

# Red Granite Advisors LLC

## Second Quarter 2009 Commentary

The stock market recovery that began in late March produced the best second quarter return in nearly six years. Although few economic indicators showed an imminent recovery, many measures were “not as bad as expected.” This was sufficient to embolden buying in higher risk sectors including emerging markets, commodities, high-yield bonds and equities of small and low-quality companies. Second quarter returns for the Russell 1000® Growth (Russell) and Standard & Poor’s (S&P) 500 Indices were 16.3% and 15.9%, respectively.

As measured by S&P quality rankings (which are based on a variety of measures including consistency of earnings and dividend growth over 10 years), lower quality stocks vastly out-paced their high quality counterparts in the quarter. In the Russell index, companies rated A- or better had an average return of 16.0% vs. 35.6% for companies rated B- and 41.3% for companies rated C. The quintile of the smallest companies (by market capitalization) in the Russell index had an average gain of 37.6% (best) while the quintile of the largest companies rose only 17.8% (worst). Despite our large cap investment discipline and emphasis on high-quality companies, Red Granite’s large cap growth portfolios were only modestly behind the Russell index. Financial, technology and energy sectors boosted performance; consumer-related and materials-related stocks lagged.

The financial markets appear to be stabilizing and responding to expectations of reflation, recovery, and re-regulation. Improved investor confidence and increased risk-taking have caused credit market spreads and stock market volatility to subside. A modest uptick in U.S. gross domestic product could occur in the third quarter due to earlier fiscal and monetary responses to the crisis. Prospects for world growth beginning late 2009/early 2010 have been enhanced by unprecedented global stimulus consisting of fiscal spending measures, record money supply growth, and central bank policies promoting low interest rates.

An economic recovery, not just the slower rates of decline we’ve seen, is necessary to sustain the current market rally. We believe the economic recovery is likely to be tepid, weighed down by Americans’ need to pay down excessive debt and rebuild savings. Rising foreclosures, bankruptcies and unemployment along with tighter lending standards and municipal budget pressures continue to foster economic insecurity. Further arguing against a sharp acceleration is the negative wealth effect wherein consumers’ net worth (70% of GDP) fell \$13 trillion over the past two years as real estate and stock markets declined.

With sluggish domestic growth, the stock market may struggle to achieve new highs in this cycle. The oversold condition created by the extremely bearish sentiment of four months ago has been reversed. Price/earnings ratios may be constrained as the U.S. faces ongoing deleveraging, increased financial sector regulation and the specters of rising inflation and taxation.

Fortunately, not all companies will be impacted to the same degree, thus, we believe the environment will likely reward active investment management vs. passive strategies. Our portfolios remain underweight in consumer staples and discretionary, financials, utilities and telecom. We will continue to focus on high quality, industry leaders and favor sectors such as energy, materials, industrials, and technology as investments leveraged to foreign economies which should be stronger than in the U.S.

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