



Equity Market Overview – 3Q09 – A rally among low quality stocks

Paul Krugman, a Nobel Prize economist, said recently that “*the end of the world appears to have been postponed.*” During the Spring 2009 lows, it certainly felt as if the market was pricing the end of the world. We believe the recent market rebound is an indication that investors have moved beyond questioning the continuation of civilization, and instead are looking forward to an economy not just getting “less bad” but one that is showing signs of growth.

Recession “Likely” Behind Us

Economists are increasingly expressing belief the U.S. economy is no longer in recession. Even Federal Reserve Chairman Ben Bernanke stated recently the recession is “*very likely over*” but warned of a moderate recovery and characterized it as an economy that won’t “feel” strong in the near term. While we agree with Chairman Bernanke that challenges remain, we have two remarks regarding his overall tempered stance. First, he would not speculate on the condition of the economy without first having solid economic data to support the likelihood of the recovery. We are encouraged by strong retail sales data and sequential monthly growth in industrial output. Those numbers included temporary effects from the “Cash for Clunkers” program but also showed growth in sporting goods, entertainment and restaurants.

Second, we believe Chairman Bernanke and other

economists are likely *underestimating the strength of the ensuing recovery.* The current recession, which started in late 2007, is the most severe recession since World War II. Historically, the most severe economic contractions have been followed by strong economic recoveries. A review of post WWII recessions with GDP declines of 2.5% or greater, the subsequent period of economic growth has averaged 7.3% (Chart 1). Conversely, milder recessions such as those in 1990-1991 and 2001, were followed by more muted economic rebounds.

Chart 1:

Economic Recovery			
	<u>Recession</u>	<u>Contraction</u>	<u>1 Year</u>
Mild	1990-91	-1.40%	2.60%
	2001	0.10%	2.30%
	Average	-0.70%	2.50%
Severe	1953-54	-2.50%	7.90%
	1957-58	-3.70%	7.50%
	1973-75	-3.20%	6.20%
	1981-82	-2.70%	7.70%
	Average	-3.00%	7.30%
Current Recession			
Estimates	2007-09	-3.70%	2.40%

It is human nature to focus on headwinds the economy will face and assume this recovery will be similar to the most recent economic cycles. Yet, we

believe the 2.4% consensus forecast for GDP expansion is low considering the severity of this recession and past recessions with similar contractions.

Anatomy of a Rebound

As counterintuitive as it may seem, lower quality companies or “junk stocks” significantly outperformed higher quality companies during the third quarter. As investors’ appetite for risk has grown, stocks with higher debt and lower profit margins have appreciated to a much greater extent than more stable companies with strong balance sheets and lower earnings variability. “Speculative” has been used to describe the current market with many forecasting a pull-back. While we agree that portions of the market are suspect and unsustainable, it does not necessarily mean the market will trend substantially lower. Instead, we believe market “internals” are likely to shift in favor of quality stocks, similar to market behavior following the “junk” rally of 2003.

As global markets recovered from the Internet bubble, many lower quality companies led the market indices higher leaving fundamentally based investors, including Rushmore, struggling to match index benchmarks. However, staying true to the RIA investment process of constructing a portfolio of stocks based on superior financial characteristics proved rewarding as quality stocks drove market returns higher from 2004 into late 2007. In fact,

RUSHMORE INVESTMENT ADVISORS, INC.



during this period, the RIA US Large Cap Growth Portfolio returned 70.4%, outperforming not only the broader S&P 500 Index, up 39.3%, but also the Russell 1000 Growth and Value Index, rising 42.2% and 61.6% respectively. We are confident that as in 2004, the market will ultimately revert to rewarding financially sound companies such as those held in the RIA portfolios.

One telling measure regarding the quality of the market rebound is a comparison of stock returns based on the Altman Z-Score. Edward Altman is a New York University professor and bankruptcy expert who developed a formula using balance sheet and income statement ratios to predict the probability of a company falling into bankruptcy. Not surprisingly, over time stocks with high Altman Z-Scores (those unlikely to go bankrupt) have higher returns than those with low Altman Z-Scores. However, in the 3rd quarter of 2009, companies in the lowest 20% Altman Z-Score ranking rose nearly twice as much as companies in the top 20%. Since the March 9, 2009 low the bottom quintile has outperformed by a factor of 2.2 times.

Earnings Growth

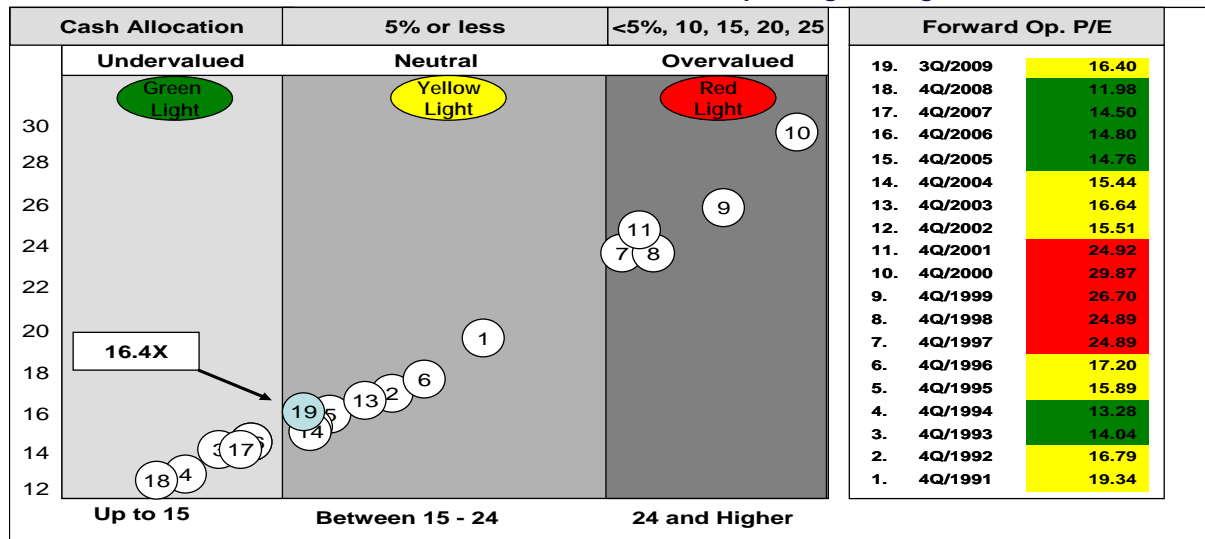
After dipping into the red in the 4th quarter of 2008, operating earnings for the S&P 500 have made a remarkable recovery, posting sequential growth in the first and second quarters of 2009 with reported earnings expected to be up 163% for calendar 2009 compared to 2008 (Chart 2). Operating earnings are expected to grow 61.4% over the next four quarters compared to the trailing four periods. Historically, price multiples expand as the market emerges from an earnings trough and the pattern has held true with the price-to-forward operating earnings ratio increasing to 16.46x (Chart 3).

Chart 2:

Economic / Earnings Outlook - as of 9/30/09						
	2006A	2007A	2008A	2009E	2010E	
Annual Real GDP	2.80%	2.00%	1.10%	-2.60%	2.40%	
CPI	3.23%	2.87%	3.85%	-0.50%	1.90%	
S&P 500						
Earnings Reported	\$ 81.51	\$ 66.18	\$ 14.97	+164%	\$ 39.35 \$ 45.84	
Earnings Operating	\$ 87.72	\$ 82.54	\$ 49.49	+35%	\$ 54.09 \$ 72.96	
Operating Chg. Y-Y (%)	14.77%	-5.91%	-40.04%	9.29%	34.9%	
P/E Reported	17.40x	22.19	60.34	27.95	26.61	
P/E Operating	16.17x	17.79	18.25	20.34	16.72	
Dividend Yield	1.75%	1.89%	3.14%	2.02%	2.35%	
	Close	Close	Close	Close	Est	
	12/31/2006	12/31/2007	12/31/2008	9/30/2009	12/31/2009	12/31/2010
S&P 500	1,418	1,468	903	1,057	1,100	1,220
12 Month Forward Reported P/E	21.43	20.24	21.38	25.48	24.00	
12 Month Forward Operating P/E	14.80	14.50	10.98	16.46	15.08	
DJ Industrial	12,463	13,265	8,776	9,712	9,950	10,950
Fed Funds Target Rate	5.25%	4.25%	0.0% - .25%	0.0% - .25%	0.0% - .25%	1.00%
10 Year T-Note	4.71%	4.03%	2.25%	3.31%	3.30%	4.00%

Source: Factset and www.standardandpoors.com

Chart 3: RIA Market Risk Indicator - P/FOE Based on Forward Operating Earnings



Source: Rushmore Investment Advisors, Inc.

RUSHMORE INVESTMENT ADVISORS, INC.



This level is in the lower end of the yellow range but we do not believe it indicates an overvalued market considering the expected profit growth and the current economic environment. On a calendar basis, S&P 500 operating earnings are expected to grow to \$72.96 in 2010 from \$54.09 in 2009, a 35% increase *and reported earnings will be up 164%*, so even with a decline in valuations the market could trend upward.

Summary of Style Performance

Equity markets continued the trend started in March 2009 with all major indexes advancing. The S&P 500 (TR) increased 16.0%, and the Dow Jones Industrial Average (Dow) and Nasdaq were similarly up, 15.3%

and 15.8% respectively. Every sector posted gains in the quarter but those most leveraged to an improving economy, such as Materials and Industrials, out-paced the overall market. Buoyed by a steep yield curve, the Financials sector posted the best returns, gaining over 25% in the quarter.

During the quarter, smaller capitalization stocks led larger capitalization stocks and Value continues to play “catch up” to Growth for the year. The Financial sector’s large weighting in the Value indices helped Value to outperform Growth in the quarter with the Russell 1000 Value (R1000V) Index gaining 18.3% and the Russell 1000 Growth (R1000G) rising 13.5%. For the year, Growth has significantly out-paced Value as the R1000G is up

25.4% YTD compared to 13.0% for the R1000V. We view much of the “froth” in the market coming from extended “value-plays” with higher debt and less attractive valuations. Historically, Value indices trade at price-to-earnings valuations below the Growth indices as investors are willing to pay for higher future growth. That said, the R1000G ended the quarter with a forward one-year price-to-earnings ratio (Weighted Average FY1 P/E) *lower* than the R1000V, despite *higher* expected growth, *higher* return on assets, *superior* profit margins, and *lower* debt ratios.

Most non-US equity markets also posted strong returns in the quarter with European indices rising over 20% in the quarter. After being the global stand-outs last quarter, several of the Asian markets posted gains, but saw greater volatility and muted returns compared to the U.S. markets. The MSCI China Index rose 8.2%, while the Shanghai Index, China’s domestic exchange, finished the quarter lower by 5.7%. Japan also saw weakness after the Democratic Party of Japan defeated the Liberal Democratic Party that had controlled Japanese politics for more than 50 years.

Outlook

We are optimistic that equity markets and the economy will both grow over the next year. With unemployment rates at just under 10% and continued job insecurity, Chairman Bernanke stated that many Americans will “feel” the economy is weak. However, if history is any indicator as previously mentioned, we believe many are

Index Returns (Data as of 9/30/09)	3Q09	1 Year	3 Years	5 Years	10 Years
<i>Large Cap</i>					
S&P 500 Index (Total Return)	15.61%	-6.91%	-5.42%	1.02%	-0.15%
Russell 1000 Growth	13.97%	-1.85%	-2.50%	1.86%	-2.56%
Russell 1000 Value	18.24%	-10.62%	-7.87%	0.90%	2.59%
<i>Mid Cap</i>					
Russell Midcap Growth	17.58%	-0.40%	-3.10%	3.75%	2.18%
Russell Midcap Value	23.62%	-7.12%	-5.65%	3.53%	7.43%
<i>Small Cap</i>					
Russell 2000 Growth	15.95%	-6.32%	-2.60%	2.91%	1.10%
Russell 2000 Value	22.70%	-12.61%	-6.65%	1.78%	8.05%
<i>Foreign Equity</i>					
MSCI EAFE Index	18.80%	-0.20%	-6.26%	3.33%	0.29%
MSCI World Index	16.90%	-4.69%	-6.38%	1.47%	-0.78%
<i>Fixed Income</i>					
Lehman US Government/Credit Intermediate	3.25%	10.01%	6.16%	4.68%	5.90%
Salomon 3-month T-bill	0.04%	0.39%	2.63%	2.96%	2.96%

Source: Zephyr Associates Inc. / Style Advisor

RUSHMORE INVESTMENT ADVISORS, INC.



underestimating the strength of the recovery. The market will react positively as analysts increase earnings growth to match better-than-expected economic news.

Where will the growth come from?

When the credit markets seized in late 2008 and early 2009, companies responded to the lack of credit and concerns about demand by significantly cutting production and depleting inventories. Production and inventories each declined over 10%, yet consumption only dropped 2%. A significant increase in production will be required to meet demand even at its weakened level. With a recovery underway in the financial markets, both secondary equity offerings and corporate bond issuance has surged as companies strengthen their balance sheets by increasing equity or trading volatile short-term borrowing with fixed long-term debt. The improvement in access to capital will continue to enable businesses to replenish depleted inventories and launch new products and services with growth potential.

Another encouraging fact is that many companies entered the recession with conservative capital structures. During the crisis, almost all slashed capital spending which increased cash on hand and created one of the largest corporate (non-financial) cash surpluses on record. As companies budget for 2010, many will be able to internally finance

delayed capital equipment and projects as CEOs and boardrooms position companies to take advantage of the economic recovery. Also, the \$787 billion stimulus package has only begun to trickle into the economy. With only a fraction of the allotted funds spent so far, the benefit to corporate profits and the economy will be evident in 2010 and beyond.

Washington

While developments in Washington are rarely a source of economic growth or catalyst to the markets, we do view the earlier headwinds created by the political landscape abating. Despite many investors' weariness towards President Obama and his policies, the market has had nine months to become familiar with the administration. Similarly, many investors viewed the reappointment of Ben Bernanke as Chairman of the Federal Reserve as a positive. Finally, healthcare reform is yet to be fully resolved but the broad outline is understood. With healthcare legislation likely to be behind us entering 2010 we are viewing the Healthcare sector more favorably.

In summary we are bullish on the economy and the equity markets, believing the current dynamics will shift from a speculative environment to one with market leadership based on fundamentals.

Thank you for your continued trust in RIA. We

know these market conditions are challenging. Please let us know if there is anything we can do to better serve you. Performance and characteristics for all RIA portfolios can be found on the following page.

*The Investment
Committee*

RUSHMORE INVESTMENT ADVISORS, INC.



RIA Portfolio Characteristics & Performance

Each of the Rushmore Investment Advisors portfolios posted positive returns for the quarter, although we are disappointed in relative underperformance compared to the benchmarks. As noted earlier in this newsletter, and in previous newsletters, we believe the pockets of the current market that are being rewarded is unsustainable and that “junk stocks” will not continue to outperform. We hold firm to our investment process and in our conviction that adding such low-quality names to RIA portfolios is a recipe for high risk and long-term underperformance. The following Portfolio Characteristics table demonstrates our commitment to constructing portfolios with superior profitability and return on equity, along with appropriate valuations that are in-line with growth expectations.

In the 3rd quarter of 2009, all RIA portfolios benefited from holdings in the Consumer Discretionary sector as investors anticipated a stronger economy and fewer headwinds to consumer spending. For example, Nike (NKE), a portfolio holding, posted solid gains as the company continued to expand brand recognition and growth opportunities across the globe. An underweight position in Financials detracted from performance, as well as holdings in the Healthcare sector due to uncertainty created by the Healthcare reform debate.

Summary of RIA Portfolio Characteristics				
6/30/2009	Large Cap Growth Equity	Small/Mid Cap Growth Equity	Non-US ADR Growth	S&P 500
Wtd Avg Market Cap (\$ in Bn's)	\$47,752	\$2,746	\$25,931	\$77,515
P/E Multiple T4Q (Reported EPS)	21.34x	21.81x	14.78x	22.26x
Forward 12-Month P/E Multiple	15.92x	17.03x	15.08x	21.39x
EPS Growth LTM %	14.75%	18.85%	19.12%	9.05%
EPS 5yr Growth %	12.93%	16.72%	13.17%	11.99%
Return on Equity T4Q	26.47%	18.82%	18.88%	18.53%
Net Profit Margin T4Q	9.96%	10.20%	13.21%	7.83%

Investment Portfolio	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception
US Large Cap Growth (Gross)	11.80%	25.21%	-2.42%	-1.47%	4.91%	1.18%	3.85%
US Large Cap Growth (Net) (Inception Date 5/31/98)	11.61%	24.57%	-3.11%	-2.23%	3.97%	0.10%	2.73%
Russell 1000 Growth	13.97%	27.11%	-1.85%	-2.50%	1.86%	-2.55%	0.04%
US Small / Mid Cap Growth (Gross)	7.18%	21.81%	-17.51%	-5.93%	1.19%	-	2.44%
US Small / Mid Cap Growth (Net) (Inception Date 12/31/00)	6.87%	20.87%	-18.34%	-6.83%	0.13%	-	1.31%
Russell 2500 Growth	17.17%	34.18%	-3.08%	-2.32%	3.74%	-	1.18%
Non-US / ADR Growth (Gross)	14.63%	25.64%	-7.23%	-2.54%	-	-	4.59%
Non-US / ADR Growth (Net) (Inception Date 3/31/05)	14.33%	25.02%	-7.88%	-3.34%	-	-	3.78%
MSCI EAFE Growth	16.81%	24.67%	-0.36%	-2.84%	-	-	3.71%



Performance Disclosure

Rushmore's composite performance results for the Rushmore products include actual total returns for all full discretion, non-wrap accounts in this strategy. These gross- and net-of-fee composite returns are calculated on an asset-weighted basis and include transaction costs and their investment of dividends. Past performance is no guarantee of future results. Further information on performance and conformance with GIPS Performance Presentation Standards is available upon request.

Performance data quoted represents historically achieved results and is no guarantee of future performance. Future investments may be made under different economic conditions, in different securities and using different investment strategies. The value of an investment may fall as well as rise. Please note that different types of investments involve varying degrees of risk and there can be no assurance that any specific investment will either be suitable or profitable for a client or prospective client's investment portfolio. Investor principal is not guaranteed and investors may not receive the full amount of their investment at the time of redemption if asset values have fallen.

Performance is expressed in US dollars. Actual performance may differ from composite returns, depending on the size of the account, brokerage commissions, investment guidelines and/or restrictions, inception date and other factors, such as the timing of contributions and withdrawals. Care should be used when comparing these results to those published by other investment advisors, other investment vehicles and unmanaged indices due to possible differences in calculation methods. Consultants and investors supplied with these performance results are advised to use this data in accordance with SEC guidelines.

Rushmore reports in compliance with CFA Institute Global Investment Performance Standards (GIPS). To receive a list and description of Rushmore's composites and/or a presentation that adheres to the GIPS-PPS standards, contact the firm at 1-800-564-8266.