Overview

As of October 1, 2010 the various market benchmarks stood as follows[1]:

Equity/Commodity Index	Year-to-Date	2nd Quarter 2010	3rd Quarter 2010
Dow Jones Industrials	3.5%	-10.0%	10.4%
Wilshire 5000 (total stock market)	3.9%	-11.6%	10.4%
Standard & Poors 500 (large cap)	2.3%	-11.9%	10.7%
Russell 2000 (small cap)	8.1%	-10.2%	10.9%
MSCI EAFE (international large cap)	-1.2%	-13.9%	13.5%
Crude Oil @ 79.97/barrel	12.92%		5.7%
Natural Gas @ 3.872/mmbtu	-13.30%		-16.1%
Gold @ 1,307.80/tr. oz.	19.41%	14.8%	28.6%

Treasury Bond Issue	Yield
90 day T-Bll	0.15%
6 month T-Bll	0.19%
2 year T-Note	0.43%
10 year T-Note	2.51%

As you can see from the equity indices above, third quarter 2010 was a strong reversal from the first half – in particular the second quarter where all the indices fell into negative territory. As discussed often on the phone and in person, 2010 has been a very active and volatile market going “not very far but at a high speed.” After a lackluster August, September 2010 turned out to be the best September in 71 years[2]. Last month the Dow Jones Industrial Average (DJIA) rose 7.7% and the Standard and Poors 500 (S&P 500) gained 8.8%. The rally was realized by institutions while individual investors, due to economic and political uncertainties, preferred investing heavily in the bond markets where yields are at historical lows. Blue-chip corporations took advantage of investors’ bond appetite to issue obligations with rock-bottom interest rates. In September Microsoft issued $4.75 billion of 3-year notes at a rate of 0.875%, the lowest U.S. corporate-bond rate in more then 3 decades[3]. Earlier in the quarter IBM issued 3-year notes with a 1.0% yield. Johnson & Johnson sold 10-year notes paying under 3.0%. Investment-grade issuance of debt was almost $612 billion in the third quarter – all at or near record low interest rates.

The third quarter returns for many international markets, especially in Asia, were most dramatic. The Thai SET rose 22%; the Indonesian Jakarta Composite gained 20%; and the Indian Sensex shot up 13% for the quarter. In fact both the Indian and the South Korean markets neared their all-time highs. Argentina's market did hit a new high. For the quarter (in U.S. dollars) stock market performance based on the Dow Jones Global Indices included[4]:

Country	3rd Quarter
Sri Lanka	62.8%
Latvia	35.4%
Chile	34.1%
Argentina	27.1%
Australia	23.2%
China	12.1%
Japan	4.4%

Even Europe showed recovery, ending the quarter with a average gain of 6.7%. We see this recovery of global stocks as general understanding that the worst may be over for the U.S. – the worlds largest economy – allowing investors to focus on growth in their domestic markets and elsewhere.

Part of the movement of institutions towards foreign stocks and in domestic equities relates to the ongoing deficit spending by Washington, as well as a lack of support for the U.S. dollar by Ben Barnanke of the Federal Reserve. Gold has appreciated nearly 30% in the past year and is currently hitting new highs. September 30 gold futures that trade on the New York Mercantile Exchange ended the day at a record high of $1,310.30 an ounce for December delivery[5]. Silver December contracts on September 30, 2009 were at 16.78 per ounce compared to September 30 this year were at 21.76 per ounce – up 29.67%[6].

The Current Picture

Better-than-expected readings on payrolls, manufacturing, retail sales, and a resumption of a downward trend in jobless claims in September resulted in last month's the strong rally. We are seeing overall slightly higher corporate confidence as expressed in stock buybacks. In August, U.S. stock buybacks rose 97% over July led by Hewlett-Packard Co.. August buybacks of $29.2 billion were seven times the size of August 2009. For the year, buybacks of $245 billion are up nearly 5 times from the same period in 2009 – a key positive indicator[7].

Although new home sales remain depressed, home resales jumped 7.6% in August from a 13-year low – to an annual rate of 4.13 million[8].

Corporations flush with cash are shopping for mergers and acquisitions including Southwest Airlines, United Airlines, Dell, Walmart, Intel, and Unilever. Global mergers are up 21.4% so far this year according to Thomson Reuters[9].

After-tax corporate profits through the second quarter were up about $1.2 trillion, marking the third-highest profits per share of the economy since 1947. The build up of balance sheet cash is about $2 trillion. During this year's first two quarters, at least 75% of companies in the S&P 500 beat expectations[10]. Thomson Reuters, which provides consensus earnings estimates, anticipates year-over-year operating earnings growth of 24% for the third quarter and gains of another 31% in this year's final three months[11].

As of this writing, the following major companies, many of which are held in client accounts, have reported significant positive revenues and earnings surprises including:

Occidental Petroleum Corp.	Deer & Co.	Humana Inc.
Ford Motor Co.	Nordstrom Inc.	Chevron Corp.
Amazon.com Inc.	Kraft Foods Inc.	Oracle Corp.
Apple Inc.	America International Group Inc.	Goldman Sachs Group Inc.
Morgan Stanley	Macy's Inc.	Texas Instruments Inc.
Aetna Inc.	Costco Wholesale Corp.	FedEx Corp.
Pfizer Inc.	Allstate Corp.	DuPont Co.
United Parcel Service Inc.	Caterpillar Inc.	Cummins Inc.

Our concern, shared by many others including clients, is that after this calendar year dramatic revenue and earnings comparisons year-over-year will diminish. Companies are running out of room for cost-cutting while top line companies will continue to grow at a nominal level – growth will increase by single digits – in other words a continuation of the slow growth economy and recovery.

For 2010 we are faced with a GDP recovery averaging in the 2 % range – well below historical recovery averages. We see stubbornly high unemployment rates in the 9 to 10% range with underemployment rates of 12 to 15% added on top. Unemployment as measured by Gallup increased to 10.2% in September – up from 9.3% in August[12]. The federal government is currently spending $3 for every $2 it collects in revenue. The federal deficit is growing at about $100 billion a month[13]. Our national debt as a percentage of the economy is more than 61%, breaking the 60% line for only the second time in the nation's history[14].

The Associated Press reported that top economists, 46 polled by the National Association of Business Economics, forcast mild economic growth of 2.6% GDP in 2010 and 2011[15]. These economists expect the economy will add jobs through the end of 2011, but not enough to bring down the unemployment rate below 9.2%[16]. They also reported that home prices will remain relatively flat through 2011. The GDP grew at a 1.7% annual rate in the second quarter 2010.

With minimal reward from fixed income securities; a flat real estate market; a volatile stock market with minimal reward; an uncertain business environment with equally unknown tax rates and policies; what are some strategies to consider?

Strategies and Concepts

Gold

Gold and other precious metals have appreciated to new highs due to expansion of the money supply both domestic and international along with the possible nuclearization of Iran. Along with Greece, the U.K. and other nations, the U.S. has spent hundreds of billions of dollars in stimulus money.

Estimates of up to $10 trillion are expected to be added to the U.S. federal debt burden – weakening the currency relative to precious metals. International buying of gold has been particularly strong. Last year India purchased 200 metric tons from the International Monetary Fund while China increased its gold reserves to 1,054 metric tons from 395 metric tons[17]. World mine production is about

2,500 metric tons – roughly 25% higher than it was in 1990 – but net mine supply is less than it was 20 years ago[18]. Also investment demand has doubled in the second quarter 2010 over the 2009 second quarter.

Our concerns with gold and other precious metals are several fold:

- timing is poor since gold has appreciated from about $250 to more than $1,300/ounce
- besides jewelry there is very little industrial purposes for gold and commodities do not pay interest or dividends since they are not corporations
- Gold, although responds well to global turmoil, does not always hedge effectively to inflation
- The price of gold generally falls as the economy improves
- According to Morningstar, $1 invested in the stock market beginning in 1980 would have grown to $24.3% by July 2010; $1 in bonds for the same period would appreciate to $18.20; $1 in gold grew to $2.23 as of October 2010[19]

Market Timing

Often we have pointed out the risks of market timing which we always consider a speculation. During the decade ending December 2009, average funds of all types – equity and debt – returned an annualized 3.18% while the average investor, which usually responds subjectively to market moves, earned an annualized 1.68%[20].

Investors, as mentioned before, are selling equities and are buying bonds – with historically low yields. Nearly $12.4 billion exited U.S. stock funds in July[21]. Investors withdrew $33.12 billion from domestic stock market mutual funds in the first seven months of this year[22]. Recall earlier that the S&P 500 rose 10.07% in the third quarter of 2010 – bad market timing indeed! According to Oppenheimer, a study shows that holding the S&P 500 for the 25 year period from March 31, 1984 to March 31, 2009 would have returned a 9.3% compounded rate of growth. If an investor missed the top 25 days during the 25 years, the return would only be 1.4%[23].

Tactical Allocation

Related to market timing but on a narrower investment category level is timing various assets. In 1999 the Russell 2000 growth index returned 43.1% while the Equity REIT index (real estate) returned –4.6%. For the year 2000 the top performers were the S&P GSCI (commodities) at 49.7% while the Russell 2000 Growth index lost 22.4%. In 2001 the Equity REIT index returned 13.9% while the S&P GSCI lost 31.9%[24]. According to Morningstar which measured 62 tactical strategy-oriented funds over 3 years found that most underperformed the Vanguard Balanced Index fund which is a static balance of 60% equity and 40% bonds[25].

Equity Investing for Total Return Using Master Limited Partnerships

Master limited partnerhships (MLPs) are publicly traded managed partnerships that avoid double taxation on their earnings since they are not treated as corporations. Holders of these shares, or unit holders, file K-1s and must pay taxes on the distributions they receive. MLPs are generally asset based and distribute income from sales of commodities such as water, oil, gas as well as interest from mortgages or rent from real estate. The Alerian MLP index, which tracks 50 energy MLPs over the last 10 years has returned 18.5% annualized[26].

Total Return Closed-End Funds

Closed-end funds, similar to mutual funds, are actively managed portfolios. These portfolios like their mutual fund cousins, can be diversified or focused by investment type, region, purpose and tax consequence. These investments have shares that are traded on exchanges, therefore a manager can invest for the long-term with no requirement to keep low-yielding cash on hand for redemptions. Closed-end funds can trade at a premium or discount from their net asset value; for example, a $1 per share in asset value can be traded at 70 cents or $1.30 on a stock exchange. The yield and total return on many closed-end funds often are superior to their related mutual funds which may use the same manager.

Dividend Paying Common Stock

Microsoft Corp. which sold $4.75 billion of low yielding corporate bonds (as stated previously, 3-year notes issued at 0.875%) currently pays about 2.8% in dividends on its common stock. The company has a AAA Standard and Poors credit rating. The dividend paid in 2003 was 8 cents per share while based on the recent payout is now 52 cents per share for 2010 – six and one-half times greater. How many bond issues have increased their yield 6.5 times its original payout in 7 years?

The IBM dividend was 51 cents per share in 2000 and is now paying $2.15 - an increase of 4.2 times its original payout. The current yield is about 2%. Johnson & Johnson common stock has a current yield of about 3.5%. Its dividend in 2000 was 62 cents per share and has risen over 3 times to its current $1.93 per share.

The S&P Dividend Aristocrat index, consisting of 42 large cap "blue chip" companies within the S&P 500, have increased their dividends every year for at least 25 consecutive years. This index as of August 28, 2010 returned 1.7% year-to-date while its broader sister, the S&P 500 performed a negative 4.5% for the same period[27]. We have seen dividend paying stocks perform well, even in environments with rising interest rates. From June 2005 for 12 months, Treasury yields rose 1.22% while equity-income stocks gained 7.6%[28]. Currently the DJIA has a dividend yield of about 2.5% compared to a similar yield for 10 year Treasuries. Dividend payouts, like bond yields, tend to rise with inflation – especially for asset laden companies. Dividend paying stocks also act as a cushion during market corrections.

Value Investing using Strategic Allocation

When evaluating sectors of the market, and companies within these sectors, we utilize great valuation concepts such as: financial ratios – price to earnings, price to book value, _______________ structure and price to cash flow, earnings and revenue growth, expending operating margins and return on shareholder equity, general management stability and success over time.

We invest with specific mutual and closed-end funds that have been most successful utilizing these and various other value strategies as well.

During the market crash starting October 2007 through the March low in 2009 the S&P 500 lost over 57% of its value. In a few cases some clients went to cash; others to fixed and adjustable rate bonds. For most clients we gradually modified portfolios adjusting to the deteriating market and economy. We applied strategic allocation concepts where we over weighted sectors that become more attractive relative to others that were "pricier". In most cases stayed invested with the general motto of: stay calm, stay in and stay the course. By doing so clients fully participated in the recovery from March 2009 going forward with market indices appreciated some 71% through September 2010. Many of our clients that avoided the pitfalls of buying high and selling low are now in "new high" territory even with the S&P 500 still 27% below its pre-crash highs. Although the S&P 500, from January 2000 through December 2009 has a negative annualized rate of return – including both the "dot-com bear" along with the "great recession bear" we see and believe the current recovery will continue. The long term compounded growth rate of large cap U.S. stocks from January 1871 through December 2009 is 8.89%[29]. For the last 5 years – January 2005 through December 2009 the rate is now slightly positive – 0.41%[30] which includes both crash and recovery. We anticipate (and hope) for the normalization process to continue – a regression to the mean – for both the economy and the market

If you would like to discuss any of the above strategies or any other investment concepts do not hesitate to call us. We are here to help you in any manner we can! We wish you a successful and happy fourth quarter 2010.

Yours,

George Gumbiner
President