

ONE YEAR LATER

Since the bear market lows in early March 2009, equity markets around the world have rebounded sharply gaining 50 - 75%.

However, equity markets remain meaningfully below the peak of October 2007. Meanwhile, the prices of fixed income securities, excluding those of government bonds, have posted gains far exceeding coupon income because shrinking risk premiums for corporate credits reached historic heights. The result is positive returns over the last year for corporates and for all types of bonds over the last two years, as shown in Table I. From the all-time highs of early 2000, the results present a similar picture: wide variance in returns, better returns from bonds than stocks. However, when viewed over 20 years, returns tend to reflect relationships that are generally described as “normal” – stocks ahead of bonds, small-caps better than large-caps. Certainly, the entry point of a one-time investment has a significant impact, whereas investing regularly over time tends to smooth out the investment experience.

Table I	Total Returns % as of March 31, 2010					
	1 st Qtr 2010	One Year	Peak 10/31/07	Peak 12/31/02	Peak 03/31/00	20 Years
Domestic Equity						
S&P 500 Index Daily Reinvested	5.39	49.77	-8.87	6.09	-0.65	8.66
Russell 2000 Index (Small-cap)	8.85	62.76	-6.49	9.61	3.68	8.93
International Equity						
MSCI EAFE ND - U.S.\$	0.87	54.44	-13.14	10.03	1.27	5.25
MSCI Emerging Markets ND - U.S.\$	2.40	81.08	-9.04	21.57	9.78	NA
Fixed Income						
Merrill Lynch U.S. Trsy Current 10 Yr	0.95	-6.30	5.50	3.89	5.69	6.66
Merrill Lynch U.S. Corporates 1-10	2.86	6.75	6.31	5.10	6.46	7.27
Other						
	Closing Prices (\$)					
West Texas Crude Oil - \$ barrel	82	49	95	31	27	20
Gold troy ounce	1124	905	797	348	278	369
U.S. Trade Weighted Dollar	76	83	73	100	98	94

* Returns with periods longer than 12-months are annualized.

Source: Lipper, Inc.

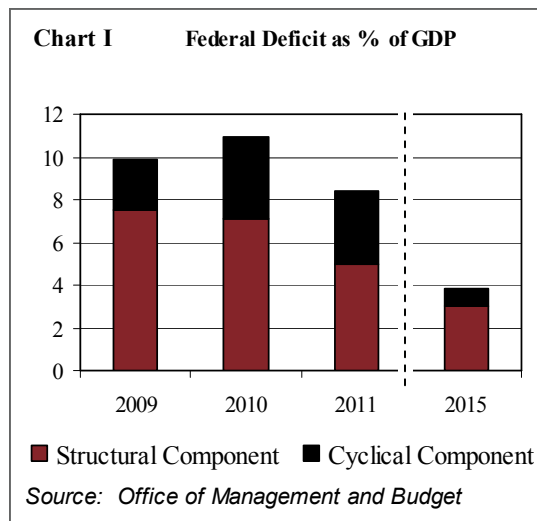
Value Matters

Last quarter, we reviewed returns over the past four decades, the change in bond yields (interest rates), the change in the valuation applied to the earnings of stocks (price/earnings ratio or P/E) and the interrelationship of the two. When interest rates are low and rise, fixed income returns contract. The current yield on a 2-year Treasury is only 1.1%. Investors in relatively short maturity corporate credits can earn double that, about 2.2%. In addition, given the very steep yield curve (the range of yields on bonds at various maturities from short to long), investors are being compensated when they extend into longer maturities, for example five years, and earn the benefit that occurs with the passage of time as the bond maturity “rolls down” the yield curve. While the return is known when a

bond is held to maturity, equity returns are uncertain. In addition, the change in P/E ratios usually has a bigger effect on stock returns than the change in earnings. P/Es have varied widely, from less than 10x earnings in the late 1970s and early 1980s to over 30x at the end of 1999. One year ago, we suggested that the stock market could be 65% higher if earnings in 2011 increased to the level earned in 2006 and sold at a P/E of 15x. The S&P 500 has risen about 50% since then and currently trades at about 14x estimated 2011 operating earnings. However, when interest rates begin to rise, as they should at some point, an expansion in P/E is less likely. Perhaps operating earnings will be better than currently anticipated. That leaves some upside, but nothing dramatic.

Bubble, Bubble, Toil And Trouble

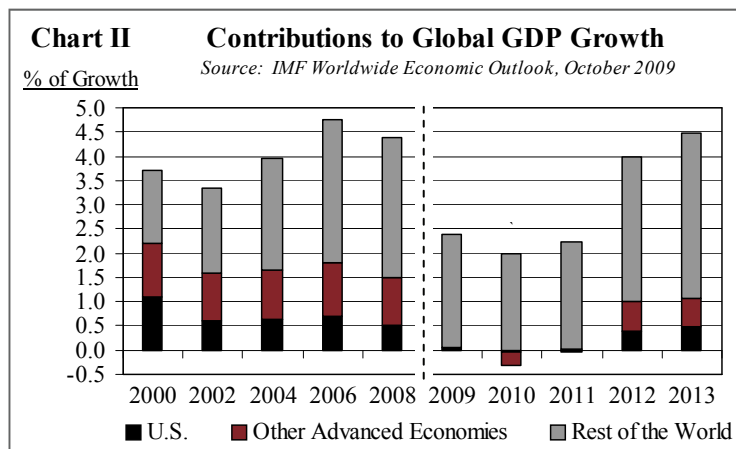
The only thing the collective "we," which includes companies and governments, can spend is cash. We can earn it. We can borrow it. Companies may also use stock, a fiat currency, to acquire other businesses. But, only the Federal Government can create money. A major investor concern is how and when the Federal Reserve pulls out some of the money it created to stabilize the financial system and what impact this will have on interest rates, bond prices and equity valuations. The U.S. Treasury is borrowing unprecedented amounts to finance historic deficits. The mushrooming government debt is caused by the combination of a cyclical deficit and a structural deficit. The cyclical deficit results from government's efforts to mute the impact of the recession with unemployment benefits and spending programs such as those to repair roads and bridges that put people to work. When the recession ends, these expenditures trail off and tax receipts grow. On the other hand, the growing structural deficit is the result of the demands on the Social Security Trust Fund by an aging population, health care programs for young and old, and mounting interest on government debt. Chart I provides a glimpse of these components based upon estimates



from the Office of Management and Budget. The Congressional Budget Office and several think tanks have even more disconcerting estimates. The structural deficit is the serious problem that could destabilize the economy and financial markets in the U.S. and reverberate around the world.

Since about half the amount of U.S. government debt held by the public is owned by foreigners, their willingness to continue to hold our debt is critical. Major factors affecting foreigners' decisions about the relative attractiveness of U.S. government debt include perceptions of future growth, economic and political stability, liquidity, budget and trade deficits or surpluses, inflation, interest rates, and supply of the currency. According to *The Economist*, among developed nations, only Australia and Canada are expected to grow faster than the U.S. in 2011, and no developed country is expected to grow as fast this year.

The IMF's global outlook, Chart II, clearly shows the growing importance of developing countries ("Rest of the World") to future global growth. Led by China and India, the developing economies are expected to grow faster this year and next, but accompanied by higher inflation. Although inflation is higher in the U.S. than other advanced economies, Europe and Japan have more deflationary tendencies right now. Interest rates in the U.S., measured by the



10-year government bond, are currently higher and growth prospects better than those of Europe or Japan, the issuers of the two other major currencies. Government bond yields are higher in Australia, China, other developing nations and troubled European countries. The U.S. runs the world's biggest trade deficit. Countries with major trade surpluses are Saudi Arabia, Germany, China, Russia and Japan (in that order). After excluding the two oil exporting nations, the trade surpluses of the remaining three are a function of their export driven policies. The U.S. consumers need to save more and spend less, but will the big exporting economies make changes to stimulate their own consumption as an offset? Finally, foreign investors need to have confidence that the U.S. will address its structural deficit.

The words of Shakespeare's witches were to double the toil and double the trouble for Macbeth. The debt bubble has created trouble for lenders and borrowers. We will toil for a long time while it unwinds.

What Are The Questions We Ask Ourselves As We Structure Our Clients' Portfolios?

Although discussion is often focused on whether the U.S. dollar should weaken, a more apt question may be whether the Chinese yuan, also called the renminbi, should appreciate?

The Yuan had appreciated gradually from 2005 until the financial crisis, when it was again pegged to the dollar. If China allowed the Yuan to gradually appreciate, the Chinese people could more easily afford foreign goods. In addition, this might be accompanied by Chinese government policies to foster domestic consumption and augment efforts to rein in their boom-

ing expansion and rising inflation.

How will the nations with aging populations (discussed last quarter) finance care for their elderly?

One reason China has a high savings rate is that there is no social safety net. People must provide for their own retirement. With one child, this burden is a mounting social problem across Chinese society.

Will the structural deficit problems in the U.S. be addressed?

The health care legislation expands coverage but does not address costs, efficiencies, cost transparency or incentives to live healthier lives. Will politicians make the tough choices surrounding the structural deficit? The size is so large that everyone agrees something must be done. How much will taxes increase? Will a consumption tax (value added tax) be part of the deficit solution?

Will deleveraging be deflationary or inflationary?

Members of the MBO Cleary and Cleary Gull Investment Groups debated this issue in March with strong views on both sides and adequate data to support either argument. In my opinion, we may have both: cost inflation (consider the cost of health care, education, regulation, transportation and materials) and continued pressure on the price of some assets.

If rising financial leverage in the U.S. spurred financial asset growth, rising housing values and personal consumption, where will future growth come from?

Will exports, new products, new distribution channels, new technologies assume the lead? Will future growth be slower without leverage? Likely.

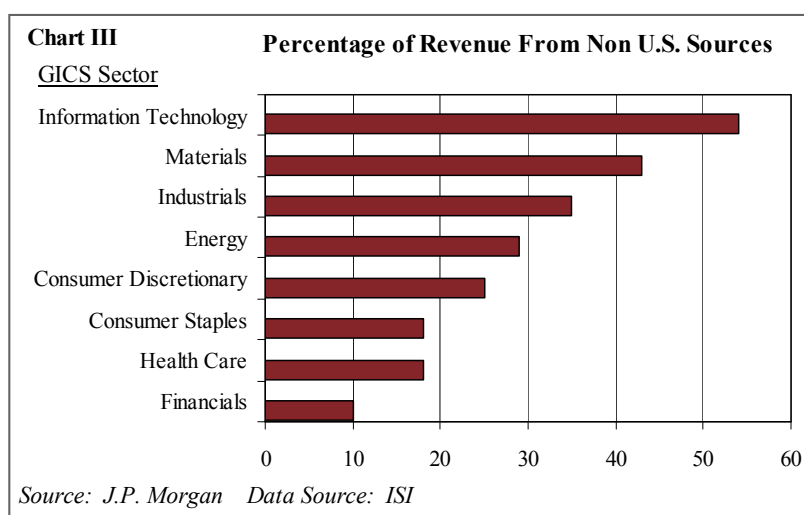
What makes this recovery different from others?

About 90% of the domestic economy is in service industries. Growth in services may create more jobs but productivity can be harder to achieve and some service jobs are low paying. Reducing interest rates to spur borrowing for growth does not work when interest rates are close to zero. Housing has typically led a recovery; not this time. The other major source of early economic recovery is inventory replenishment, which is occurring. The baby boomers are beginning to retire and may change their consumption and savings habits.

Have corporate profit margins begun an extended period of contraction because of rising regulation and rising taxes even though productivity is strong?

If growth is higher in less developed markets, shouldn't this apply to the growth of U.S. companies in foreign markets?

Consider Chart III (below) showing that many companies are already deriving a significant portion of their business outside the U.S. Why not capitalize on it?



Will long-term interest rates rise?

Certainly short-term interest rates will, but do long-term rates have to? Could the yield curve just flatten?

What could cause P/E ratios to contract?

In periods of heightened uncertainty, rising interest rates and shrinking profitability, P/E ratios tend to contract. P/E ratios expand when future prospects are bright and/or interest rates are falling.

How will we manage longevity risk?

This is a question for all of us, whether young and saving for a far-off retirement, or approaching "normal retirement" with many years still to live. Institutions are facing this challenge by shifting the risk to employees, replacing pension plans with defined contribution plans. The U.S. government needs to change how "normal retirement" for social security is determined and tie it to changing life expectancy. I started my career over 40 years ago; today's mortality table says I will live six years longer than it said then. Shouldn't I adjust for that? Shouldn't we all?

Given these questions, the investment risks and opportunities, we believe that it is critical to remain diversified and maintain the rebalancing discipline. We combine different strategies with proven and flexible managers who may invest across asset types and around the world or who concentrate with particular expertise; then, we assure that the managers employ rigorous value disciplines. We continuously reevaluate managers and portfolio structure. We strive to understand and learn from history. We endeavor to be patient.

Accounting - An Art, Not A Science

Very good managers read annual reports from the back, where the footnotes are located, and evaluate how managements generate and allocate capital: acquisitions, share buy-backs, dividends, research and development, etc. Why? Because this is how they are able to better understand what is really going on in a company, evaluate and compare results among companies.

Consider that the difference in reported and operating earnings reached its widest point in 2008, as shown in Table II. What causes these differences?

Operating earnings exclude one-time items such as write-offs of bad loans, acquisition costs and severance costs related to plant closing, etc. Prior to 1988, the difference was so small and isolated that aggregate data for earnings of the S&P 500 Index companies was not even published. Earnings are also affected by a variety of accounting rules that allow management discretion with treatment of items such as when revenues are recognized or how assets may be depreciated.

Recently, it has come to light that financial institutions have the ability to employ tactics such as repurchase agreements to move liabilities off the balance sheet at quarter-end in order to show less leverage at reporting periods and, therefore, look healthier than they may be. This was the situation with Lehman Brothers. While legal, this certainly can be viewed as deceptive and raises questions about whether we have seen all of the “bad assets” yet. We continue to have concerns about the

valuation and disclosure of financial assets and liabilities and some skepticism about the durability of the very strong relative performance of the financial sector that we have been experiencing since year-end.

On the positive side, cash to total assets of *non-financial* S&P companies is at a 35-year high. For non-financial corporations,

the return on capital minus the weighted average cost of capital is near prior peaks. We are already seeing an increase in acquisitions, particularly big companies buying small companies. Cash may also be reinvested in re-

search, development and internally generated opportunities. However, because many S&P companies, actually companies of all types and sizes, are global, some of the estimated \$970 billion in cash is held off-shore. Currency restrictions and tax consequences may keep much of the non-U.S. cash overseas and unavailable for dividends and share buybacks but still available for other activities.

Table II

	S&P 500 (Earnings per Share)					
	2011E	2010E	2009	2008	2007	2006
Reported	\$72.20	\$65.00	\$51.30	\$14.88	\$66.18	\$81.51
Operating	\$83.00	\$76.00	\$56.47	\$49.51	\$82.54	\$87.72
% Difference	15%	17%	10%	233%	25%	8%

Source: S&P and Leuthold Research Group

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