INVESTMENT STRATEGY
JANUARY 2011

The year 2010 was quite eventful, but not in the ways most "experts" and market forecasters predicted. Among other things, they predicted single digit returns for U.S. stocks and double digit returns for Chinese and Brazilian equities. The Shanghai Index (China) did have a double digit return, but it was a negative 14% compared with a positive 12.8% for the U.S., while the Brazilian Index was up a mere 4%. This again demonstrates that having the best reported economic growth doesn't mean investors in already overvalued (high expectation) equities will benefit from that growth. Forecasters also predicted that Europe would soar and the dollar would plummet. Instead, the European Stock Index was up a puny 1%, the Euro was shunned versus every other currency, and the dollar actually appreciated for the year. The strong performance of U.S. equities was the result of corporate profits that continued to exceed expectations and modest initial stock valuations that provided ample room for appreciation. In short, with low expectations, conditions were ideal for the U.S. to surprise on the upside, but few saw this and fewer still took advantage of the opportunity.

Of course, critics will assert that ruin is right around the corner and realization of their prior predictions is merely delayed. We believe a less dramatic and far more positive outcome is again the most likely scenario for 2011. Leading economic indicators are the most positive they have been in seven years. As it stands today, the economy continues to see positive trends in consumer spending (+5.5% over the holidays), capital goods orders (+14.4%), job openings (+23%), and employment (800K more jobs than a year ago). In addition, the government finally resolved the vexing tax issues in a manner that should provide added stimulus to the economy in 2011.

Through a last minute compromise, Congress agreed to extend the current Bush tax cuts for another two years. This offers more certainty and confidence to consumers, small business owners, and investors. The compromise also included a one-year, 2% reduction in payroll taxes that will lower 2011 tax bills up to $2,136 for each working American. Additionally, Congress provided an accelerated depreciation plan for companies that make capital investments in 2011. This plan allows companies to write off 100% of the capital goods they purchase in 2011, creating an incentive to spend on these items now. This should boost corporate spending and growth broadly across the economy. Outside of a major unforeseen and unlikely economic shock, all these factors should provide extra incentives for job growth and the economy in 2011.

As you may recall from our past letters, and especially our October 2010 Strategy, we spent considerable time over the past year describing the unhealthy state of the fixed income market because of its extreme popularity as a refuge for frightened investors. In last quarter's investment strategy, we laid out the key facts describing how unattractive current interest rates are for long-term investors and how the likelihood for long term

investment success from current interest rate levels is low. As the economy improves, these historically low interest rates have no where to go but up. During the past quarter, we began to see investors shifting away from government and municipal bond mutual funds. The resulting lower demand helped push down prices in these bond markets, driving interest rates higher despite the Federal Reserve's extreme efforts to keep rates down. The municipal market was further impacted by growing default anxieties, resulting in the worst quarterly performance in municipal securities since 1994.

We expect this trend to continue in 2011 with rates pushed higher by a steadily improving economy. Added pressure will come from the massive amount of bond issuance that will be required by corporations and governments over the next few years. This is a potent recipe for declining bond prices. We see the fixed income markets providing needed income stability for appropriate portfolios but do not expect appreciation from this asset class in 2011. However, by the end of 2011, we would expect the long-term fixed income market to be far more attractive for investment. Our current fixed income strategy is to focus on short to intermediate term maturities in the corporate bond market until the situation improves for long-term investors.

For equities, despite interim corrections, we expect 2011 to be as good as or better than the past year. Worries are a key foundation for bull markets. The news will continue to focus on extreme predictions that, while possible, are not probable. From a historical perspective, equities, especially our favored large, high quality dividend paying segment, are still undervalued. For the companies we own, the past few years have strategically been very important. The end of the "easy credit era" provided an ample assortment of reasonably priced acquisition targets for these large disciplined companies. These strong companies were able to secure key niche technologies, refresh or refill their product pipelines, expand their global scale and footprint, and gain stronger positioning on competition through apt acquisitions. These actions should result in higher growth and greater profit margins in the years ahead.

Barring an unlikely economic shock, we expect the high quality segment of the equity market to return more than 10% in 2011, as they emerge from a long period of under appreciation by the marketplace. The top-tier companies we own are still valued more cheaply than their lesser peers, despite consistently maintaining higher profit margins and earnings, while also possessing higher growth potential from their above average exposure to rapidly expanding developing markets. The following table displays part of an internal study comparing the high quality large stocks held in our client portfolios with the average large company represented by the S&P 500. The study includes 30 of the largest positions we currently hold across client portfolios (of course,

no portfolio contains every one of these stocks). The table demonstrates that the dividend yield, average profit margin, and revenue growth of these high-quality companies are greater than the S&P 500 universe of stocks. For example, despite being cheaper in PE valuation, the dividend yield average of 3.0% is more than 60% higher than the stock market average of 1.8%. It is also important to note that 27 out of the 30 companies increased their dividend in 2010 and most have increased their dividends consecutively for ten years or more.

COMPANY NAME	P/E 2011	DIV YIELD	NET PROFIT MARGIN	REVENUE 5 YR AVG GROWTH
3M COMPANY	14.6	2.4%	15.8%	3%
ABBOTT LABS	10.3	3.7%	18.6%	10%
ACCENTURE	15.0	1.5%	8.3%	7%
AFLAC	9.4	2.1%	12.7%	7%
AT&T	12.0	5.9%	10.8%	19%
BB&T	18.8	2.3%	8.5%	10%
BRISTOL-MYERS	12.0	5.0%	19.1%	3%
CHEVRON	9.4	3.2%	8.5%	-1%
COCA-COLA	17.6	2.7%	24.9%	8%
CONOCOPHILLIPS	11.2	3.2%	4.5%	-1%
DISNEY (WALT)	15.4	1.1%	10.3%	3%
DOVER	15.4	1.9%	8.5%	-1%
EXXON MOBIL	11.5	2.4%	7.8%	-2%
GENERAL ELECTRIC	14.9	3.1%	7.8%	-1%
HARRIS CORP	9.7	2.2%	11.6%	11%
30 COMPANY AVG	**13.3**	**3.0%**	**13.2%**	**5%**
S&P 500	**14.0**	**1.8%**	**8.3%**	**2%**

COMPANY NAME	P/E 2011	DIV YIELD	NET PROFIT MARGIN	REVENUE 5 YR AVG GROWTH
HOME DEPOT	16.1	2.7%	4.7%	-7%
HONEYWELL INT'L	21.2	2.3%	7.7%	2%
IBM	11.9	1.8%	13.9%	2%
INTEL	11.1	3.4%	26.2%	1%
JOHNSON & JOHNSON	13.0	3.5%	20.9%	5%
KIMBERLY-CLARK	13.0	4.2%	9.6%	5%
LILLY (ELI)	7.7	5.6%	23.5%	10%
MEDTRONIC	10.5	2.4%	22.5%	8%
MICROSOFT	11.2	2.3%	30.2%	8%
NOKIA ADR	12.1	4.8%	5.7%	5%
PEPSICO	14.6	2.9%	11.9%	9%
PROCTER & GAMBLE	15.7	3.0%	14.3%	4%
STRYKER	15.3	1.3%	17.9%	8%
VERIZON COMM	16.0	5.5%	5.9%	7%
WALMART STORES	12.4	2.2%	3.3%	6%

In 2010, smaller, lower quality stocks appreciated the most. In 2011, we expect that, as investors flee depreciating fixed income securities, they will logically move into dividend paying, high-quality large U.S. companies. Although these seemingly boring companies are not appearing on many year-end hot stock pick lists, they have proven their competitive advantages and superior management consistently over time. For instance, over the past decade the Standard & Poor's 500 Index ended about 5% below its level 10 years earlier. However, high-quality stocks, as shown by the Standard & Poor's Dividend Aristocrats (companies which have raised their dividends every year for 25 years or more), fared much better than the average, gaining 104% during the same ten-year period. We strongly believe quality and dividends do matter and even more so when they are on sale!

Truly yours,

Keating Investment Counselors, Inc.