

Red Granite Advisors LLC

Third Quarter 2009 Commentary

After a sharp rebound in the second quarter, stock prices gained momentum in the third quarter as the financial system continued to stabilize courtesy of unprecedented fiscal and monetary stimuli in the U.S. and worldwide. Anticipating economic recovery as the next step, investors bid up stocks in traditional early-cycle sectors, such as consumer discretionary, financials and technology, while selling more defensive companies in health care and consumer staples. The Russell 1000® Growth and S&P 500 Stock Indices returned 13.97% and 15.61%, respectively, in the quarter. Red Granite's equity portfolio exceeded both indices in the third quarter.

While some economic indicators have improved, temporary government programs were largely responsible for stabilization in the housing, auto, and banking sectors. The Federal Reserve's recent announcement that a number of their stabilization programs will expire or be reduced undoubtedly raises concerns about the next step in the cycle and sustainability of the recovery. Recoveries are typically spawned when bankers expand the flow of credit to consumers who then satiate their pent-up demand, which leads to replenishment of inventories and sparks growth in the business cycle. Unfortunately, the current recovery seems to lack many of these self-reinforcing conditions.

Banks have been chastened by crippling losses and remain in need of additional capital; consumers are striving to reduce debt and increase savings. Losses on residential real estate and other debt have weakened bank balance sheets. Growing defaults on commercial real estate debt aren't helping matters. From the 2007 high through June 2009, the Federal Reserve estimates that consumers lost \$12 trillion of their net worth. As a result, deleveraging and risk-aversion will likely guide economic decisions of both bankers and consumers for an extended period of time.

Following seven months of an exceptional stock market rebound, valuations for many companies now reflect expectations for financial results and management guidance that allow little room for disappointment. Corporate cost-cutting has supported profits over the past couple quarters but revenue growth, which has not been evident, is needed to sustain profits. Revenue growth is also likely to be important for additional stock price appreciation because with the S&P 500 price-to-earnings ratio (P/E) now at 20 times the 2009 earnings estimate we suspect that the majority of P/E expansion for this cycle is behind us.

We anticipate greater differentiation in the performance between stocks of high-quality versus low-quality companies. Companies with high-quality fundamentals, solid balance sheets and strong cash flows that can support growth internally and/or from acquisitions should achieve faster, more sustainable revenue and earnings growth rates than those of low-quality companies with inefficient cost structures, too much debt and weak cash flows. In this business cycle, companies with high-quality earnings are likely to be valued at premiums relative to low-quality companies that won't be able to sustain growth through the use of debt and financial engineering common in past business cycle recoveries.

In an environment where growth is difficult to achieve, our investment strategy should continue to serve clients well. Our goal is to identify and invest in companies with leading industry positions that are capable of gaining market share based on defensible competitive advantages. We favor multi-national companies in the technology, energy, and materials sectors that should benefit from stronger revenue growth overseas and steer clear of most companies in the financial and consumer sectors that depend on the debt-burdened, slow-growth domestic economy. Thank you for your interest and support.

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