this point. The actions taken by the administrations last fall and this spring, whether or not we agree with the specific moves, has provided some time for the world to catch its breath and eliminate some of the irrational behavior that was so prevalent. The basic functions of the short-term corporate financing markets are working again, and the odds of another financial powerhouse disintegrating are fairly low. The automobile sector is 90% of the way through its latest restructuring and will likely be out of the news for quite some time. All these things are positive and provide a level of comfort that maybe the worst is behind us.

Before one would read the paragraph above and conclude that we are overly positive, let us be clear about the realities that we see in the world today, and the storm clouds we see on the horizon:

1. The housing market is beginning to stabilize but is not near its ultimate bottom. There is simply no mainstream financing available, and the supply of foreclosures and homes for sale will take a substantial amount of time to digest. Until that supply is absorbed, prices will continue to drift lower. The rate of descent will slow, but the prices will still be going down. This will continue to be a real, and psychological, impact on consumer spending habits.
2. Unemployment is not close to its high. We are approaching 10% for the first time in decades, and it is likely that we will see a rate that approaches 11% before all is said and done. Adding personnel is just not very high on companies' list of things to do in a stagnant economy with tremendous uncertainty in the near future.
3. The massive amount of debt the government has taken on has to be repaid at some point. Whether this is with higher taxes or higher inflation (or both), it has to be repaid. This is a mind-boggling feat if one stops to think about how much money must be retired from the system.

So, while we are very encouraged by the stabilization in the markets, it is very hard for us to get excited about the next several quarters. Don't get us wrong, markets can continue to rally as people feel that the worst is behind us. There is a great deal of money on the sidelines that is anxious to re-enter the markets. Any material rally, though, from these levels will be in the face of considerable headwinds. Getting stabilization is the easy part as people simply need to feel that the world is not going to end. But, sustainable growth in market values can only come from real revenue growth accompanied by real earnings growth in companies. That is going to be very challenging for the foreseeable future.

The question that everyone seems to ask during this correction is whether or not the market will go back and test the lows reached in early March. That would entail a decline of more than 20% from current levels. The obvious answer is that it is impossible to tell for sure, but it is feasible. A correction after a massive rally is completely normal, and very healthy, for the markets. Markets do not go straight down (even though it sometimes seems that way), and they do not go straight up. The stair-step pattern is the norm, and this time should be no different. After a 40% move higher, even IF we are now in a bull market, we should experience a retracement of approximately half of the rally. That implies a 20% pullback from the highs reached in early June. To reiterate, that would be healthy and very typical. Whether we go back to test the March lows will be determined by the strength of the economic outlook for the second half of the year. It is quite possible that we do, and investors need to be positioned appropriately. **We cannot state this strongly enough. If an investor is not sure they can stomach a decline back to the March lows, they must take action steps now!** There are numerous ways to restructure a portfolio to still participate in a rally if one were to occur from these levels, while at the same time protecting against a potential repeat of the 1st quarter. Please let us know if you are not sure how you feel about your current allocation. Asset allocations have changed quite dramatically as a result of the strong performance achieved in the 2nd quarter. Do not assume the allocation you currently have is still the best one for you. Let us discuss your situation with you and develop a game plan to adjust to the market in the second half of the year.

Thank you for the trust that you show in our firm and the opportunity you give us to work with you. Please let us know if there is anything about your portfolio that you would like to discuss or any questions that we can answer for you.

Have a great summer!

Regards,

Christopher Alan Zook
Chairman and Chief Investment Officer