Walden Capital Newsletter

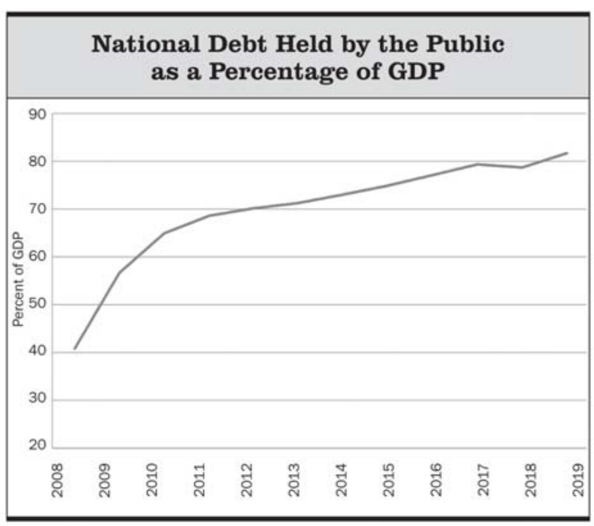
Walden Capital Advisors | **Second Quarter 2009**

Quarterly Investment Commentary

As we look back on a tumultuous first half of the year, we are struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years. The large-cap S&P 500 was up 15.9% for the quarter, bringing the year-to-date increase to 3.2%. You may recall that large cap stocks fell sharply for the first couple months of the year and then rallied over 36% since then. The small-cap Russell 2000 gained 20.7% for the quarter, ending the first half of the year up 2.6%. Foreign equities have outpaced domestic stocks this year, gaining 25.4% this quarter and 8.0% year to date. Growth has performed significantly better than value year to date. On the fixed-income side, we witnessed a turnaround from 2008 with corporate bonds outperforming Treasury bonds.

The Market and the Economy – Uncertainty Reigns

The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears past; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. And though economic activity continues to worsen, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of the huge debt bubble continue to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the level where it might have been without the artificial boost of the credit bubble. While it probably allowed us to avoid a depression, the massive bailout and stimulus spending (along with longer-term demographic factors such as



Equity markets rebounded across the board during the second quarter, showing positive year-to-date returns for most sectors.

The overall environment has improved, but plenty of problems remain. Macro issues are unusually important in this environment, and there are several key areas we are assessing to help us make portfolio-level decisions.

Highly significant questions include when housing will bottom, what the longer-term impact will be of government stimulus and other policy actions, and whether investors will remain risk averse in the years ahead.

In all but our optimistic scenario, the returns we expect from broad asset classes are about average in the years ahead. But we think continued tactical opportunities and value added from our active managers improve our return outlook.

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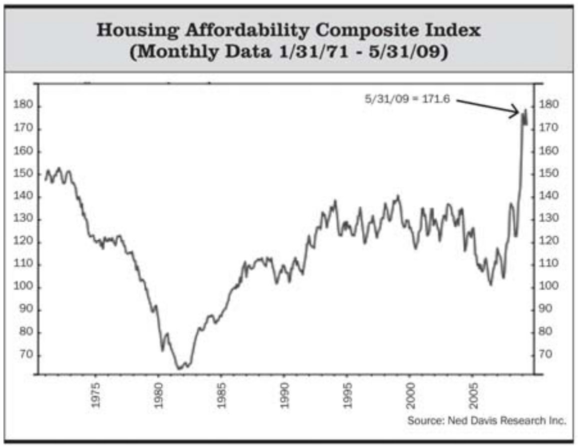
spiraling health care and other entitlement spending) is causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

Other conflicts are at play that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have recently been a



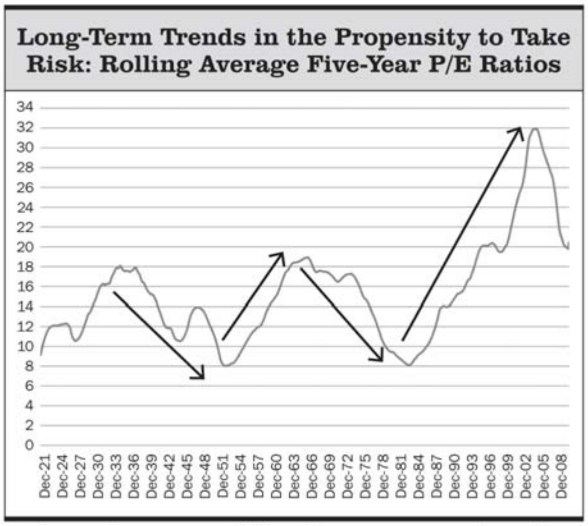
Higher points indicate greater affordability.

few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There is more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high

unemployment will make things worse.) Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Demand-driven inflation also is unlikely. Over the intermediate term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.

That brings us to another issue, which is the tightrope that policy makers have to walk with respect to stimulus. We believe that in aggregate, government intervention probably saved us from an economic depression, but have we dodged the only bullet? Given the actions to date, the Fed and the Treasury are clearly committed to doing whatever it takes to help the economy find a floor so that it can grow again. On the other hand, if there are no more bullets to dodge, it will be difficult to know when the timing is right to unwind the stimulus. If it is unwound too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to budgetary woes. In any event, there will be great political pressure to deal with on both sides of the issue.

Investment returns will also be influenced by investors' willingness to take on risk, which tends to build during bull markets and break down in bear markets. The degree of investor risk aversion is an unknown that will impact returns in the years ahead. It is likely that higher-than-normal risk aversion will subside very gradually and that stock P/E multiples in five years will be average or below average relative to the last 50 years and returns will likely be average and not particularly exciting. If we look beyond five years we can anticipate a gradual return of normal risk taking leading to higher returns.



Looking at 5-year average P/Es makes it easier to see the tendency for multiples to go through lengthy periods where they rise and fall.

We Consider a Range of Outcomes in Making Portfolio Decisions

Broadly speaking, these conflicts create a very wide range of possible outcomes. Our intellectual honesty demands that we recognize that no amount of analysis will allow us to determine exactly how the coming years will unfold, so we direct our analytical effort toward thinking carefully about what would happen across a range of outcomes. This process of scenario analysis gives us important insights about how to position our portfolios.

In all but our most optimistic scenario, we believe returns from stocks and bonds over the next five years will be no more than average. Fortunately, as we invest for our clients we are not limited to just what the broad stock and bond markets give us, and this is a source of optimism for us. Because this is an environment in which many stocks and bonds have traded at prices below what their fundamentals suggest they are worth, our managers have made investment selections that added a lot of value over their market benchmarks. While some of the lowest-hanging fruit may have been taken, pricing disconnects remain that we think could continue to give our managers a tailwind in the years to come.

Pricing disconnects exist at the asset class level as well, and we expect to see more opportunities if markets experience further periods of high volatility. We have already enjoyed strong returns from our tactical position in high-yield bonds. We have also continued to fund positions in emerging-markets equities. We recognize that emerging markets may be more volatile in the shorter-term, but we are prepared to accept that because of our confidence in the potential longer-term reward. In addition to these tactical asset class moves, our bond managers are also using their flexibility to take advantage of undervalued areas of the bond market when they consider the long-term opportunity to be sufficiently compelling.

Overall, our portfolios have a modestly conservative bias as we are working slowly back to original target allocations. We believe that prudence is called for given the high level of uncertainty in the economy and financial markets, but that good investment opportunities do exist. We will continue to work hard to identify and take advantage of these opportunities.

Please contact Walden Capital Advisors promptly if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.