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CAPITAL IDEAS

HELPING CLIENTS BECOME SUCCESSFUL INVESTORS

VOLUME 12, NUMBER 2, APRIL 2009



THE ROAD TO SOLVENCY (CONTINUED) BY CHARLIE SMITH

Once the results are out, however, banks with the weakest balance sheets will be quietly told to either raise more private capital, sell assets, obtain more capital from the U.S. Treasury, or do all three.

For the sickest institutions, the result will be massive dilution to common shareholders and (perhaps) a haircut to creditors, much as we've already seen with Citigroup. In the meantime, the Fed has been busy cutting short-term interest rates and buying up longer-term bonds in order to boost the profits of banks. It's working; several large banks have already reported meaningful increases in first quarter earnings. Financial authorities are essentially trying to buy more time for the financial system by helping it heal itself through increased spreads on loans and securities. The problem is that at many banks bad loans are still increasing at rates equal to or greater than net interest income. Commercial real estate and credit card loans are the latest segments of the bank loan book to suffer outsized losses.

Essentially what we have is another chapter in the ongoing race between the deflationary effects of falling collateral values in the economy and the capital generating capacity of the banks (either through earnings or capital injections). Policymakers are determined to keep the current system viable, and are doing everything they can to prevent further deflation of asset values. Treasury Secretary Geithner and Fed Chairman Bernanke have said as much.

Recent indications of both a thawing in private credit markets and a lessening in the rate of decline in the real economy lead us to believe they are on the right path.

The journey will not be a smooth one, and the potential for sharply higher inflation down the road as a result of the Fed's massive money creation is real. That is tomorrow's problem, however.

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QUARTERLY REVIEW

BY: DENNY BAISH

Despite solid gains in the month of March, the major equity indices fell sharply in the first quarter (see accompanying chart). Double digit losses were the norm for both domestic and international stocks. The large-cap Dow Jones Industrial Average dropped a little more than 12%, while the MSCI EAFE index of international countries, lost 14%.



BENCHMARK INDEXES	
INDEX	FIRST QUARTER RETURN
DJIA	-12.48%
S&P 500	-11.01%
S&P MID-CAP 400	-8.66%
RUSSELL 2000	-14.95%
MSCI EAFE	-13.94%
BARCAPAGG BOND	0.12%

Investors continued to sell stocks during the first two months of the quarter, picking up where they left off in 2008. The initial reaction to the Obama Administration's plan to manage the credit crisis, rising unemployment numbers, declining auto sales, and the possibility of GM filing for bankruptcy were among a number of factors contributing to the declines in January and February. The markets began to turn around in March when some banks stated they would be profitable in the first quarter. The S&P 500 had its best monthly performance since October 2002 giving investors hope that the worst may be over.

In looking at the domestic stock market for the first quarter, small-cap companies lost more than their large-cap and mid-cap counterparts. In addition, value stocks significantly underperformed growth stocks due in large part to the weakness in financials.

International developed markets posted results similar to the domestic markets during the first quarter. The MSCI EAFE lost 14% on top of its 43% loss in 2008. On the other hand, emerging markets posted a surprising gain for the quarter: the S&P/IFCI Emerging Composite rose 1%. It appears that investors' appetite for risk is coming back, and that the markets most hit on the downturn will lead coming back.

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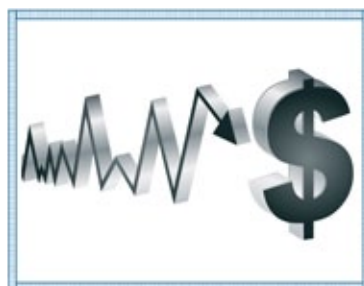
The fixed income markets turned in mixed results for the first three months of the year. After a disappointing 2008, high yield bonds bounced back, gaining 6%. Government bonds and corporate bonds were essentially unchanged during the quarter. International bonds underperformed all others in the bond market, finishing down 6%. This decline is due largely to the strength in the Dollar relative to both the Euro and the Yen. The Barclays Capital Aggregate Bond, a broad fixed income benchmark, ended the quarter essentially flat.



THE ROAD TO SOLVENCY

BY CHARLIE SMITH

Before we speculate on what might occur over the next few weeks with regard to the next phase of the ongoing tumult in the U.S. financial system, we wanted to briefly summarize what



happened to the system in the fall of last year. While it seems like ancient history, there's a need for clarity on this topic because, for some reason, both policy-makers and the media seem incapable of stating the facts.

It's a sort of "open secret" which no one wants to talk about. The fact is that the system nearly collapsed, and it avoided collapse only because the Federal Reserve created more than a trillion dollars out of thin air. In the fourth quarter of 2008, the Fed created enough new money to make whole the population of bank depositors, money fund shareholders, and derivative counterparties who demanded their money back. Cash, like all physical objects, cannot reside in two different pockets at one time. Either a depositor or a borrower has it, not both. And when a large enough fraction of the depositing public suddenly and simultaneously demands it back from intermediaries, the lender of last resort either steps in or the system fails. The

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ATMs worked last fall because the Fed stepped in. This was the "liquidity crisis" everyone talked about. The point is that we need to better understand it in order to see the way forward. It happened because a critical mass of market participants (you and me) recognized that many financial institutions might not be "solvent" (that is, have assets worth more than their liabilities) and therefore able to make good on their promises. Simply put, a solvency crisis begat a liquidity crisis. The Fed put a giant tourniquet on the liquidity crisis, and we've been working on the solvency crisis (i.e., working to save the limbs of the financial system) ever since. Some institutions may be beyond help. We wrote about two candidates for amputation (Citigroup and Bank of America) in our previous newsletter. The surgeons have been dithering and the crisis drags on because some of the very sickest patients are big enough and powerful enough to demand a second opinion. This second opinion is coming soon, in the form of "stress tests" being administered to the nation's twenty largest banks by the federal government. Results are due in the first week of May.

**SIMPLY PUT, A SOLVENCY CRISIS
BEGAT A LIQUIDITY CRISIS.**

Here is what we think will happen when the grades come out: First, none of the banks will fail the test. This is because policymakers believe (right or wrong) that the risks to the financial system of admitting the insolvency of a major bank are not worth taking.

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IS IT NEWS OR ENTERTAINMENT?

BY DOUGLAS KREPS

After a year and a half of negative stock market performance, investors' patience is wearing thin, even among those with long time horizons and after a rally that began in March. Perhaps no more telling of the tensions that are boiling over was the battle between Jon Stewart of Comedy Central and Jim Cramer of CNBC. The war of words is interesting to us, as it represents the changing landscape of how people get information and form opinions.



In the old days (1988!) we got our financial news from the *Wall Street Journal* and the business pages of local newspapers. CNBC began operations in 1989, and the financial media have evolved at warp speed ever since. Whether it was the Motley Fool website, or the more recent creation of mostly unedited (and unverified) "blogs," it seems that there is an insatiable demand for information about the economy, companies, and investor behavior.

Without question, the power of television and the internet have enabled individual investors to access information that just a generation ago was available only to the "professionals" on Wall Street. We have created an incredible system of information capitalism that delivers tools barely available to the pros in the early 1990's to the average Joe for free. Just watch the advertisements from the brokers on CNBC, and you will see tools that just a few years back would have cost thousands of dollars.

But is it for the better? Are we better served by the wealth of information, or is it distracting us from the fundamentals of investing? And has the financial press become as much entertainment as it is a tool to gain insight to help us manage our portfolios?

These answers are not clear yet, but we believe that sometimes less can be more. Our investment philosophy is based on three principals: is it *rational, repeatable, and ethical?* Rational investing comes from understanding the fundamentals of a company and the overall economy. If you do not want to do the hard work

to wade through the details of a company's quarterly and annual SEC filings, then you will not succeed, no matter how many Fast Money episodes you watch. If your strategy is not repeatable over time, then you will end up subject to the often random swings of emotion that the market presents every day. A sound strategy is key to long-term investment success. Last, and most important is ethics. Whether it be insider trading or outright fraud, we only learn about a firm's lapse in ethics after the damage is done.

Good research upfront can help determine whether a fund manager or corporate CEO has the right stuff, but at the end of the day, you have to trust the people you are investing with. If not, take your wallet and find someone who will be a good steward for your money.

As for Mr. Cramer and Mr. Stewart, we suggest that they are both on television because they provide entertainment. Sometimes we may get a nugget of political insight from Jon, and we may hear some good stock ideas from Jim. But synthesizing these nuggets into an investment strategy cannot be left up to the media. There is no substitute for a consistent plan and fundamental research.

After all, it's your money, not theirs.