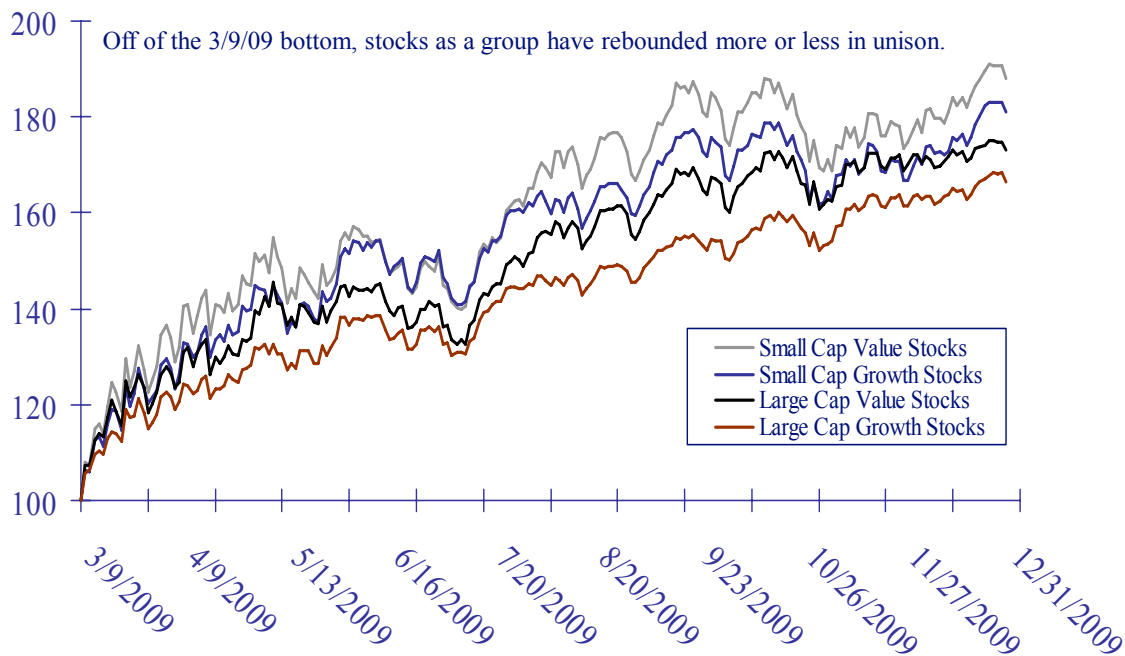


The Anatomy of a Recovery

When we examine the stock market recovery from its March 9, 2009 low, it is evident that most broad categories of stocks have rallied more or less in unison. As can be seen by the chart below, small cap value, small cap growth, large cap value and large cap growth stocks produced a tight cluster of returns through year-end 2009. This phenomenon is illustrated by the narrow range of colors at the far right of the chart below.

2009 Recovery: 3/9/09 – 12/31/09



Source: Russell Indexes

If we were to add the more familiar S&P 500, NASDAQ and MSCI EAFE (foreign stocks) indexes, the conclusion would be the same, but the chart would be an almost indecipherable confusion of colors. For clarity, we have limited our analysis to the four broad stock categories depicted above.

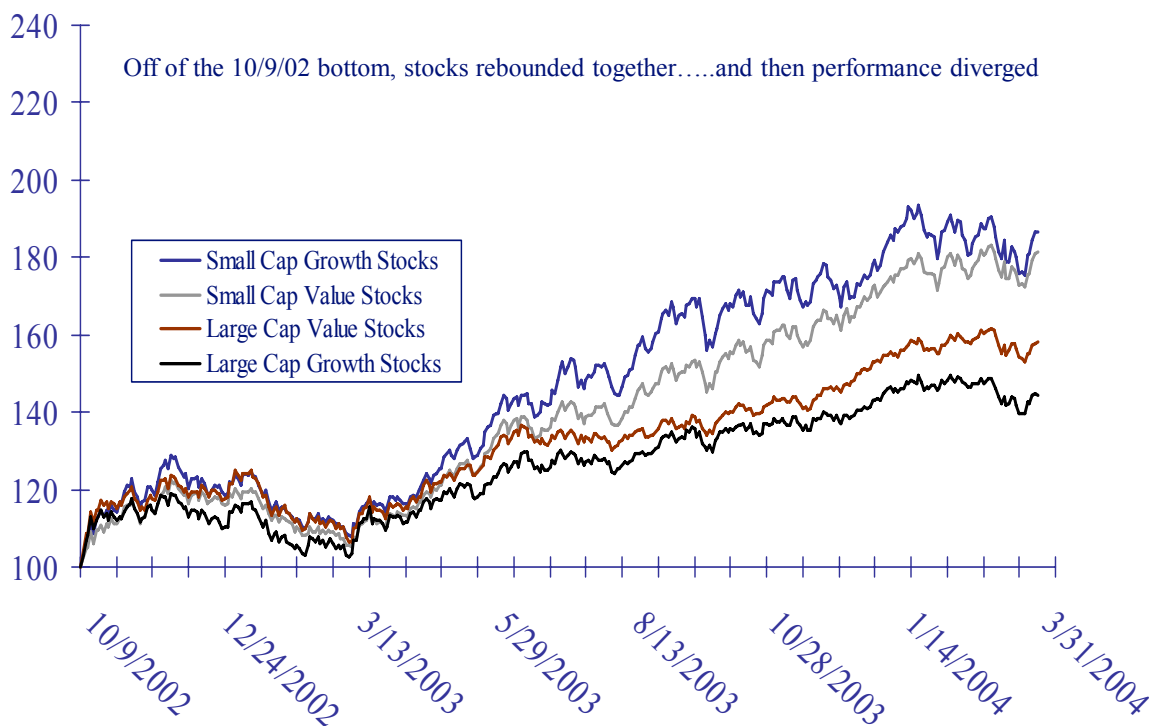
The reason stocks have rebounded together so far during this recovery likely has to do with the broad-based decline that preceded it. As stocks dropped to their March 2009 lows, no asset class, stock category or country was spared. In hindsight, sheer panic drove the markets downward as the global financial system was pushed to the brink. Such an impartial slide is unusual and helped define this time period as one of the most trying of the last 75 years. It also left most assets classes well below their intrinsic values. Other than pure fear, there was no reason for stock prices to have gone as low as they did. As that fear has dissipated, the equity markets have corrected to the upside en masse in an effort to realign themselves closer to the fundamentals.

The Recovery after the Technology Bubble

The technology bubble was a different experience entirely. The worst of the declines were limited to technology and growth stocks, particularly large cap growth stocks. Both small cap value and large cap value stocks held up relatively well during the darkest days of 2000, 2001 and 2002. Small cap value, in particular, offered a refuge from the storm.

During the recovery (see chart below), stocks bounced in unison at first, but by May 2003 a divergence became evident. By the end of the first quarter of 2004, small cap growth and small cap value stocks proved to be the clear leaders. If we were to add the NASDAQ and the S&P 500 to the chart, the NASDAQ would be in the upper half and the S&P 500 in the lower. Regardless, the conclusion is clear – there was an obvious delineation between leaders and laggards.

2003 Recovery: 10/9/02 – 3/31/04



Source: Russell Indexes

What May be Ahead

No two bear markets and their recoveries are the same, but it is unlikely all stocks will continue to rise in lockstep as we move forward. While we expect stock prices in general to move higher over the next year or two, we expect some stock categories to perform better than others. At some point, we will see leaders emerge from the pack like they did during 2003 and 2004. Our intention is to be invested in those leaders. As we move forward, careful security selection will be vital.

A Recap of Our Investment Strategy During These Time Periods

As our clients know, we have a unique investment philosophy. Unlike most investment managers, we do not limit our investment universe to the traditional investment style boxes: value, growth, large-cap, small-cap, foreign, domestic, etc. Rather, our philosophy is to invest in the areas of the market with a

high probability of appreciating over a multi-year time period. We accomplish this by maintaining maximum flexibility in regard to capitalization, style and strategy.

This philosophy has paid off during these last two bear markets. During the 2000-2002 bear market, we avoided large cap and technology stocks based on valuation concerns. We embraced the smaller more cyclically-oriented stocks because they were simply too cheap to ignore. As the technology bubble deflated, our stocks took off.

In the recent bear market, we shifted to traditional defensive stocks (which included the sales of our bank stocks in early '07) in preparation for a slowdown. This active decision cushioned us some, but the decline proved to be broad-based. Then as the mood darkened during late 2008 and early 2009, we shifted into economically-sensitive stocks (including retail) which helped us outpace the major indices significantly during 2009. Our flexibility has been the key to our success over the last decade and we expect it to continue to be important moving forward.

A Word on the Federal Debt

As expected, the federal debt continues to be a topic of heated debate. Since our 2nd Quarter 2009 analysis titled, *Will the Federal Debt Sink the U.S.?*, federal debt has increased from 74.7% to 84.1% of GDP. Deutsche Bank forecasts that it will increase to 97% of GDP in 2010. While high, many other countries have significantly larger current and anticipated debt levels. Italy's federal debt is expected to eclipse 127% of GDP in 2010 and Japan's is forecasted to be approximately 200% of GDP. The UK is not far behind with a projected 2010 debt level of 89% of GDP. The Euro Zone as a whole is expected to reach debt levels north of 80% of GDP in 2010. Government debt is not a U.S.-centric issue, it is a global one.

These debt levels are not all that surprising. The world is emerging from an unusual period where drastic stimulus measures have been enacted globally to stave off financial meltdown. High government debt is a worrisome bi-product of these needed measures. From another perspective, we are fortunate that governments have been able to sustain these debt levels in their efforts to keep the global economy moving forward. Had a major economic power stumbled like Dubai or Greece, who are both in the midst of major debt crises, the world might be in dire circumstances.

What level of government debt is sustainable? According to the Maastricht Convergence Criteria, to join the European Union a government's debt should not exceed 60% of GDP. While this percentage appears to be somewhat arbitrary, it at least offers some context from an international perspective. Targeting a debt to GDP ratio around 60% seems to be a reasonable goal over the next decade or two for the U.S. and other major nations. This can only be accomplished by a combination of an increase in growth and taxes and decreased government spending. The goal in the short term should be to stabilize the federal debt level by halting its upward trajectory. It is worth noting that the U.S. has had significantly higher debt levels. For example, federal debt as a percentage of GDP reached nearly 130% in 1946 due to World War II.

We are very pleased with our performance in 2009 as our client portfolios handily outperformed the major indexes. We think 2010 will present many opportunities and we remain optimistic for the year ahead. Thank you as always for being a valued client.



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