

MARKET OUTLOOK...

The Dow Jones Industrial Average has staged an impressive six-month rally since it bottomed out on March 9th of this year at 6,549. The Dow is currently up approximately 50% from its annual low with the index now at 9,700 (as of 9/30/09). A market improvement of this magnitude has only occurred on a few other occasions in the United States, most notably following the Great Depression. So the question we are frequently asked today is:

Are we in a new bull market phase, or is this just a temporary rally that will end with the market revisiting the March 2009 lows? We wish we knew the answer to this question, as it would make our job a lot easier, more fun and less stressful. But since we cannot predict the future with any certainty, we will try to focus on a few things we know for certain.

Stock prices had become inflated relative to earnings, revenue, asset values, and economic activity.

It was time for the market to do what it has always done in the past — revert to its mean.

Following is a summary of key market points over the past ten years:

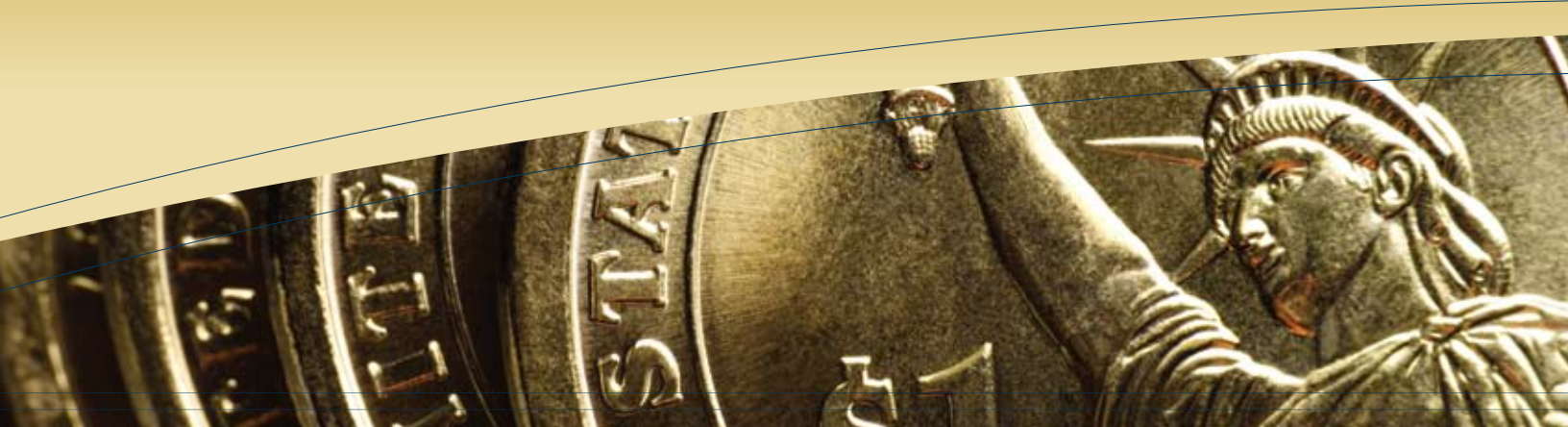
- March 1999 – The Dow first reached 10,000
- January 2000 – The market peaked at over 11,700
- Spring of 2000 – The market entered a three year Bear market, dropping to approximately 7,400 by the spring of 2003
- December 2003 – The Dow surpassed 10,000 again and entered a new bull market
 - October 2007 – The Dow reached 14,164, over 90% higher than the bottom in 2003
 - March 2009 – The Dow fell below 6,600, a 54% drop from the peak in 2007, and a 12-year low
 - From March 2009 to the present, the market has staged a 50% rally but still remains below 10,000, first reached over 10 years ago

If we learn anything from the above historical examples, it's that the stock market over the past 10 years has been a source of great volatility, but provided no substantial net return. In hindsight, it makes sense that the stock market performed poorly given the excesses of the late 1990's that needed to be corrected. Stock prices had become inflated relative to earnings, revenue, asset values, and economic activity. It was time for the market to do what it has always done in the past — revert to its mean.

MARKET DATA

The Dow Jones Industrial Average, currently at 9700, remains more than 30% below its peak in 2007.





STOCKS – CHEAP OR EXPENSIVE?

So where do we stand today? Is the market still expensive, or is it cheap? Looking at the absolute numbers of the Dow or S&P won't tell us anything, other than we are at the same levels seen 10 years ago. Prices have to be looked at in relative terms, or in the context of where they stand compared to the earnings potential of corporate America.

The excesses of the 1990's have been unwound and valuation levels are much improved. However, the market is not nearly as attractive from a valuation standpoint as it was in 1982, the end of the last secular bear market. So from that perspective, the market looks reasonably priced – not expensive anymore, but not extremely cheap.

WHAT TO EXPECT FROM HERE

Now we get into the “predicting the future” part, and we can give an opinion and our best educated guess going forward. We think the odds favor the stock market outperforming the bond or CD market over the next several years for the following reasons:

1. The economy is gaining momentum. We wrote in April that there were signs of life in the economy. Since then, we have seen gradual improvement in most areas of the economy, with the notable exception of the employment situation. Manufacturing is now in growth mode. Housing has stabilized with inventories down significantly, sales rising, and prices improving. Retail sales are rising, albeit slowly, supported by moderate income growth. The banking industry has stabilized, and lending standards are easing — a necessary ingredient for continued economic growth. Inventories are at very low levels and will need to be restocked, which is

another positive sign for growth. We believe we are at the point of a self-sustaining economy, and the US Government will gradually reduce the support programs it needed to prop up the economy over the past 18 months.

2. Interest rates remain extremely low. The bar is set very low for stocks to outperform bonds.

The 10-year treasury rate at 3.25% is lower than the dividend yield on many high quality blue chip stocks. Short term rates remain between 1% and 2%. The chances of getting better than 2% or even 3.5% from stocks seems pretty high to us, given the current level of the stock market and the momentum we are starting to see in the economy.

3. We believe the market is underestimating the earnings potential of Corporate America. Corporations have been very aggressively reducing costs during this recession. They have shed labor at a record rate, and an argument could be made that they have downsized too much relative to the decline in the economy. Productivity is extremely high, and any uptick in demand should result in very strong earnings. We think this earnings growth can support the current level of the stock market and push it higher over time.





WHAT CONCERNS US?

Like most investors and US citizens, the level of deficit spending by our government is of significant concern. If we do not get the deficit down, the long term potential of our economy will be reduced. Interest rates will likely be higher, inflation risk elevated, the dollar weakened, and our overall competitive position reduced.

Our hope is that as the economy improves, spending will decline and income (tax receipts) will improve. This will help the deficit; however, to what degree is an open question. Political views aside, our government needs fiscal discipline and a balanced budget for the long term health of our economy.

Other concerns include the employment situation (with the employment rate near 10%), consumer debt

levels still elevated, weak commercial real estate and the potential for anti-growth policies (i.e. higher taxes, protectionism) coming out of Washington. These factors will likely continue to act as a headwind to economic growth.

CONCLUSION

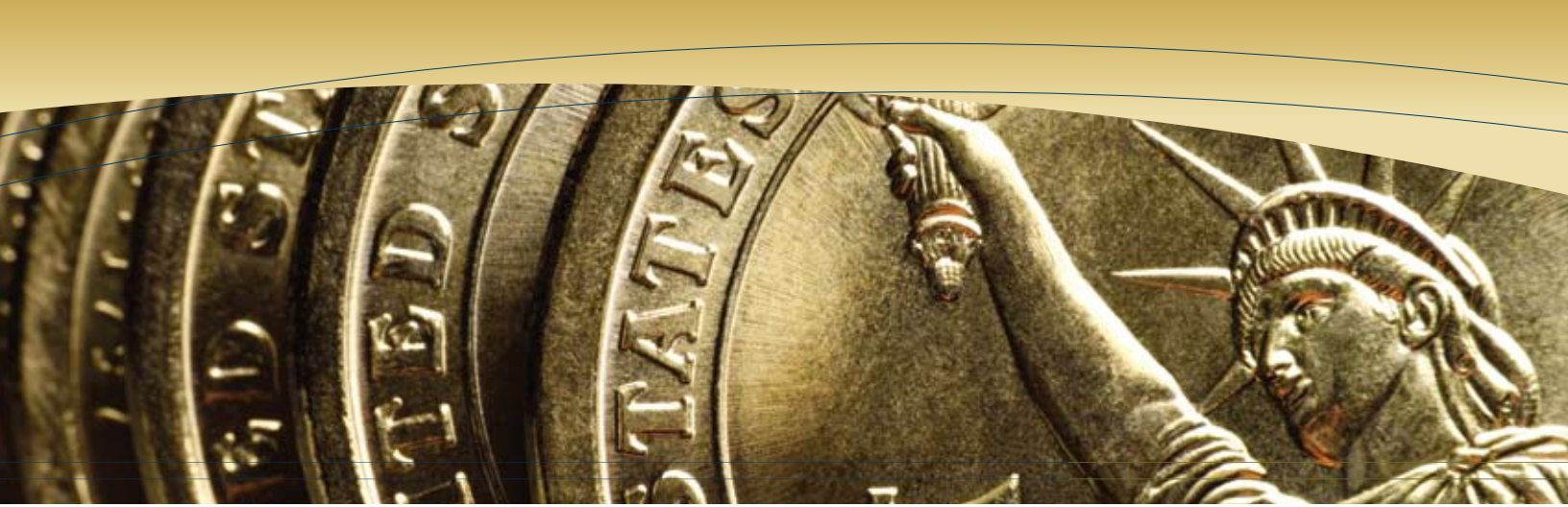
Most investors need to earn a return at least equal to, if not greater than inflation. If we assume inflation will average between 2% and 3% over time, a 100% fixed-income investor cannot earn the inflation rate after taxes in the current interest rate environment.

Over time, stocks have returned roughly 10% per year. Over the past 10 years, as noted, stocks have fallen very short of earning their average return, and many equity investors have become discouraged and skeptical of stocks. Going forward, we believe the odds favor better returns from stocks, both in absolute returns and relative to bonds.

However, this does not mean we advocate being fully invested in stocks. Even if you have a long term investment time horizon, short term volatility can cause investors to make decisions that damage returns. It seems to us that for most investors, a balanced portfolio of roughly 50% to 60% in stocks and 40 to 50% in bonds is a prudent structure. Any more than that in stocks seems to cause too much pain in the kind of down markets we saw in 2008, while any less than that seems to cause regret at missing out on strong market rallies like the one we've seen since March. The former encourages selling near market bottoms, while the latter encourages buying near market tops. As we've noted in past newsletters, the right allocation depends on your specific circumstances (i.e., income needs, investment time horizon, other assets, etc.), but the key is to find that allocation which allows you to stick to your plan without being overcome by fear or greed during the inevitable market volatility.

In our last newsletter we noted that over a 10-year period, stocks have a 96% chance of earning a positive return and an 80% chance of outperforming fixed income. There will no doubt be bumps along the way as we are in the process of working through many problems facing this economy. However, remember that if all the news was good news, stocks would be much higher and opportunities much lower. Remember 1999? ■

low	close	chg	vol	100s
5.12	5.16	+0.01	19751	
1.66	1.71	-0.09	458	
0.35	0.35	-0.03	456	
2.18	2.26	+0.05	34954	
6.89	6.99	-0.06	5251	
5.47				



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INDEX VALUES AND RETURNS*				
	12/31/08	9/30/09	Price Change	Total Return
S&P 500	903.25	1,057.08	17.03%	19.26%
Dow Jones Industrial Average	8,776.39	9,712.28	10.66%	13.49%
Nasdaq Composite	1,577.03	2,122.42	34.58%	35.59%
Merrill 1-5 Year Bond Index**	106.81	103.18	-3.40%	0.31%
Consumer Price Index	0.10%	-1.50%***	NA	NA

*Results according to Bloomberg unless indicated
 **Results according to Merrill Lynch at mlindex.com
 ***As of August 2009