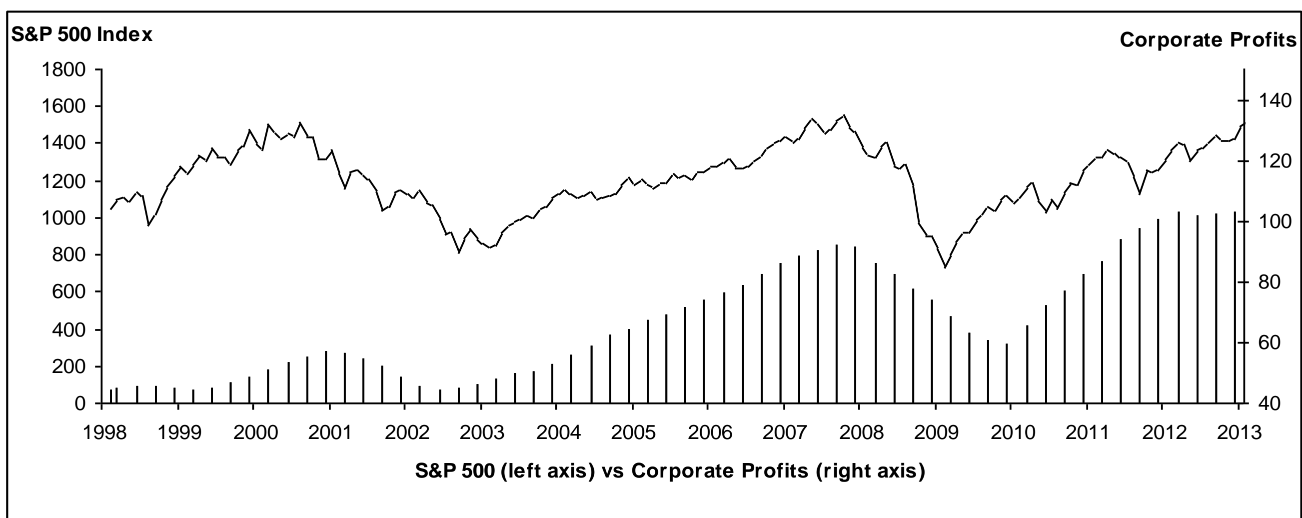
INVESTMENT STRATEGY
APRIL 2013

In spite of a lack of participation by large segments of investors, the S&P 500 Index made a new all-time high during the first quarter. Thus far in 2013, the S&P 500 has gained 10%. Much more impressive is the 132% gain in the Index since the market bottom in March 2009. Despite these gains, there is no shortage of market forecasters predicting an imminent crash for a variety of reasons. We are encouraged by this skepticism because it provides the "wall of worry" that all long-lived bull markets climb. These fears and negative forecasts restrain overly rosy expectations, contain speculative excesses, and prevent the market from becoming greatly overvalued. Although overdue for a short-term correction of 4-7%, we still believe the markets have considerable room to appreciate for several reasons, including attractive stock valuations, a strengthening economy, and the likely flow of new investor money into equities.

Since the March 2009 market bottom, the S&P 500 has recovered all of its losses and in the process added $10 trillion to the value of American equities. During this recovery, approximately 59% of S&P 500 stocks have set new multi-year highs. This indicates that market gains have come from a broad set of companies rather than a single sector or theme. This is a much healthier situation than the market tops in 2000 and 2007. At the 2000 peak, technology companies made up 35% of the S&P 500 Index. In 2007, financial stocks accounted for 22.4% of the market's capitalization. Today, none of the 10 major industry sectors make up more than 18% of the index.

In addition to the broad market gains we have experienced, stocks are more attractively valued today than they were in 2000 and 2007. For illustration, we included the chart below that shows the S&P 500 Index (single line) compared to the amount of corporate profits that are supporting those stock prices (filled area beneath index).



As you can see in the chart, the companies that make up the S&P 500 are roughly 11% more profitable today than in 2007. However, we would argue that profits were artificially inflated in 2007 by bank "earnings." Those "earnings" quickly turned into massive losses over

the next few years. The effect of those losses is plainly seen on the chart as they substantially reduced total earnings in 2009 and 2010. As a consequence, we believe true earnings are probably 20% higher today than during the last peak in 2007. Meanwhile, during the 2000 peak, the chart shows the relatively small level of profits that were supporting extremely high stock prices. In fact, stocks were trading above 31 times earnings, more than double the current level. This was a clear recipe for the stock underperformance we experienced during the 2000's.

For a more historical perspective, consider that the index currently trades at 15.4 times reported profit. Since 1962, the average bull market topped out at prices that were 19.9 times profit. In actuality, the current record high comes at a lower valuation than any high since 1980. In addition, since 1945, on average the S&P 500 has climbed for 30 additional months after exceeding a previous record and gained 59% during that period.

Despite a large number of historical precedents and contemporary evidence that favors further advances in the market, the average retail investor still believes trouble is just around the corner and any number of reasons could send us into a new recession. We do not agree and are actually quite encouraged by recent indications that the economy is strengthening. Most notably, housing is firmly in recovery mode after six years of being a drag on the economy. For example, according to real estate data provider CoreLogic, U.S. home prices increased 10.2% in February from a year earlier. More importantly, the supply of previously owned homes on the market was down 23% from a year ago and inventory is now at the lowest level since 1999. The lack of houses on the market has spurred home builders into action. In February, permits to break ground on new homes were up 34% from a year earlier. As a result, the construction industry added 48,000 jobs in February, the biggest increase since 2007.

In addition to the growing strength in housing, the biggest driver of expansion over the past four years has been the energy renaissance going on within our borders. The development of new extraction technologies has completely reshaped the future outlook for meeting America's oil and natural gas needs. Since 2006, U.S. production of crude, natural gas, and bio-fuels has grown by a third, or 3 million barrels a day, about the same output as Iran, Iraq, or Venezuela. Projections now estimate that by 2020, the U.S. could leapfrog Saudi Arabia and Russia to become the world's largest oil producer. In addition, within the next decade the U.S. may not need to import oil from any source other than Canada. All told, it is estimated that the unconventional oil fields that have recently become available directly accounted for $238 billion in economic activity and 1.7 million jobs in 2012.

Although the direct benefits are notable, the indirect benefits from new energy production will have wide ranging implications for U.S. global competitiveness. In fact, the energy renaissance has jump-started several other major industries across the economy, including chemical, steel, and railroads. In the chemical industry, several plastic makers and fertilizer producers have announced new plants that will be built in the U.S. In the steel industry, new plants are being built for the first time in more than 35 years. Energy intensive industries are benefiting from U.S. natural gas prices that are a third of the price compared to Germany and a

quarter of the price compared to South Korea. Meanwhile, American factories paid roughly half the going rate for electricity compared to Chile or Mexico and a quarter of the price versus Italy.

The manufacturing production coming back to the U.S. is also encouraging large scale investment in the railroad industry. Actually, North American railroads are in the midst of a building boom unlike anything since the industry's Gilded Age in the 19th century. This year the five major U.S. based railroads are expected to invest $14 billion in their networks. As a result of greater investment and better use of technology, U.S. freight rail rates are nearly half what they were three decades ago, despite much higher fuel costs. Much like the energy industry, a more efficient transportation network will have wide ranging effects on the entire economy as it improves U.S. competitiveness.

Given this remarkable resurgence in U.S. competitiveness, we find it peculiar that most investment strategists are still recommending large allocations to direct international investing. Unfortunately for their clients, this has worked out poorly over the past five years. Since the previous market peak in 2007, the S&P 500 has now regained all of its lost ground. In contrast, China's Hong Kong market is still down 29%, Brazil is down 14%, Tokyo is down 26%, and Germany and London are down low single digits. We expect this trend of U.S. outperformance to continue as the competitive benefits of lower energy prices and greater U.S. productivity continue to bear fruit.

As a result of growing U.S. competiveness and attractive equity prices, we believe it is still very likely that investors will move more heavily toward U.S. stocks. During the first quarter, individuals added almost $20 billion to stock mutual funds. However, this amounts to just 3.5% of the withdrawals out of stock funds since 2007. If investors begin to move more heavily back into stocks, we believe the market has the potential to rally significantly higher. We also believe the likely catalyst for a move toward equities will be somewhat higher interest rates and, therefore, lower bond prices. In the first quarter, interest rates finally started to rise and the Dow Jones Corporate Bond Index declined 1.1%. Time will tell if the first quarter marks the beginning of the major shift from overpriced bonds to reasonably priced stocks. In the meantime, we believe our clients will be best served by continuing to own many of the best companies in the world that provide large and growing dividends.

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