



ANDRESEN & ASSOCIATES

P.O. Box 1434 Salinas, CA 93902-1434

Phone: (831) 758-1575 or 1-800-345-9644

Fax: (831) 758-1576

PETE@ANDRESENASSOC.COM

WWW.ANDRESENASSOC.COM

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10/28/2009	Value	YTD %
Dow Jones Industrial Avg	9882.17	12.6%
Vanguard 500 Index	\$98.12	20.1%
Vanguard Total Bond Index	\$10.41	5.8%

GUESSTIMATIONS... THE CLOUDY CRYSTAL BALL

Fall came in with a torrent here in Salinas, with rainfall levels of about 3". Our average annual rainfall here is 14 inches, so that means we received as much as 1/5 of our average annual rain in October. Are we going to have more rain soon and keep this up, or are we now going to stay dry for the next few months?

The same could be asked of the financial markets. Are they going to keep rising rapidly, or will we see a cool-down, or even a correction? We recently hit 10,000 on the Dow Jones Industrial Average. Will we have a few months of profit-taking after this? The reality is that we don't really know what will happen.

It is most probable that the financial markets will perform as they have in the past in similar circumstances. Although market behavior in this situation has been quite variable through history, the most common market response would be a sideways trajectory for the rest of the year. Profit-taking might even cause the markets to decline slightly. We would then expect the new year to include a subdued upturn.

However, an unlikely positive or negative surprise can nevertheless trigger dramatic results. We have to look at potential high-impact events, even if they are improbable, and ask if our portfolios are prepared to deal with any tumult which may arise. Part of our job is to think the unthinkable.

Without trying to guess, we are scanning the ether for indications of what may happen next. We are reviewing several recent themes which may affect portfolio behavior in the next six months and beyond.

VALUATION

Recent valuation signals from the stock market indicate that the rate of stock market growth should slow down dramatically in the near-term. **The easy money in this recovery is behind us.**

The median P/E is 17 versus 12 in January. By this measure the market has gone from undervalued to reasonably valued. The estimated yield of the stock market has gone to 2% versus 3% in January. Again, this indicates that the stock market is fairly valued. Our reading of Value Line's VLMAP statistic is now 55%, which indicates an average of a 10% return in approximately the next 5 years. That indicates a fairly valued market, as opposed to the phenomenally undervalued reading in January of 135%.

Barring any other news, history tells us that the most probable market trend is a very gradual market, perhaps beset by volatility or profit-taking, but still with a mild upward bias for the next few years. Dividends and other cash flow should contribute substantially to returns. We may see a correction between now and year-end, but historically it should not be long-lasting.

Given these statistics alone, these are the most likely outcomes. Of course, that which is probable is by no means certain.

GEOPOLITICS

I am reading various analyses of the possibility of war with Iran. If you are like me, even thinking about such an event is distressing. After all, Iran is not Iraq. Fighting Iran would be going up against the most militant of Islamic radicals, well-funded and deeply committed to destroying us.

For the immediate present, this doesn't warrant the slightest uptick of adrenaline. We are studying this in depth, so you don't have to. We are trying to balance the unlikely and unpleasant with the higher probability of peace. Call me if this concerns you. From my perspective, we are diversified enough now to withstand what may happen.

ECONOMY

In the movie "The Jerk", the hero, comedian Steve Martin, is targeted by an inept assassin who attempts to kill Mr. Martin as he works as a gas station attendant. The assassin misses rather badly and blows away an entire row of full cans of motor oil. Our hero mistakes the intent of the gunshots and runs away screaming, "Stay Away From The Cans!"

Likewise, we are witnessing a variety of economic events and we in fact have no idea what is actually happening. But just as Steve Martin knew there were gunshots, we can tell that things are changing.

For example, the "cash for clunkers" program produced a genuine stimulus to the economy. But it resulted in less car sales in the following month.

The Fed Funds rate is .25%, which is essentially negligible. Money is dirt cheap. But the banks are reluctant to loan, and people are afraid to borrow, so all the funding the government is putting into the system is essentially like pushing on a piece of well-cooked pasta. Eventually it will take, but not yet. Theoretically, it might even light off an economic boom. Meanwhile the Fed opines that employment will stay above 8% at least through 2011.

In contrast to that, we have news that first-time jobless claims and inventories are both dropping substantially, indicating that in the future we may have more good news on the table from those arenas.

We haven't seen a profound solution to the foreclosure issue. An entirely new wave of foreclosures may or may not take place as flex rate mortgages reset and bubble payments become due. Like the possibility of war, we genuinely don't know what will happen, so overreacting with our money may cause more harm than good. This is one more reason that the Fed will do handstands to keep interest rates down through 2010. We need to remember that the Financial Panic of 2008 isn't done yet. The bottom line, to me, is that the data points to a slow, uneven, yet genuine recovery. The world is getting through this.

HOW WE ARE CONFIGURING YOUR INVESTMENTS

My response is to watch carefully and intentionally do nothing. In my opinion, trading at this point would simply churn the portfolios with little result. Our holdings have gradually become more diversified through 2009. We should expect to ride out any correction which might occur from now through December.

In the early months of 2010, my current plan is to diversify even further, and rebalance *modestly* simply to increase diversification and cash flow.

We've had our treat for the year....let's hope we avoid a trick. Happy Halloween!

Administrative note: Our office will be closed for Thanksgiving on November 26 and 27.