INVESTMENT STRATEGY
APRIL 2011

Volatility returned to the markets as a number of global issues burst into the headlines. Unrest is sweeping across the Middle East as rising food prices and a regime challenge in Tunisia provoked demonstrations against several other long established autocratic governments. In addition, Japan suffered a tragic earthquake and tsunami that will certainly drop that country into recession and over the short-term dent worldwide economic growth. These uncertainties triggered a mild U.S. stock market correction of 6.4% that was actually overdue after the S&P 500 gained 28% from August 31st through February 18th. We do not believe these events are likely to derail the economic recovery, but they have brought future energy needs sharply to the forefront of public attention.

The developing dynamic in the Middle East is both hopeful and unsettling. Increasingly, young, educated, and media savvy populations are demanding democratic representation against autocratic rulers that have been in place for 20 years or more. Demonstrations are being spurred by a lack of opportunity for young professionals in these countries. Unfortunately, a change in governance is not likely to improve this situation in the short-term. Difficult transitions may lead to extended civil disorders and open the door for extremist groups to hijack a movement into unsavory waters. One is reminded of the Russian and Iranian Revolutions and the rise of Nazism in Germany as examples of extremists gaining control during tumultuous times.

The more immediate economic concern is international oil markets. Since the Mideast unrest began, oil prices have increased more than 25% to the highest point in more than two years. Despite what the media would have us believe, this increase in price is not due to a fundamental lack of supply, but due to precautionary inventory building and speculation that unrest could migrate and multiply across the region. The greatest risk to oil prices is if either Iran or Saudi Arabia becomes embroiled in similar turmoil. However, because of the size of their oil industries, these countries are wealthier and thus more stable. We would not expect either of these regimes to fall in the near future. When it comes to the current supply/demand dynamic in the oil markets, oil and natural gas production in Egypt is already back to pre-crisis levels. We would also point out that Iraq's oil production is ramping up and becoming a significant factor. Over the next few years, international oil companies are helping to increase Iraq's oil production by as much as 3 to 4 times the current level.

The other issue causing recent uncertainty is the horrific earthquake and resulting tsunami and nuclear disaster in Japan. These events were truly tragic and show that in spite of significant preparation, we are still at the mercy of both "Mother Nature" and flawed human institutions. The most stunning example of this is the loss of control of the Fukushima nuclear facility on Japan's northeast coast. Even though the facility had a large seawall designed to protect it from tsunamis, the recent earthquake was Japan's largest in recorded history and the resulting wave exceeded the engineering assumptions built into the plant's defenses. Even worse, it appears that Tokyo Electric had been lax for many years in

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its maintenance and safety work and was incredibly slow in reacting to the crisis. As a result, as much as 25% of the electric power on Japan's main island is down for an indefinite period.

The disruption of the third largest economy in the world will certainly be a restraint on worldwide economic growth by at least 0.5% for the next quarter or two. However, this slowdown will be more noticeable in Asia than in the U.S. Despite its size, Japan only represents 1.2% of U.S. bilateral trade. What is more difficult to estimate is how extensive the effects will be on global supply chains. Japan is a major producer of parts for many complex automotive, industrial, and technology products. Without these critical parts, products cannot be completed and thus cannot be sold. As an example, Japan makes at least 15% of the parts that construct Boeing's major jets. This kink in the supply chain will delay sales and reduce short term economic growth. However, these lost sales are due to a lack of supply not a lack of demand, and therefore, shouldn't have significant long-term ramifications for a still strengthening economy. In summary, these catastrophes will undoubtedly hurt growth in the short-term, but reactions to major disasters such as hurricanes and earthquakes usually lead to a jump in economic growth for the intermediate to long-term.

As mentioned earlier, a major result of these recent global events is a renewed focus on securing our future energy needs. Currently, the most important component of U.S. electricity production remains coal which provides cheap and readily available energy that is domestically sourced. However, the environmental and pollution costs of coal are large which makes it likely that the proportion of electricity generated by coal will decline in the future. Nuclear power was expected to fill much of the void left by coal, but after recent events we do not see this as likely. Oil will remain the most important transportation fuel for the foreseeable future but using more oil for electricity generation isn't rational or economical. Wind, solar, and geothermal are alternative energy sources but they are presently very costly. Without government subsidies, most of these technologies are not economically competitive with more traditional energy sources. We believe it will likely take ten to twenty years before these sources could begin to play a significant part in our overall energy production.

The most logical energy source to fill our future needs is the deep shale reserves of natural gas being unlocked in the continental U.S. by advanced drilling and fracturing techniques. Natural gas burns 30% cleaner than oil and 60% cleaner than coal and is also much cheaper, reliable, and available within our borders. In addition, technology is already available to make natural gas a primary transportation fuel if the commitment to installing the needed infrastructure is made. As an example, natural gas service stations recently opened in Rifle and Grand Junction, Colorado, allowing passenger vehicles to travel from Los Angeles to Denver entirely on natural gas. The drawbacks are that natural gas is difficult to transport and the new techniques to tap shale rock have come under criticism for some accidents that led to ground water pollution. These accidents have generally been caused by human error because of the general lack of experience workers have in this rapidly growing, emerging industry. Through a combination of proper incentives, monitoring and regulation, these issues should be largely overcome.

As an investment opportunity, we do not believe the actual drilling companies will necessarily be the greatest beneficiaries from the movement to higher natural gas usage. While the major energy companies we own will generate a good return from gas drilling, these companies are primarily held to provide portfolios with consistently growing dividends and protection from inflation. Since the oil company stocks have already moved up 25-40%, the more interesting investments at this time are the companies that service the natural gas industry through drilling services, natural gas distribution infrastructure, and gas turbine power plants. In anticipation of this trend, we have already added a number of well positioned companies to client portfolios over the past few years.

To give just a few examples, Dover Corporation controls over 50% of the market for drill heads, bearings, piping, sucker rods, and pressure sensors needed for horizontal drilling. Dover is also a leading producer of fluid pumps used heavily throughout the oil and gas, biofuel, and chemical industries. Honeywell International is involved with natural gas distribution as the maker of valves, gas meters, gas filters, and pressure regulators. Honeywell is also involved with the cleaning and refining of natural gas. General Electric is a leader in natural gas turbines as well as nuclear power turbines. However, GE is far more dominant in natural gas than nuclear power, so the nuclear accident in Japan could end up a net benefit for the company. GE has also focused on expanding their deep water oil servicing business during the past year through several acquisitions. As an aside, we will point out that GE does not appear to have any legal liability for the ongoing nuclear accident in Japan even though they were involved in building the reactors 40 years ago. Under Japanese law, the plant operator has sole responsibility for the safe operation of the power plant.

Meanwhile, the markets have remained surprisingly resilient in the face of heightened uncertainty. The first quarter of 2011 has actually been the best first quarter since 1998. Going forward, we expect the markets to remain volatile as recent events continue to play out. Oil prices will likely stay elevated as long as there is unrest in the Middle East. We would also not be surprised by another, larger market correction. Although the S&P 500 Index suffered a mild correction of 6.4% during late February to March, since then, the market has bounced back strongly. It would not be unusual to retest these recent lows. In conclusion, despite heightened market volatility, we still strongly believe that high quality, dividend paying equities are the best asset to hold for intermediate to long-term investors.

Truly yours,

Keating Investment Counselors, Inc.