Cutler Investment Group LLC

Economic Update: Cautious Optimism

4th Quarter 2009

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The 3rd Quarter of 2009 continued the remarkable recovery of equities from the March low, with the S&P 500 Total Return index returning 14.46%. The 2009 bull market rally has been led by many of the same securities which led the bear market of 2008. We believe that these riskier companies will not generate the most favorable long-term returns, and have stayed true to our conservative investment approach. Staying defensive is a prudent approach in today's economic environment, with significant risks remaining for investors. Notable among these risks are a declining dollar, commercial real estate losses, and ever present regulatory surprises.

The 3rd Quarter of 2009 continued the remarkable recovery of equities.

Given the recent reclamation of Dow 10,000, it is worth noting the importance of downside protection for investors. While the markets have rallied over 50% in the past several months, the Dow Jones Industrial Average sits nearly 40% below the all-time peak of 14,164 of October, 2007. The impressive year-to-date market returns are distorted by the low base from which this rally began. It is tempting for investors to focus on year-to-date gains during a strong market rally, but as the above data demonstrates, long-term investment value is created through protecting principle during periods of economic weakness. Cutler's Equity Income strategy is designed to do just that, generating value through downside protection, while achieving market-level returns during bull markets.

Purely from a technical perspective, the fact that major indices remain 40% below all-time highs would suggest there is potential for upside. At Cutler, we are fundamental investors, focused on the earnings and dividends generated by the portfolio holdings. While earnings have been rising, they remain substantially below the levels associated with the previous highs. This would indicate the market is currently fairly valued at roughly 15 times next years' earnings estimates. As we look forward, we continue to anticipate a sideways equity market or modest pullback from these levels through year-end, and reserve the right to be pleasantly surprised if proven incorrect!

"When you earn a dollar, it has gained your respect.
When you invest that dollar, the investment should reflect your respect."

- Kenneth R. Cutler

Paying Dividends

The Importance of the Dollar: Revisited

Matt Patten
President / Portfolio Manager

In this quarter's 'Paying Dividends' article, I would like to address the recent dollar weakness.

Nearly five years ago, Cutler's quarterly newsletter focused on the falling dollar. Our commentary heading out of the past recession included, for example, the following excerpt, "a weak dollar may help the beleaguered U.S. manufacturing sector, and ultimately inject much needed jobs into the economy." The drop in value of the US dollar had a significant impact on the last bull market. Energy companies, whose goods are priced in dollars and sold globally, led the market higher. Industrial companies, with a customer-base closely tied to commodity producers, followed this rally higher. Today, the weakness in the US economy, historically low interest rates, and ballooning fiscal deficits are once again putting downward pressure on our currency. What are the implications? Will we see a market similar to the early part of this decade, or a return of the 1970's stagnant equity markets?

The ability for a weaker dollar to produce a sustained market rally is limited. A weak currency does not create value; innovation and investment ultimately do. While a weakening currency may help domestic companies with substantial international operations, it reduces the attractiveness of the US as a destination for foreign capital. The short-term result is both an increase and decrease of the demand for US equities simultaneously. The long-term result is a decline in the attractiveness of the US as a destination for capital, with increased investment most likely directed toward the fast-growing emerging economies. Truly, it is in our national interest to maintain our position as the globally dominant currency.

> ***"A weak currency does not create value; innovation and investment ultimately do"***

While significant trade and fiscal deficits contribute to the declining value of the dollar, the Federal Reserve plays a substantial role as well. The Fed has historically been late to raise interest rates on the heels of a recession. Given the depth and severity of the current downturn, the Fed is justifiably cautious about raising rates aggressively. However, a stronger indication from Mr. Bernanke about a willingness to raise rates would help stem the declining dollar. It would also provide a necessary pre-emptive strike against inflation. While this would negatively impact equities in the short term, in Cutler's view it would be beneficial for the dollar and investors in the long run.

Paying Dividends will occur in Cutler's Quarterly Newsletter and will feature rotating authorship by members of the Cutler team, presenting on topical subject matter. Look for Erich Patten's article in our 1st Quarter-2010 newsletter.

GLOBAL MARKET UPDATE

EMERGING ECONOMIES: LEADING THE ECONOMIC RECOVERY

Year-to-date the best performing international sectors were energy, consumer discretionary, materials, financials, and information technology. The dominant market trends were led by a weakening U.S. dollar, improving capital markets, and a rebound in corporate profitability. For the quarter and in local currency terms, the best performing developed equity markets were Greece and the Netherlands, advancing 27.4% and 25.9% respectively. Japan was the worst performing, sliding a modest 1.2%. On a U.S. dollar basis, the MSCI BRIC (Brazil, Russia, India, China) Index was up 18.1%, as investors believe that these large emerging economies are leading an economic recovery.

The economies of Europe experienced mixed results this quarter. Spain continues to struggle with Europe's highest unemployment rate of 18% and an economy heavily influenced by housing and tourism - areas that have not rebounded as of yet. Germany and France, however, seem to be performing much better. This can be partly explained by Germany's own "cash for clunkers" program, and to a lesser extent that of France.

The U.K. faces currency pressures as markets focus once again on interest rates, inflationary expectations, and its public finances. The Pound was the only major currency to weaken versus the dollar, and the U.K. central bank has hinted it may increase quantitative easing or pursue negative rates (similar to Sweden). The government has also been rumored to be considering increasing the pension age, which would raise taxes and decrease the deficit.

Currency trends played an important role across the globe. In Asia, central banks have been intervening in the currency markets to stop the appreciation of their currencies versus the U.S. dollar. China abandoned the appreciation of its currency and re-pegged to the U.S. dollar to meet growth targets. The cheap Chinese Renminbi is once again fueling an asset bubble in the Chinese property and stock markets. The explosion of China's bank credit has led to industry overcapacity and may eventually increase non-performing loans. This is an important risk for international investors to monitor.

Overall, we remain optimistic toward global equities and view the recent gains as validation of an early recovery. Growth in the emerging economies in Asia have led the recent recovery, with targeted and effective economic stimuli. Ultimately, a sustained recovery, however, will depend on the ability for American consumers to bolster Asia's economic output. After all, one of the most important lessons from 2008 was that the world's economies remain very correlated.

Large emerging economies leading the way

Fixed Income Update

Roth IRA Conversion: A Viable Option?

Individual Retirement Accounts (IRAs) are one of the most prevalent investment vehicles. These accounts allow invested money to grow tax-free; taxes are paid only when funds are withdrawn in retirement. An option will soon become available to many investors with IRAs, which may help reduce one's retirement tax burden - converting a Traditional IRA to a Roth IRA. A Roth IRA is similar to a Traditional IRA, except that taxes are paid up front and money taken out during retirement is income tax free. Currently, individuals with Adjusted Gross Income over $100,000 are not allowed to do a conversion.

Beginning in 2010, however, individuals with an Adjusted Gross Income above the $100,000 threshold will be permitted to do a Roth IRA conversion. Income generated by a conversion can be recognized over a two-year period, thus allowing for a reduction in the immediate tax impact of the conversion. This two-year tax advantage is only for conversions completed in 2010.

> ***"Converting an IRA to a Roth IRA may be particularly attractive given the recent economy"***

Converting an IRA to a Roth IRA may be particularly attractive given the recent economy and investment returns. With portfolio values lower today than in previous years, an opportunity exists for investors to pay taxes (at today's rates) on a smaller asset base and move their money into an investment vehicle with future tax benefits. While the down market has affected all investors, this tax wise strategy may allow those with Traditional IRAs an opportunity to turn lemons into lemonade.

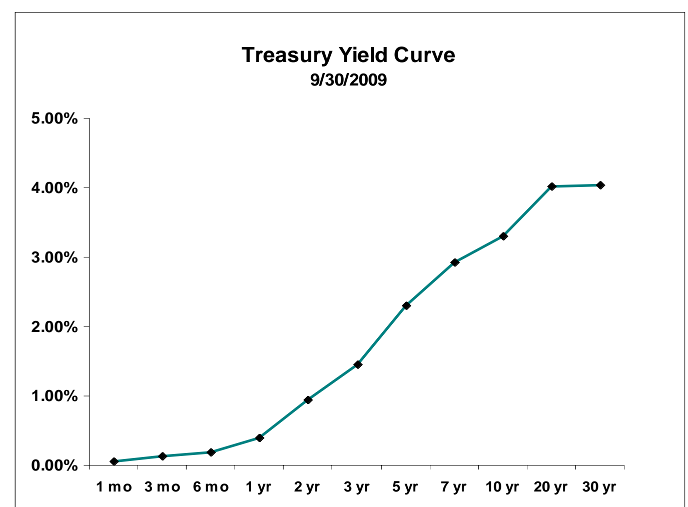
To learn more about Roth IRAs, please give Cutler a call today.

Fixed Income: Credit Indices Roar Back

After a dismal 2008, the credit indices have roared back in 2009. During the Third Quarter of 2009, the Barclays Capital Aggregate Index produced a total return of 3.74%.

Over the last 12 months, all credit sectors posted returns that exceeded the Treasury sector. The largest decline in rates came in the 30-year US Treasury, as its interest rate declined from 4.32% to 4.05%. The smallest change occurred in the 3-month Treasury bill. This rate dropped to 0.11% from 0.18%. The larger declines came about in the 5+ year time frame. Moderately weak economic numbers and a strong sense that inflation is not an immediate concern caused the mild decline in yields.

Interest rates remain low and bonds are expensive, as yields continue to hover around historic lows. Consequently, it is more reasonable to err on the conservative side of the duration spectrum relative to the benchmark. However, market rallies in any direction may be opportunities to either lengthen or shorten the duration of the portfolio versus the benchmark. The yield curve remained steep during the third quarter, but with interest rates lower, any meaningful yield curve extension is posed to undertake too much risk. We continue to think that the best tactical opportunity is to stay neutral to the term structure and await future opportunities.



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