



GHP Investment Advisors, Inc.

Quarterly NEWS

First Quarter 2009

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History Doesn't Repeat Itself, but it is a Useful Guide

We often use historical analogies to inform our thoughts about current economic and financial conditions. In recent months some clients have questioned whether the use of historical examples is appropriate if the current credit crisis is truly unprecedented and that perhaps the same rules do not apply.

We do not believe history repeats itself, nor do we believe that past patterns and problems will play themselves out in an identical manner in the future. Rather, past experience is merely a vast database to examine important relationships. Examples include the effect of interest rates on investment, the nature of how monetary policy impacts the financial system and inflation, the relationship between credit and unemployment, etc. The list is endless, but past experience is all we have when trying to determine the future impact of current conditions.

Of course, none of us know what the future holds, but we are forced to make decisions today that impact this unknowable future. We continue to believe that an understanding of current economic conditions, combined with a healthy but skeptical knowledge of history, helps us as investment managers to tune out the noisy chatter of the moment that may be contrary to our clients' interests.

Each business cycle is different. They differ in terms of their timing, causes and magnitudes. One thing that never changes, however, is that cycles contain upswings as well as downswings. Another thing that rarely changes is that people are generally surprised that the economy is cyclical. **During good times, the majority of people believe the boom will continue indefinitely and they believe the same thing in reverse when the inevitable downturn occurs.**

The most recent economic upswing started in mid-2002 and ended in late 2007. While the global economy experienced a period of general economic growth, we also witnessed the formation of three simultaneous bubbles: real estate, commodities and highly leveraged finance (which we have discussed at length in previous letters and will not discuss in this newsletter). There is a common link among these three areas: very low interest rates and excessive liquidity in the financial system.

The Real Estate Bubble

From our vantage point of managing your portfolios, we noticed the excessive risks in each of these three areas and we pulled our holdings back to almost nothing. A good example of our thinking is illustrated in **Table 1**, which highlights the average dividend yield paid by Real Estate Investment Trusts (REITs) over the past decade or so. Remarkably, dividends fell from a healthy 8.7% in 1999 to a mere 3.7% in 2006. This was due to the very strong price appreciation experienced by income producing real estate. Residential real estate, of course, experienced a similar phenomenon. That is why we not only avoided commercial REITs but all forms of mortgage-backed bonds as well.

As you can also see in **Table 1**, we use a yield benchmark of 6.7% to determine whether we believe the risks in REIT securities are too great. This number is based on our review of the historical relationships between real estate yields and long-term interest rates. We did not change this benchmark despite the fact that interest rates fell well below their long-term relationship with the inflation rate and REIT yields fell well below their relationship with long-term interest rates. Rather we chose to use these historical relationships as one of our guideposts to make the determination that the risks were great and becoming larger as time went on. **In this regard, we were quite pessimistic about commercial real estate despite the prevailing optimism at the time. Now that prices are falling, our interest will likely grow as yields improve.**



The Commodity Bubble

Similar to the real estate analysis above, we also develop benchmarks for commodities such as oil, natural gas, metals and agricultural products. We monitor these benchmarks to help us determine the risks prevailing in the marketplace. **Often psychology or excessive liquidity can disconnect prices from underlying fundamentals for a period of time.** Over the long run, however, commodity prices should eventually reflect the underlying costs of production, and this is how we determine our benchmarks.

A good example relates to our view of the oil markets. **Chart 1** displays the production costs for crude oil in different regions around the world. This chart comes from the Energy Information Administration (EIA). The EIA estimates that “lifting costs” for a barrel of crude oil ranged from a low of \$4 in Africa to a high of \$8.30 in Canada. “Finding costs” range from a low of \$5.26 per barrel in the Middle East to \$63.71 in the U.S. Gulf of Mexico. This means that as of 2006 (the latest information available) the marginal cost of production for a barrel of oil was around \$70.

The price of oil, however, pushed all the way to almost \$150 per barrel last summer. Moreover, as you can see from **Chart 1**, a marginal production cost of \$70 is likely a spike driven by the rush to drill at any cost during the bubble. In other words, the cost of rigs, personnel, drilling rights and other expenses were bid up during the boom. As recently as 2003 (just prior to the boom) total production costs in the Gulf of Mexico were closer to \$15 per barrel. As the boom ebbs and the cost of drilling rigs and other equipment declines, we believe that the underlying marginal cost of production will likely settle at somewhere between \$35 and \$50 per barrel.

Prices for oil company stocks fell precipitously last year to meet this changed reality. We believe this is an area of investment that may now offer reasonable risks and decent return opportunities. During the boom, boosters made the case that the fundamentals of the oil markets had changed because of growing scarcity and rapid economic growth in China and India. According to this viewpoint production costs could be safely ignored since they did not reflect the new realities as they did in the past. We agree that the long-term future of China and India remains bright and that they will continue to increase their oil consumption when the current downturn ends. We also believe that oil appears to be somewhat scarcer than in previous decades, but we remain firm that these facts will continue to be reflected in the rising marginal cost of production and that the market price will trend with this cost over time. Our pessimism about the oil boom was a reflection of our understanding of the relationships between oil production costs, their trends over time and the unrealistic market price. These factors are now reversing, thereby changing our assessment of this area of investment.

What about the Stock Market?

Corporate earnings have probably the most significant influence on the long-term direction of stock prices. As was emphasized above, investors seem to forget that the economy is cyclical and that corporate profits are no exception. Right now investors are spooked by the precipitous and unexpected decline in profits. **Chart 2** tracks the Earnings per Share (EPS) for the S & P 500 Index over the past 20 years. So far, earnings are down 32% from the peak in 2007 through December 31, 2008 (excluding the significant losses reported by AIG in the fourth quarter of 2008).

A historical pattern that is likely to repeat itself this time around is that deep downturns typically produce bigger profit recoveries, probably due to corporate America's lower cost structure as demand revives. In the first 36 months following the 1990 and 2001 recessions profits grew by 39% and 74% respectively. This pattern has repeated itself in every economic downturn.

The long-term growth rate for the S & P 500 Index EPS is about 7%. As you can see from **Chart 2**, this was the case from the peak prior to the 1990 recession to the next cyclical peak in 2000. During this period of time earnings doubled. Similarly, earnings grew from \$56.79 in 2000 to \$91.47 at the next peak in 2007. **You might remember that many pundits thought earnings were overstated in 2000 due to the lax accounting standards revealed in the Enron and other related scandals. During that period, many investors believed earnings might never reach their former highs, particularly with much stricter accounting rules coming into force. Yet profits grew 61% despite these rules, or an average of 7% per year.**



We believe that earnings will recover at some point in the near future and that when we arrive at the next peak, earnings will likely have grown significantly in the interim. We do not deny the current reality of rising unemployment, credit restrictions, mortgage foreclosures and other economic problems, we just believe that these cyclical phenomena will come to an end and we will enter a new growth phase.

Just as real estate and oil prices were unrealistically high during the boom based on overly optimistic “new era” thinking, **we believe that the current assumptions about a “pessimistic new era” of zero-profit growth are equally unfounded.** At present stock valuations, earnings do not need to grow at their traditional 7% rate to be significantly undervalued in our models.

Sources of Long-Term Economic Growth

Studies have shown that long-term economic growth is driven largely by innovation. Innovative business concepts and technologies open up new markets and allow existing industries to create new products and services as well as improve productivity. Some of the newer innovations are small in economic terms but will likely create millions of jobs in the future. The list is long, but a few examples include: the declining cost of video production and transmission, the ability to collect and analyze massive databases, the falling cost of global telecommunications, handheld computing devices (like the iPhone and Blackberry), social networking on the Internet, genetic testing, health care information systems, biotechnology, etc.

A permanent feature of an innovative economy is that the industries and occupations of the future are largely unknowable. This uncertainty stokes fear during periods of mass layoffs and economic slump. **Market psychology can drive prices to levels well beyond their rational intrinsic values—both too high and too low.** We try to maintain composure in both environments. We study past economic relationships to help us determine benchmarks for the rational intrinsic value of a variety of investment categories. When asset prices exceed our benchmarks we minimize investment in these areas, but when they are below our benchmarks we recommend investment. Our analysis, of course, is not foolproof, but based on this analysis we believe the stock market is at least 50% undervalued. **This is why we counsel staying the course.** ☞

Table 1
Real Estate Investment Trusts Average Dividend Yield

	Benchmark Dividend Yield	Actual Dividend Yield	Over/Under Valuation
12/31/2008	6.7%	8.3%	-19.3%
12/31/2007	6.7%	4.9%	36.7%
12/31/2006	6.7%	3.7%	81.1%
12/31/2005	6.7%	4.6%	46.6%
12/31/2004	6.7%	4.7%	43.8%
12/31/2003	6.7%	5.5%	21.4%
12/31/2002	6.7%	7.1%	-5.0%
12/31/2001	6.7%	7.1%	-6.2%
12/31/2000	6.7%	7.5%	-10.9%
12/31/1999	6.7%	8.7%	-23.0%
12/31/1998	6.7%	7.5%	-10.3%
12/31/1997	6.7%	5.5%	22.3%
12/31/1996	6.7%	6.1%	10.7%
12/31/1995	6.7%	7.4%	-9.1%
12/31/1994	6.7%	7.7%	-12.6%

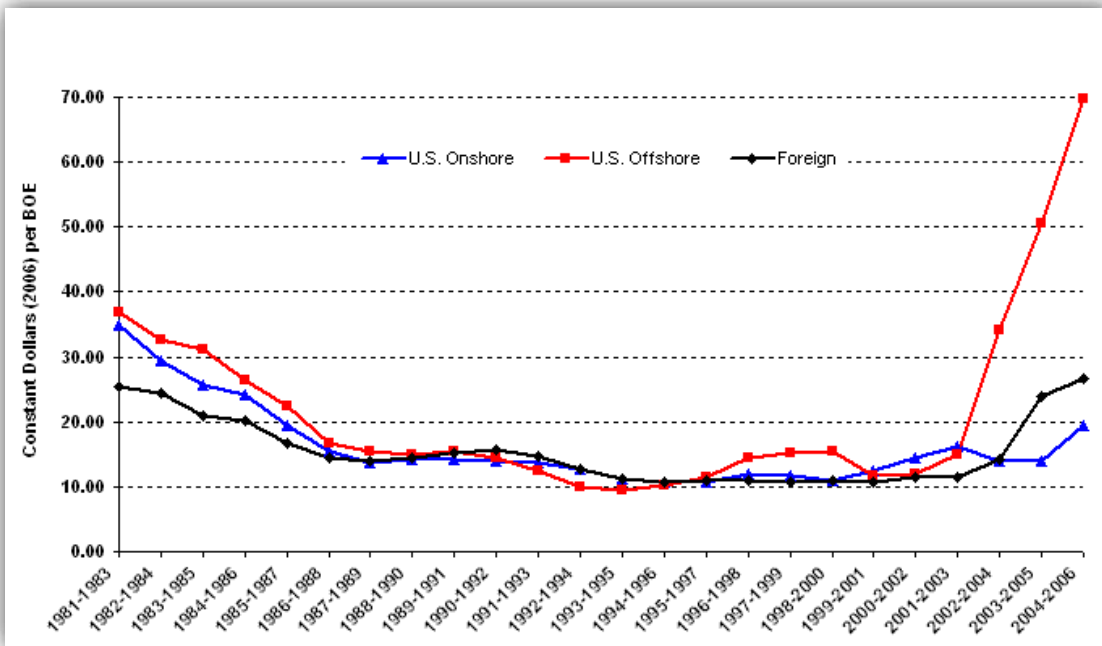
Notes: GHPIA benchmarks are based on proprietary models.

Source: www.nareit.com Performance Statistics by Property Type



Chart 1

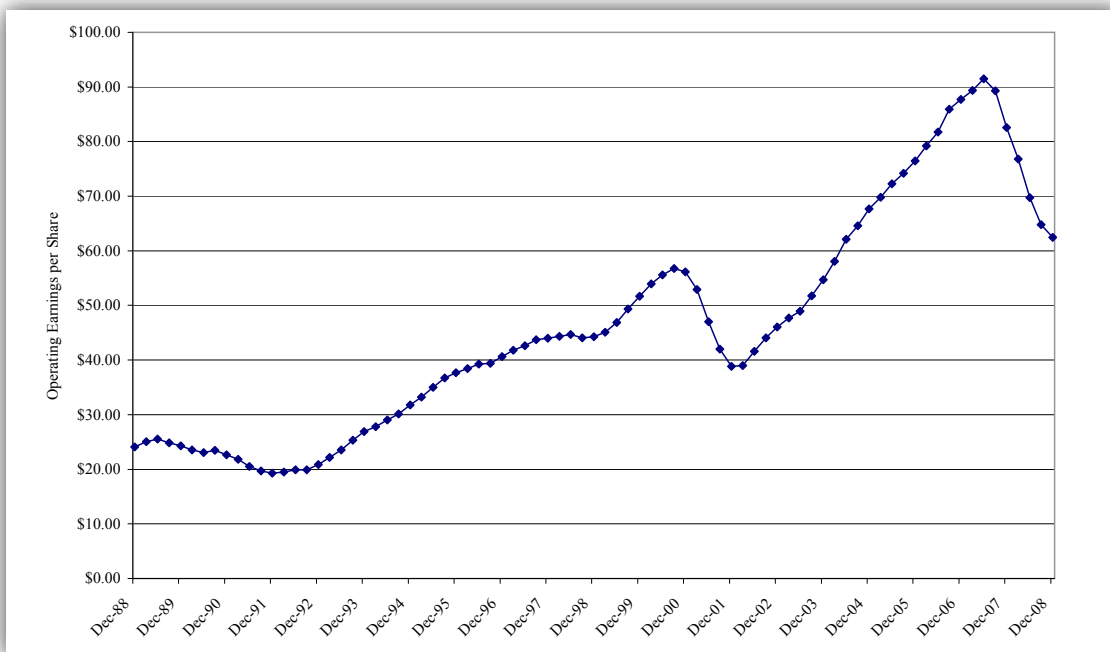
Total Upstream Costs per BOE for FRS Companies
1981-1983 to 2004-2006



Notes: Costs are the quotient of costs and reserve additions for each three-year period. BOE = Barrels of oil equivalent
Source: Energy Information Administration, Form EIA-28 (Financial Reporting system).

Chart 2

S&P 500 Index Earnings Per Share (1988-2008)



Source: www.standardandpoors.com.
Data as of 3/31/09



Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2009:Q1	P/E Benchmark	Over/Under Valuation	Price/Book Value 2009:Q1	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	11.1	27.0	-58.9%	2.6	5.7	-54.2%
Large-Cap Value Stocks	14.5	20.2	-28.4%	1.4	2.5	-44.0%
Mid-Cap Growth Stocks	10.9	24.8	-55.9%	1.9	4.5	-57.8%
Mid-Cap Value Stocks	12.6	19.1	-33.9%	1.2	2.2	-45.9%
Small-Cap Growth Stocks	12.6	23.2	-45.8%	1.5	3.5	-56.9%
Small-Cap Value Stocks	16.2	18.2	-10.8%	1.0	2.1	-52.4%

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.*

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 04/03/09.

Returns by Index

Index	YTD
DJIA Total Return*	-12.48%
NASDAQ	-3.07%
S&P 500*	-11.01%
S&P 500/Citigroup Value	-16.11%
S&P 500/Citigroup Growth	-6.18%
S&P MidCap 400/Citigroup Value	-12.11%
S&P MidCap 400/Citigroup Growth	-5.10%
S&P SmallCap 600/Citigroup Value	-18.78%
S&P SmallCap 600/Citigroup Growth	-14.85%

DJIA & NASDAQ: Dow Jones Industrial Average Index Total Return & NASDAQ Composite Index. Provided by Thompson Financial Company as of 3/31/09.

S&P Returns: Standard & Poors (April 1, 2009) Standard & Poor's Reports March 2009 Index Returns. Press Release.

**Dividends Reinvested.*

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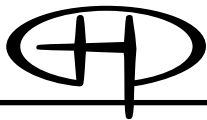




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