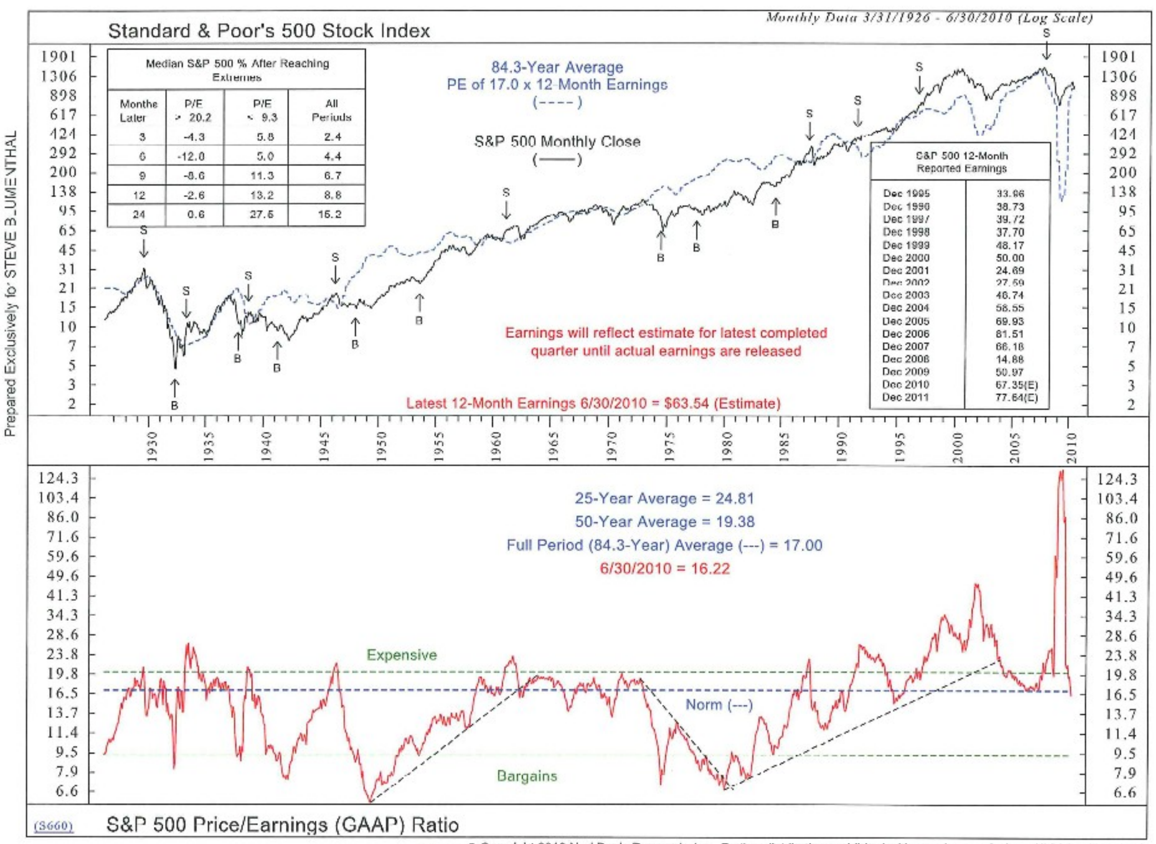
CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

July 17, 2010 Market Update – Valuations Still Expensive

Recently I wrote about valuations as measured by actual reported earnings and how those reported earnings compare to current price and how that combined Price to Earnings Ratio (PE ratio) compared to historical PE ratio's to determine if the market was Overvalued, Undervalued or Fairly priced. Most recently the PE ratio was just north of 16 times earnings. While Wall Street is parading the good news, I believe it is far too early to get excited. Remember, historically, long-term secular bear periods end when PE ratios drop below 10.



Taking a further look into three important valuation measures tells a less optimistic story.

DJIA Price to Book Value Ratio – The 86.5 year norm is 1.96. An overvalued reading is north of 2.9 (today the DJIA Price/Book Value Ratio is at 3.36 according to data from Ned Davis Research (June 30, 2010). The market is expensively priced). There were only a few periods in the last 86 years when the reading was north of 2.9 -- 1927-1930 and 1996-present. It reached a high of 4.4 just prior to the crash in 1929 and it reached a high of 4.8 at the top of the last bull market in 1999-2000. Since 2000, the reading has remained in the overvalued area and the bear market continues. It declined from 4.8 to 3.0 from 2000-2002 and rose again to 4.7 by 2008, where it peaked just before the last meltdown. At prior secular bear market lows, the reading was south of 1.2. This reading clearly reflects that the market remains overvalued.

S&P 500 Price to Dividend Ratio – The 12-month trailing dividends on S&P 500 companies through 6-30-10 was $22.05. Since 1925, an overvalued (expensive) Price/Dividend Ratio reading is above 35. If you take 35 times $22.05, you get an S&P 500 Index at 816. This is far below today's S&P 500 Index level at 1090. The 85 year Price/Dividend Ratio norm is 27. If you take 27 times $22.05 dividends you get an S&P Index at 595.35. That's a pretty scary thought. While it is a low probability, it certainly has potential. Given that dividends were significantly reduced during the recent credit crisis, we can normalize the current dividend rate tied to current earnings. Optimistically, assuming dividends on the S&P 500 Index at $37 (normalized at 50% of $74 earnings potential), if you take an overvalued (expensive) reading of 35 times $37 dividends you get an S&P 500 Index at 1295. $37 dividends times the 85 year norm of 27 equals an S&P 500 Index at 999. Bargains are found when the Price/Dividends Ratio equals 18. If we take the optimistic assumption on dividends being $37 (remember, actual dividends for the last 12 months equaled only $22.05) times the 18 bargain level achieved at past secular bear market lows, you get an S&P 500 Index at 666. My two cents is I don't believe corporations are going to raise dividends in the current environment in such a way that will move the 12-month dividend number from $22.05 to $37. My best guess is that based on the 85 year norm, the range on the S&P 500 Index is somewhere between 999 and 595.35. Bargains can be found at 666 and below. Either way, the S&P 500 Price/Dividend Ratio clearly reflects that the market remains overvalued.

One last valuation measure, the S&P Industrial Average Price to Sales Ratio – I'll save you the pain of working through the math and simply reflect that this ratio also reflects an expensive market. Over the last 56 years, when this ratio is in the "Market Expensive" zone, the S&P has gained 1.1% per year. This has happened about 33.2% of the time (or in 18 years out of the last 56 years). When the Price/Sales Ratio is in the "Market Attractive" zone, the S&P has gained 12.3% per year (that has occurred 35.4% of the time or in 20 years out of the last 56 years). Long-term statistics that show the market to be bullish about 33% of the time, choppy to sideways about 33% of the time and bearish about 33% of the time. Why so many investors continue to hold a one directional bull market belief is puzzling.

In summary, I don't see the attractive values that Wall Street is so excited about. The economic backdrop remains stressed. The great deleveraging continues, high unemployment persists, state and local budgets are in crisis, and global economic and debt issues remain. On top of that is anemic housing activity, a retrenched consumer, and coming higher federal, state and local tax rates. What is the driving force for business earnings expansion that can support excessively high valuations? And remember, at past secular market lows, stocks are significantly undervalued (not excessively overvalued, not normally valued). I believe the secular bear is far from over.

We may very well see the markets revisit the 2008-2009 crash lows before a new long-term secular bull market begins. I continue to believe we are in a choppy to sideways pattern similar to past bear market cycles. There will be some attractive low volume rallies, some violent declines, but net-net little progress over the next seven or so years (much like the past ten years and much like 1966-1982).

I believe it is important to have a portfolio game plan in place and be prepared to execute that plan. I think a typical portfolio should include a blend of both active and passive investment strategies. Rebalance the allocations periodically with discipline and tactically manage your equity risk exposure (reducing at optimistic extremes and averaging in at pessimistic extremes). Be careful with your bond exposure. I see low rates for now but higher rates in the future. Ladder a bond portfolio; otherwise, be prepared to defend rising rate risk. I believe a portfolio weighting of 33% stocks, 33% bonds and 34% Active/Absolute Returns provides a more balanced and better diversified path in this environment. This replaces the old 60% stocks/40% bond allocation baseline standard. I'm personally allocated to absolutes, I'm beginning to build a laddered tax free portfolio, and I trade my 401k more tactically (I remain 100% in cash in my 401k waiting for a pessimistic extreme investor sentiment reading tied to logical support / better valuations). Of course, your allocation and exposure should be tied to your needs, goals and time horizon. The overall key here is to combine Active management with Passive management and please please please do not chase returns in either category. I see far too many investors continually making the same old mistake - chasing returns just after a good move. Behaviorally, we humans believe in the long-term but all the statistics clearly show we behave short-term. That is not an investment plan. It is a question of balance combined with the discipline to follow your portfolio game plan. The top advisors in the business coach/guide their clients in this way.

There is a place for active investment management in most investment portfolios. We work with hundreds of independent investment advisors. Talk to us, we can show you how to include a portfolio of non-correlating active investment strategies with a passive portfolio and how this can help create a clearly defined and balanced investment game plan. There are many ways to grow money in the current environment. We can show you how our strategies correlate with the general markets and how our strategies and the general markets correlate with some of the popular funds used by many advisors. We have the resources and technology and can generate the reports you need to better educate your clients and help you grow your business through this very difficult investment environment.

Please reach out to your CMG investment advisor representative for additional information and of course please let me know if you have any questions.

With kind regards,
Steve

Stephen B. Blumenthal
President, CEO
CMG Capital Management Group, Inc.
150 N. Radnor Chester Road
Suite A150
Radnor, PA 19087
steve@cmgfunds.net
610-989-9090 Phone
610-989-9092 Fax

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