



Austin Calvert Flavin
Investment Advisors
Established 1981



Quarterly Review

CULTIVATING WEALTH AND COMFORT FOR OUR CLIENTS THROUGH CUSTOMIZED PORTFOLIO MANAGEMENT

4Q2009

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Banner Year for Equity – Will the Economy Follow Suit?

At the outset of 2009, few, if any, market analysts could have predicted the path that equity markets would follow over the course of the year. From the S&P 500's nosedive of 28 percent over the first two months of the year to a 67 percent jump from mid-March until year-end, 2009 proved to be truly a year of unpredictability. In our 2009 Second Quarter letter, we referenced Alan Greenspan's question: "Are we beginning a prolonged recovery or a false dawn?" Based on the majority of economic indicators, it appears the economy is moving toward a recovery, albeit it a potentially "jobless recovery" as the unemployment rate hovers at 10 percent and is predicted to remain high for several quarters.

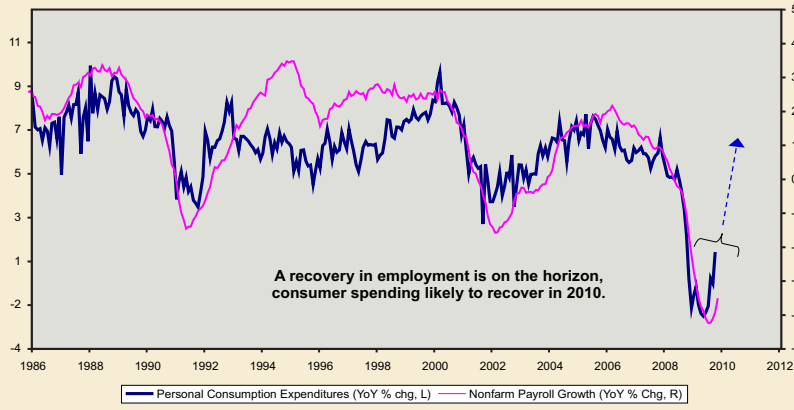
In addition to employment concerns, a number of hurdles to a sustained recovery remain. The Federal Reserve has, through various avenues, injected record levels of liquidity into the U. S. economy. The financial press continues to dedicate a great deal of attention to the Federal Reserve's "exit strategy." In other words, how does the Federal Reserve begin withdrawing the massive amount of liquidity in the economy to reduce the potential for high inflation? Fed Chairman Ben Bernanke suggests several approaches, including reverse repurchase agreements (continuous lending of Federal Reserve securities short term in order to soak up liquidity).

Chairman Bernanke has also proposed the creation of term deposits for excess reserves held at the Federal Reserve. Such measures, while politically more palatable than raising the Fed Funds rate, are most likely insufficient to adequately control inflation. The Federal Reserve continues to telegraph various means to deal with excess liquidity, but there has been very little communication as to when these means, coupled with rate increases, might be implemented. Other concerns continue to be housing, budget deficits, credit availability, and the financial health of the consumer.

On the positive side, after a year-long contraction, the U. S. economy grew 2.2 percent from July through September according to the Commerce Department. A survey of economists conducted by Bloomberg forecasts U. S. economic growth at 3 percent in the fourth quarter of 2009, and an average growth of 2.6 percent in 2010. After several quarters of negative growth, these positive growth forecasts are welcome. However, the key to sustaining any economic recovery is employment. Consumer spending accounts for about two-thirds of the U.S. economy. If a person is unemployed and has no income, he or she cannot spend. The chart on the next page depicts the relationship between consumption and job growth. What will cause companies to hire and drive the unemployment rate lower?



Recovery in Consumption Dependent on Job Growth!



Source: International Strategy & Investment

Part of the answer is capital expenditures. If capital spending rises, companies will begin to gradually hire new employees to meet higher demand. Jim Owens, CEO of Caterpillar, recently announced his company will begin recalling some of its laid-off workers. We expect to see other companies follow suit as capital spending increases based on: 1) a strong global recovery, 2) renewed infrastructure build-out in emerging market countries, 3) a long overdue hardware and software upgrade cycle, and 4) the government spending \$440 billion of the \$787 billion fiscal stimulus package in fiscal year 2010.

Equity Market Review

Small Capitalization, Low-Quality Stocks Lead Initial Rally While Technology Stages a Comeback

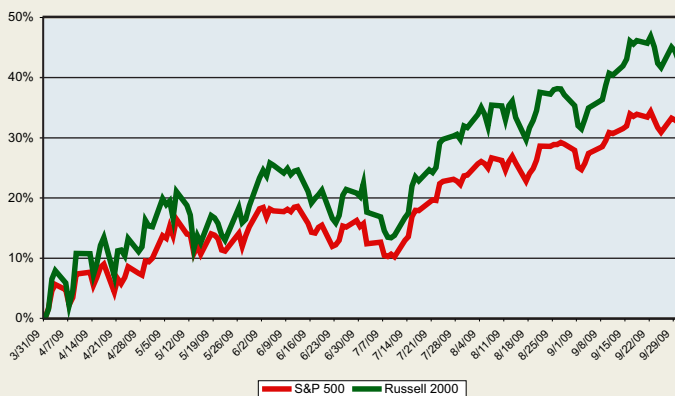
The early months of a bull market are characterized by strong performance from smaller capitalization stocks, lower-quality stocks, stocks selling below \$1, and by stocks of money-losing companies. This trend was clearly evident in 2009 as such stocks led the market over the first five to six months of the rally – from March until September. As investors having a longer-term focus entered the market and as they sought to take advantage of the weak U. S. dollar, larger, multi-national, high-

er-quality stocks regained leadership. The charts below illustrate this point. Smaller stocks, depicted by the Russell 2000 Index, led the S&P 500 over the second and third quarters of the year by almost 10 percentage points. As market leadership changed, the S&P 500 outperformed the Russell 2000 by over 2 percentage points in the fourth quarter.

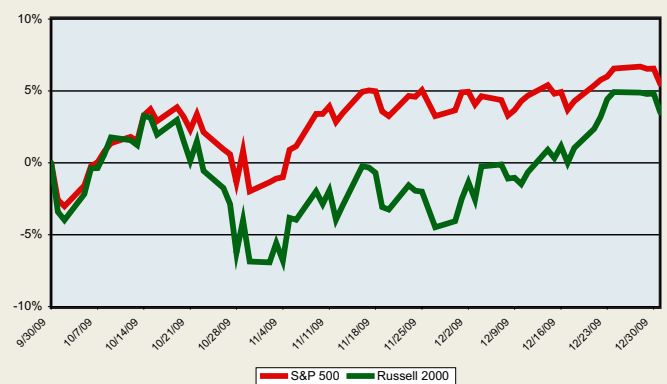
With regard to market sectors, information technology stocks produced the largest gain for the year, posting a 60 percent gain. As noted earlier, investors are betting on a long overdue technology upgrade cycle to take

place in 2010 and 2011 as the economy recovers and businesses initiate capital spending plans. According to Gartner (a technology research and advisory firm), spending on computer hardware and software declined 5.2 percent in 2009, but is forecast to rise by 3.3 percent in 2010. Another mid to late stage cyclical sector, materials, posted the second-highest 2009 sector return of 45 percent. The defensive sectors – telecom, utilities, and consumer staples – posted the year's poorest performances of 2 percent, 7 percent, and 11 percent, respectively, as investors sensed the recovery and became less risk adverse.

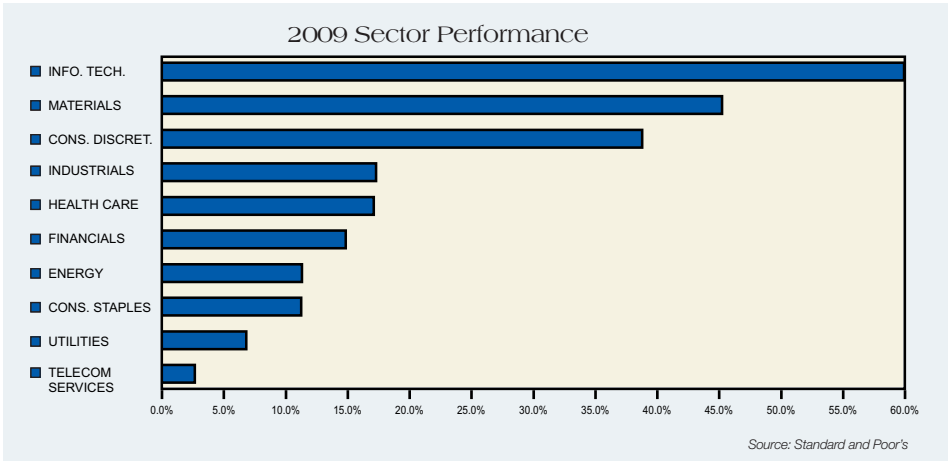
Comparative Returns (03/31/09-09/30/09)



Comparative Returns (09/30/09-12/31/09)



Source: Bloomberg



In 2009, stocks traded almost entirely on the macro outlook for the economy and little else. Early in the market rally, gains were driven by a realization that the financial system would avoid a total meltdown. Gains later in the year were based on prospects of a slowly improving economy. Traditional equity metrics such as earnings and dividend growth, cash flow quality, and balance sheet strength were generally not considered. As we move into 2010, investors will again return to using such measures for their stock selection and portfolio allocation choices. Active equity management and stock-picking ability will become much more

important in the coming year.

Many Reasons to Like Large Cap Stocks in 2010

Looking ahead to 2010, there are a number of diverse factors favoring continued gains by large capitalization stocks. First, in terms of valuation, one can develop a strong case for large cap stocks being cheap on a relative basis. The S&P 500's price is currently about 25 times its earnings, boosted by the rally since March. However, the index is cheap and the price-to-earnings ratio falls to about 14 when compared to the average fore-

cast 2010 earnings by equity analysts surveyed by Bloomberg. As most companies have severely cut expenses through capital spending and head-count reductions, 2010 earnings must derive from sales growth as opposed to further expense reduction. Second, the weak U. S. dollar drives exports, which in turn profits domestic multi-national (large cap) firms. Of course, the other side of this equation makes imports more expensive to domestic consumers and high import prices can play a part in boosting inflation.

Third, a great many pension funds are over-allocated to bonds relative to stocks. The significant equity rally of 2009 may foster a rapid rebalance of pension fund allocation in favor of equity. Finally, the specter of inflation could fuel an increased allocation to equity by many investors. For those investors with an allocation defined by equity, fixed income and cash, equity is the best inflation hedge primarily due to a company's ability to raise its prices in response to higher inflation. These reasons point to a strong case for continued growth in equity markets, particularly large cap, in the coming year.

International Outlook

Beyond China

A great deal of attention continues to be on China and its amazing economic growth record – the country's growth was 8 percent and 9.6 percent for 2009 and 2008, respectively. While attention on China is certainly justified, there are many "growth stories" associated with other parts of the globe, which while not as prominent, are quite compelling. Growth rate estimates for Chile and India, as examples, range from 4.5 to 6 percent for 2009, depending on the source.

An unprecedented amount of monetary stimulus took place last year across the world. For example, key government-controlled borrowing rates were reduced by 20 percent in Russia to 94 percent in Chile during 2009, according to International Strategy & Investment. Reduced borrowing costs allowed local firms in emerging markets such as Brazil and India to reignite their infrastructure development. As we noted earlier, such development fuels demand for products and services of many U. S. multi-national companies.

In terms of investment performance, China's index, the Shanghai Composite, posted almost an 80 percent return for 2009. As a comparison, other emerging market indices posted similar numbers for 2009 – India: 79 percent, Brazil: 83 percent, and Mexico: 45 percent. Given the large shadow cast by China, it can be tempting to focus on that market, but opportunities in other emerging markets abound as the global recovery takes effect.



Fixed Income Review

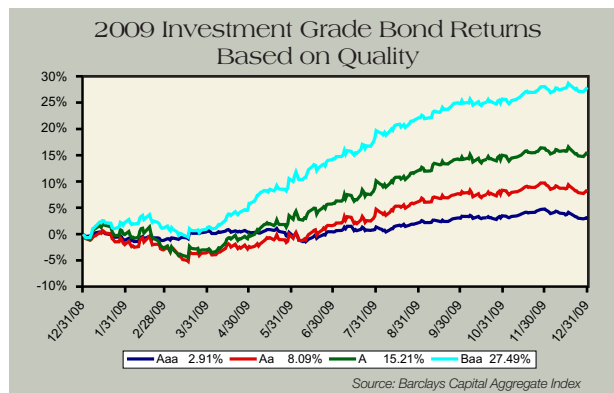
Risk Appetite Returns as High Yield Bonds Surge

The fixed income markets were not too popular at the beginning of the decade as the equity markets, fueled by the dot-com mania, dominated. But as that bubble burst, and we moved through the massive failures of Enron and WorldCom (among many other corporate giants), and on to the end of the decade with the financial collapse of 2008 into 2009, bonds—at least U.S. Treasuries and Corporate bonds—outperformed U.S. Equities over the ten year period from 2000-2009.

Last year, investors sought safety in the fixed income market. Flows to bond funds continue to be strong, while interest on money-market funds remains at an average of less than 0.1 percent. As the chart below indicates, investment-grade corporate bonds posted some of the

best performing returns among fixed income sectors last year. However, the high yield (lower quality corporate bonds) sector's 2009 return of 58 percent far outpaced all other types of fixed income as investors' appetite for risk increased concurrent with the improving economic conditions.

The chart below further illustrates this trend within the investment grade sector as the lowest rated investment grade bonds, Baa, significantly outperformed higher quality A, Aa, and Aaa rated bonds.



The coming year could prove a difficult one for fixed income investors as a result of an oversupply of bonds. The federal government has issued in excess of \$1.4 trillion of debt in 2009 and plans to increase supply into 2010. Corporations can issue debt to fund future projects at the

current low rates, so corporate supply continues to increase as well. Rising interest rates, the ever-growing deficit, and impending healthcare legislation are all looming on the horizon and could negatively impact fixed income securities.

Muni Bond Demand Remains Strong

The municipal bond market witnessed a record issuance in 2009, driven by the new Build America Bond (BAB) program. The BAB program provides for taxable municipal bonds intended

to reduce a municipality's borrowing costs. Investor demand for municipal bonds was strong in 2009, and drove yields to 40-year lows. As state and local governments face continued budget problems, bond issuance from strong municipalities is attractive as the alternative taxable yields remain low, and income taxes

are set to increase. Municipal markets produced quite a reversal last year as the Bank of America Merrill Lynch Municipal Master Index gained 14.5 percent in 2009 - its best performance since 2000, compared to -4.0 percent in 2008 - its worst return for the decade.

2009 Total Returns of Selected Barclays Capital Indices

US High Yield Bond	58.21%
US Corporate Bond	18.68%
US Municipal Bond	12.91%
US TIPS	11.41%
US Aggregate Bond	5.93%
US MBS	5.89%
US Intermediate Government Credit	5.24%
US Government Credit	4.52%
US Government Agencies	1.95%
US Treasury Bond	-3.57%

4th Quarter Scoreboard

Index	12/31/09	9/30/09	3-Mth Chg	12-Mth Chg
S&P 500	1,115.10	1,057.08	6.0%	26.5%
S&P/Citigroup Value	525.07	507.07	4.2%	21.2%
S&P/Citigroup Growth	582.37	542.64	7.8%	31.6%
Russell 2000	625.39	604.28	3.9%	27.2%
10-Year T-Bonds (Interest Rates)	3.84%	3.30%	-6.4%	-17.6%
Crude Oil - W.T.I. (Nearby future)	\$79.36	\$70.61	12.4%	77.9%
Gold (Troy oz.)	\$1,096.20	\$1,008.00	8.8%	24.0%
CRB (Commodity Research Bureau) Index	283.38	259.39	9.2%	23.5%