

Letter to Investors

Dr. Charles Lieberman, Chief Investment Officer



ADVISORS CAPITAL
MANAGEMENT

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The markets enjoyed quite a dramatic rally in the third quarter, its second consecutive strong quarter, as prospects for an economic turnaround induced some investors to get back in the equity markets and liquidity continued to improve in the credit markets. Policymakers remains fixated on improving conditions further. Indeed, with unemployment approaching 10% and possibly exceeding that level before job growth resumes, there is every reason to expect policy to remain recovery oriented. Thus, we remain positive regarding the equity market's prospects for the visible future.

The rebound in capital markets in 2009 is a mirror image of the decline experienced in 2008. In 2008, only one asset class performed well, U.S. Treasury bonds, while most everything else declined in value, with the most risky assets declining the most. In contrast, the riskiest assets have performed the best in 2009, while Treasury bonds are the only asset class that has fallen in value through the end of the third quarter. The same mirror image applies to bonds, domestic stocks and foreign stocks. Yet despite the major rally since the low in March 2009, stocks are still below where they were prior to the failure of Lehman.

Some of the market rally in 2009 is not much more than the reversal of the severe selloff that was precipitated by the fear of a depression. Debt markets froze completely late in 2008 and households and firms cut back dramatically in spending out of self preservation, worsening the recession, and they liquidated assets even at depressed prices, out of fear prices would fall further. As the Federal Reserve became very aggressive in adding liquidity into the economy to help promote a recovery, it became clear that the worst fears of the market would not be realized and markets started to recover. We are still early in this recovery process.

Credit markets have recovered most dramatically. Where companies could not borrow at all in the fourth quarter of 2008, companies are now selling multi-billion 10-year bond offerings for less than 5% in many cases. Corporate bond yields have been dragged down to such low yields by the even lower yields on Treasury bonds. We think these yields are actually too low from a long-term perspective and we have implemented strategies to limit our downside, as yields revert to more normal

levels over time. However, equity markets are still below pre-Lehman prices, as already mentioned, so they appear to offer further upside over the coming quarters. Despite the weakness in the economy during the first half of the year, profit margins actually rose, as firms cut costs even more than they suffered revenue declines. As revenues recover, profits should rise quite sharply and analysts are raising earnings estimates for 2010 almost daily. The markets remain somewhat volatile and relative valuations remain distorted, so we continue our efforts to exploit these opportunities as we uncover them. - Dr. Charles Lieberman

"I'll Get Back in When the Market Corrects" - John Petrides, Growth Portfolio Manager

The proverbial correction that investors have been waiting for in the equity market, in my opinion, is happening right now. Since the recent bottom on March 9th, 2009 through September 30th, 2009 the S&P 500 index is up approximately 56%. Many investors, the media, and bloggers have been talking about "an imminent correction", "going too far too fast," "where are the fundamentals to support this rally," "this is a dead cat bounce," "September is historically a horrible month, and I will wait until October to get into the market" or my favorite, "I missed it." Do comments like these sound familiar? I would give them a slight bit of credence if this was May, when fundamentals had not been proven yet, but now the Bears are running out of arguments against having some equity exposure.

In the spring of 2009, companies had limited visibility on demand and were still slashing costs. The credit markets were strained. The banks were being "stress-tested". A housing bottom was still a question mark and unemployment was still rising at a frightening pace. Although the market had begun its rally, the Bears still had a case to avoid the equity markets. However, since September 30th, the S&P 500 is about flat, with fundamentals remarkably better than six months ago. From a macro standpoint it is safe to say that the US is out of a nasty two year recession and has avoided a financial meltdown. Housing starts, sales, and prices have bottomed and have begun to turn up. Industrial production has improved,

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MANAGING IN THE RALLY

A look back at ACM's strategic management decisions from the most recent quarter.

Fixed Income: Continued move from short-term, high quality bonds to longer term investment grade bonds (max 10 years, BBB or better) and high yield paper. We are locking in elevated interest rates to take advantage of historically wide credit spreads. Still avoiding Treasuries.

Convertible Bonds: Added converts into our fixed income strategy. These continue to be very attractive for their bond features with the added potential for an equity kicker.

Master Limited Partnerships: (MLPs) Increased weighting to MLP's for income oriented accounts. MLP's should provide an inflationary hedge.

Trust Preferreds: Managed positions and maintained weighting to Trust Preferred stocks. These investments continued to provide recurring income.

U.S. Equity: Took advantage of our cyclical recovery positions and continued to focus on value. Underweight defensive sectors such as telecom and utilities.

Non U.S. Equity: Maintained our commitment in China for our Growth investors by purchasing companies that we continue to believe will benefit from the growth of China's middle class.

ACM's Quarterly Reports through Q3 2009 are available on our website at www.advisorscenter.com. Form ADV are available upon request.

Letter to Investors

A Letter from Dr. Charles Lieberman (cont. page 1)

although capacity utilization rates are low. A tremendous amount of liquidity has been pumped into the system, inflation remains non-existent.

From a micro standpoint, now that the shock and awe of 2008 is over, management teams of every company have had time to adjust. Inventories have been rationalized. Debt has been paid down, or refinanced to longer maturities and at cheaper rates. Dividends have been cut, and share repurchase and capital expenditure programs suspended – equaling to a higher amount of free cash flow. Overall, companies are now in a better capital structure than before 2008 and working in a leaner operating environment, which will translate into huge operating leverage and higher earnings power when demand truly kicks in. During this earnings season, a large majority of companies have met or exceeded analyst earnings expectations, and have commented on increased orders, sustainable backlogs, and offered future earnings guidance, which means there is light at the end of the tunnel.

In my opinion, we are in the proverbial correction phase now because investors are selling, even though earnings and fundamentals are improving – money is being taken off the table which is surely a short term phenomenon. Investors are capturing massive gains because of a percentage run-up, not looking at underlying fundamentals.

If using a P/E (price-to-earnings) multiple as a standard way to value a business, one must determine what the “E” is and its growth rate. If management is seeing demand start to improve and confidence being restored, and have right-sized the respective business with massive inventory and operating cost cuts, and have improved the cash flow and balance sheet, then it is fair to say in most cases, the “E” will prove to be understated and thus the market is undervalued.

I am not prognosticating on the shape of the recovery. If one looks at a chart of the Dow Jones since 1920, one would find many

V's, U's, W's, J's (rarely L's), N's, etc. but the shape of the line is generally up-and-to-the-right. I am looking to find strong business models trading at a discount to intrinsic value, with solid earnings growth capabilities over a long term horizon. I'm also not looking at the world with “rose-colored” glasses. I know the consumer is still stretched. I know banks are still suffering losses even though they are better prepared today than one year ago. I know the commercial real estate market is looming (along with the CMBS market), I know the government's new involvement in corporate America frightens die hard capitalists. Concerns still exist, but fundamentals are improving too, and if we have learned one thing from the financial crisis over the past year, it is that households, corporations, and governments adjust and respond to changing times.

The equity markets have pulled back some in October, yet fundamentals have bottomed, if not begun to improve. Visibility has returned to the market. All of this equates, or will equate to undervalued businesses with solid long-term growth prospects, trading at big discounts to intrinsic value. I will end with this thought in relation to where we are today fundamentally; ask yourself this, do you remember where we were a year ago? If investors were afraid to take risk then, what about now?

Systematic Investing your way back toward a long-term plan. - Kevin Kern, Managing Member

With over \$3 trillion dollars still on the sidelines it's easy to see that a number of investors are still wondering how to get back into the stock or bond market. Our recommendation for long-term investors is to be invested sooner rather than later. For some this might require a systematic investment plan to help them get started. Systematic investing takes a predetermined dollar amount and invests it into the market over time. For example a client may decide

to use the next six months to become fully invested with a \$300,000 portfolio. This plan would require that \$50,000 be invested monthly ($\$50,000 \times 6 = \$300,000$). Because of this commitment the client would be buying into the market at different levels throughout the time period.

If the market was to rise in value, the monthly investment of \$50,000 would purchase fewer shares of securities. If the market was to go lower the client would be able to purchase more shares for the same amount of money. Over a six-month period this approach would soften volatility and smooth out cost basis, but more importantly the client would be getting back into a long-term investment plan.

ACM has created a systematic investment plan which allows clients to get back into the market by using monthly installments over the next six months. Give us a call to discuss how to get started.

Q3 Composite performance reports and ACMs Form ADV Part II available upon request.

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