



### Third Quarter 2009 Performance Report

This feels so much better! Just six months ago the world was on the brink of financial collapse, the stock market hit a twelve year low, credit was unavailable, the world economy looked like it was falling into a deep recession, if not a depression and it seemed as if spring would never come.

The financial system didn't collapse, it just stumbled. The banks were able to raise the capital they needed to fill the holes in their balance sheets. Now credit is readily available at cheap prices to the big players and we are beginning to see an easing in the small business market. There is little doubt we are in a recovery and all the bears can hope for is another leg down before the world economy starts humming again. The change in the investment climate hasn't been lost on the stock market, which is up 50% since its low in March. Amazingly, interest rates are near their all time lows despite the stock market's advance. That gives the recovery lots of room to run before high interest rates choke it off.

People who say the stock market is ahead of itself either didn't realize how near we came to driving off a cliff last year, or don't appreciate how much progress we have made in fixing the mess, in an incredibly short period of time. Most of the market's run is simply due to the fact that the panic is over. Now we will see how much further the market can go as the recession eases and the recovery begins.

Remember, if the stock market goes down 50% and up 50%, it's still down 25% from its highs. Percentages and averages can be terribly misleading. In this case they are probably overstating the degree of the recovery, which has been impressive, but hardly off the charts given the severity of the sell-off.

I've noticed that there is a one to one relationship between those pundits who believe the market will have a severe correction and those who never thought the market would get off the floor. Not that I blame them, predicting the market is a nearly impossible task at best, but it's hard to understand how they can be so confident now after being so wrong. Apparently, keeping your job as a market prognosticator, has more to do with your powers of persuasion, than your actual ability to predict the future.

We claim no such clairvoyance, but we have great faith in capitalism and ability of free economies to heal themselves. We are also quite aware of the inescapable habit of markets to go to excesses. So, when there is a housing bubble or a financial crisis we aren't that surprised. It's happened time after time for as long as there have been financial markets.

Putting the current crisis in that perspective led us to treat it the same way we've treated every other panic we have seen in our investment career. We tried to limit our losses by staying diversified. We bought more of industry groups that the market had punished the most. We got more aggressive as the market went lower and when everybody said there was no hope, we were pretty sure we were near the end.

We entered this correction underweighted in the hot financial and commodity stocks that crashed the hardest last fall, not because we knew there would be a crash, just because we know you limit risk by not overweighting hot groups. We bought these groups on the way down, suffering through the double dip in March as our newly purchased stocks and bonds suffered from a second leg down. We took another round of tax losses, rebalanced portfolios and found some new companies that we thought were trading too cheaply in the panic.

We were surprised as anyone by the strength of the rally this summer, but were able to fully participate in it because we remained fully invested and exposed to the groups that saw the biggest rebound; financials and technology, the industries the smart guys had given up for dead. It didn't hurt to have some exposure to mid and small cap stocks. They have outperformed big caps this year, as they often do in the first stages of a recovery.

Now comes the easy part. The world's economies are on the mend and there is no better time to be an investor than during a recovery. There will be setbacks. Right now we are probably overdue for a pause in what has been a spectacular market rally both in stocks and corporate bonds, but we will ignore the bumps in the road. If we could remain fully invested in a panic, a correction won't scare us. The risk of missing the recovery isn't worth the small chance of getting the timing of trading a correction just right.

The market has rallied enough to cause us to get a little more cautious though. We've started to sell a few financial and tech stocks that have gone up so much that we have gotten over-weighted in those areas and we'll be rebalancing stock and bond accounts to keep them on their targeted allocations. If the much anticipated market correction finally happens, there are still some stocks on our shopping list we'd love to own at lower prices. If not, we'll just keep pairing down the winners.

Stocks may have long way to go, but the outsized returns we experienced this year in bonds are probably a thing of the past, for a lot of reasons. Most of the move in corporate bonds came from the simple fact that we went from assuming everything that wasn't guaranteed by the Federal government was going bankrupt to a buying panic, as investors tried desperately to pick up some kind of yield versus money markets that were paying nothing.

Then there is the fact that interest rates are at generational lows and unlikely to get lower unless there is a depression. I, and hopefully you, have forgotten how many years ago we turned bearish on long bonds, but suffice to say it has been long enough that we'd both be broke by now if that was our only position. Now our only option is to hold our losing position until we are either right or dead.

The final reason to be bearish on bonds is that they are currently in favor with the two groups of investors that are generally wrong, even more than I am, foreigners and the retail investor. These guys always get corralled into a losing position before the market sheers them.

As the stock market goes up we'll be buying bonds with the proceeds of the stocks we are selling in balanced accounts, but we'll keep them short unless we are playing a special situation. We'll just have to be consoled by the fact that low bond yields are the price we are paying for healing the economy and boosting our stock returns.

In the last twelve months we have experienced a decade's worth of turmoil. The market has thrown everything it has at us, but we stood up well because we entered the crisis with a sound investment philosophy that remained consistent. The only real test of portfolio strategy is seeing it through good and bad times. If it has to change, even in extreme market conditions, it's wrong.

The same is true of your asset allocation decision. If you lost sleep in the last market downturn, it's time to gradually start moving to a more conservative asset allocation. If you think you are missing the recovery, you should ask us to increase your allocation to stocks until we get the growth you need. We want to find an asset allocation that will make you feel comfortable in good and bad markets. We'd be glad to help you make this important investment decision.

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