The National Bureau of Economic Research has determined that the current recession started in December 2007, putting us at 18 months and counting. Since 1945, the average duration of a recession has been 10 months, with the two longest topping out at 16. That means we are well beyond the norm, and are now in the midst of the longest contraction since the Great Depression. Whether this means the end of the recession is near, we will know only with hindsight. But given the recent interpretation in the markets that less-bad news is good, it seems that some investors believe that the economy has served its time and a recovery is at hand. We believe that a crossroads of investor psychology is upon us, and more than ever, the "softer" side of investing matters.

Recessions Since 1900		
Recession Begins	Recession Ends	Number of Months
Sep-1902	Aug-1904	23
May-1907	Jun-1908	13
Jan-1910	Jan-1912	24
Jan-1913	Dec-1914	23
Aug-1918	Mar-1919	7
Jan-1920	Jul-1921	18
May-1923	Jul-1924	14
Oct-1926	Nov-1927	13
Aug-1929	Mar-1933	43
May-1937	Jun-1938	13
Feb-1945	Oct-1945	8
Nov-1948	Oct-1949	11
Jul-1953	May-1954	10
Aug-1957	Apr-1958	8
Apr-1960	Feb-1961	10
Dec-1969	Nov-1970	11
Nov-1973	Mar-1975	16
Jan-1980	Jul-1980	6
Jul-1981	Nov-1982	16
Jul-1990	Mar-1991	8
Mar-2001	Nov-2001	8
Dec-2007	?	18 to date
Average: Whole Period		14
Average: Since 1945		10

Schools of Thought

A contrarian investment philosophy embraces the idea that money can be made by differentiating your thinking from the herd mentality: sell the mania, buy the dips. Securities temporarily can overshoot their "fair values" in either direction, providing attractive entry and exit points in anticipation of a boomerang effect. The theory may be logical, but the execution is tricky. Investors who snapped up financial stocks that were a "steal" at 30% below their 2007 highs were distraught as they watched these stocks spiral toward losses of 70-plus percent. This phenomenon happens often enough that in value-investor speak it is called "catching a falling knife." On the other side of the coin, investors who believed that technology companies were wildly overvalued in the late 1990's, which indeed most were, likely missed out on several years of impressive gains. Beyond sheer luck, timing the bottoms and tops of these market trends seems nearly impossible.

In both of these cases, the underlying reasoning was sound. What then, drove the prices of these stocks to such extremes? After decades in which the theory of efficient markets[1] dominated the financial landscape, recent years have seen

[1] The efficient market hypothesis is rooted in the belief that markets are completely efficient and rational. It is impossible to outperform the market since all relevant information is priced into every security, and any trends that form are completely unpredictable.

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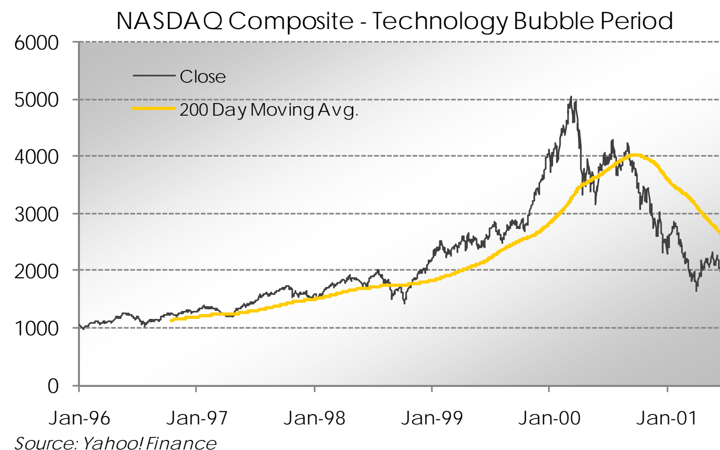
resurgence in the study of investor behavior, or *behavioral finance*. The premise behind behavioral finance theory is that markets *do not* behave rationally, and may be driven, at least in part, by human emotions. Followers of this theory point to the technology bubble and the housing bubble as clear examples that crowd mentality and emotion can drive markets for extended periods of time (see chart of NASDAQ composite during the tech bubble, below). Ironically though, the belief that markets are efficient is so firmly entrenched in investor psychology the idea may play some role in creating the mania. As investors piled into non-revenue generating internet companies and drove up real estate values, they reassured themselves that if the market was bearing out these prices, then the assets must be worth that price. We all know how those stories ended.



Source: Yahoo! Finance

Despite the knowledge that markets are not completely efficient, it is no easy task to consistently outperform. The historical data confirm this. While in any given time period there are managers who beat their benchmarks, to do so consistently over a multi-year period is very rare. As we wrote in our Q & A primer on ETF's in January, a majority of all actively-managed funds underperformed their benchmark index in 2008. The quarterly *Standard Poor's Index Versus Active* (SPIVA) scorecard compares performances of actively managed mutual funds versus their benchmark indices. The latest scorecard results, in the table below, show that an overwhelming number of active funds underperformed their benchmarks over multi-year periods.

Percentage of Active Mutual Funds That *Underperformed* Their Benchmarks
As of Dec. 31, 2008

Fund Category	Benchmark	1 Year	3 Years	5 Years
Equity				
Large Cap U.S. Equity	S&P 500	54%	65%	72%
Mid Cap U.S. Equity	S&P MidCap 400	75%	70%	79%
Small Cap U.S. Equity	S&P SmallCap 600	84%	78%	85%
International Equity	S&P 700	64%	77%	84%
Emerging Markets Equity	S&P/IFCI Composite	65%	84%	90%
Fixed Income				
Invest.-Grade Intermed. Bond	Barclays Intermed. Gov't/Credit	90%	91%	90%
General Municipal Bond	S&P National Municipal Bond	81%	85%	96%
California Municipal Bond	S&P California Municipal Bond	95%	95%	100%

Source: Standard Poor's Index Versus Active (SPIVA) scorecard, as of Dec. 31, 2008

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The Diagnosis

The question, then, comes down to one of asset allocation. At this point, how aggressive should investors be in their allocation toward risk-bearing assets like equities? Given the challenging economic landscape, as well as the knowledge that mispricings and emotion can take over for certain periods of time, investors face a difficult choice. Fundamentally, the current situation is precarious. We are confronted with a damaged financial system awaiting reregulation, an indebted consumer, rising unemployment, a stagnant service sector (which makes up two-thirds of U.S. economic output), and potential inflationary pressures down the road. All of these factors point to keeping your powder dry and maintaining higher weightings in fixed income and cash equivalents. Meanwhile, we saw the S&P 500 stage an impressive advance from its low in early March before pulling back somewhat in the last week. Despite the economic "green shoots" the bulls cite as proof that this rally is here to stay, we think it is hard to deny the degree to which momentum and the crowd's fear of being left behind contributed to this bounce off the bottom.

Cautious investors now are faced with a dilemma: continue to hold out for better confirmation that an economic recovery is forming, or embrace the optimism and participate. For anyone who rode the bear market to the bottom, the choice is fairly straightforward: as long as your time horizon is sufficiently long, stay invested. The S&P 500 fell in excess of 55% from October 2007 peak to March 2009 trough; this will require a more than 130% gain to get back to the high. Despite the recent rally there is still a long way to go. Investors who serendipitously sold some or all of their equities before the worst of the declines have a more complicated choice to make.

Personality Profile

As at any point in the markets, we believe that the key to choosing the right plan of action is to ***know your risk tolerance*** and to invest according to your ***time horizon***. Some investors are decidedly risk averse, and therefore happy to stay out of riskier assets for the reward of a good night's sleep. Their priority is capital preservation, and they generally do not need to "make up ground" for previous losses. Given their aversion to volatility we advise our clients who fit this profile to remain in our Ultra Conservative Tactical Model, which has minimal equity exposure, a heavy allocation to fixed income and cash, and holdings in alternatives such as gold to serve as "hedges" for economic weakness. Examining the hypothetical risk and reward characteristics of this Model, we feel it provides extremely risk-averse clients with a high degree of safety. When we believe that we really have seen the bottom in the housing market, that foreclosures have slowed, and that we have a clearer picture of how the banking and financial landscape will change, then we will recommend for these clients to move back to their longer-term Strategic allocation targets.

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Other investors are naturally comfortable with assuming greater risk and prefer to have exposure to potentially-risky but higher-returning assets. They have a time horizon of at least an entire market cycle, and are willing to endure some pullbacks in order to take advantage of the run-ups. Their risk profile allows them to feel comfortable in equities despite the lack of clarity on some outstanding economic issues. For clients like this, we believe they can begin to move toward our longer-term Strategic Model allocations. These models have more traditional equity/fixed income balances, full allocations to our "opportunistic" thematic holdings, and lower weightings in weak-growth hedges.

One of the ways we determine the suitability of an investment for a client is to calculate its hypothetical "bad case scenario" loss. This implies a year in which the investor will experience returns that are worse than 95% of all of the returns possible for that portfolio allocation, given its expected return and standard deviation. We use this calculation as a way to gauge our clients' tolerance for down-side risk. If the "bad case scenario" loss is more than they could tolerate in a given year, then we would recommend moving to a more conservative allocation. The table below shows the hypothetical loss calculations, as well as the median (50th percentile) of the portfolio return distribution, for our Ultra Conservative Tactical, Conservative Strategic and Moderate Strategic Models during several historical time periods.

Current Recommendations Based on Risk Profiles			
Risk Profile	**Ultra Conservative**	**Conservative**	**Moderate**
Time Horizon	Short	Medium to Long	Medium to Long
Volatility Tolerance	Averse	Tolerable	Comfortable
Primary Goal	Capital Preservation	Growth, Income	Growth
Model Recommended	Tactical - Ultra Conservative	Strategic - Conservative	Strategic - Moderate
Equity	Very low	Relatively Low	Relatively High
Fixed Income/Cash	Very high	Relatively High	Relatively Low
Opportunistic	Half weighting	Full weighting	Full weighting
Economically Sensitive	Low-growth hedges	Inflation hedges	Inflation hedges
50th Percentile "Median" & 95th Percentile "Bad Case Scenario" Return Estimates			
Credit Crisis (Nov 2007 - Present)			
50th Percentile Median	-0.5%	-8.9%	-14.4%
95th Percentile "Bad Case"	-12.9%	-28.5%	-38.0%
Tech Bubble Aftermath (Apr 2000 - Feb 2003)			
50th Percentile Median	7.3%	-0.9%	-6.0%
95th Percentile "Bad Case"	1.6%	-12.1%	-21.2%
Mid-2000's Boom Years (Jan 2003 - Dec 2006)			
50th Percentile Median	8.1%	14.3%	18.4%
95th Percentile "Bad Case"	1.5%	4.6%	5.5%
Long-Term Historical Period (Jan 1988 - Present)			
50th Percentile Median	7.9%	8.6%	8.8%
95th Percentile "Bad Case"	0.5%	-4.1%	-8.1%

The table shows that during the current Credit Crisis period, the median return for the Ultra Conservative Tactical Model would have been an annualized loss of -0.5%, and the "bad case scenario" loss would have been just under -13%. While

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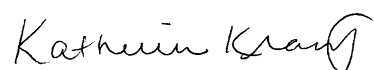
negative, these scenario returns compare very favorably with the -37% loss that the S&P 500 experienced in 2008. Conservative and Moderate investors, with their more aggressive risk profiles and thus higher equity allocations, would have stood to lose a greater amount. The Tech Bubble Aftermath paints a similar relative relationship between the models, but with less extreme returns. During the good times, represented by the mid-2000's "boom" years of 2003-2006, there was little incentive to invest with the more conservative allocations. In fact, the "bad case scenario" returns were all positive and even increased as the allocation became more aggressive. The Long-Term Historical period, which encompasses more than 20 years of data, gives us a multi-cycle perspective on the tradeoff between risk and return for the three models. These data highlight why it is important for investors to understand their risk tolerance on both the up side and the down side.

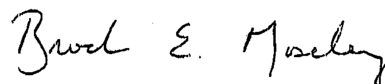
The Treatment

Anyone who has read our recent research knows that our outlook falls into the cautious camp. We think the hurdles in front of an economic recovery are still high, and that the fundamentals do not support the equity gains we have witnessed in the last 3 months. We made a decision to significantly reduce our clients' equity holdings in July 2008, after which the S&P 500 sank another -44% to its March 2009 low. Our down-side protection strategy proved beneficial over the last 12 months while the markets seemed to be trading on little more than fear and momentum. Although emotion will likely continue to play a part in the markets' trends, we are encouraged by some easing in volatility and differentiation in performance across sectors and styles.

Investors who value risk aversion, like many of our clients, may wish to sit out until the evidence of a recovery is more solid. We believe that the markets still need to adjust expectations for slowing rates of consumer spending and growth, and that the credit landscape will be changed for years to come. However, we also believe that investors with some tolerance for volatility could begin to invest selectively and have a reasonable expectation of gains over a 3-5 year time horizon. One of the hallmarks of Miracle Mile Advisors is the customization we provide for our clients. Now, more than ever, the consideration of each family's risk tolerance, time horizon, and investment profile is of the utmost importance.

June 23, 2009





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