Sitka Pacific
Capital Management LLC

May 2009

Dear Investor,

In April, stocks continued their advance that began in early March. However, unlike in March, market breadth was poor as the rally was fueled almost entirely by short-covering. This market action appeared similar to most other short-term rallies we have seen over the past year and a half, and in the second half of April it appeared the market was approaching the end of another bear market rally.

However, at the end of the month, the rally continued higher and extended its advance in early May, even as the rally continued to weaken internally. There have been other bear market rallies over the past year, but this one has by far been the largest. We'll discuss our short-term outlook for stocks and other markets in this month's letter, and then provide a short review our expectations for each of our portfolios.

Despite the Fed's decision to start buying Treasury bonds, the yield on the 10-year Treasury bond rose to 3.12% in April—up from a low of 2.46% in March—and has continued rising in early May. If the Fed's actions have had any effect in lowering rates, it hasn't been apparent yet. It seems the Fed's intervention may have frightened off a greater amount of private (or foreign government) capital from the Treasury market than it has brought to the table itself, for net negative effect on Treasury bond prices. If the current trend continues, we'll likely see the Fed commit itself to monetizing even more government debt.

As stocks continued to rally, the dollar and gold declined, while economically sensitive commodities such as copper and oil rose. This is all within a continued theme of a "loosening up" of financial conditions that began in March. As mentioned in last month's letter, it was possible this rally might go on further than most people expect, and it has done that. We'll have more to say on this theme in the following pages.

On a more administrative note, you may know that Sitka Pacific has grown significantly over the past year, and in March we completed our registration as an SEC-registered investment advisor. In order to comply with SEC regulations and GIPS guidelines for disclosing our returns, we will no longer be reporting monthly returns for our portfolios in our client letters, as we have been. In the future, we will publish our portfolio returns in audited summaries on our web site.

Of course, as our client, you are able to track the performance of your account in real-time by checking your account online. In the table below, we will continue to publish the returns of various market indexes to give you a sense of how select areas of the marketplace are performing.

Stock Indexes	April	2009	Market Indexes	April	2009
S&P 500 Stock Index	+9.4%	-3.4%	HFRX Global Hedge Fund Index	+1.6%	+2.3%
MSCI World (ex USA) Stock Index	+12.4%	-3.2%	US Dollar Index	-0.7%	+4.3%
Amex Oil Index	+5.4%	-8.5%	CRB Commodities Index	+0.9%	-3.1%
Gold and Silver Index	-10.8%	-3.1%	Gold (Continuous Contract)	-3.3%	+0.5%

*   *   *

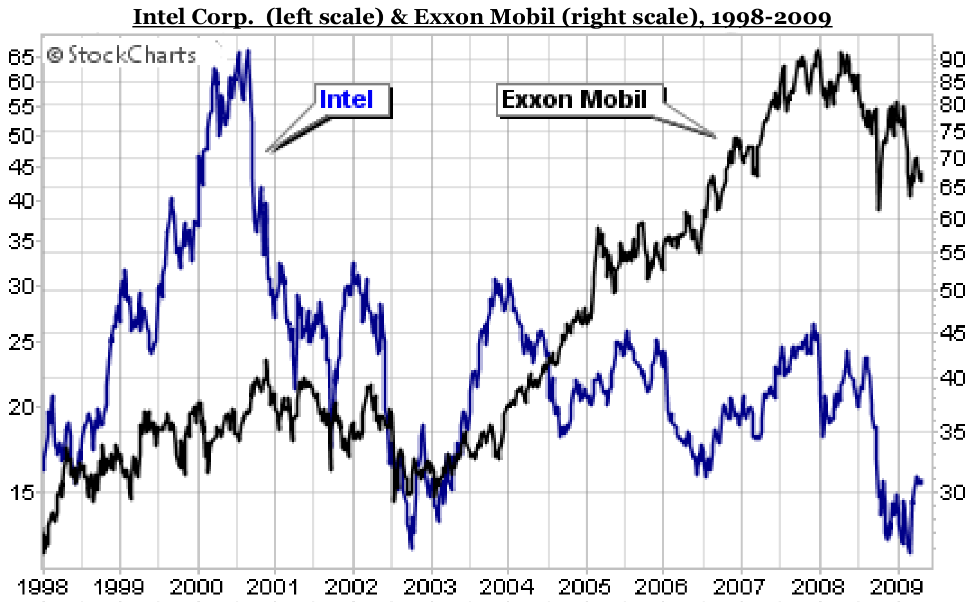
During the technology bust earlier this decade, when technology stocks declined more than most people thought possible, the question on many investor's mind at the time was "when will it be time to buy tech stocks again?" Since many of those stocks had declined 90% or more, it seemed like a tremendous opportunity to invest—if you could somehow know which companies would survive.

However, a study of market history suggested that markets that go through such booms and busts rarely recover for many years, if not decades. Prices eventually reach a low at some point, but the greatest gains made during any subsequent bull market are never made in sectors from bubbles that have just burst. This is why many surviving technology stocks, like Intel, are today trading at or below where they were after the tech bust in 2002. Meanwhile, stocks in other sectors, like Exxon Mobil for example, remain far above their 2002 lows.

When the market goes through a major theme shift, as it did earlier this decade, the old market leaders always give way to new market leaders. The old market leaders often advance as the market recovers, but in the long run they fail to keep up with other sectors.

In fact, the prior market leaders often enter a *market purgatory*, in which they spend many years recovering. During that time their stock prices generally stagnate.

Intel Corp. (left scale) & Exxon Mobil (right scale), 1998-2009



Flash forward to today. The main reason why financial stocks are not a good investment today, despite losses of more than 90% in some cases, is the same reason why technology stocks were generally not a good investment in 2002. The collapse in financial stocks over the past 2 years will take decades to recover from, during which time other areas of the market will produce far better returns. In the long run, it is best to move on from the scene of these crashes and search for more promising opportunities.

Thus, although financials and other sectors that have been at the center of the housing bust almost certainly posses little long-term potential return from here, in the short-term anything can happen. What we have seen over the past couple months is evidence of that, as financial stocks have rallied close to 100% from their March low (although they are still down nearly 70% from their 2007 peak).

We anticipated the recent rally in the market, but we didn't anticipate that the market would rally as far as it has in such a poor technical fashion. Since the March low, some sectors have rallied vigorously, while many other sectors—with, arguably, a better fundamental outlook—have risen either modestly or not at all. In previous rallies over the past year and a half, short-covering in sectors such as financials, housing, and consumer discretionary stocks have been accompanied by decent buying in most other sectors—but not this time.

In fact, as the market continued to rise throughout April, the breadth of the advance continued to weaken. In a new bull market, we would expect to see increasing participation and volume as the market continued to rise. But during this rally, we have seen the opposite.

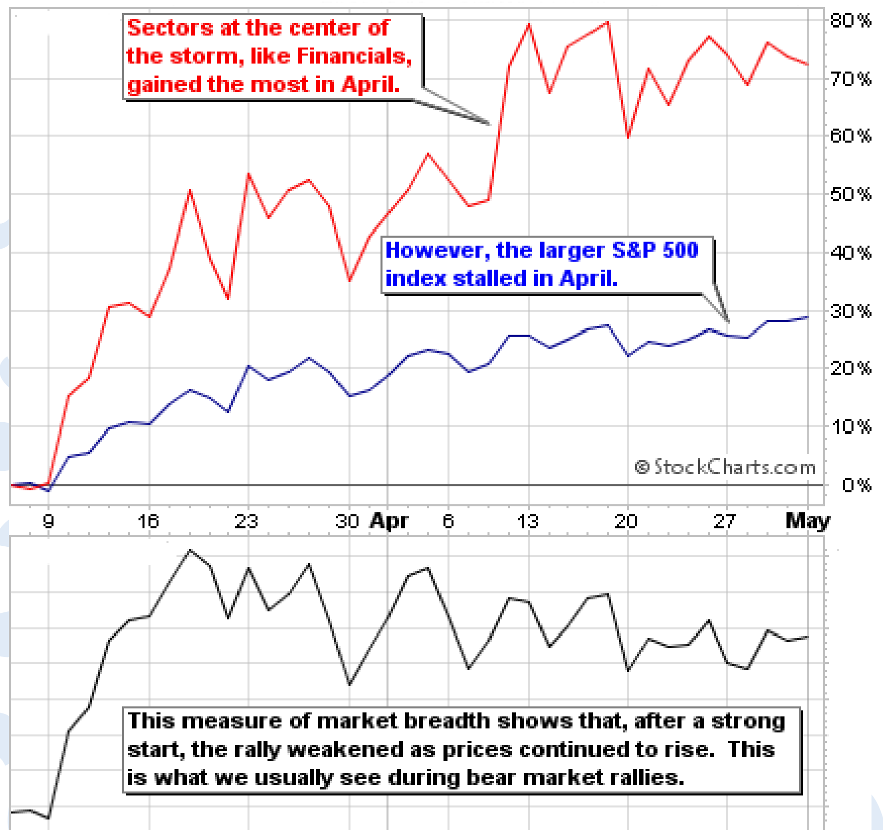
We live in the age of information and computers, and every investor/trader nowadays has access to enormous amounts of readily available information. Within a few minutes, they can see everything from the latest statement from a company's CFO, to how a particular stochastic oscillator or trend indicator looks on that company's stock.

Despite having access to all this data, when you listen to the most experienced market technicians describe how they feel about the market, they are almost always rather vague. They will usually talk about how the market doesn't *feel* right if they are turning bearish. Or if they are quite bullish, they will perhaps rattle off a seemingly inconsequential list of reasons to be positive—none of which are very convincing.

The reason for these seemingly 'fuzzy thoughts' is that despite all the data we have access to these days, the best way to get a sense of where the market is headed it to do what people have been doing since the invention of the ticker in the 1800s: watch the tape. Over many years of watching the market, good technicians get a sense for what constitutes a healthy advance that is likely to continue, and what feels like a weak advance that is prone to failure. Despite all the technology, and all the numbers and charts we use for visual aid, accurate market forecasting is still a subtle art.

The current rally feels like a bear market rally, for a number of reasons. As was mentioned above, market breadth has been narrowing as this rally has progressed, when we should be seeing it expand. At the bottom of this chart is a measure of that breadth, and you can see that after peaking in mid-March, it has been declining even as the market has continued higher.

Financial Stocks and the S&P 500, March-April 2009



This is the typical pattern that we see during bear market rallies—though it's clear the current rally is more than a typical bear market rally (more on this in a minute).

Also, at the end of last month the S&P 500 had rallied close to 30%, but 1/2 of that advance was due solely to financials and consumer discretionary stocks. These heavily shorted sectors together only represented roughly 19% of the S&P 500 at the end of March—less that 1/5th of the index.

When we see the weakest 1/5th of the market responsible for racking up 1/2 the gains during a rally, and the rest of the market fails to increase its participation over time, it is a strong hint that the advance is built on a weak foundation.

All this doesn't mean the market cannot rally further. In fact, after the advance in the last few days of the April, it was clear the market was getting ready for another leg up. However, bear market rallies have a way of going on just long enough for the majority of people to forget that we are in a long-term bear market, and it appears it has accomplished that already.

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Even if our interpretation is correct, and the rally from the March low is not the start of a bull market, it doesn't necessarily mean stocks are primed to fall to new lows any time soon (although that is still a possibility). Over the past 30 years, we have been conditioned to expect a more or less consistent cyclical response in the stock market; stocks go up with the economy is doing good, and they go down when the economy is in recession. However, that 1:1 correlation is not how things always work out.

We have been talking a lot about Japan lately, and the reason is that Japan is the most recent example of a demographics-fueled deflation that is in many ways similar to the current situation here in the US. Of course, there are key differences between our current situation and Japan's experience, but the similarities are useful to aid our thinking.

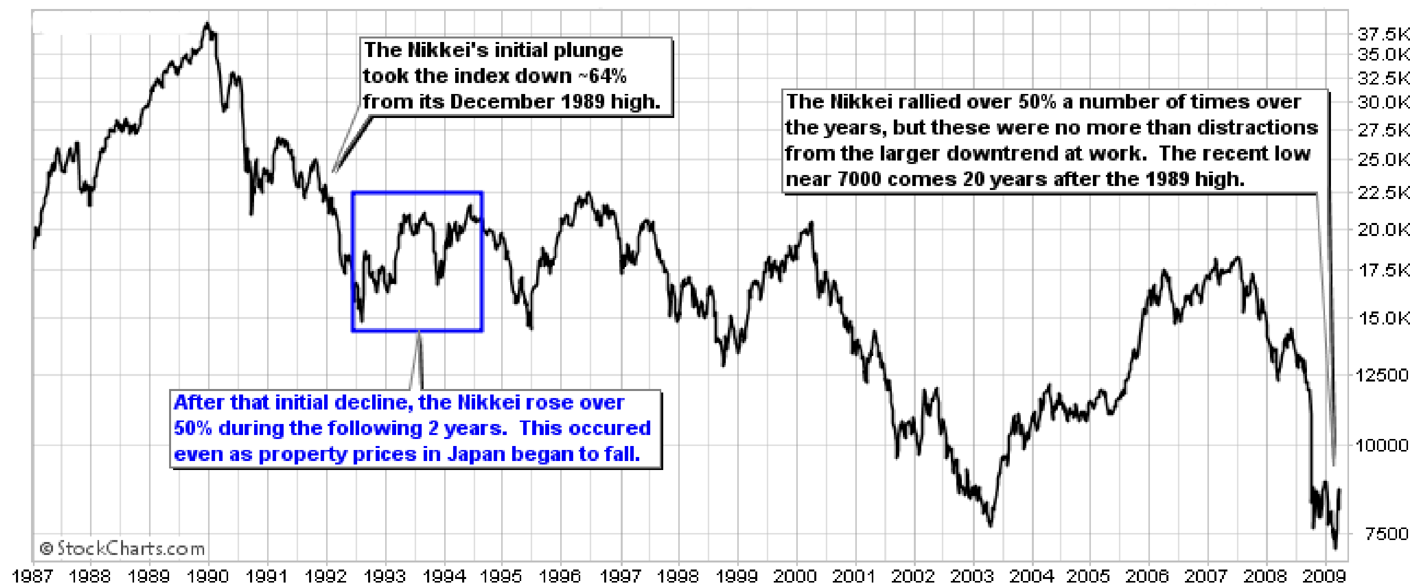
What happened in Japan in the 1990's was a demographic shift into retirement, where a large portion of the population went from a lifestyle of earning, saving and spending to a lifestyle of not earning, living off assets and spending less. This resulted in less demand for investments like stocks, less demand for housing, and less demand for material "things" - and the prices of all these fell.

In the US, it's likely we are now starting a similar demographic shift into retirement, and that has coincided with what appears to be a peak in spending and debt. In all likelihood, the next 10 years will see lower demand for stocks, real estate and "things" just as it happened in Japan. The important thing to remember is that these are *generational* forces at work, and they will play out over decades, not months or years.

It is in that context that we are viewing our stock market, and the recent rally. The chart below shows that as Japan's stock market descended during the last 20 years, it did not go straight down—there were a number of large rallies along the way. In the 1990's there were three rallies of over 50%, and during the rally from 2003 to 2007 the Nikkei rose over 100%.

The rallies during the 1990's coincided with many "false dawns" in Japan's economy. Each time Japan emerged out of a recession, there was great hope that *this time* growth would gain traction and Japan would return to its former glory days. Yet overall the economy remained weak, weighed down by deeper demographic forces, and in time another recession would come along and take the markets down again.

Japan's Nikkei 225 Average, 1987-present



The rally in our stock market since March has coincided with a number of economic indicators improving from the state they were in earlier this year. There is nothing yet that signals that the economy is starting to emerge from recession and grow, but its clear the economy is now contracting at a slower rate than it was three months ago. This, of course, is a tremendous relief to the markets, and it's not surprising to see stocks go up and conditions in the credit markets improve.

However, if we take a step back and consider the larger demographic and consumption trends now in place, we can see why the current rally doesn't have the strength of a new bull market. That's because even if stocks have stopped declining for the time being, like the Nikkei was after its low in 1992, a new bull market may still be a very long way off.

The exact path the market takes over the next ten years will depend a lot on how the economy is doing at each particular moment, whether the Fed is successful in creating some inflation, or whether deflation continues unabated. These issues will undoubtedly continue to influence the markets in the short-run, but they all need to be viewed in the context of the larger demographic drag now exerting itself.

Given what we have seen so far, it's clear the low in March was a major bottom. However, the rally from that low has been weak, and almost certainly not the start of a large bull market. Although conditions can certainly change for the better or worse in the coming months, we wouldn't be surprised if the US stock market has now entered a broad trading range similar to the Nikkei between 1992 and 2000.

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Just as with the US market since 2000, the long, slow decline in the Nikkei over the past 20 years has been a disaster for those investors who took the wrong approach to stocks for that type of market environment. These periods are terrible for buy-and-hold investors, but they are not bad for those who manage to use the price swings to trade in and out of the market.

Buy-and-hold is not always a bad approach; it just needs to be done in a market environment that will reward it. While the Nikkei was stagnating in the 1990's, markets in other parts of the world were booming and rewarding buy-and-hold investors richly. Also, even in stagnant markets there are always pockets of stocks tied to strong underlying investment themes that perform independent of the broader market. For instance, as the chart on page 2 shows, anyone who bought-and-held Exxon Mobil at the peak of the market in 2000 has very little to regret, even after the slump over the past year.

Each of our portfolios focuses on this approach to the markets, in one way or another. In Absolute Return, we are able to invest outside the US in any market that appears to offer a good opportunity. In Dividend Growth and Hedged Growth, individual stocks are chosen based on *durable* fundamental trends, so that we stay focused in areas of the market that are gaining momentum on their own accord. And in Commodities Focus I, we are able to buy-and-hold stocks in the areas most directly tied to long-term global trends that will depend little on the path of US market. With these long-term thoughts in mind, let's take a look at the short-term outlook for each of our portfolios:

In **Absolute Return**, we have made some well-timed entries and exits into and out of various markets over the past 6 months, and that has left us with a healthy gain so far for 2009. We certainly would not expect our timing to be good all the time, but our goal is to produce a better return with less overall risk than a diversified portfolio that is *not* actively managed—and we have met that goal over the past couple years.

We continue to hold onto positions in precious metals, and we have recently added exposure to energy and other commodities, which may areas that we hold for some time. On an inflation-adjusted basis, the CRB commodities index is now lower than it has been for several decades, and the long-term bullish case for

commodities in the face of rising global demand hasn't changed with this recession. On that basis, we're inclined to give these positions a longer leash at this point.

Since January, we have scaled out of Treasury bonds. As time goes by, it seems more likely that the low in yields near the end of 2008 may have been a very significant turning point for Treasuries—perhaps ending the almost 3 decade bull market in Treasuries. This bearish long-term outlook for Treasury bonds is not set in stone at this point, but it does now leave the burden of proof on the bulls. At the same time, the high risk in corporate bonds has not decreased enough to make a strong enough case for our investment, so at the moment we are on the sidelines with regard to bonds.

Near the low in March, we greatly increased our exposure to stocks, but we have cut back significantly in the past few weeks. The stock market could continue to move higher from here, but we are already seeing enough red flags to leave us in an increasingly defensive stance. However, we have accumulated positions in a handful of US stocks, along with a number of foreign stock funds, that are now considered buy-and-hold positions. We'll continue to hedge these positions the best we can if we feel the market is at risk for a significant decline.

Hedged Growth has had a difficult stretch over the past month. Although we have increased and decreased our market exposure in line with the prevailing market trend relatively well, since late March the markets have been powered higher by steady short-covering in the sectors of the market with the poorest fundamentals. With very little buying in other areas of the market, this left losses in the short side of our portfolio unmatched by stocks we were long.

Hedged Growth is a stock portfolio that is designed to perform independently of the market. It does so by buying stocks with good and improving fundamentals, and by shorting stocks with poor and deteriorating fundamentals. By having some of the portfolio long and short at all times, we're less dependant on which way the market goes. We supplement this stock selection by adjusting our net exposure to the market, in an effort to reduce risk and volatility further.

Our stock selection for Hedged Growth is based on sets of quantitative rules that *objectively* seek out sectors and stocks that have embarked on *durable* trends of outperformance (or underperformance, in the case of stocks we short). The vast majority of data we consider is centered on the health of the businesses behind the stocks. These are numbers that most people fall asleep to when they hear, such as return on equity, change in tangible book value, etc. This bottom-up approach keeps us invested in healthy companies with characteristics that have historically been associated with outperforming stock prices, and keeps us short only stocks whose businesses are deteriorating significantly.

What this stock selection process *doesn't* do is try to guess major trend changes that haven't yet solidified into durable market trends. This 'wait and see' approach is designed to avoid just the type of catastrophic losses we have seen over the past 2 years; it is what kept us out of certain sectors in 2008 that were in the middle of a historic collapse. Even though these stocks often bounced back strongly in many short-term rallies on the way down, their underlying fundamentals continued to deteriorate and we were never tempted to guess if a bottom had arrived.

The main vulnerability of this type of approach is just what we have seen over the past 2 months: a market that very quickly shifts in a way directly counter to the fundamentals. It's not very often we see a short-covering rally like the one coupled with such little buying in healthier areas of the market. In that sense, April was a "perfect storm" for Hedged Growth.

If this rally from the March low were to evolve into a real bull market, we would see the short-covering ease and the broader market take a larger role powering the advance. This would improve the performance between our long and short positions, as Hedged Growth picked up stocks in the strongest sectors.

However, as market breadth has continued to narrow, it seems more likely that this rally is a bear market rally that will eventually come to an end. The stocks that temporarily came under intense buying pressure from short-covering will fall back. This also will return Hedged Growth back to a positive spread track.

Even after this April's decline, Hedged Growth remains up 17% since the bear market began in 2007, and up 48% since inception in July 2005. Despite a number of speed bumps along the way, we've produced those returns by staying committed to our stock selection strategies and by adjusting our market exposure according to market conditions. We'll be doing just that in the month's ahead.

In **Dividend Growth**, we removed our hedges and increased our market exposure near the March low. Since we had avoided most of the decline in the market in January and February, the advance over the past 2 months has left us with a solid year-to-date gain.

However, as we have discussed above, the market appears to be weakening and so we will likely be back to a more defensive stance relatively soon. Until the markets reach a more steady state after this bear market, we will continue to adjust to the market conditions the best we can.

Commodities Focus I is now in a very good position for buy-and-hold investing, and we are 100% invested at this time. We remain invested in our *Core Stocks*, which include energy and other commodities stocks, and also have a sizable allocation to precious metals and related stocks.

Gold remains in a strong position, trading near $900/oz after having consolidated for the past year just below its high near $1030/oz. And despite the end of the seasonally favorable period in March, gold stocks are near a new high for the year. This continued strength into May is unusual, and it could signal that the market is preparing for the next leg up in its 9-year bull market.

At the same time, the price of oil has moved higher towards $60/bl, and natural gas has recently begun rising as well. This strength has reignited interest in energy stocks, which are now receiving an added boost from a falling US dollar.

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The financial markets have been moving at lightening speed over the past few months, and the noise that often passes as news seems to have only increased as well. Hopefully these letters help you cut through some of that noise and at least give you some idea of the thinking behind the management of your account.

As always, if you have any questions about your account or issues raised in this letter, feel free to contact us. We'd be glad to hear from you.

Sincerely,

Brian McAuley

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