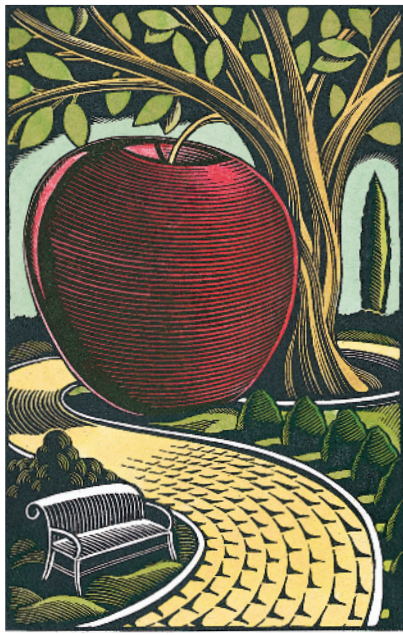


Investments

THE VIEW FROM LOWRY HILL

FOURTH QUARTER 2010



THIS ISSUE'S FEATURED TOPICS:

- ◆ Investor concern about slowing growth in the overall economy, coupled with renewed fears of deflation, pressured the stock market throughout the summer. Long-term investors are able to capitalize on this volatility by rebalancing in favor of equities. Contrary to the decline in share prices, corporate America is quite healthy.
- ◆ We continue to recommend that clients plan for several possible economic scenarios. While inflation seems a distant possibility, it can spike with little notice. Bonds have become quite expensive and will lose value with rising interest rates.
- ◆ We believe stocks are attractive relative to bonds. Stock dividend yields almost equal the 10-year Treasury yield, yet stock returns can gain additional benefit from earnings growth and multiple expansion. The tax on dividends may increase at year-end. However, corporations can move to stock buy-backs if the dividend tax rate goes much higher than the long-term capital gains rate.

MANAGING VOLATILITY

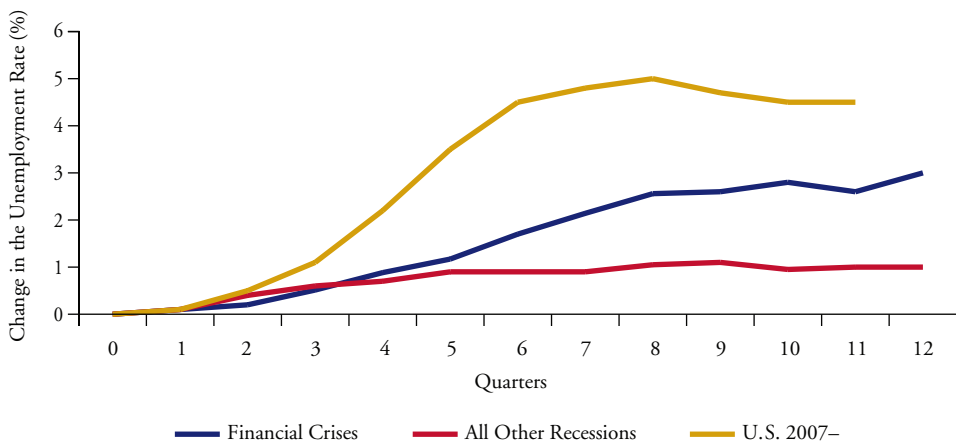
Moods again sank over the summer as investors worried about the possibility of a double-dip recession and deflation. Just a year ago, investors were in the opposite camp, concerned they were missing the rebound and afraid that inflation would spike. The key for long-term investors is to separate themselves from the “crowd.” As Warren Buffett stated, “Be fearful when others are greedy and greedy when others are fearful.”

For many investors, this methodical approach is hard to execute because it is so tempting to be swayed by the thinking-of-the-day. We encourage our clients to establish an overall asset allocation that is appropriate for their circumstances over short, medium and longer time horizons. Short-term market fluctuations can provide opportunities to rebalance.

THE OVERALL ECONOMY

Overall economic growth in the U.S. is still sluggish, particularly when compared to growth typically observed following recessions. The unemployment data has not significantly improved. If unemployment remains high (keeping wage growth low), consumer spending—which represents 70 percent of GDP—likely would remain lackluster.

CHANGE IN THE UNEMPLOYMENT RATE FOLLOWING BUSINESS CYCLE PEAKS
ASSOCIATED WITH FINANCIAL CRISES AND OTHER RECESSIONS



Source: Empirical Research Partners, August 2010. Data: 1960 through July 2010.

The Federal Reserve has indicated that it will keep short-term interest rates low as long as necessary. There is even conversation about instituting another round of “quantitative easing,” a monetary approach Federal Reserve Chairman Ben Bernanke has endorsed as a tool to combat deflation. With quantitative easing, the Federal Reserve would buy Treasury bonds and possibly other fixed income securities, keeping the yield curve lower than normal to encourage investment.

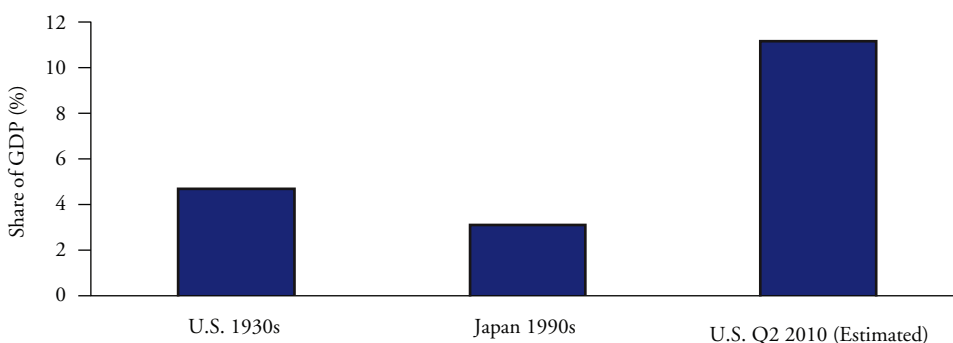
Low interest rates usually would lead to a pick-up in economic activity, but excessive debt also has to be paid down. High levels of debt can take years to alleviate, and there are no easy solutions. Over time, a combination of slow, steady economic growth and debt repayment would make the consumer sector of the economy stronger.

THE STOCK MARKET IS NOT THE ECONOMY

The economy may be sluggish, but corporate America appears quite healthy. Corporate profit margins are near record highs, thanks to tightly managed expenses and an improvement in revenue. Second-quarter earnings actually came in at a better-than-expected level. Revenue growth was solid, and cash flow was strong. Capital expenditures rose for the first time in a year (Empirical Partners Research, August 2010), and industrial production is rebounding faster than previous recessions (Ned Davis, September 2010).

The level of corporate profitability is quite high. U.S. corporate profits are almost three times higher than what has been seen in other recovery periods and account for 11 percent of GDP. Companies are flush with cash and have the ability to reinvest in new growth opportunities and/or raise dividend payments. Merger and acquisition activity has also gained momentum.

U.S. AND JAPAN CORPORATE PROFITS AS A SHARE OF GDP



Source: Empirical Research Partners, August 2010.

While concern remains that corporate earnings growth will slow, we believe the absolute level of profitability is high, and significant bad news is already reflected in stock prices. In addition, many large non-financial corporations participate in the growth of healthy international economies, including China and other emerging markets. These multinational companies have the ability to invest in and grow their overall businesses even if the U.S. continues to muddle through the recovery. Good investments can be made when prices are depressed. The key lies in appropriate asset allocation, periodic rebalancing and good stock selection.

SEVERAL POSSIBLE SCENARIOS

In our third quarter 2009 issue of *Investments: The View From Lowry Hill*, we discussed planning for several possible scenarios. Today, the average investor fears deflation. Under that scenario, owning high-quality bonds and cash would be a benefit. However, there is always the possibility of rising inflation; owning some assets that are poised for that outcome is also important.

ASSETS TO OWN UNDER DIFFERENT SCENARIOS

	Deflation/ Double-Dip Recession	Return to Normal (Inflation 2–6%)	Significant Inflation (6%+)
<i>Thesis</i>	<ul style="list-style-type: none"> ◆ Extended deleveraging ◆ Tighter lending ◆ Higher unemployment ◆ More wage pressures 	<ul style="list-style-type: none"> ◆ Credit markets heal ◆ Confidence is restored ◆ Profitability normalizes ◆ Employment rises 	<ul style="list-style-type: none"> ◆ Unprecedented global monetary and fiscal stimulus leads to high inflation
<i>Strategy</i>	Own high-quality bonds, less cyclical stocks and cash	Own equities	Own equities, real assets (commodities, energy, timber, real estate), Treasury Inflation Protected Securities
<i>Avoid</i>	All risky assets and leverage	Long bonds	Bonds

Inflation is a function of money and credit growth, the level of aggregate demand relative to capacity, and changes in wages and productivity. Currently, money supply and credit growth are modestly expansionary, overall demand is low, and wages are depressed (given high unemployment levels). However, these factors can shift rapidly. When inflation does rise, the value of “safe assets” such as bonds erodes, and the price of goods may increase—hitting bond investors with a double-punch.

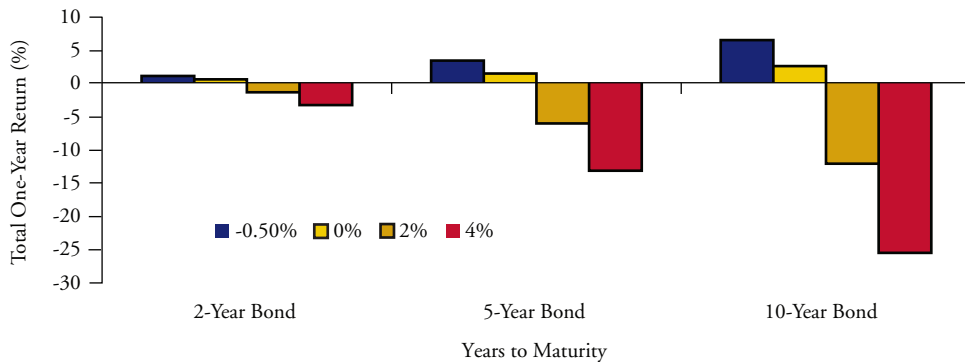
Our advice for clients is to establish an asset allocation that is appropriate for their particular circumstances, plan for several possible scenarios, and then rebalance at periodic points. We expect the stress caused by debt, deflation and an aging demographic profile to lead to continued volatility. Thoughtful, long-term investors can use these fluctuations to their advantage.

BONDS ARE EXPENSIVE—A BOND PRIMER

Today, assets like equities (that perform well in rebounding economies) appear relatively cheap while bonds seem overpriced. The yield on the 10-year Treasury bond has declined to 2.5 percent, a level not seen since the financial meltdown in December 2008 (and prior to that, not since the 1950s). A low yield equates to a high price.

Bonds are generally perceived as a “safe” investment, but when interest rates rise, bond prices decline. The price erosion of longer bonds in the face of rising rates can be significant. Investors who buy individual bonds will receive the face value at maturity, but the purchasing power of those dollars will be less with inflation. Bonds with longer maturities are more volatile than those that are shorter. The farther into the future a bond’s payment is to be received, the greater the bond’s price sensitivity to interest rate fluctuation.

TOTAL RETURN ON A BOND OVER THE NEXT YEAR AS INTEREST RATES CHANGE



Source: Bloomberg. The 0% columns reflect Treasury note yields as of 9/29/10. Assumes interest rates change X percent by 9/30/11.

In the current environment, we keep new purchases for our clients fairly short in length-to-maturity—generally less than 10 years, which makes the average life even lower. Additionally, we buy bonds opportunistically, looking for high-quality bonds at attractive prices. It is true that bonds (particularly very long ones) should hold value in the event of calamity, but this outcome is only one possibility among many.

PORTFOLIO CONSTRUCTION

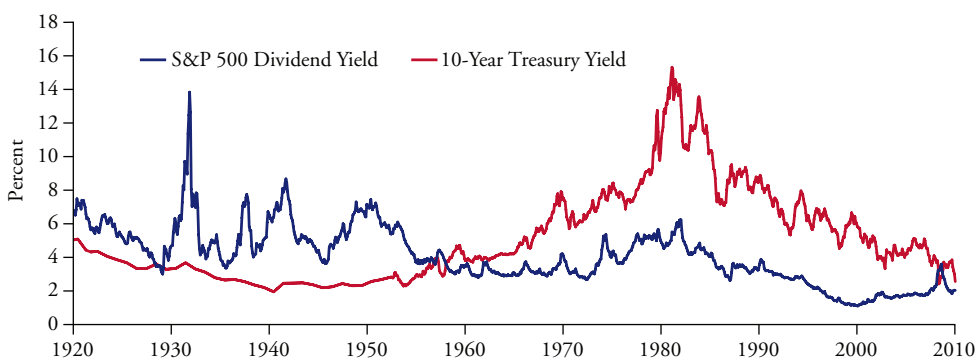
When we are establishing an asset allocation for our client portfolios, we assess a range of topics that include risk tolerance, need for capital preservation, outside income and spending, desire for liquidity, and the extent of leverage. There is a big trade-off between long-term savings and current spending. For some, wealth preservation is more important than growth. The asset allocation can be tailored to different long-term objectives.

Portfolios require periodic rebalancing to realign with the target asset allocation. We believe in the concept of “reversion to the mean” and take a contrarian approach (i.e., trying to buy when assets are out of favor and trim when assets have risen in price). Disciplined rebalancing becomes even more important in a volatile, but low-return environment.

STOCK SELECTION

We believe stocks are attractive relative to bonds. Today, interest rates are so low that the 10-year Treasury bond yield almost equals the S&P 500 dividend yield. This differential is down substantially from a peak in the early 1980s. Bond prices will decline with rising rates. Yet stock investments provide at least an equivalent yield, plus the potential for growth in earnings and expansion of the price-to-earnings multiple. With growing cash positions, companies are likely to raise dividend payments, buy back stock or invest in new growth opportunities.

S&P 500 DIVIDEND YIELD VS. 10-YEAR TREASURY BOND YIELD



Source: Robert J. Shiller, St. Louis Federal Reserve.

There is a possibility that dividend tax rates will rise at year end if the Bush tax cuts are allowed to expire. The impact of an increase largely will depend on whether the tax moves to the same level as the long-term capital gains rate (currently 20 percent). If the rates are equal, we believe little will change as it relates to corporate behavior and our investment strategy. However, if dividends are taxed at a much higher ordinary income rate (as much as 39.6 percent), we believe companies are likely to respond by favoring share buy-backs over cash dividends. In this case, investors would prefer capital gains rather than dividends. For those tax payers captured by the Alternative Minimum Tax of 28 percent, the incremental tax increase would be mitigated.

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