

QUARTERLY ECONOMIC UPDATE

OCTOBER 1, 2010

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Low Bond Yields. Low Equity Valuations.

In our July 1, 2010 Economic Update we took the view that although the economy was temporarily slowing, the U.S. was not headed back into recession. We found equity valuations compelling and stated our belief that “this is a time of excellent investment opportunities.” In the face of an almost continuous onslaught of negative news and bearish sentiment we stated, “We can’t say things will turn positive in the markets today, but we do believe that this is exactly the wrong time to let our emotions get the better of us.” And while record amounts of funds poured into bond funds, for the quarter ending September 30th, the S&P 500 appreciated 11.3% inclusive of dividends.

What we have recognized for some time is that equity investments are as attractive as they have been in many years. While emotions may rule the markets in the short term, we have a high degree of confidence that at some point, markets do reflect the underlying value of the individual issues. Exactly when the markets recognize that attractiveness is beyond our, or anyone else’s, control. For that reason, we just don’t predict the markets. We do, on the other hand, attempt to take advantage of opportunities when the markets present them. So at the beginning of the summer, when pessimism was

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Economic Statistics

	3rd Qtr (9/30/10)	2nd Qtr (6/30/10)	% Change	1 Yr Ago (9/30/09)	% Change
S&P 500 Index	1,141.20	1,030.71	10.7%	1,057.08	8.0%
10 Year Treasury Yield	2.51%	2.93%		3.31%	
Gold Spot (\$ / oz)	\$ 1,308.35	\$ 1,242.25	5.3%	\$ 1,007.70	29.8%
WTI Crude Oil (next future)	\$ 79.97	\$ 75.63	5.7%	\$ 70.61	13.3%
GDP Qtr / Qtr	N/A	1.7%		1.6%	
CPI Y / Y	1.1% (Aug)	1.1%		-1.3%	
Unemployment Rate	9.6% (Aug)	9.5%		9.8%	

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setting in, we held our ground. When the Dow Industrial Average dropped below 10,000 near the end of August, we concluded opportunities were, in fact, better than before.

Now as we enter the 4th quarter, we are again faced with the question of whether it is time to get out of the stock market and shift into bonds. Since we have devoted so much of our space in our April 1 and July 1 Economic

The strong movement in the equity markets last quarter strengthens our conviction that it is a fool hearty game to attempt to time the markets.

Updates to a discussion as to why we think stocks still represent an excellent opportunity, we thought in this Economic Update, we'd provide additional perspective as to what is going on with interest rates and the bond markets.

For 29 years, with limited interruptions, interest rates have been falling. Starting from a high of 15.8% on September 30, 1981, the 10 year U.S. Treasury bond yield fell to 8.8% by September 30, 1990 and 5.8% by September 30, 2000. One year ago that yield stood at 3.3% and as of September 30, 2010, we were looking at rates of about 2.5%. While corporate bonds have generated somewhat higher yields, the overall trend has been similar.

How did we get here? This Economic Update is not the appropriate vehicle for an extensive history and analysis of so many years. But, roughly speaking, rates fell through the 1980s primarily as a result of government and Federal Reserve (Fed) policies that broke the back of 1970s' inflation. Rates continued to fall through the 1990s as Federal budget deficits turned to surpluses. And rates continued to fall through the 2000s, as the decade was bookended by recessions with the Fed actively keeping rates low, and imports from China and other countries helping to keep inflation in check. More recently there has been continued downward pressures on rates caused by a flight to the safety of the U.S. and U.S. government securities combined with fears of a deflation and a double dip recession. This recent behavior merits further examination.

When Lehman Brothers collapsed in September 2008, which signaled the acceleration of the U.S. financial crisis, there was a flight to quality. As can be seen in the

nearby chart, money poured into Treasury securities and interest rates plummeted. The 10 year Treasury bond fell to just above 2% and T-Bill rates briefly traded below 0%! As the crisis passed, investors began to take on more risk. Interest rates began to rise as markets focused on growth and possible inflation.

Despite the depth of the recession, the recovery was beginning to proceed in text book fashion. But, in late 2009 and early 2010, a financial crisis in Greece precipitated a currency crisis with the viability of the Euro coming into question. At first interest rates in the U.S. continued to rise. Then, panic set in, and U.S. Treasury securities became the investment of choice for many. As a result, interest rates began falling once again. Then at about the time the European crisis was being resolved in early summer (at least for the near term), economic growth in the U.S. slowed significantly. As we pointed out in our July 1, 2010 Economic Update, such slowdowns are to be expected. But with unemployment hovering near 10%, talk shifted to the likelihood of a double dip recession and deflation. Now interest rates tumbled. Having just reached 4% in early April, five months later we are looking at a 10 year Treasury rate of around 2.5%.

10 Year U.S. Treasury Yields



The important question is, which way do interest rates go from here? One thing for sure is that the markets are yielding contradictory signals. While interest rates are near historical lows suggesting disinflation or even deflation, gold is at historical highs suggesting

future inflation. The equity markets are trading at valuations (despite the recent appreciation) which suggest little or no growth. Despite this, risk premiums on corporate bonds, which generally rise in weak economic conditions and fall during periods of growth, have fallen significantly from their recession levels. Therefore, to develop our outlook, we have to go back to the heart of our analysis regarding the economy.

As we explained in our July 1, 2010 Economic Update, we believed the economy would not slip back into recession. Among our observations were that slowdowns were normal after an initial burst of economic activity and that the current unemployment rate does not tell us which way things are heading. Corporations have excellent balance sheets, inventories are lean, and there is significant pent up demand. Emerging market growth is still robust and the emerging middle class will be a significant factor in driving future growth. It is true that over the summer construction remained anemic, final domestic demand slowed (though it remained positive) and private sector employment growth barely remained positive. While not strong, these indicators do not point to recession. Additionally, when we look at some other factors such as import prices, industrial production, personal consumption, and durable goods orders, we get a positive – though not glowing – picture of the economy.

Further, we like to look at the anecdotal information from individual companies to glean what is actually happening in the real world. Using equities in our clients' portfolios, we can see positive underlying trends that bode well for the entire economy. For example, Norfolk Southern (NSC) reported 2nd quarter volumes up 21.8%. This railroad and others are delivering goods to a broad swath of the economy. Pall Corp (PLL) which makes filters for everything from medical applications to industrial and municipal applications reported Western Hemisphere industrial revenues up 21% for the quarter ending July 31st. PLL's products are generally disposable, and revenues are reflective of current levels of business activity. Intuit (INTU), a provider of tax and accounting software reported that its Small Business Group's revenues were up 9% for the year and 16% for the quarter ending July 31st. For Microsoft (MSFT), a disappointing September quarter will be one that only shows 20%

revenue growth. We have plenty of other examples, but for those who are fond of saying that the improvement in corporate earnings is only the result of cost containment and not top line growth, we say that it just isn't so. The bottom line is that we expect the economy to continue to grow – albeit slowly for the near term.

As growth eventually accelerates, the rate of inflation will likely accelerate as well. Government deficits will drive up the supply of bonds. Interest rates will almost certainly have to rise.

We have obviously been too early with this forecast, but we believe that the 29 year bull run in bonds has nearly run its course.

Going forward, there will be periods of time when a flight to safety or economic slowdowns temporarily drive interest rates lower. But, we expect that the phenomenon of steadily falling bond yields will become a thing of the past.

So to answer the question, should an investor switch from stocks into bonds? The answer is entirely dependent on individual investors' risk tolerances, objectives, and available resources. That is an issue that should be discussed with your Financial Advisor and other professionals. But once that strategic asset allocation is determined, we believe portfolios should be positioned towards the maximum end of equity tolerances and towards the lower end of fixed income tolerances.

Equity Strategy

During early 2009, we set the basis of our equity strategy for the next few years. Our analysis had led us to the conclusions that stocks were uncharacteristically cheap and that while the recession would be severe the world would not come to an end. While not knowing how the entire situation would game out, we were of the strong opinion that 5 years hence we would marvel at how cheap stocks were during this time frame. Initially we built positions in the medical (e.g. TEVA), technology (e.g. Intel), and consumer staple (e.g. Kellogg) sectors. Then recognizing the strong positioning of industrial America we added such positions as Timken,

Now is not the time to reach for yield.

Temple-Inland, and ITT. Today, technology stocks and industrials represent our clients' largest holdings. We have underweighted financial stocks with the view that upside potential might be limited though downside risk had not been eliminated. Early in 2010, we started nibbling at foreign companies that play to the strength of their own domestic demand. Such companies include Brasil Foods and China Surveillance & Security.

As the pessimism of this summer set in, we revisited our positioning and overall strategy. We concluded that the best course of action was to stay put. Stocks that were backing off represented even more attractive valuations, and our economic outlook had not changed significantly. The strong movement in the equity markets last quarter strengthens our conviction that it is a fool hearty game to attempt to time the markets.

Reviewing client holdings, we are quite pleased with the performance of positions in the industrial sector. Stocks such as Caterpillar, Fedex, Pall, and Timken well outpaced the market. We are less pleased with the performance of the technology sector. Stocks such as Micron, Intel, and Microsoft have underperformed the market. While technology stocks have reported outstanding earnings, valuations have been compressed. Concern has arisen that the recent earnings were strictly the result of a onetime consumer boost which may be waning. While we agree that the rate of consumer purchases is decelerating from earlier in the year levels, we believe the market is ignoring a second, and perhaps more powerful, leg from corporate spending in the information technology arena. In our July 1, 2010 Economic Update we stated that the technology sector represented one of the most attractive areas to invest. That conviction has not changed. Still, we will continue to monitor progress in this sector and reevaluate positioning as needed.

During the quarter, we did make one significant transaction by selling all positions in Mosaic (MOS), a producer of potash and phosphate based fertilizer. In late July, an environmental group won an injunction against the company and the Army Corps of Engineers which prevented MOS from expanding a large phosphate rock mine in Florida. As a result, MOS made plans to close the mine which represents roughly 30% of its phosphate rock capacity. As we had no way of knowing how or when the court issues would be resolved, we felt that continued investment in MOS could not be justified. Our investment strategies are predicated on identifying predictable earnings and cash flows streams, and in this case that was not possible.

Despite our decision to sell MOS, we still had great faith in the agriculture cycle. There has been under investment in capacity, while a growing middle class in emerging nations should lead to increased demand for improved diets. This, in turn, should lead to increased demand for fertilizer, seed, chemicals, and equipment. We evaluated many alternatives and determined that we could increase exposure to the broad segment while reducing risk exposure to individual companies by investing in the Market Vectors Agribusiness ETF (MOO). Most clients already had MOO in their portfolio, but given the diversification within the ETF we felt it was appropriate to increase client holdings. The underlying components of MOO consist of 45 companies engaged in producing chemicals & fertilizers, agricultural products, agricultural equipment, live stock operations, and biofuels production. Underlying valuations are quite attractive, and clients gained exposure to additional medium and small cap stocks as well as international equities.

Fixed Income Strategy

As should be apparent from this Economic Update, we believe that interest rates are more likely to rise than fall. In such an environment, an investor should hold bonds with short durations. This enables the investor to either wait until the maturity of current holdings to reinvest at higher rates or sell existing holdings at little or no loss. Bonds with longer maturities are generally more sensitive to changes in interest rates. While such bonds generally appreciate more when interest rates fall, they also tend to have a greater fall in value when interest rates rise. In that scenario, an investor is faced with the prospect of collecting payments at a below market yield or selling the investment at a loss to collect a higher yield. It is for this reason that we have, for the most part, kept maturities shorter than 10 years.

It is true that we had taken this stance early in 2010. As a result, fixed income returns have not been as high for our clients as for those who extended maturities on their holdings. We must, though, return to our basic tenets of investing. Specifically, when one is compensated for the risks of investing, it is appropriate to strive for higher returns. When one is not compensated for the risks of investing, it is more appropriate to strive to preserve capital. Given the low level of current interest rates and our outlook for the future, we do not believe the fixed income markets in general are compensating investors for the risks they are assuming. Now is not the time to reach for yield.

