Quarterly Newsletter

Market Commentary

Equity and credit markets continued to stage an impressive rally through the third quarter bringing year to date returns on most major indexes to over 20%. The recovery of financial stocks translated to higher performance for value indexes than for growth. Small cap stocks modestly outperformed large cap and a weakening dollar led to the international equity indexes outperforming the US. At the bottom in March, the equity market traded at its lowest valuation since the early 80s, discounting a near-depression. Now the market is discounting a slow economic recovery, which has made equity investing significantly riskier. As is typical of the early stages of a recovery from bear market lows, the rally has been dominated by low quality stocks. Highly levered and / or money-losing companies that were pricing in a high probability of bankruptcy in the first quarter are now being priced for an economic recovery.

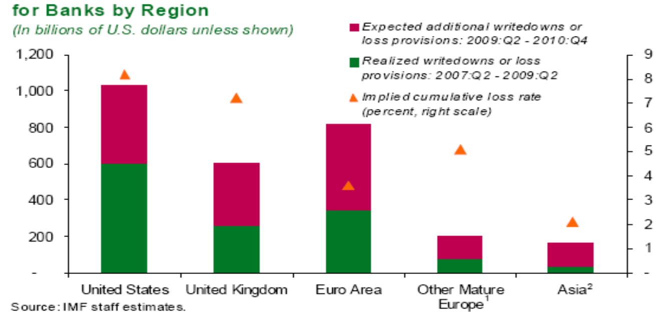
The result of the rally is that the margin of safety has largely vanished for most common stocks, particularly the riskier or lower quality companies. All that had to happen for stocks to perform in the first quarter was for the world to not end. At current valuation levels clear evidence of sustained economic growth over the next 12-18 months is necessary. Stocks are not overvalued, by and large, but are now fairly priced for the consensus economic forecast of 2010 US real GDP growth of around 2%.

If stocks are fairly valued now, the potential exists for them to become overvalued as a result of latecomers trying to not miss out on the rally and the need to deploy the still large amounts of liquidity sitting in zero-yielding money market funds. A more robust economic recovery than consensus view is also not beyond the range of possibilities. On the downside, potential still exists for a sustained period of zero real growth or a return to recession.

Expect more Banks to Fail

The banking crisis that began in 2007 has not ended. The chart from the IMF's October 2009 Global Financial Stability report shows that banks in the US are approximately 60% through recognizing the total loan losses, while European banks are less than halfway through. Commercial real estate loans will comprise the majority of future losses recognized by US banks as over a trillion dollars of commercial mortgages mature over the next three years. Regional banks that may have missed the subprime residential mortgage debacle face major challenges as their loan books are fully exposed to commercial real estate. The availability of cheap CMBS (securitized commercial real estate loans) priced regional banks out of financing core properties, resulting in disproportionate exposure to construction loans and lower quality assets. Construction loans comprise $462B out of $1,750B in commercial real estate loans held by regional banks, totaling 40% of equity capital for all FDIC insured banks. Small banks (<$20B assets) average 10% construction loans, which cannot be easily extended or refinanced, as there is typically no income and the property may not even be completed.

Figure 1.9. Realized and Expected Writedowns or Loss Provisions for Banks by Region



Source: IMF staff estimates.
[1]Includes Denmark, Iceland, Norway, Sweden, and Switzerland.
[2]Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

Government Deficits will Constrain Growth

The financial markets have not yet shown concern for the massive federal deficits projected over the near future. Since the Reagan era, US government debt has stayed between 60 and 70% of total GDP. Government sources project debt levels equaling 100% of GDP by 2010 and remaining at these levels the first half of the decade. The fiscal projections for the UK, Europe and Japan likewise show a dramatic increase in debt levels as a result of the financial crisis and various stimulus programs. At the very least, higher government debt levels require more tax dollars to service the debt which will result in lower economic growth than would otherwise be the case. With unemployment approaching 10%, sustained inflation remains unlikely barring a commodity supply shock. While inflation remains a risk for the intermediate term, it is likely that the money created by the Fed over the past twelve months has simply filled in the deflationary hole left by the massive destruction of wealth caused by the financial crisis.

This increased level of macroeconomic uncertainty requires a higher margin of safety for investing. No longer can a long term expectation of low inflation and the soundness of G7 currencies be taken for granted. While the most extreme inflationary scenarios remain a low probability, the consequences are severe enough that portfolios should take them into consideration. Exposure to multiple currencies and real assets are the primary ways for investors to protect themselves. Fortunately, this protection is relatively inexpensive today (which of course it will not be if and when any of these scenarios actually materialize).

Attractive Investment Opportunities Remain
MLPs remain the most attractively valued real assets. The large energy MLPs own and operate the core energy infrastructure of the US. For the most part they are toll-gathering regulated monopolies with little exposure to commodity prices. A diversified portfolio of these companies can obtain a yield of over 8% which should grow by 3-5% annually. Historical distribution yields have been closer to 6% and increasing confidence and interest in the sector will likely result in yields returning to these levels over the next couple of years.

High quality large cap stocks lagged the recovery, but offer the best long term return potential. The stock of companies with investment grade credit ratings returned -17.9% on average for the twelve month period ending September 30 (A rated or better returned -16.6%). Stocks with below investment grade ratings, excluding those who have gone bankrupt such as Nortel or General Motors, returned -23.3%, so even with the rally quality stocks outperformed by over 500 basis points.

While spreads have narrowed considerably, there are still selective opportunities in credit. High yield bonds currently have lower yields than they did prior to the collapse of Lehman, making broad index-oriented strategies unattractive. With non-investment grade corporate default rates currently above 10%, the supply of distressed and defaulted debt is increasing. Recent signs of stabilization in most housing markets and an increase in recovery values from foreclosures bode well for distressed non-agency mortgage backed securities.

Margin of Safety
"Confronted with the challenge to distill the secret of sound investment into three words, we venture the motto: Margin of Safety" - Benjamin Graham

Successful investing has always and everywhere depended upon being able to identify favorable risk and reward combinations. It is even more important today as the economic environment will likely continue to severely punish thoughtless risk-taking. The rally in equity and credit markets has enhanced the relative attractiveness of quality assets and diminished the potential returns of speculation. Investors should continue to focus on the long term, reserving near term liquidity needs in high quality fixed income. The assumption of risk in stocks or other assets should be done only with an adequate margin of safety – i.e. making sure there is room to survive with a modest loss should things go bad. While a smaller number of investment opportunities offer this margin than was the case six months ago, attractive long-term investments do remain available. Our goal is to continue to identify and monitor them for our clients.

Commentary by
Stephen C. Browne, CFA
Chief Investment Officer

News

***Paul Comstock Partners named** Five Star: Best in Client Satisfaction Wealth Manager*

Texas Monthly formed a partnership with Crescendo Business Services, an independent research firm, to identify the "best in client satisfaction" wealth managers serving the Houston area. The resulting list of 2009 FIVE STAR Wealth Managers represents those wealth managers in the Houston area that scored highest in client satisfaction. These wealth managers represent less than 2 percent of the wealth managers in the Houston area. For more details, please visit our website.

A special thank you to those who participated in the survey. We continue our commitment to treat each client as though they are our only client.

Smart Investing Monthly Conference Calls

Join us each month as we discuss current market trends, wealth transfer planning, and investment related topics. Our goal at Comstock is to provide you with information that enables you to make investment decisions you can trust. For more information on the upcoming calls listed below or to listen to recordings of past calls, please visit our website **www.paulcomstockpartners.com** under Smart Investing Resources.

Upcoming Call for Families

The Thanksgiving Project - Family Philanthropy In Action
Tuesday, November 03, 2009 - 11:00am Central/ 12:00pm EST

For some, it is difficult to start a conversation about wealth responsibility with their children or grandchildren. We have found that philanthropy can be a great tool for teaching both the young and old about financial responsibility.

We invite you and your family to join us to discuss questions such as: When is it a good time to talk to our kids about money? Where do we start? How do we get them involved and interested in philanthropy?

We suggest a simple yet powerful holiday project that begins at the dinner table during Thanksgiving and ends during the holiday season in December. We will discuss ideas you may use to help facilitate the conversation. We will also discuss ways to identify personal and family values that help make this process even more meaningful.

Join Paul L. Comstock, Chairman, and Alison Comstock Moss, VP Strategic Development, for a multi-generational approach to teaching wealth responsibility through philanthropy to the next generation. For a copy of the handout for this call, please visit our website, www.paulcomstockpartners.com, and click on the link to “download the supporting materials.”

Call Instructions for ALL Comstock Smart Investing Conference Calls

Dial **(888) 632 5950** and reference **Smart Investing Conference Call**. Please call **five minutes** ahead of the call start time. Each presentation lasts approximately 30 minutes and then participants will have the opportunity to ask questions.

Upcoming Call for Advisors

Master Limited Partnerships Explained
Thursday, November 12, 2009 - 10:00am Central/ 11:00am EST

In an effort to share the results of our most recent research and due diligence efforts, we would like to invite you and your colleagues to join us on our Smart Investing Conference Call tailored specifically to those who advise individuals serving as trustees.

Our November topic centers on the fact that:

- The Dow is up after a strong recovery rally, and
- Interest rates are at an all time low;
- Trustees of split interest trusts have a double burden of performance

We will explore the results of our recent extensive due diligence in a segment of the public market we believe offers attractive investment opportunities for trustees of split interest trusts. As you know, these trusts, under UPIA, as adopted in most states, require a trustee to consider the needs of both the income and remainder beneficiaries, the impact of inflation on each and management costs. In addition, how taxes impact the long term nature of a return is also an important considerations whether statutorily required or not. To that end we have been exploring MLPs (Master Limited Partnerships) and how they can offer a strong diversification opportunity when compared to the current pricing of traditional stocks and bonds.

We invite you to join Paul L. Comstock, Chairman, Steve Browne, CFA, Chief Investment Officer, along with J.C. Frey, Partner and Portfolio Manager, Kayne Anderson, to discuss the attractiveness of MLPs for inclusion in the funding of non-charitable split interest trusts.

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