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Midwest Investment Management

PERSPECTIVE™

To Our Clients and Friends

During the recent holiday season, Midwest Investment Management redirected its budget for holiday greeting cards and postage to northeast Ohio charities.

I am pleased to announce a donation to the Cleveland Plain Dealer Charities Holiday Spirit Program which serves approximately 30 local human-service agencies, including:

- American Red Cross (Cleveland chapter)
- Bellfaire JCB
- Benjamin Rose Institute
- Cleveland Foodbank
- Fairhill Center
- Free Medical Clinic of Greater Cleveland
- Hunger Network of Cleveland
- United Way First Call For Help
- WomenSafe

On behalf of our Partners and staff, I want to extend our best wishes for a healthy, safe, and happy 2009.

J. Mark Wipper
Managing Partner

"…the market is moving through the trough of a classic recession"

The U.S. Economy Examined:

"It's In A Tunnel, Not A Grave"

By Norman F. Klopp, Jr., CFA, Partner

As a new year begins, we believe it's productive to discuss the current economic implications for the stock market.

The market experienced unprecedented volatility during the 4th quarter of 2008. It was a very weak quarter closing out a severe "Bear Market" year, as the housing crisis became a mortgage crisis that quickly evolved into a global credit crisis that precipitated a global recession. As these events unfolded, the market was presented with a "tsunami" of unknowns, and *the market hates unknowns*. And as the federal government got involved in the "solutions", the market faced even more unknowns.

Why does the market hate unknowns? Day by day, minute by minute, the market measures risk and reward. Until an *"unknown"* evolves into a negative or positive *"known"* the risk/reward process is in the dark. The prevailing tendency is to sell. *Only when the market has some knowledge can it again function as the risk/reward arbiter.*

Indeed, we are in a recession (which we view as a tunnel), not a depression (analogous to a grave). While more severe than the recessions of 1990 and 2001, and very similar to the recessions of 1970-1974 and 1980-1982, it has been magnified significantly by the worldwide credit crisis.

As we pass through the "tunnel", we expect to encounter some serious bumps along the road. How we navigate these obstacles will determine how quickly and safely we emerge. As this newsletter went to press, the most important factors influencing the U.S. economy were:

Credit Markets:

A number of short-term risk measurements indicated a "thawing" of credit markets; major companies indicated more normal activity in the short-term commercial paper market; the sharp recent decline in mortgage rates stimulated a 58% increase in applications for purchase mortgages (as opposed to refinancing).

Consumer Confidence:

Still volatile at low levels; we expect this index to begin a sustained recovery in the first quarter of 2009.

Unemployment:

Accelerated to 6.7% and is probably headed to 8.5% to 9.0% during 2009. This is a "lagging" economic indicator.

Housing Prices:

Housing prices were down 16.6% year-over-year, the 20th consecutive month of year-over-year declines; however, the sequential rate of change began to moderate.

Home Sales:

Sales of existing homes appeared to have stabilized and inventory showed signs of modest decline. Mortgage applications were up 58% and monthly home sales in some depressed markets posted double-digit gains.

Mortgage Foreclosures:

Monthly foreclosures remained high and are likely to continue through the first half of 2009; major banks announced programs to "work with" homeowners to avoid foreclosures. (However, over 90% of all mortgages are being paid on-time.)

Inflation:

Significantly lower oil, industrial, and agricultural commodity prices pushed recent inflation numbers into negative territory, giving the Federal Reserve great flexibility to deal with the financial crisis.

Government Policy:

The federal government was taking unprecedented steps to moderate the economic impact of the credit crisis and stimulate the economy; although the methods present significant long-term potential risks, the enormous and varied economic stimuli should positively impact the economy over the next few years.

Analytical statistics

In late-2008, the market saw valuation levels not seen in decades, if ever. The dividend yield of 3.2% on the S&P 500 index exceeded the Federal Funds rate of 1% by the widest margin in 50 years. The Price/Earnings Ratio on trailing 12-month earnings of the S&P 500 was the lowest since the 1990-1991 Bear Market. Measures of investor fear, as indicated by the now-popular VIX Index, were at record levels.

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It's in a Tunnel... *(continued from page 1)*

> **"Well-managed U.S. companies will participate in that growth..."**

> **"This is the time to stay the course..."**

In addition, we saw an historic amount of cash sitting in money market funds, savings accounts, CD's and other short term instruments—an amount equal to more than 80% of the total market value of all companies in the S&P 500 Index. At the last cash peak during the 2002 Bear Market, that number was about 60%.

We believe the fourth quarter of 2008 and first quarter of 2009 will mark the depth of this recession. GDP was down about 4.0% in the fourth quarter and could be down 2.0% in the first quarter of 2009. Second quarter GDP could be flat, and a modest recovery could take place in the second-half of 2009, leading to full-year 2009 GDP declines of 0.5% to 1.0%.

Looking ahead

For us to predict an end to the Bear Market, *we must see the stock market begin to react positively to negative news.* The logic behind this is that the market proves it is sufficiently discounting the negatives, and we continue to see signs that this is starting to happen. **This is a good indicator that the market is near its bottom.**

The "after-effects" of this economic shock will not pass quickly. Beyond 2009, we believe consumers will go through an extended period of deleveraging or reducing debt to more normal levels relative to personal income, and the savings rate will increase. This trend will, however, slow the longer term annual economic growth rate to 2.5% to 3.0%, creating much less upward pressure on domestic inflation and interest rates. We expect continued economic expansion in emerging countries such as China, India and Brazil. Well-managed U.S. companies will participate in that growth through diversification and exports.

We expect to see some signs of economic recovery in the second half of 2009. Beyond that, the impact of the historic credit crisis that we are in will have a long-term moderating impact on domestic economic growth as consumers put their financial "house" in order. This will be however, a positive end to the long multi- decade U.S. credit binge.

Five predictions

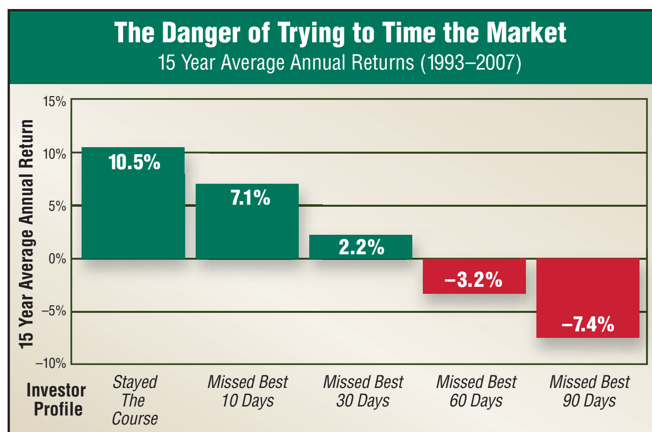
In summary, we believe the market is moving through the trough of a classic recession. It will end, eventually, and we will ask what brought it to an end. I believe we will note that:

1. A number of short-term risk measurements narrowed in late-2008 indicating a "thawing" of credit markets that continued into 2009.
2. The housing market stabilized in 2009.
3. Consumer confidence began to recover through 2009.
4. Consumer spending began to recover driven by the huge stimulus of lower gasoline prices. (A \$2-per-gallon decline, which occurred during the fall of 2008, equated to \$23 billion that stayed in consumers' pockets every month).
5. Emerging country growth, that had moderated, re-accelerated and again became a source of incremental economic growth.

History lessons

History demonstrates that when the market recovers, it is quick... *and as an investor, you really have to be in the market!* In fact, you should always be in the market with a well-thought-out strategy. Why?

- ***Because over the last 75 years, 90% of the markets gains have taken place on only 7% of the trading days.***
- If we look at all Bear Markets since 1962, we find that the average peak-to-trough decline was 33%. The worst, until now, was 1974 with a 48% decline.
- In just twelve months after the market bottomed in each of the Bear Markets since 1972, the average gain was 42%; the best was the 54% gain after the 1974 Bear Market.
- Since 1928 the market has provided positive returns in 74% of the years.
- Since 1928 the market has provided positive returns in any 5-year period 93% of the time.



Source: Bloomberg and Davis Advisors. The market is represented by the S&P 500® Index.
Past performance is not a guarantee of future results.

The chart above shows the negative effect of trying to time the market.

This is a time to stay the course with a sound investment plan. In fact, we encourage you to add to a portfolio of quality equities. It may not be easy to do if people around you are fearful. But, heed the words of Warren Buffet: *"Be fearful when others are greedy. Be greedy when others are fearful."*

If you're not a Midwest Investment Management client, and the Bear Market took a bite out of your portfolio, Norm Klopp can help you achieve long-term investment success, while avoiding unnecessary risk. He can be reached at (216) 830-1135 or nfk@mimllc.com.

401(k) Plan Sponsors Warned: Avoid Personal Kickbacks, Select Investment Advisor Carefully

By Jack Nakel

PITTSBURGH, PA—Companies that sponsor 401(k) plans need to exercise great care and due diligence when selecting advisory services for their plans—in particular, the plan's investment manager.

That advice, as well as the consequences of ignoring any laws that regulate 401(k) plan investments, were the focus of a day-long symposium conducted here recently by the U.S. Labor Department and Internal Revenue Service.

"Federal law requires fiduciaries of 401(k) plans to have undivided loyalty to the plan's members and beneficiaries, not to the sponsor of the plan," said Norman Jackson, deputy regional director of the U.S. Labor Department's Employee Benefits Security Administration. "A plan and its sponsoring company are separate entities."

"A game of golf… is viewed as a kickback."

Kickbacks defined

"Plan fiduciaries are prohibited from receiving a payment or benefit from anyone, such as an investment advisor or accountant, in connection with a plan transaction," said Anh-Viet Ly, an employee benefits law specialist at the DOL in Washington, DC.

Plan sponsors, trustees, accountants, investment advisors, and plan administrators are all considered "fiduciaries" because they are in a position of trust.

"The payment or benefit doesn't have to be a direct payment or cash," Ly warned. "A game of golf or a deluxe meal at a fancy restaurant is viewed as a kickback. So is an intangible gift, such as having the accountant for the 401(k) plan prepare your personal tax forms for free."

It is also unlawful for the 401(k) plan to receive services from "persons in interest"—a list that includes parents, siblings, in-laws, or friends of the plan's fiduciaries. "Sometimes we have to dig under the surface to figure out relationships to the plan," said Ly.

"Being prudent is process-oriented, not results-oriented."

Process, not results

Most 401(k) plan participants have seen a decrease in their account balances in recent months because of stock market volatility, but fiduciaries "who acted prudently in selecting an investment advisor cannot be held liable for the results," said Jackson. "Being prudent is process-oriented, not results-oriented."

Fiduciaries cannot be held accountable for poor investment performance, as long as the plan has:

- Established and maintained a written document listing investment goals for the members;
- Established a prudent process for selecting an investment manager;
- Selected investment alternatives considered prudent and diversified;
- Ensured that fees and expenses of the plan are reasonable;
- Monitored the activities of the plan's investment manager.

"If employees complain about investment performance, our investigators ask if a written plan exists," Jackson stated. "Although fiduciaries are not responsible for investment performance, selection of an investment manager is a fiduciary act."

Penalties and fines

If a plan fiduciary fails to fulfill his or her obligations to the plan, or a plan sponsor acts in violation of ERISA, "the DOL and IRS may assess civil penalties, and the people involved could be removed from serving the plan," said Joan Solonsky, pension law specialist for the EBSA. "The fiduciaries may be required to restore any losses to the plan."

"We take 401(k) rules very seriously"

"Fiduciary oversight and protecting workers' 401(k) assets are matters we take very seriously," says Midwest Investment Management Partner Robert J. Yaroma.

"We expend the effort and take the time to help companies that offer 401(k) plans stay in compliance with federal regulations," said Yaroma. "Our service includes helping plan sponsors and trustees understand their fiduciary obligations. We also help educate plan participants about investment options in their 401(k) plan."

Robert J. Yaroma

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Companies throughout Ohio have switched the assets in their 401(k) plans to Midwest Investment Management because we offer an attractive combination of independent advice, low fees and comprehensive services. To learn how your plan could benefit from our services, contact Robert J. Yaroma at (216) 830-1129 or rjy@mimllc.com.

This story is not intended to provide legal advice and is not offered as such. Specific questions regarding 401(k) plan eligibility, enrollment, and administration should be discussed with your plan administrator and legal counsel.

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How We Protect Client Portfolios During Periods of Stock Market Turbulence

By Elmer L. (Al) Meszaros, CFA, Partner

For nearly all investment managers in the U.S., 2008 was a trying year. Even here at Midwest Investment Management, finding a way to avoid the worst effects of stock volatility was not easy in 2008.

Even "uncorrelated" alternative investments, such as commodities, declined in value along with the stock market, confounding the proponents of such strategies.

Ever since our firm was formed in 2000, a cornerstone of our investment philosophy has been to employ tactics that attempt to protect client portfolios.

How, you may ask, can that be done?

We can employ five major principals to help protect our client's portfolios in times of market turbulence:

1. An appropriate amount of fixed income securities (bonds) or cash is needed for stability (to keeps emotions calm) and also to take advantage of opportunities. Cash or fixed income instruments are often under-rated and unappreciated until the bad times come.

2. Quality investments are critical to "staying the course" in a downturn. Quality offers not only peace of mind, but the reasonable assurance of a rebound once things improve. Thus, "blue chip" stocks and U.S. Treasury Notes—or similar instruments — represent the core of client portfolios.

   In addition, our ongoing investment research, which includes direct contact with companies, aids in the assessment of quality.

3. Position limits are exceedingly important to account for what we don't know, or to serve as a "safeguard" in case something goes wrong. Typically, a 3% "position size at cost" is established and periodically reduced if the position increased substantially.

We strive to stay on "Iceberg Alert," watching for unexpected events that may lurk "below the surface."

4. We watch valuations closely, so as not to buy or hold overpriced securities. For example, back in 2000, we avoided technology stocks for client portfolios. In 2007, we sold many financial stocks (Merrrill Lynch, Bank of America, Sallie Mae). In 2008, we avoided energy and commodities stocks, as well as emerging market stocks.

   We also avoid lower-rated or high-yield bonds, and long-term bonds because the risk was not properly priced in.

5. We strive to stay on "Iceberg Alert"—that is, we watch for unexpected events that may appear benign but could be disastrous. Of course, nobody can always succeed in preventing a harsh decline; that's the reason for the 3% position limits mentioned above.

Even choosing mutual funds for client portfolios requires great care. Thus, we're careful

We watch equity valuations closely, so as not to buy or hold over-priced stocks.

about structuring portfolios with significant sector overweight. We select diversified, rather than narrowly industry focused funds, with a low cost structure, and a philosophy we can understand. We also look for a long-term record of success. These are the primary elements for safety and the prospect of an eventual rebound.

In summary, not losing significantly in a market downturn is a key building block of superior long-term performance. More importantly, it is aimed at protecting the way of life for our clients who have placed their trust in us.

Al Meszaros has navigated client portfolios through turbulent markets for over three decades—with great success along the way. If you are not a Midwest Investment Management client, let Al put his experience to work for you. He can be reached at (216) 830-1133 or elm@mimllc.com.

We hope you enjoy reading our quarterly newsletter, which contains news about our firm, its investment philosophy, the economy and market trends. We suggest you retain these newsletters for future reference.

Perspective is published quarterly by Midwest Investment Management LLC, Cleveland, Ohio for its clients, friends and members of the business community. All information contained herein reflects the opinions of the authors and does not necessarily constitute investment advice. Past results are no guarantee of future performance.

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