Investment Strategy
January 2010

The ability of the world economy and capital markets to recover from severe economic shocks was sorely tested over the past year as some of the more dramatic events in recent history unfolded. These events, which led to the first global recession since World War II, uncovered weaknesses throughout our financial system and economy. The 17-month period ending in March 2009 was the most painful market decline in two generations. However, this was followed by the sharpest market rally since 1938. Despite problems that still need to be resolved, this recovery stands as a testament to the resilience of the most successful economic system the world has known.

As we stand today, the economy is moving forward with a growing momentum that we believe is unlikely to get derailed over the next year. There are still massive government stimulus programs that have yet to be spent as well as unprecedented global economic coordination among world leaders. Additionally, nearly all of the world economies are recovering in unison. The resulting positive feedback will likely propel economic growth forward, even when the stimulus programs wind down at the end of 2010. Further, since the flight to quality peak last March, the roughly 12% decline in the U.S. dollar is starting to produce positive trade benefits for U.S. exports.

A key lesson to be learned from the past year is not to get overly pessimistic. The U.S. and global economies are far more resilient than most experts, average citizens, or TV pundits believe. Early last year, the news flow was incredibly negative as it portrayed the prospect of a complete breakdown of financial and economic systems. As you will recall, the media offered no hope for recovery, even as that recovery was beginning to unfold. To successfully invest through this crisis of confidence took faith in the American economic system and belief that better days lay ahead, even if one was unsure of the actual path to prosperity. This core belief is what Warren Buffett wrote about over a year ago in his op-ed piece in the New York Times ("Buy American. I Am."). Unfortunately, this belief is what many investors lose when times seem the darkest but bargain opportunities are the greatest.

The contrast between the beginning of this decade and the beginning of the last decade reveal the dangers of taking sentiment to an extreme. In January 2000, stocks had returned 18.2% per year for the previous ten years and were priced for continued great expectations at 33 times average earnings. Technology, the Internet, and the 'new economy' were going to solve all problems. Optimism could not have been higher. Indeed, no price was too high to pay for Internet related companies with questionable potential and no profits. Biotechnology and the deciphering of the human genome held the greatest promise of all: banishing disease. The economy was booming and there had not been a recession in nine years. With unemployment then below 4%, there were serious labor shortages and millions of technology workers had to be imported. The two business bestsellers were Dow 36,000 and The Great Boom Ahead. It seemed to be the best of times, but the boom mentality led to massive over-investment in technology and capital goods, and a "bust" quickly ensued.

777 EAST ATLANTIC AVENUE, SUITE 303 • DELRAY BEACH, FLORIDA 33483 • (561) 278-7862 • FAX (561) 265-1055

Now, in January 2010, exactly the opposite frame of mind prevails. During the past decade we suffered two recessions and two major bear markets and, despite the recovery, expectations are somewhere between miserable and muted. Additionally, the financial system went through its worst crisis since the 1930's. Today's best sellers suggest "range bound markets," the "new normal," and a "20-year bear market." We are now told that stocks are not for the long term because investing in an S&P 500 index fund in January 2000 resulted in a 24% loss (without considering dividends) for the following ten-year period. This, despite the fact that 96% of all ten-year rolling holding periods have been positive for stock returns, and 100% of all rolling twenty-year periods have been positive. Consensus today, fostered by the media, is that other asset classes are superior to U.S. stocks, especially bonds, emerging markets, and commodities. At Keating Investment Counselors, we strongly disagree with this approach of looking in the immediate rearview mirror to extrapolate into the future.

Throughout 2008 and early 2009 there was a massive flight to safety into U.S. Treasury bonds, with 2% yields, making them perhaps the most overvalued asset on the planet. As a result, ten-year Treasury bonds had a negative return of 10% in 2009, driving huge flows of money into corporate bonds. Our expectation for 2010 is that corporate bonds will provide little more than their 4-6% coupons. Of course, fixed income investments do provide an important complement in many client portfolios, generating income for living expenses and reducing portfolio volatility during market declines. However, equities will provide the bulk of wealth accumulation and defense against inflation over the next 5-10 years.

As for emerging markets and commodities, these were the two best performing asset classes over the past decade. The history of these markets tells us the probability of this continuing for another decade is highly unlikely. From a fundamental standpoint, we believe investors are far too confident that emerging economies will continue to grow exponentially, without any growing pains or bumps along the road. Additionally, we saw the extremely high prices commodities commanded in 2007-2008 as end-of cycle and speculation driven, rather than fundamentally driven, price increases. We do not expect to see these prices again soon.

We believe equities, multinational and U.S. large company stocks in particular, provide the best opportunity for wealth creation over the next decade. A primary reason for such optimism is that stocks are reasonably priced at 18 times trailing earnings and 15 times expected earnings, almost exactly their long-term average. As mentioned previously, this compares with 33 times earnings in 2000. A second reason is that large companies seem poised to begin reporting record increases in profits. Companies have slashed costs, productivity is setting new records, and companies have the largest amount of cash on their

balance sheets in 50 years. Even a small increase in sales will lead to sizable profit gains. These gains will increase management confidence; leading to re-hiring, new hiring, and new capital investment, further fueling the economic recovery.

Over the next decade, we expect that equities will provide above average returns as investors expectations are currently incredibly low. As for 2010, most pundits expect U.S. market gains of 5-10% and weak economic growth of 2.6%. Whether gains are below average or above average, the most relevant fact is that the highest quality, large multinational companies are priced cheaper than the average company, and 20-30% below their long term average valuations. Whether the economy turns out weaker or, as we expect, stronger than consensus, these companies are positioned to deliver strong earnings and dividends to investors on even modest revenue increases.

In summary, our clients experienced much better returns than those reported by index fund investors over the past decade. We are active value investors, not passive index investors, and we choose to buy when quality is on sale. In 2000 we did not buy into the overvalued sectors of the market (technology, media, and telecom were 42% of the market in 2000 versus 23% today), but took advantage of boring old-fashioned dividend paying companies like Abbott Labs, Apache, Johnson & Johnson, McDonald's, and PepsiCo when they were on sale. Ten years later, these companies had produced substantial gains: Abbott +59%, Apache +545%, Johnson & Johnson +38%, McDonald's +55%, and PepsiCo +72%. With dividends received, the gains were even greater. Meanwhile, even the successful technology companies have yet to see their January 2000 highs: Microsoft -42%, Qualcomm -47%, Intel -50%, Cisco -55%, and Dell -72%.

We are constantly amazed that people will hurry to buy almost anything at a "20% off sale," but when it comes to stocks they will shun anything that is marked down, no matter how high the quality. Investors forget that stocks are a share of ownership in a business which entitles them to the profits and dividends of the business now and in the future. We are only too happy to buy top quality stocks at 20-40% off, especially when they pay attractive dividends. We believe there are many opportunities still at hand, including whole sectors such as consumer staples, healthcare, and telecom. Bottom line, in terms of the economic, credit, and market cycles, we are closer to 1982 (false and persistent pessimism) than 2000 (false optimism). We believe many of the opportunities and rewards will be similar to the superior returns seen after past bear markets in 1982, 1991 and 2003.

Truly yours,

Keating Investment Counselors, Inc.