Investment Strategy
October 2009

The past year has been difficult for all participants in the economy. Investment portfolios and home prices suffered significant declines and many people lost their jobs or had their hours reduced significantly. The stock market reacted to the severe financial shocks of September and October 2008 by pricing to discount a second coming of the Great Depression. As discussed in our Investment Strategies earlier this year, we did not believe that such an extreme outcome was likely. As intense fear scared less disciplined investors out of the market, the more likely outcome was a once in a generation buying opportunity. In particular, our April Investment Strategy discussed the importance of staying invested in order to participate in the tremendous recovery that lay ahead.

By the end of April it was evident that an extreme outcome was not likely and the S&P 500 Index began the best seven-month period since 1938. Bank stress tests revealed that the banking system was stabilizing and capital markets were beginning to show signs of returning to normal through the issuance of substantial new equity and record amounts of new corporate debt. As we moved into the summer, housing sales and starts bounced from their lows and the rate of job losses finally began to slow. Second quarter corporate profits exceeded low expectations, as the substantial cost cutting of the prior two quarters resulted in improved profit margins. However, it became clear that companies had cut costs and employment well below the levels needed to support current demand and a rebound in industrial production and GDP was very likely. This rebound began to materialize in the third quarter and, by mid September, Fed Chairman Ben Bernanke declared that the recession had probably ended in August. By this time, investment grade corporate bonds had gone from fear driven yields above 9% to a more reasonable 6% or less and the stock market averages had climbed by more than 50% from their March lows.

With recovery underway, the discussion now moved to the subject of a possible W-shaped or double dip recession. However, history reveals that only one of the past twelve recessions since the Great Depression produced this double dip pattern: 1980 followed by 1981-2. In this case, the Federal Reserve rapidly raised interest rates and the government mistakenly tried to balance the budget long before the economy had fully recovered. These policy mistakes choked-off a tentative recovery and set the stage for the second, deeper recession. Those same two mistakes are very unlikely now. February's large stimulus plan is only now starting to be seriously spent and the Fed has officially stated that short term rates will be kept below 1% for the foreseeable future. In fact, world governments are in unison in keeping interest rates low while coordinating massive fiscal stimulus programs - significant reasons to believe the next two to three years should see continuing economic recovery.

Those same individuals raising the fear of a double-dip recession also argue that the stock market has recovered too quickly and is now over valued. Although there will be bumps along the way, we believe the stock market has only just begun a recovery that we see lasting three to five years. Recall that the bottom of the bear market was reached on March 9, 2009, after a 57% decline occurring over 17 months from the prior market peak on October 9, 2007. This was the third worst bear market decline of the past eighty years, exceeded only by the

1929 and 1937 bear markets. At its recent peak on September 15, the market had recovered 57% from the March low, but was still 32% below its October 2007 high. By comparison, bull market recoveries since 1932 averaged 45% in the first 12 months, but they averaged 164% over fifty-seven months. Additionally, since the recent bear market was so sharp and severe, there is good reason to believe this recovery will be above average. However, even if it is just average, we likely have more than 100% of gain remaining.

As a result, we believe most stocks have only moved from being ridiculously cheap to being significantly undervalued. Even more importantly for long term investors, the highest quality stocks have remained the most undervalued. Typically, in the initial surge of a bull market, the lowest quality sectors and companies lead the market rally. Companies whose very survival was in question are usually most viciously punished during the market decline and tend to snap back quickly. This is driven by risk takers buying up risky assets on the cheap in the hope of hitting the big strike, similar to investors buying up foreclosed homes for pennies on the dollar. Once this initial speculative rally dissipates, the more seasoned money will return to the market looking for the high quality companies that have benefited competitively from the downturn and are poised to emerge and lead the market forward.

We believe we are now close to this transition. In anticipation of this market move, we have been buying high quality companies at a discount to position client portfolios for the expected growth ahead. The following table shows many of the stocks we have been adding over the past twelve months. These are all high quality, dividend paying, leading companies that fit within our long-term focus and investment discipline.

COMPANY NAME	P/E 2010	10 YR AVG P/E	NET PROFIT MARGIN	5 YR AVG NPM
ABBOTT LABS	11.8	20.2	18.1%	13.8%
ACCENTURE	13.7	19.4	8.6%	5.6%
AFLAC	8.4	19.1	12.1%	9.7%
APACHE	10.8	16.7	22.6%	26.3%
AT&T	12.3	15.9	11.8%	11.0%
AVON PRODUCTS	15.8	21.9	7.1%	8.1%
BB&T	16.8	13.4	13.7%	25.6%
BRISTOL-MYERS	10.4	20.1	18.6%	12.4%
CHEVRON	9.7	13.1	7.6%	8.7%
COCA-COLA	16.0	26.4	22.8%	20.6%
ELI LILLY	7.2	22.4	24.5%	9.9%
22 COMPANY AVG	**13.1**	**22.3**	**13.7%**	**12.9%**
S&P 500	**15.2**	**19.3**	**6.2%**	**-**

COMPANY NAME	P/E 2010	10 YR AVG P/E	NET PROFIT MARGIN	5 YR AVG NPM
GENERAL ELECTRIC	18.4	23.3	9.4%	11.8%
HOME DEPOT	16.4	24.3	4.2%	5.8%
IBM	11.1	19.5	12.6%	10.1%
JOHNSON & JOHNSON	12.5	22.2	20.3%	19.4%
MEDTRONIC	11.9	31.5	22.3%	18.9%
NOKIA	14.3	26.7	7.1%	10.8%
PEPSICO	14.4	24.3	13.3%	13.8%
PROCTER & GAMBLE	14.2	22.3	15.6%	13.6%
STRYKER	14.0	34.0	17.1%	14.5%
WAL-MART	12.6	26.4	3.3%	3.5%
WALT DISNEY	15.1	28.0	9.3%	10.1%

Interestingly, even after participating in a market recovery of over 50%, these 22 stocks are still selling for an average valuation 13% below the S&P 500 and almost 40% below their own 10-year average PE multiple. Additionally, these companies have profit margins that average 13.7% versus 6.2% for the average of all S&P 500 companies.

Why are these stocks priced so cheaply? The answer is essentially because the best were the last to be sold. In particular, large pension funds and university endowments were forced to sell the last of their blue chip stocks in February and March to meet liquidity needs. For years they had been reducing high quality bond and stock holdings in favor of alternative

investments like private equity, hedge funds, commodities, and undeveloped real estate. These investments were supposed to have better returns with less downside risk during a bear market. However, these assets declined sharply along with all other asset classes. Even worse, they could not be readily sold and produced no regular cash flow, such as dividend or interest income. In March, Harvard announced that they didn't own any stocks. However, by April, Harvard faced a liquidity crunch due to the difficulty in selling their alternative investments, forcing them to cancel a major planned facilities expansion in Boston and to effectively borrow money to meet additional capital calls from private equity investments. The final tally for Harvard was a 28% investment loss for the year ended in June. Shortly afterwards Yale, Stanford, and Princeton reported similar results.

Additionally, despite the rally, individual investors have been avoiding stock funds in favor of bond funds. According to the Investment Company Institute, mutual fund investors poured $240 billion into bond funds so far in 2009, but only $14 billion into stock funds! Sadly, mutual fund investors have a perfect long term record of doing exactly the wrong thing by looking in the rear view mirror: avoiding last year's losers and buying last year's winners. This year they have fled stocks to buy last year's big winners - government bonds, which now offer yields of only 3.3%. In the opinion of a number of observers, including Warren Buffett, government bonds represent the most overpriced investment class. Of the money flowing into stock mutual funds, most has gone into developing and emerging market funds where the greatest economic growth is expected. However we believe the best reward-risk ratio and opportunity for participating in foreign growth is in large multinational firms with global consumer brands that typically get 40-60% of their revenues from outside the U.S. Unlike direct foreign investments, these are currently more cheaply priced and with much less risk.

Over time, we expect allocations to shift back towards easily understood, liquid investments that produce regular cash flows – old-fashioned stocks and bonds. Consequently, we believe patient stock investors in high quality, large companies will be generously rewarded for years to come. As value investors and reasoned contrarians, we are happy to take advantage of this tremendous investment opportunity.

In summary, we believe the really important question is not whether we may have a near-term correction in the stock market at any time - that is quite likely. We do not serve you, our clients, well by trying to predict the short term gyrations of the market – this is not a way to accumulate real wealth. More important, we focus on solutions to help you achieve your long-term financial goals. Since we believe that the next significant long-term move in the market is up, we have positioned client portfolios in the large high quality companies that offer strong reward-risk ratios and that will fully participate in the coming recovery.

Truly yours,

Keating Investment Counselors, Inc.