KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Strategy
July 2008

The past year has been a trying time of turbulence and an especially challenging period for investors of all persuasions. For perspective let us review some stock market results so far in 2008. U.S. large company stocks as represented by the S&P 500 declined 11.9% during the first half of the year. The average U.S. stock declined 15.5%. International stocks have fared worse with the FTSE Euro Top 100 Index of large European companies declining 21.8% and the Tokyo Nikkei index declining 12%. Advocates of emerging market investing had an even more exciting ride. The Chinese Hong Kong index, which is open to foreign investors, declined 22.1%. China's Shanghai index, open only to Chinese citizens, declined 49.6%. Meanwhile, the Indian market is down 41.4% during the first six months of 2008.

Momentum investors have clearly been withdrawing from stocks globally and, instead, have been moving assets in hot pursuit of rapidly rising commodities. Over the past year crude oil is up 98%, natural gas 88%, corn 116%, soybeans 95%, gasoline (wholesale) up 49%, and wheat 14%. While prices have primarily risen because of supply issues compounded by the rapid growth in demand from developing countries, the commodity run-up is also a function of the trillion plus dollars that are now "playing" the commodity markets in search of better returns. The ability of these prices to continue to rise nearly unabated despite a significant decline in worldwide growth expectations over the past year concerns us greatly. A doubling in prices is bound to lead to changes in consumer behavior and to demand destruction. We feel that these commodity prices are forming a bubble and strongly recommend to our clients the reduction or elimination of outside positions in this area. However, the conservative integrated oil companies we own have not risen to the degree of the commodity itself. The prices of these stocks may even rise with a drop in oil prices, as their refining and chemical divisions should have wider margins and become more profitable.

With all of this upward pressure on basic commodities, there is substantial inflationary pressure building in the economy, which is restraining stock prices due to the fear of lower future earnings. Official inflation has averaged 2.6% annually for the past ten years. It has risen to 4.1% for the past twelve months. Meanwhile, "real" inflation for real people has been closer to 4% per year over the past ten years and substantially higher recently. What this means for investors is that they must now focus on capital preservation in the face of both official and real world inflation that is likely to run above 4% for the next year or two and average about a third more than in the last decade.

Historically, the best investments during inflationary times were equities and real estate. Since 1970, there have been five periods that had negative economic growth coupled with inflation above 5%. During those periods, the S&P 500 returned an average of 6.2% while real estate returned 4.9%. As in earlier big commodity runs in the 1970's, we think the

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real long term winners will be the shareowners of the great companies that have flexibility, bargaining power, and pricing ability in a more inflationary, slower growth environment.

Financial stress and market turbulence is likely to continue to capture headlines over the near-term, but we believe the turmoil of this past year is also creating great opportunities for long term investors with at least a 5 year outlook. As the markets grapple with credit fears and higher inflationary expectations, the best stocks are indiscriminately dumped with the worst. In this unsettled and confusing environment we find many of the world's best companies have been temporarily put on sale. At present, the valuations of the best companies are at the same levels as the ordinary companies. In the middle of June, our research showed the 51 biggest and best global companies selling at 14.8 times earnings while the average company was selling at 14.6 times earnings. Yet the largest companies were twice as profitable and were growing about twice as fast as the average company!

Increasingly, we have been able to add new companies, such as globally iconic brands Disney and Nokia to client portfolios, as well as add to our best existing positions at remarkable value prices. These quality companies have a long history of being faithful to shareholders by returning cash in the form of dividends and share buy backs. The importance of these dividends in tough, inflationary environments should not be underestimated.

There are several good reasons to focus on dividends. First, many people, whether accumulating retirement funds or already in retirement, need or desire more predictable cash flows. Well-covered and growing dividend payouts provide this comfort while avoiding the sale of assets to meet current income needs during a down market. Second, contrary to popular market belief, recent studies demonstrate companies that pay dividends actually produced more growth across all time periods and market sectors during the past 50 years. It is likely that the management of companies that pay dividends are forced to be more careful and disciplined in their use of retained funds and are less likely to do "empire building" projects. Third, stocks with meaningful dividend yields and with consistent records of growth generally have less downside volatility in bear markets. Some recent studies show about 30% less volatility. That has been our own experience over 35 years and that fact should be of great interest to risk-adverse investors.

On average, our stock portfolios currently have a dividend yield of 3%, almost 40% higher than the S&P 500 average. Clearly, we want to own companies that increase their dividends at rates higher than the inflation rate. Dividend growth is essential for retired clients living off investment income seeking to retain purchasing power in an inflationary environment. A quick look at thirty of our core company holdings demonstrates both a stellar history of rising dividends (15% compound annual growth rate) and recent dividend increases (14%) well above inflation. Of course we have had some disappointments among the financials in the past year, notably with dividend reductions by Citigroup, Fifth Third

Bank, and Washington Mutual.

The following chart of top holdings shows the average yearly dividend growth rate over the past five years, the number of consecutive years the company has increased their dividend, and the percent of dividend increase in the past twelve months.

Name	5 Year CAGR	Years of Consec. Dividend Increases	Change Last 12 Months
Abbott Labs	7%	34	10.8%
BankAmerica	13%	29	14.0%
Carnival	33%	5	14.3%
ConocoPhillips	19%	8	14.6%
Chevron	12%	19	12.1%
Deere	19%	5	27.0%
Disney	11%	4	12.9%
Dover	7%	51	8.1%
Emerson	9%	50	14.1%
Exxon	9%	24	14.3%
General Electric	11%	32	10.7%
Honeywell	8%	3	10.0%
Intel	39%	5	23.9%
Johnson & Johnson	14%	44	10.8%
Nordstrom	27%	26	18.5%
Kraft	11%	6	8.0%

Name	5 Year CAGR	Years of Consec. Dividend Increases	Change Last 12 Months
Kimberly-Clark	11%	32	9.4%
Coca Cola	11%	44	11.8%
Lilly	6%	39	10.6%
Medtronic	14%	29	13.6%
3 M	10%	48	4.2%
Microsoft	19%	4	10.0%
Nokia	18%	11	47.6%
Pepsico	20%	35	13.3%
Pfizer	18%	39	10.3%
Procter & Gamble	11%	53	14.3%
Teleflex	12%	29	6.3%
Target	19%	35	14.2%
U.S. Bancorp	16%	35	6.0%
Wells Fargo	10%	19	11.0%
Average	**15%**	**27**	**14%**

We like the odds of owning these kinds of companies: dividend yields that are above average, dividend growth that is more than twice the highest annual inflation rate of the past twenty years, and a record of consistent and persistent dividend increases. Whether markets experience rainy or sunny weather, these factors keep compounding in our favor. Indiscriminate sell-offs are opportunities to add to and improve holdings, but staying the course with companies like these is the key to investment success and to achieving clients' long term goals.

We cannot predict the economy, nor the short term movements of the stock market, but most of the negatives are well known, have been more than fully aired by the media and presumably nearly fully incorporated in current stock prices. We expect the stock market will move erratically, but, as a whole, trend upward as the economy works through these different issues. Commodity prices should begin to subside in the next few months, relieving considerable pressures from the U.S. consumer. As these developments come to pass, we would expect a stronger stock market over the next few years.

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Keating Investment Counselors, Inc.