

2009 Market Review & Outlook for Next Decade

How a Tactical Investment Strategy Can Help Investors Build Wealth and Manage Risk in a Secular Bear Market

2009 Market Review

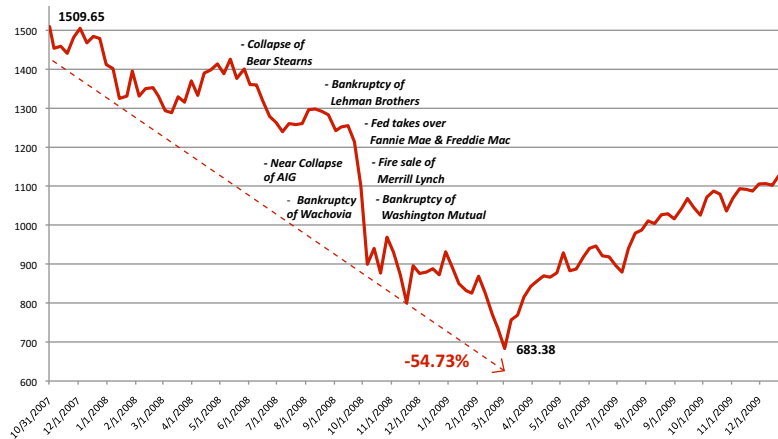
Twelve months ago, the panic sown by the bankruptcy of Lehman Brothers pushed financial markets close to collapse. Global economic activity, from industrial production to foreign trade, was falling faster than the 1930's. It seemed another Great Depression was on the horizon. However, this time the decline was stemmed within months in what later could be known as the "Great Stabilization."

After plunging 37% in 2008, the S&P 500 index fell another 8.43% in January and another 10.64% in February. January's decline was the worst ever for that month and February's plummet was the second worst. The S&P 500 finally bottomed on March 9th, but by then the S&P was down another 24.63% on top of the -37% wreckage in 2008. To put it another way, if you had invested \$1,000,000 in the S&P 500 at the top of the market in 2007, that investment would have been worth about \$390,000 at the bottom of the market in March 2009. The destruction ruined a lot of nest eggs that were invested in strategies that do not go to cash or hedge against excessive risk.

During most of the carnage in 2008 and early 2009, the Baker Avenue Market Sentiment Indicator was in bearish territory, prompting us to raise cash and preserve capital in the All Cap Core portfolio. After staying bearish for a record 10 months, our indicator finally turned positive in early April 2009.

The rally that ensued off the March bottom was just as remarkable as the decline. However, the rebound was not by chance. It was the result of the biggest, broadest and fastest government response in history, though many are calling it "artificially induced" and temporary. Teetering banks were wrapped in multi-trillion dollar bailouts with public cash and government guarantees. Central banks slashed interest rates and governments around the world embraced fiscal stimulus strategies. The remarkable activism helped stem panic, prop up the financial system and paved the way for stocks to recover. Overall, the S&P 500 closed the year with a gain of 26.47%.

S&P 500 Performance (10/31/07–12/31/09)



Source: Bloomberg

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Despite the overall gain, 2009 capped the worst decade for stocks in stock market history. U.S. stocks have underperformed virtually all asset classes since 1999, including most foreign stock markets, U.S. bonds, gold, oil, and even real estate. Since the end of 1999, U.S. stock prices on average fell 1% per year. More sobering still is the fact that \$1,000,000 invested in US equities in a traditional buy-and-hold strategy at the beginning of the decade would have been better off getting placed under the mattress, even after the eroding effects of inflation.

Nonetheless, most of Wall Street is still trying to convince its clients that staying fully invested, 100% of the time, remains the best investment strategy. The reality is however, that investors have lost their confidence and are more fearful than they have been in many years. While the market rallied in 2009, investors pulled out of stocks funds and put a record \$349 billion into bond funds. Investors have learned an important lesson—why employ the same investment strategy that has not worked in the past decade? Why would the next decade be any different? Fortunately, there is a solution. We believe there can be significant opportunities for investors to build wealth and manage risk who utilize a *tactical* approach—more on this in a minute.

Outlook for the Next Decade

Although it appears we avoided a repeat of a Great Depression scenario, significant challenges remain for the U.S. economy. The rebound from the March low is likely getting most of its power from speculation fueled by rock-bottom interest rates and unprecedented government stimuli, rather than from a fundamental recovery in the U.S. economy. Consumer spending is weak and is likely to remain weak for the foreseeable future, especially as consumers continue to increase their savings and avoid the temptations of credit. This is a major problem for the economic recovery since total consumer spending is responsible for approximately 70% of U.S. gross domestic product. Most of this consumer spending has been driven by credit. The spending environment is likely to remain challenged as banks have significantly tightened lending standards since the financial meltdown.

Moreover, personal incomes are barely growing as businesses have trimmed work hours and cut wages and salaries. This trend is likely to continue as businesses look for ways to slash costs and rely on increased productivity and outsourcing. Consumer spending is also being suppressed due to overleveraging during the boom times and the estimated \$13 trillion in wealth destruction from the decline in stock prices and home equity. Speaking of home equity, real estate prices are still falling in more places than they are rising and one in four homeowners who has a mortgage is “upside down.” On top of all this, the surge in deficit spending into the trillions will force lawmakers to increase taxes to pay for the runaway stimulus measures and healthcare initiatives.

Perhaps the most significant challenge going forward is the “stimulus conundrum” on economic policy. Washington’s budget deficit has skyrocketed while the Federal Reserve has injected trillions of dollars into the market. If these expansionary policies are reversed too quickly, it may cause the already feeble recovery to falter. For example, while home prices have recently stabilized, according to a widely quoted, though limited 20-city index, prices could resume falling if the government removes the stimulus measures and incentives too soon. However, if these expansionary policies are kept in place for too long, another massive asset bubble could form, cause runaway inflation and create a surge in interest rates, which would put the economy in serious jeopardy. The timing for removing the stimulus is very precarious indeed. As such, investors should not be confident that the Fed will be able to engineer a soft landing

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with so many problems to contend with. After all, the Fed's track record for avoiding asset bubbles up to this point hasn't exactly been stellar.

As a result of all the artificially induced stimuli, we believe there is high likelihood that the next 10 years for the U.S. stock market will be something similar to the Japanese market during the past 20 years. Nonetheless, there were major opportunities in the Japanese market to make impressive returns if you utilized a tactical investment approach rather than a buy-and-hold approach.

Similarities Between Japan and the U.S.

The dynamics of the Japanese economy and stock market share many similarities with that of the United States. Although the Japanese are known for their superb engineering, strong work ethic, and conservative values, they, too, have suffered through an asset bubble and devastating financial crisis. The pins that popped the Japanese stock-market bubble in 1989 were overvaluation in Japanese stocks, a banking crisis, and a real estate bubble. Similarly, the United States inflated its own stock-market bubble in 1999 when stocks in the S&P 500 were trading at an all-time high of 44 times earnings, substantially above the long-term average of 16. Furthermore, the United States is now dealing with its own banking crisis and aftermath of a real estate bubble burst, which nearly caused a complete collapse of financial markets around the world.

Moreover, Japan's aging population has proven a hindrance to a domestic recovery, and the United States has a similar problem with an aging "baby boomer" workforce. As of 2008, 40% of the workforce in the U.S. was baby boomers. This portion of the population will begin retiring in significant numbers in the next 5-10 years, which will have major ramifications for certain industries. For example, it will create a vacuum of skilled labor that a younger workforce may not be able to replace. What's worse, the younger generations likely will not be able to adequately fund the growing commitments of Social Security.

Unlike Japan in the 1990's, the U.S. currently has two wars to finance along with what appears to be an endless fight against terrorism. The recent terrorist attempt on Flight 253 on Christmas Day over Detroit is a somber reminder of the potential damage a successful terrorist attack may have on U.S. consumer and investor confidence. Significant geopolitical risks also remain in Iran and North Korea over their nuclear weapons program. As such, the probability is low that the U.S. will be able to resolve these issues in a diplomatic manner, thus creating another possibility for economic destabilization because of military action.

The bursting of the Japanese stock-market bubble gave birth to a 20-year bear market that just started showing early signs of a possible turnaround. In the past 20 years, the Nikkei 225 index has fallen 82% from its all-time high in December 1989 of 39,916, with a 70.9 price-to-earnings ratio, to its recent low of 7,021 in March 2009.

The S&P 500 index fell nearly 58% from its all-time high in 2007 to its March low in 2009. If Japan's market is any indication of what the future may hold for the U.S. market, the outlook for strategies that stay fully invested and avoid proper risk management techniques is grim. Buy-and-hold strategies using simple portfolio diversification efforts will not be sufficient, especially during what we believe is a long-term bear market. While we hope that U.S. markets will fare better than Japan's, we believe it is important to be prepared for the possibility it does not.

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Secular Bear Markets

Long-term bear markets, like Japan's 20-year bear market, are called *secular* bear markets. Secular markets are market cycles that last for multiple business cycles, with each business cycle lasting for approximately 4 years. Secular bear markets last on average about 18-1/2 years. Excessive speculation and overvaluation are usually the factors that give birth to secular bear markets. The factors that continue to feed secular bear markets are economic stagnation and price/earnings (P/E) multiple compression.

Besides having faced two speculative bubbles in the past 10 years, the U.S. still faces significant economic challenges ahead. **We believe, along with many other notable analysts, that the U.S. market is now in the middle of its own secular bear market that started in 2000.** If the U.S. secular bear market lives up to its average life expectancy, buy-and-hold investors would have another 9 years of dismal stock returns. The U.S. is no stranger to secular bear markets. In fact, since 1900 the U.S. has seen 3 secular bear markets that experienced an average decline of 66%, when adjusting for inflation.

U.S. Secular Bear Markets 1900-20XX

Years	Duration	Number of Recessions	Starting P/E	Finishing P/E	Decline (Inf Adj)
1901-1921	19 yrs 6 mos	6	25.24	5.13	-69%
1929-1949	19 yrs 9 mos	4	32.56	9.07	-67%
1966-1982	16 yrs 6 mos	4	24.06	6.64	-62%
Average	18 yrs 7 mos	4.67	31.52	6.95	-66%
2000-Present	9 yrs 7 mos	2	44.20	??	??

Source: Pring Turner

What has ended secular bear markets in the past is a significant *undervaluation* in stocks with price-to-earnings ratios falling into the single digits. The current price-to-earnings ratio of the S&P 500 is about 20, according to noted economics Yale professor Robert Shiller. If the current secular bear market were to end with an average P/E of 6.95, this would imply a price target of 392 for the S&P 500 index, based on current earnings. This would mean a massive -65% crash in the market from current levels! However, if corporate earnings increase faster than stock prices, P/Es will still be compressed. As a result, there could be a combination of increased earnings and falling stock prices leading to extremely undervalued levels. Such a scenario could occur if consumers are forced to continue to liquidate assets to pay down their debt and higher tax burdens.

What does this sobering outlook mean for investors? While younger buy-and-hold investors may still see gains in their portfolios over the *very long term* (20+ years), those who depend on their investment portfolios to supplement their living expenses face a serious dilemma. Investors approaching retirement or who are already in retirement are living longer and therefore need their portfolios to grow to keep up with inflation and last for the duration of their lifetimes. As such, they cannot afford to face another destruction in their portfolios like in 2000-2002 and 2008-Q1 2009. Such an occurrence would devastate their lifestyles, especially if it's anything close to the -65% correction mentioned above. That's the bad news; here's the good news.

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While younger buy-and-hold investors may still see gains in their portfolios over the *very long term* (20+ years), those who depend on their investment portfolios to supplement their living expenses face a serious dilemma.

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Cyclical Bull Markets Within Secular Bear Markets

Within secular bear markets, there are cyclical bull markets in which investors can profit. The table at right illustrates these opportunities within historical secular bear markets.

Cyclical markets last for 1-2 business cycles; therefore they have shorter durations than secular markets. For example, despite having a 20-year secular bear market, Japan's stock market produced a number of cyclical bull markets that produced no fewer than four 50%-plus rallies.

Secular Bear Market in Japan (1989-2009)



Source: Bloomberg

Bottom line: Investors can build wealth in secular bear markets by identifying cyclical bull markets to invest in, and by being risk-sensitive and avoiding bull traps along the way. In other words, investors need to be nimble by going long when the trend is bullish and move to cash, bonds, or even short when the trend is bearish. This is a *tactical* approach to investing.

Despite two significant bear markets that permanently changed the lifestyles and living standards for many investors over the past decade, the majority of Wall Street institutions continue to sing the same tune of a buy-and-hold mantra. In contrast, Baker Avenue employs a tactical investment approach that adapts to changing markets. In other words, we believe there is more to risk management than simple diversification, this is especially true during secular bear markets.

We analyze a universe of over 4,000 stocks to measure the momentum and risk of the market. When the Baker Avenue Market Sentiment Indicator is positive (any reading from 50 to 100) we believe investment risk is low, and will therefore invest capital in high relative strength stocks that have solid fundamentals. When the indicator is negative (any reading less than 50) and market volatility is high, we play defense and move up to 100% cash. The exception to our negative territory is when the market becomes extremely oversold and sentiment drops below a reading of 10, which signals our special "Blue Buy" opportunity. Such levels historically have been rare and excellent entry points into the market. By being opportunistic in oversold markets, we can take advantage of rebounds in cyclical bull markets.

U.S. Cyclical Bulls Within Secular Bear Markets

Date	Dow Close	% Gain
1906-1921 Secular Bear Market		
11/22/1907	53.08	
11/19/1909	100.53	89%
9/25/1911	72.94	
10/8/1912	94.12	29.03%
12/24/1914	53.17	
11/21/1916	110.15	107.16%
12/19/1917	65.95	
11/3/1919	119.62	81.37%
12/21/1920	66.75	
5/5/1921	80.03	20.10%
1929-1949 Secular Bear Market		
11/13/1929	198.69	
4/17/1930	294.07	48%
7/8/1932	41.22	
3/10/1937	194.4	372%
3/31/1938	98.95	
11/12/1938	158.41	60.09%
4/28/1942	92.92	
5/31/1946	212.28	128.45%
1966-1982 Secular Bear Market		
10/7/1966	744.32	
12/3/1968	985.21	32.36%
5/26/1970	631.16	
1/11/1973	1,051.7	66.62%
12/6/1974	577.6	
9/21/1976	1,014.79	75.69%
4/21/1980	759.13	
3/25/1981	1,015.22	33.73%
2000-? Secular Bear Market		
3/6/2003	7,673.99	
10/9/2007	14,164	84.57%
3/9/2009	6,547	
12/31/2009	10,428	59.27%

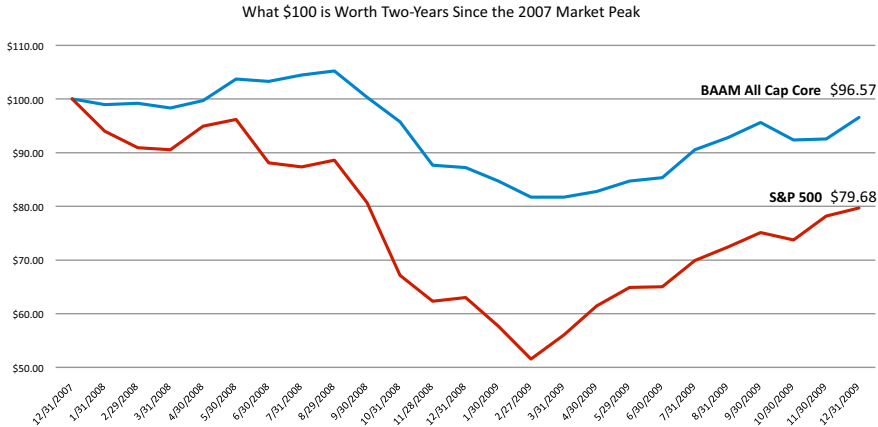
Source: Trading Online Markets

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The performance of our tactical approach has been successful in this difficult market environment. Our performance over the past two years highlights the importance of risk mitigation and minimizing losses in down markets. In the past 2 years, the All Cap Core strategy has maintained its value with less volatility than the overall market. In contrast, the S&P 500 index is still down nearly 20% over the past two years, despite the strong rally in the market in 2009.*

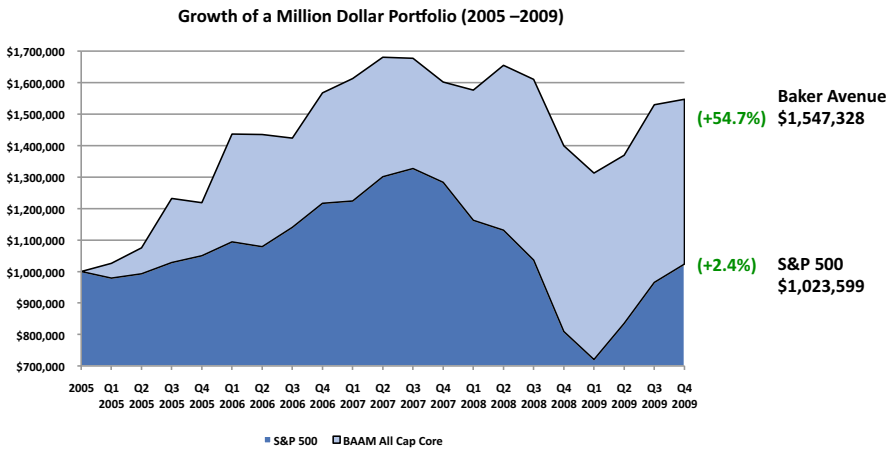
All Cap Core Performance vs. S&P 500 (12/31/07–12/31/09)



Source: Bloomberg

Over the five past years, our investment performance is even more compelling. On a cumulative basis, the All Cap Core gained 55% net of fees despite going through the worst bear market since the Great Depression. The S&P 500 on the other hand, has gained only 1% over the past 5 years. In positive markets, the All Cap Core was able to capture 90% of the up move. In negative markets, the All Cap Core captured only 60% of the down move. In other words, the All Cap Core captured nearly all the gains in up markets, but also declined significantly less than the market in down markets. That's what risk management and tactical strategies are all about: striving to beat the market with less risk.

All Cap Core Performance vs. S&P 500 (2005–2009)



More Tactical Strategies to Beat a Secular Bear Market

In addition to measuring investment risk with market sentiment, tactical investing involves identifying markets with high relative strength and positive momentum.

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Although we are likely in a secular bear market in the U.S., there are other global markets that are in secular bull cycles. For example, international markets in the BRIC countries (Brazil, Russia, India, and China) have shown significantly higher relative strength versus the U.S. market over the past 10 years. Since the end of 1999, Brazil's Bovespa Index has returned over 301%, Russia's MICEX is up a whopping 802%, India's SENSEX Index has gained 308%, and China's Shanghai Composite Index has gained 175%. The S&P 500 Index, on the other hand, has lost a disappointing 9% during the past decade. A tactical investment strategy employing relative strength analysis helps identify opportunities such as the BRIC markets, while avoiding markets that are underperforming.

Another tactical approach to employ in a secular bear market is alternative investment strategies, like hedging. The benefits of hedging include uncorrelated returns with the market and also potential for profit opportunities in down markets. Hedging investment strategies involve controlling market exposure through the combined use of long investments and short selling. Short selling is a strategy for profiting on the prospects of an asset declining in value. Therefore, if a market is highly overvalued as is typical at the onset of secular bear markets, there can be an opportunity to create wealth by hedging with short selling.

Conclusion

Despite the overall gain in the market this past year, U.S. stocks have underperformed most asset classes over the past decade. The next 10 years may also disappoint investors as the U.S. still faces numerous challenges that could jeopardize the economic recovery. The U.S. faces the daunting prospects of an enormous budget deficit, a weak and highly overleveraged consumer, a frail real estate market, higher taxes, and a conundrum of how long to maintain a loose economic policy that may cause yet another asset bubble or rampant inflation. Like the Japanese market over the past 20 years, the U.S. market may be in a long-term secular bear market born from too much speculation and overleveraging.

Having ridden through severe losses in 2000-2002 and 2008, investors do not want to experience those types of declines again. Many investors are worse off now than they were ten years ago with negative returns and inflation. If investors are worse off today with a buy-and-hold strategy, why should they employ the same strategy again for the next 10 years?

Baker Avenue uses a tactical investment approach with our Market Sentiment Indicator, which measures the overall risk and momentum of the market. In positive markets, we invest in stocks with high relative strength for capital appreciation. In negative markets we move to cash or bonds to protect investment capital. Therefore, we believe we can help investors build wealth and manage risk even though we may be in a secular bear market. The success of our investment approach over the past five years highlights the fact that our tactical strategy can help investors protect against downside risks while also enjoying the upside returns of the market when the opportunity is at hand.

We wish you a prosperous, *tactical*, and Happy New Year. As always, please contact us with any questions.

Sincerely,

Baker Avenue Asset Management, LP

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Disclosures

BAAM All Cap Core Equity Composite consists of fully discretionary portfolios that invest in all cap equities and cash. The portfolios are designed to generate a positive return over the medium to long term, with a focus on capital preservation. For comparison purposes, the composite is measured against the S&P 500 and the Russell 3000 indices. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represents over 80% of the investable U.S. equity market. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The minimum account size for this composite is \$100,000.

Baker Avenue Asset Management, LP has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

Baker Avenue Asset Management, LP ("BAAM") is an independent registered investment adviser. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Returns are presented net of all fees and include the reinvestment of dividends, interest and other income. The composite consists of bundled-fee and non-bundled fee portfolios. Net of fee performance was calculated using the highest applicable annual bundled fee of 1.25%, applied monthly. Prior to January 1, 2007 the net of fee performance was calculated using the highest applicable annual bundled fee of 1.5%, applied monthly. In addition to a management fee, accounts pay transaction fees or all-inclusive fee based on a percentage of assets under management. Other than brokerage commissions, this fee includes portfolio monitoring, consulting services, and in some cases, custodial services. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Additional information regarding policies for calculating and reporting returns is available upon request.

The maximum fee schedule is as follows: 1.75% per annum of assets under management. Baker Avenue Asset Management, LP in its sole discretion may waive or reduce the management fee with respect to one or more clients or agree to apply a different management fee for a client. Carve-outs are included in this composite from inception on January 1, 2005 until March 31, 2009. After March 31, 2009, only pure accounts were included in the composite. The portfolio accounting system automatically allocates 100% of the total cash to the carve-out.

The BAAM All Cap Core Equity Composite was created on January 1, 2005. Baker Avenue Asset Management, LP's compliance with the GIPS standards has been verified for the period January 1, 2005 through June 30, 2009 by Ashland Partners & Company LLP. In addition, a performance examination was conducted on the BAAM All Cap Core Equity Composite beginning January 1, 2005. A copy of the verification report is available upon request.

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