



DEIGHAN

ASSOCIATES

INVESTMENT QUARTERLY

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MARKET COMMENTARY

Third Quarter 2009

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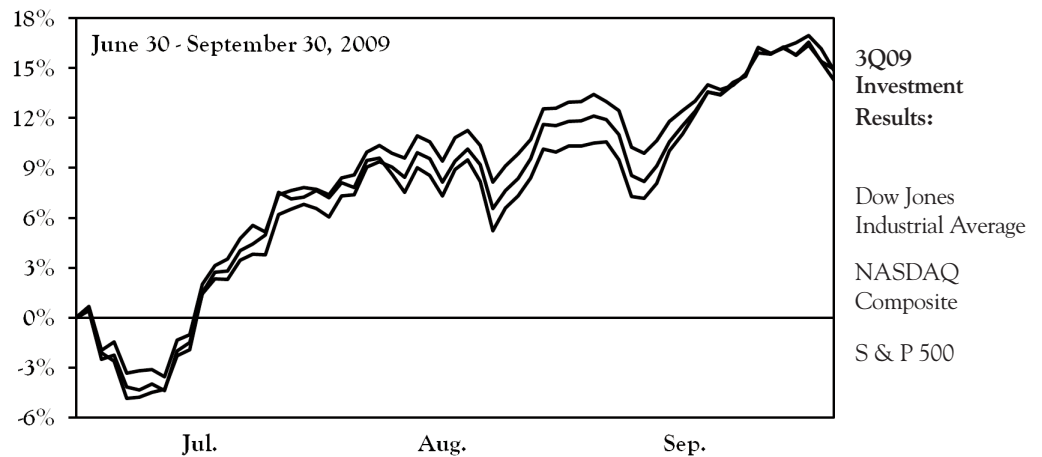
We find that by some measures very little is different.

Just over one year ago, Lehman Brothers filed for bankruptcy. It was the largest corporate failure in U.S. history, triggering a panic that led to indiscriminate asset destruction around the world. Since then, we've witnessed further corporate failures, large and small. We've witnessed radical government response. We've witnessed the election of America's first black president. And we've witnessed a market rally in excess of 55%. That's a lot to cram into one year.

But for all the uncertainty, heartbreak, and change – despite the market's stunning rally and the constant assertions that we've turned the corner – we find that by some measures very little is different. The S&P 500 Index closed at 1,166 on September 30, 2008. On

There has been improvement in both housing and manufacturing. However, housing has been aided by the First-Time Home Buyer Tax Credit and low interest rates. Manufacturing has been boosted by a weak dollar and short-term government initiatives like "Cash for Clunkers". We're concerned the recovery wouldn't look as strong without these stimuli, especially given that the tax credit is about to expire and that interest rates cannot remain forever near zero. Nor can the federal government continue to throw money at every problem.

We're also concerned because the consumer is in no shape to pick up the slack. Industrial production and GDP might be on the rise, but unemployment has not improved. Last



September 30, 2009 it closed at 1,057. We write this not to depress, but rather to provide context. Investors thought things were dire a year ago. Many think roses are pushing up today, and yet the market has gained no ground. So which is it?

Where the market is concerned, there is usually more risk in optimism. The tech and housing bubbles were perfect examples. Therefore, we choose to remain a bit skeptical.

week, initial jobless claims rose by more than expected, and payroll data indicated more jobs were cut than forecast. Despite strong August spending, which was heavily fueled by government subsidies, personal incomes continue to lag. Mathematically, the labor market would need to create 400,000 jobs per month for the next 18 months in order to offset the 7 million workers who have lost their jobs since December 2007. Even if this were to happen, Americans

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need to increase their savings to make up for the wealth they've lost. A higher savings rate means less spending and slower economic growth.

Much has been done to get the patient up and walking, but how well will he stand when we remove the crutch (or crutches in this case, as there are several)? If interest rates are increased too soon, it could snuff out the nascent recovery by re-freezing the gears of commerce and discouraging home purchases. We find it interesting that analysts who just a few months ago were very measured in their outlook now speak much more openly about the recovery and its strength. Our opinion? Yes, a full recovery will happen over time as we work out the issues at hand. But there are too many near-term risks for us to rule out the possibility of a pullback, and there is no guarantee of a V-shaped recovery.

Despite the difficult year, client portfolios have weathered the storm well. Over the

larger companies with international exposure. Successful security selection is one way a manager can limit losses or generate outsized returns.

Another way is through diversification and asset allocation. Lately, questioning the merits of diversification has become a popular practice among portfolio management studies. On the one hand, asset correlations did rise significantly during the worst of the crisis, as assets were devalued indiscriminately. Such is one of the drawbacks of having an ever more integrated global society. However, we can say without doubt that diversification played a large role in protecting client portfolios on the way down and boosting them on the way up. And so we ask the same question. Where will the growth come from? It's hard to shake the feeling that the U.S. faces significant headwinds over the next decade. We as a nation have amassed stunning amounts of debt, which needs to be paid back.

*It pays to be choosy,
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trailing twelve months, our average client portfolio gained between 2-3% net of fees, while the S&P 500 lost nearly 7%. We are not heralding victory just yet, but we do view this as evidence that it pays to be choosy, especially now. Yes, the market has posted a stunning rally. Yes, economic news has been increasingly encouraging. Do we feel comfortable jumping in to chase further returns? Not exactly.

Instead, we're working to add value to client portfolios by being measured in our approach. According to professor Robert Shiller of Yale University, in March stocks traded as low as 12 times their average earnings over the previous ten years. Today, they are selling around 19 times earnings, which is above the long-term average of 16. This indicates that large portions of the market may be overbought. With this in mind, we're looking for pockets of value. We seek companies with attractive prices relative to earnings, and we want companies with compelling stories. We often ask ourselves, where will the growth come from over the next five to ten years? Increasingly, we've focused on smaller companies with unique value propositions and

At the same time, we have very real problems on a variety of fronts, including infrastructure, the environment, education, retirement savings, and healthcare. Some of these great challenges could pose great opportunities for the right businesses. But we've been reducing our overall allocation to U.S. companies for some time. The growth engines of the next decade appear to be overseas, in emerging markets in particular. As a result, we've built significant international holdings into all of our client portfolios, in equities, bonds, commodities, and real estate.

When writing a commentary like this, it's easy to sound dour. But that's not truly the case. We are simply being proactive and risk-aware. You deserve to know any potential risks your money might face, and we're here to help you manage that risk. We welcome the recovery, if it truly is here, and we have worked that potentiality into our investment plans too. But every dollar lost is doubly hard to earn back, and so you can understand our caution. Amazingly, the next time you receive this newsletter it will be 2010 – a new decade! By then the crisis of 2008 might seem like a distant memory. Let's hope it is so.

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BECOME A SUPERHERO

At the 2009 Schwab Conference in San Diego, one of the best sessions was a roundtable discussion with Laurence Fink, CEO of Black Rock, and Mohammed El-Erian, CEO of PIMCO. Both men are industry giants possessing broad market insight and something even rarer these days – sterling reputations in the investment world. The discussion was moderated by Tyler Mathisen, a CNBC commentator.

“I did everything right!” said Tyler, puffing up like a bantam rooster. “I wasn’t like those Enron employees! I diversified my account with lots of US stocks, but it didn’t protect me! Why?” In short, Tyler wanted to know why this downturn was so widespread and intense; whether something like it will happen again; and what an investor can do about it.

El-Erian looked out at the sea of investment advisors and replied, “If you sucked the air out of this room depriving everyone of oxygen, it wouldn’t matter what shape you were in. The fit and unfit alike would be writhing on the floor gasping for air. This is essentially what happened a year ago. The confidence implosion following Lehman’s collapse was so great that everything was called into question. Once steps were taken to restore some level of confidence it was as if the air were pumped back into the room. At this point, diversification mattered, because the fit stood up first and then helped the unfit to their feet.”

El-Erian’s point is that there are certain earth-stopping market events where correlations for all assets converge and prices drop simultaneously. During these moments, it doesn’t matter whether you’re fit or unfit, whether your portfolio is properly diversified or not – values are going down. However, within a properly diversified portfolio there should be enough different players such that a few will start recovering faster, shouldering the entire team. Diversification may not feel useful going into a crisis, but it is crucial when coming out of one.

So, we have an answer to the first question, why this downturn was so widespread. Will something like it happen again? We don’t want to scare you, but yes. Looking at just the last decade, we’ve seen two major market corrections. Modern portfolio theory doesn’t like to think about outlier events

like market crashes, because they throw a monkey wrench into all the nice, neat calculations. However, it has become apparent that investors need to be prepared to deal with market turmoil, both financially and psychologically. Corrections are part and parcel with investing, and positive returns are not achieved without assuming some level of risk. We do our absolute best to protect your assets by diversifying across a variety of investments. In fact, we want your portfolio to be like a well-assembled team of superheroes, each with their own strengths for particular situations. But keep in mind that all superheroes have weaknesses. This means there are things that you, the investor, need to do to help them.

- **Avoid excessive long-term debt.** Leverage has its place on the personal balance sheet. For example, buying a home. However, make sure you can comfortably carry your debt load in the event of a lost job or poor health.

- **Avoid carrying short-term debt, and do your best to pay off credit cards monthly.** Credit cards can be useful in a pinch, but they should not be relied upon for supplemental income. Try visualizing credit card debt as unhealthy, artery-clogging fat. If you let it build up, it takes a lot of hard work to get rid of it.

- **Think hard about how much it costs to fuel your current lifestyle and whether it’s worth it.** Should you simplify? There are no rules here except your rules, but sometimes it pays to think about what really matters. Again, it is often a tradeoff – personal freedom in exchange for second homes, camps, or boats.

- **After you’ve reduced your debt burden and freed up extra disposable income, determine the cash reserves you would need to get through another downturn.** Let us know this amount, and we will incorporate it into your asset mix. If you have enough liquidity going into a crisis, then it prevents the need to sell investments at depressed prices.

- **Finally, work to mentally accept both challenge and change.** We live in interest-

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Soundbytes

Matthew Skaves successfully completed the Level II exam for the Chartered Financial Analyst designation. The CFA Program requires candidates to study for and pass three levels of examination. The CFA Charter is the designation of excellence in the investment community.

Jean Deighan was chosen to receive a Paul Bunyan Citizenship Award as part of the city of Bangor’s 175th birthday. The award recognizes individuals who have made a significant contribution to the quality of life or the enhancement of community assets.

Jean Deighan attended IMPACT, Schwab’s annual conference for independent investment advisors. This year’s conference included a number of educational sessions and featured keynotes by speakers Mohamed El-Erian and Robert Reich.

Heidi Farren has left Deighan Associates. We wish her well as she pursues other interests.

BECOME A SUPERHERO *continued from page 3*

ing times. There will be great moments and there will be somber moments. But if you've got your house in order, then there's always going to be a light at the end of the tunnel.

Many investors went into the current crisis unprepared. They needed to sell depressed investments to come up with cash to pay the bills. Or they sold depressed invest-

ments because holding on proved to be too much of a challenge. These types of actions can have lasting effects on a portfolio's health. In preparing for challenge and change, your investments have a role to play, and you have a role to play. There is one mistake that investors often make. They forget they're a member of the team. With a little work, we know you can become a superhero.

FAMILY OFFICE NETWORK

We have decided to re-run this short article outlining our upcoming online platform, for those who missed it last time.

These days, more and more people are using electronic communication to expedite and simplify their daily lives. With this in mind, we will soon be rolling out an online system that will have the ability to be a one-stop shop of sorts for your financial life. We have partnered with Family Office Network (FON), a company specializing in online document storage for independent investment advisors.

We are excited about this system for a few reasons. First, it will allow you to have secure electronic access to reports that you would normally receive from us by postal mail, such as quarterly reports, tax reports, and newsletters. It will also provide us with the ability to electronically interface with you using a secure platform. For example, we will be able to upload sensitive documents for your approval, such as letters of authorization, that we would otherwise not be able to send by email. Additionally, we can grant specific limited file access to other professionals in your life, like attorneys or accountants. Your CPA, for example, could log onto the system and access your tax folder, saving him or her time and you money. Or, you could partake in a conference call with your attorney and your Deighan advisor, each of you logged into the system viewing the same documents from different locations.

Another exciting feature will be the ability to aggregate your non-Schwab accounts into one place. This means a few things. First, for those of you who would like us to manage your outside 401(k) or 403(b), such as TIAA-CREF or Fidelity, we will be able to download information from those plans

directly into our portfolio management software. This will allow us to manage your non-Schwab accounts in concert with your Schwab accounts. Second, you will have the option to view information from any financial institution with whom you do business via your FON login. For example, you could set up your FON account to show your Bangor Savings checking account and your Bank of America credit card. You control which institutions appear as part of your FON login, and you control what Deighan Associates can see. If you want to be able to view your credit card through FON, but you don't want us to see that credit card, then simply don't grant us access.

We recognize that online security must always be at the forefront of a system like this. That's part of the reason why we've chosen Family Office Network. FON's servers use state of the art 256-bit AES encryption and are redundantly backed up in San Diego, Denver, and Zurich. All emails into and out of the system are encrypted, and the system complies with SEC and FINRA retention requirements.

We plan to roll the system out soon. We will send you an email invitation to join the system, as well as a notification via postal mail. It is important that we have your correct email address. Therefore, if you have any doubt that we may not have your correct email address, please contact us. We will also be contacting clients for whom we do not have email addresses. Once you are registered in the system, you will be able to login by visiting our website at www.deighan.com.

We hope that the brief description above excites you as much as it does us. The FON system will allow us to provide you with a higher level of service in a more efficient manner. Stay tuned for more information!

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