



Growth | Preservation | Partnership

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Kicking the Can Down the Road

Over the holiday break, my daughter completed a school assignment in which she interviewed her grandfather about his life experiences. He had been a navigator in the Army Air Corps during World War II, shot down and imprisoned in a POW camp, and a successful entrepreneur following the war. Then again, just yesterday, Laura Drynan received a copy of a commendation that was awarded to her grandfather for attacking enemy positions under heavy fire while serving as a WW II Navy pilot, an act of bravery that earned him the Navy Cross, an award second only to the Congressional Medal of Honor. These men demonstrated incredible sacrifice and selflessness. More people need to stand up today and confront our nations' most challenging issues. Given the election results of November and the "shellacking" of incumbent politicians I believe many others share this opinion. Living beyond one's means, be it as an individual, a nation, or globally, has come home to roost and we're forging through the days of reckoning. Massive intervention by the Fed has stabilized the financial sector and the economy is now on the mend but the tendency to defer tough fiscal decisions still dominates the political landscape. In this note we'll review the current environment, the risks that abound, and the investment strategy we are following.

The S&P 500 index began 2010 at 1115 and it crossed that level 165 times while investors wrestled with the strength of the recovery. As spring approached the economy was slowing and initial jobless claims began creeping higher. By late August, Chairman Bernanke and his coterie of Fed Governors sprung into action and announced the Fed's willingness to initiate round two of quantitative easing. Mr. Bernanke even appeared on the television program "60 Minutes" to talk up the Fed's ability to stimulate a recovery. It worked. Prior to the Fed's announcement business activity was sputtering and the equity market had declined 4%. Following the announced intention of QE II, animal spirits were bolstered and the equity markets appreciated 20% during the last four months of the year.

Our economy is like a three legged stool comprised of consumers, businesses, and government. If any leg is wobbly then growth falters. Consumers are nearly two years into their commitment to frugality, a healthy change in behavior. Household debt has declined by \$1 trillion to \$11.5 trillion and Americans are saving 6% of disposable income (roughly \$700 billion per year), up from almost zero three years ago. Corporate America is in excellent financial shape, balance sheets are strong, margins are expanding, and earnings are approaching pre-recession levels. We believe one of the themes of 2011 will be the resumption of capital spending by the private sector as signs of the rebound persist.

The wildcard in the equation is government policy. The United States and much of the developed world needs to begin addressing structural imbalances in the public sector. Anxiety surrounding sovereign debt in the European Union remains although the euro has recovered somewhat from its collapse in June. The fifty US states face a collective budget deficit of \$140 billion, and over \$3 trillion of unfunded pension obligations. (Remember, states cannot post budget deficits.) Federal debt has ballooned and the fact that Baby Boomers begin turning 65 this year will put additional pressure on Social Security and Medicare. We aren't bold enough to predict how the government budget problems will be resolved but we do believe that the seeds for another crisis lie within.

The dilemma is how one balances a strengthening consumer and business environment against the risk of government budget problems. We plan to continue investing with cautious optimism. Emerging markets remain as promising an investment as ever. BRIC nations are likely to generate GDP growth of almost 5%

which exceeds recently raised US GDP forecasts of 3%. China's economy continues to expand at an 8-10% pace. Although inflationary pressures are forcing China to raise rates, the real solution is probably to allow the currency to appreciate vs. the dollar.

We believe the technology sector remains attractive and added to our exposure in 2010. We will continue looking for new opportunities in that area, particularly businesses that enhance information flow and connectivity. Financial stocks should continue to recover from the crisis of 2008 as credit quality improves and dividend payments are reinstated. Energy remains a long term theme; both the need for resources, as well as a greater conservation.

We're excited to be back in the business of stock picking in an improving business environment. However, being fiduciaries of your money we are also keeping a wary eye on the horizon. Government budget practices are clearly high on our worry list. Given our capital preservation focus, we are balancing our stock investments with fixed income, MLPs, REITs, and preferred stock at levels that we believe are appropriate for the risk tolerance of each account. With bond yields rising on an improving future economic outlook, we have started to be a bit more aggressive in reinvesting the proceeds from maturing bonds.

Kasim Reed, the democratic mayor of Atlanta, sums up our feelings regarding state, federal, and global deficits:

"The bottom line is that for the country to do and to be what we have been...there must be a generation tough enough to stick out its chin and take the hit...It is time to begin having the types of mature and honest conversations necessary to deal effectively with the new economic realities we are facing as a nation. We simply cannot keep kicking the can down the road."

We wish you the best for a healthy and happy New Year. We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,



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