



Sizemore Capital Management 2009 Second Quarter Investment Outlook and Commentary

To Our Investors,

During the second quarter of 2009, things certainly took a turn for the better. The economy shrank at a slower pace than expected, and stocks and other risky assets rocketed off of their panic lows of the first quarter. Investors appeared to reach the conclusion that, while we are still in a serious recession, the world is not ending. As a result, stock valuations improved to “normal” recession levels. Panic and hysteria were replaced with regular fear and worry. At this stage, we believe that stocks are modestly undervalued, though after a 50% rally in most major indices, stocks are no longer the incredible bargain they were in March. Most importantly, the “meltdown” phase has passed, and while we may continue to struggle with recessionary conditions for several more quarters, there is no longer a real risk of systemic failure.

We are proud to say that Sizemore Capital Management’s portfolios had an excellent quarter. **Our actively-managed Tactical Portfolio returned 13.1% for the first half of the year, beating the S&P 500 by a full 10%.** Our high concentrations in Taiwanese stocks, infrastructure, and luxury goods contributed most to our returns.

The total returns for our passive Strategic Portfolio Allocation models were the following:

Preservation of Capital	0.23%
Conservative Income	(1.96%)
Growth and Income	(0.09%)
Growth	2.53%
Aggressive	3.00%

The Preservation of Capital portfolio did exactly what its name implies: once again, it finished the quarter flat, preserving capital. The Conservative Income and Growth and Income portfolios suffered slight losses, due mostly to their exposure to the real estate investment trust (“REIT”) sector. The Growth and Aggressive portfolios more or less matched the performance of the S&P 500.

Portfolio Review

During the second quarter, we made one significant change to the Tactical Portfolio. We reduced our target allocation to US large cap stocks (tickers IVV/SPY) by 10% and carved out a new allocation of the same amount in high-yield bonds (ticker HYG).

On May 19, 2009, the day of the allocation change, we wrote:

Stocks, as represented by the S&P 500 index, have gained 33% from their bear market lows in March. We still see significant upside to stocks at these prices, but we believe that stocks need time to “digest” their recent gains. At this point, we see a better risk/return tradeoff in high-yield corporate bonds. Though significant risk remains in the economy, and the recession may well linger for several quarters or even years, liquidity has returned to the market. The “panic” stage of the crisis has passed. Stock and bond prices might fall from here, but the risk of “meltdown” appears to have passed. **In this environment, we would expect high-yield bonds to perform well, perhaps even outperforming equities.** We believe that current yields compensate us for

the default risk inherent in high-yield bonds. Our targeted holding period for this security is 9-18 months, though as always, our holding period can change with market conditions.

We would reiterate some of these points here. As we said at the beginning of this letter, we still view stocks as mildly undervalued and believe that the major indices will likely see gains over the next 9-18 months. We would expect these returns to be somewhat modest, however, most likely not to exceed 20-25% over the period. In high yield bonds, we believe the returns could be significantly higher than equities and with less volatility. At time of writing, HYG yields in excess of 10%. Only time will tell, but between the high yield and potential capital gains, we would expect total returns well in excess of 30%. Should the default rate markedly increase in the months ahead, our assumptions could prove to be far too optimistic. But given that the credit markets have improved in recent months, we view a large spike in defaults as being unlikely.

Moving on to our existing positions, we are quite satisfied with their performance over the past quarter. Taiwan (EWT) benefitted from a strong revival in Asian and emerging markets. *The Economist* reported that industrial production in Taiwan jumped by an annualized 89% in the second quarter ("From Slump to Jump," June 30, 2009). This break-neck growth rate is unsustainable, of course, but there are reasons to be enthusiastic about an extended recovery in Asia as domestic demand remains strong and exports begin to recover. Furthermore, Asian equity valuations remain attractive. At this point, we are comfortable with our current exposure to Asia via Taiwan, and we may consider increasing our allocation to the region if a good opportunity presents itself.

Another reason we favor Asia over other foreign markets is the relative cheapness of the US dollar. Sentiment against the US dollar has reached extreme levels, particularly vis-à-vis the euro. While we understand the arguments against the dollar, we believe the bearishness has reached illogical levels. Yes, the United States is a fiscal and monetary mess; but then, so are Europe, the UK and Japan. We see nothing uniquely bad about the dollar that justifies its current low levels, and we believe the dollar could be an excellent contrarian buy. We profited on a dollar rally in late 2008 by buying an inverse euro fund (DRR). We may choose to go this direction again. In the meantime, our portfolio remains well positioned to take advantage of a rising dollar. Asian exporting economies thrive on a strong dollar. And our exposure to European stocks remains virtually nil. In our view, the euro could fall 20-50% against the dollar in the years ahead. So this means that US investors would have to earn 20-50% on their European stocks *just to break even on the currency move*. We intend to keep our exposure to Europe at an absolute minimum until the dollar/euro exchange rate returns to something more rational.

Our bond positions (LQD and VKQ) have recouped nearly all of their 2008 losses during the first half of 2009 on a total return basis. These investments continue to perform as expected.

Our other major allocations—to the luxury sector (ROB) and infrastructure (PXR, FMO, MFD)—have strongly outpaced the S&P 500 this year. When we first bought ROB, the luxury stocks in its portfolio such as Coach, Tiffany, and Moët Hennessy Louis Vuitton were cheap, trading at what we believed to be incredible bargains for such high-quality companies. Of course, they got a lot cheaper during the meltdown of 2008, falling more than the general market. This is something that we never understood. Yes, luxury goods and services fell out of favor during the crisis and recession. Who can justify buying a \$1,000 handbag for their wife when they just saw their net worth evaporate in a twin housing and stock market crash? But once consumers get accustomed to the good life, they have a hard time giving it up. And most of the growth in luxury spending is in China and emerging markets—which have fared better in this recession—and not the United States. Plus, as we have written before, most luxury companies were financed very conservatively. Yes, their earnings could suffer for several quarters as consumers postpone or eliminate some amount of high-end spending. But their risk of true financial distress or bankruptcy is and always was virtually nil.

It appears that Mr. Market finally sees our logic. ROB vastly outperformed the S&P 500 during the first half of 2009. We continue to see value in this holding and have no immediate plans to sell.

Meanwhile, our infrastructure plays have also delivered as expected. PXR, FMO, and MFD all stand to benefit from a macro trend of global infrastructure spending, and the market is finally starting to realize

this. All three have performed very well in 2009, and FMO and MFD pay an attractive dividend to boot. We are quite satisfied with each of these positions.

Looking Ahead

We remain bullish on our portfolio prospects for the remainder of the year. Our major investment themes—corporate and municipal bonds, infrastructure, luxury, and Asian shares—appear to be appropriate for this environment.

Here's looking forward to another quarter,



Charles Lewis Sizemore, CFA
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