2010 – The Year Where Faith Prevailed

What changed between July 1 and December 31? Not much…. and yet, quite a bit. Yes; that is a confusing statement. So, we will attempt to explain. If one looks at economic measures such as employment, gross domestic product ("GDP") growth, etc., not much changed although many economic indicators improved slightly over the past six months. However, if you gaze upon perception and sentiment - or investors' faith - quite a bit changed!

What is Faith? To quote Webster:

Faith: *"(1) firm belief in something for which there is no proof, (2)**:** complete trust."*

Why did "*faith*" keep popping to mind as we prepared this commentary? Simply stated, not much happened in 2010 from an economic standpoint, aside from improvement in corporate profits. Yet, investors drove the equity markets sharply higher in the 4th quarter to finish the year with solid gains. Major market averages increased by 10 – 15% in 2010. Gains of that magnitude usually require some meaningful economic support. However, this year, such gains only required faith that the investment environment was headed in the right direction and that the Federal Reserve was going to flood our financial system with as much money as necessary to stimulate - or, at least, to prop up - the U.S. economy.

The Game Changer

The three factors mentioned above came into focus in the 2nd half of the year.

First, it became well known that the Federal Reserve was going to launch a second **quantitative easing program** (QE2). The Federal Reserve made it clear that they would not stop the printing press until either they ran out of ink, or the U.S. economy began to improve, whichever came first. Such anticipated levels of financial system liquidity led to optimism found upon the perception that the "Fed was on our side" even more so than had been hoped.

Second, **corporate profit results** from the 2nd and 3rd quarters were well above targets. More than 73% of S&P 500 companies beat expectations in the third quarter. Corporate managers continued to do an *excellent* job managing their businesses which allowed small revenue growth to translate into solid earnings growth. In spite of modest, if any, revenue gains, company managers delivered solid profit growth that surprised investors. These positive earnings surprises rendered stock valuations more reasonable than originally estimated. As a result, investors re-priced the stocks to reflect the improved profitability of corporate America.

The final factor impacting the stock market's performance in the 2nd half of 2010 was **the sea change that occurred in Washington**. During October, polling data clearly indicated that a tidal wave of voter sentiment that would create a dramatic shift in power in the House and Senate. The market viewed these changes positively which provided more fuel for the stock market rally. After the actual results of the election were known, the market paused in November as markets tried to digest what changes in policy might result, if any.

Then we saw the "game changer"! Much to the world's surprise, the Administration showed a willingness to **extend the Bush era tax cuts** [thereby, avoiding the largest tax increase in U.S. history without such extensions], compromise on the estate tax, and roll out a payroll tax reduction. This series of aggressive "supply side" fiscal stimulus was clearly not factored into market sentiment. The result was a strong year end surge to the markets.

Why were those tax policy decisions such a "game changer"? First and foremost, the absence of tax increases directly translates into more spendable cash for taxpayers than what taxpayers might have been anticipating without the continuation of the current program. Very simply put, if people have more money in their paychecks, they might just spend it. Second, corporate managers now have some visibility to their tax liabilities for the next two years. While making the tax cuts permanent would have given the most definitive visibility, at least two years' visibility is better than NONE, which is what existed as we approached the December 31, 2010 'sunset' timeline. Third, the cuts will translate into cash flow that could help offset a portion of the increases that will occur in company healthcare costs. Before the tax cuts were announced, companies were faced with painful increases in healthcare outlays <u>and</u> a likely increase in their taxes. Now, taxpayers can use the tax savings to pay for some of the increased healthcare expenses. The tax status quo is significant because with better taxation visibility, companies might be more comfortable hiring people! Perhaps with this better taxation clarity and with balance sheets flush with nearly $1.6 TRILLION or so dollars in cash, companies might be more inclined to spend some of that cash hoard which could then translate into significant economic activity.

In summary, what really changed in the 2nd half of the year? Company profits grew. Profit growth was concrete / tangible positive change; but most of the changes in the investment environment were purely investors' perception. This is where faith enters the equation. We should not forget that "perception is reality and reality is perception." When markets do not have a reason to go down and opinions are more optimistic, stock prices tend to drift higher. So as corporate profits continued to show strength and the opinions of investors improved starting with positive expectations regarding QE2 and culminating with the avoidance of the largest income tax increase in U.S. history; investors voted with their money / investment dollars and took stock prices higher. Put another way, a decent environment with faith in the future, whether warranted or not, created a really nice rally!

Each of these factors came to fruition in the 2nd half of the year and allowed investors to experience two of the largest back-to-back quarterly rallies in history. Most major averages jumped by more than 10% during the 4th quarter, on top of their 10+% rally in the 3rd quarter. So when we say the market had a nice year, it is really more accurate to say the stock market had a tremendous 2nd half of the year! This is even more apparent when we remember that the markets were <u>down</u> more than 5% for year on the first day of July. Rebounding from negative return territory at mid-year puts into perspective the last six months' strong rally!

<u>So Now What?</u>

After the rally, what does 2011 hold in store for investors? As usual at this time, we will do that which we really prefer not to do. We will gaze into the future and do our best to predict what will be the major themes, and possible outcomes, in the upcoming year. As always, we are required to say that these themes can and will change throughout the year but this is our view today.
First the negatives. Here are the items that concern us as we look at 2011:

- Unemployment is still uncomfortably high and must eventually be controlled in order for the economy to have any sustainable positive momentum.
- Sovereign debt problems in Europe, and candidly here in the U.S., have not been definitively solved; those problems have just been pushed down the road by shorter-term, temporary fixes.

Hopefully, those economies will stabilize and tax revenues will increase which will alleviate some of the strain.

- We believe interest rates are going to continue their surge higher from levels experienced in December. Higher interest rates could pose a threat to market valuations, especially if rates rise too fast.
- Year-over-year corporate profit comparisons are going to get more difficult in 2011. During 2010, companies were announcing results compared to the previous year (2009), when the economy was at the depth of the recession. For 2011, comparisons will be against the higher profits experienced in 2010 resulting is a slower rate of growth...
- Municipal and State finances continue to be an impending debacle. Unfortunately, there is no visible simple remedy that does not involve austerity programs similar to those announced in Europe. Needless to say, if state and local services are slashed in order to balance budgets, the economic and, perhaps, social backlash could be substantial.
- The Commercial Real Estate market is still very soft. There is a massive wave of loan maturities facing the industry again in 2011. If the environment stays the same as it is today, most of those properties will be able to find new loans, but many will not. Furthermore, if the economy shows weakness, the number of problem loans could increase dramatically. In fact, it is difficult to talk to people in the real estate industry about their businesses without coming away depressed. There are not many 'happy campers' in that area of our economy!
- The U.S. government debt levels are scary. As with all debtors, our country is at the mercy of those who finance their debt. If creditors [e.g., China, India, Mid-East oil cartel countries, etc.] decide to stop lending us money by buying U.S. government bonds / debt, the game of musical chairs ends badly. Whether buying of U.S. debt wanes due to a determination that the U.S. dollar is no longer the currency of choice, or due to a political divide, the result would be catastrophic to the U.S. economy.
- The costs that companies will face as a result of health care reform are still not totally quantifiable. For instance, our company employee healthcare costs will have increased by more than 50% in two years! Our company is not the exception; we are fairly typical. If healthcare costs turn out to be much higher than expectations, those additional costs will be an additional negative for company profits and planning for growth.
- Stock valuations are not cheap. As we have said numerous times, stock valuations are not expensive; but they certainly cannot be classified as cheap. Street expectations call for the members of the S&P 500 to generate a composite $95.62 in earnings in 2011. At the yearend price of $1,258, that means the index was trading at 13.15 times estimated earnings. This is an expensive valuation level for the stock market. However, the market will likely face a 'head wind' of rising interest rates in 2011 which could combine with a short fall in corporate earnings due to a slower economic growth rate for the U.S. economy as a result of the stimulus package [QE2] not having the desired or envisioned impact.
- And that is our main point and concern we have expressed for the last year and a half. If the U.S. economy finds itself in the summer of 2011 with virtually all of the stimulus money spent and yet not much economic growth, investor sentiment and psychology will potentially have another colossal shift in perception. If we do not see meaningful job growth and economic progress but merely have a few trillion dollars of new debt to eventually be repaid, investors ~ foreign and domestic ~ are not going to be pleased!

Now the positives. Here are the things we are optimistic about when we look at 2011:

- Income tax policy is now a positive. We are not sure if anyone could have predicted the change in the Administration's stance on taxes but we feel strongly that these measures have a much higher likelihood of stimulating the economy than most anything else that has been tried.
- Valuations are not expensive. At 13X earnings, valuation multiples have room for expansion if profits can continue to grow and the economy starts to gain some traction. As a result, we feel stock prices are very capable of increasing by a similar percentage as of the corporate cash flow growth rate for corporate America...
- There is a great deal of cash from companies and investors that is looking to be put to work. Again, if the economy can show some traction, longer-term capital investments should provide fuel to the economic momentum. Long term, this is likely going to lead to inflation but short term this will be a positive.
- Congress is going to have gridlock. Yes, to us Congressional gridlock is a positive. The less that the government interferes with business putting capital to work the better. If corporate planners have less reform to worry about, they can focus on running their businesses which translates to some of that cash we mentioned above being ploughed back into new capital investments and new jobs for America.

When an investor simply looks at the two lists above, one would certainly be right in determining that we see a lot more to be concerned about then to be excited about. While that is true that we continue to see the "cracks in the foundation" that we have talked about for several quarters, it is also true that the magnitude of the new events of the last 60 days have given us a more balanced outlook. We are "cautiously optimistic". There are some very good things going on within our economy; but, there are still concerns that have kept us from being completely optimistic.

<u>How to Invest in 2011?</u>

Our longer term investment philosophy for clients incorporates a client's need or desire for return coupled with their tolerance for risk or volatility. Thusly, every client should have their own asset allocation or diversification plan that is suitable to their particular personal and financial situation. We further believe that clients' portfolios should be periodically rebalanced to realign with these longer-term asset allocation targets. However, at times, we have been comfortable with allocations that are slightly out of balance in an effort to take advantage of perceived market opportunities. Likewise, we have rebalanced portfolios more frequently in a similar effort to take advantage of perceived market opportunities. Currently, we do not see any dramatic dislocations to take advantage of in the markets as we did in early 2009. Therefore, we believe an asset allocation that is consistent with a client's normal or targeted longer term risk/reward parameter is appropriate going into 2011.

There is only one area of the investment markets for which we are extremely concerned; this is long dated fixed income securities. We continue to shout caution from the rooftops. If your portfolio has fixed income holdings with maturities longer than five (5) years into the future, please review and understand how much risk you may be taking should interest rates indeed climb sharply from current levels. In the fixed income portfolios we manage, we continue to shorten duration and average maturity for our clients. We encourage you to have a conversation with us about any fixed income holdings that you may be holding in other parts of your investment portfolio.

<u>As always, our year-end quarterly report contains **A SUMMARY OF ALL YOUR REALIZED GAINS AND LOSSES FOR THE YEAR**. Quite simply, if you provide your tax preparer a copy of this report along with your 1099's from your custodian or brokerage firm that reports interest and dividends on your accounts,</u>

the preparer should have everything needed to complete your income tax return with regards to the separately managed portfolios we oversee for you.

2010 was very good to us and we are sorry to see it go. That said, we are excited about 2011 and all of the interesting things that it may have in store. We appreciate all the trust you place in us as we endeavor to be the best stewards we can for your portfolio. Please let us know if you have any questions. All of our very best for a wonderful New Year!