INVESTMENT STRATEGY
JULY 2010

After a 79.9% rally from the market lows of March 2009, the stock market is currently undergoing its first true correction. During the past quarter, the market has declined approximately 15% from the recovery high on April 23, 2010. This decline is entirely normal and to be expected after fourteen months of such large gains. In fact, in a July 1st interview on CNBC, former Federal Reserve Chairman Alan Greenspan described the current situation as "a typical pause that occurs in an economic recovery." He added that the "recent decline is more international than it is a domestic affair." Nonetheless, it has raised anxiety levels for many investors and consumers. An important contrast is the business community, which continues to gain confidence as indicated by numerous surveys of chief executives and other top managers. The confidence of company management is a key factor in reaching a fully sustainable economic recovery that no longer depends on government stimulus to drive demand.

Current investor anxiety was sparked by stories of fiscal and debt troubles among some of the smaller European nations, the uncertainties of financial regulatory reform, as well as a possible slowing of the Chinese economy. These issues have triggered fearful outcries from pundits and investors who believe the economy is susceptible to a double-dip recession and that the current bull market is nothing more than a 'suckers' rally'. Although these issues have the potential to restrain economic growth, we continue to believe that the important factors for a slow but steady recovery remain in place.

Why are we confident in the recovery of the U.S. economy when the average citizen is so apprehensive? History has shown that every recovery and bull market is led by confidence from the business community. To gauge management confidence we utilize surveys done by a number of different organizations, but more importantly, we are interested in actions that signify confidence such as dividend increases, acquisitions, and large investment projects. As an example, a recent Business Roundtable survey found that 39% of chief executives expect to boost their payrolls in the second half of 2010. Meanwhile, 43% expect no change and only 17% expect a decline.

In another survey, 30% of CEOs expect their overall industries to hire employees in the next year compared to 3% a year ago, while only 22% of CEOs expect industry employment to shrink in the next year compared to 86% with those expectations a year ago. In addition, a separate survey of senior finance executives found that nearly three out of four say their companies are now in growth mode. On the other hand, consumer confidence, which is uninspiring, tends to lag and does not show upward movement until well after a sustainable recovery is in place. Many describe this phenomenon as climbing the proverbial 'wall of worry'.

A further sign of confidence has been the large number of dividend increases during the first half of 2010. In fact, a Standard & Poor's study found that 136 of the companies included in the S&P 500 Index have raised their dividends in the first six months of 2010 and only two have reduced or omitted dividends. This contrasts with all of 2009 when 136 companies raised dividends and 78 decreased or suspended payouts. In addition, we have seen a multitude of acquisitions in the technology and healthcare sectors over the past year with more acquisitions likely in the Energy sector. Further, several of our investments such as Home Depot, Wal-Mart, and Intel have accelerated expensive capital projects during the downturn in an effort to gain a competitive advantage over competitors as the economy expands.

What gives these corporate executives growing confidence in the face of such uncertainty? A solid rebound in key elements of economic activity as shown by increasing current orders as well as more clarity regarding future customer demand in the form of advance orders. The need for clarity in the business world cannot be overstated. The financial crisis of 2008-2009 provided less clarity for future business plans than at any other time in virtually every current CEO's lifetime. This caused management teams to go into lock-down mode in which they cut inventories and payrolls far more than warranted. An example of management's trepidation was the move by the majority of companies to offer little if any long-term earnings guidance to analysts for the 2009-2011 timeframe. However, in a sign of recent confidence, economic bellwether FedEx Corporation recently offered its first full-year earnings forecast since the recession started.

There are several other economic indicators helping convince managers that the recovery will become self-sustaining. Sales of non-defense capital goods excluding aircraft were up 17.3% in May compared to a year ago. Total railroad carloads in the U.S., a key early indicator of commerce, were up 16.2% over the same period. Further, the amount of inventory held by manufacturers, retail outlets, and wholesalers compared to sales is at an all-time low, dating back to 1991, when these figures began to be tracked. We have also read anecdotal reports of significant shortages for parts in the industrial and technology sectors due to this overly severe cut back in inventories. These factors have resulted in recent increases in the number of weekly hours worked, wages, and the hiring of more temporary workers. In contrast, announced layoffs have dropped to the lowest level since 2007.

As a result of this increased management confidence, we are starting to see higher rates of capital spending on mergers and acquisitions, research and development, supply chain investment, and dividends to shareholders. As management

progressively loosens corporate purse strings, it naturally creates jobs both inside and outside the company which in turn increases consumer confidence. Of course, management can only increase spending if they have the resources. We are encouraged by the fact that the corporate "purse" is larger than ever before. In fact, a recent Standard & Poor's report estimated that non-financial companies in the S&P 1500 Index have more than $1 trillion in available cash.

It is important to keep in mind that, in our more than forty years of stock market experience, the most worrisome times have been when there have been no worries. An esteemed elder statesman among market strategists recently opined, "The historical truth in the stock market is you want to buy stocks when there is skepticism and fear all over the place and sell when everyone is feeling complacent." The fact that there is such a negative bias to the current news flow and the general investor psyche leads us to be more confident in our long-term investment decisions.

We accept the fact that there are several global issues that, combined with poor governmental policies, could derail the economic recovery. Based on past history and current data, we believe the probability of this happening is relatively low. However, we have to be conscious of these potential risks. As such, while we feel the best position is to be fully invested, we continue to remain in very conservative investments both from a quality standpoint and a sector standpoint. If the economy suddenly accelerated into high gear and widely exceeded growth expectations, our portfolios would likely lag the overall market due to their conservative deployment. However, we believe this positioning gives our individual clients the highest likelihood of successfully meeting their unique mix of portfolio goals for income, growth, and safety while minimizing their exposure to a possible worse than expected outcome.

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