Lassus Wherley ...a view from the top
Building Better Futures
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Hard to Believe it is 2011!

Food for Thought

Someone asked me for the names of the best companies to buy this year. I responded that we don't recommend individual companies, but if we did—I would buy any company that manufactured or sold snow blowers or ice melt. The year has started off with some very crazy weather which we hope isn't going to continue for the entire winter. Many of us got stranded over the holidays. I had one of those "planes, trains, and automobiles" trips myself trying to get home from Austin, Texas to NJ after Christmas. It was quite an adventure and took me two days to go by several canceled flights, two planes, two unexpected overnight stays and a train by way of Washington, D.C. What you learn from this type of experience is that patience is a requirement in life, that there are many interesting people who appreciate the small things in life, and where there is a will there is a way. I was told several times that I couldn't get back to NJ until late Wednesday and this was Monday morning. But I stayed on the computer and finally tracked down a flight to D.C. Of course, then I couldn't get on a train because all the trains were booked for that evening so I had to track down a hotel. But I managed to get a room and a train for 6:30 am the next morning. By noon on Tuesday, I was home in NJ.

Of course, my luggage decided to stay in Houston. I am truly grateful that I don't work for an airline and that I am not responsible for getting luggage to the right place during a blizzard. Thank you Continental for finding my luggage and getting it to NJ. Thank you to all the friendly people I met in Austin, Houston, D.C. and all along the route of my travels.

So how does that experience relate to the economy and investing? First, I was amazed at the number of people traveling during the holidays and that bodes well for many industries. Second, in my two days of travel, I had the opportunity to talk to people from many parts of the country and from many industries. Most of these folks were becoming more positive about growth and what was happening in their businesses and lives. I arrived home exhausted but feeling better about the world!

Much Ado About Something!

2010 turned out to be a better year for the US stock market than many had expected at the beginning of the year. As the year 2010 drew to a close, two events occurred with important implications for markets and the economy in 2011. The Federal Reserve announced that they would go forward with a plan to buy $600 billion in US Treasury securities in order to stimulate the economy (QE2), and Congress passed a Tax Package which extended the Bush tax cuts. These moves signaled concern on the part of the Fed and the federal government that the economic recovery was still fragile enough, and unemployment was still high enough, that further stimulus was required.

Both the Fed's announcement of QE2 and the Tax Package, however, were met with rising interest rates as investors saw them as potentially increasing the federal budget deficit in the future. This prompted some investors to reduce their commitment to bonds. After a year of steady inflows, individual mutual fund investors decided to start pulling money from bond funds as they anticipate rising interest rates. The rally in US stocks has continued in the wake of the Tax Package, as institutional investors believe that it will be good for economic growth.

The Tax Package included four measures which should stimulate economic growth this year. These are: the cut in the payroll tax for 2011 for individual wage earners from 6.2% to 4.2%, an extension of jobless benefits for the long-term unemployed, a reinstatement of the 35% top rate for the estate tax for 2 years, and an extension of the Bush tax cuts (including those on capital gains and dividends) for all.

These measures should have positive effects over the upcoming year. Concerns about them focus on their impact on the federal budget deficit over the longer term. While the Bowles Simpson Deficit Reduction Commission was not able to garner enough votes to get their proposals sent to Capitol Hill for action, there is a growing sense of the need for Congress to begin to address the issue of government spending.

In the weeks since the Tax Package was passed, economists have increased their estimates for US economic growth for 2011, and these increases fed the rally in stocks in December and continuing in January. Economists are now looking for GDP growth in 2011 of 3% on average, with some estimates as high as 4%. This estimate is likely to be moving higher as we continue in the New Year.

This year we expect to see a tug of war between the forces which slow economic growth and those that enhance it. Deleveraging on the part of consumers and municipalities and declining housing prices may slow growth. On the other hand, stimulative fiscal and monetary policies, strong growth abroad, and pent-up demand will boost output. For example, the payroll tax cut and stronger job gains should help promote personal spending, and the 100% expensing of capital spending (included in the Tax Package for 2011) should boost investment spending by corporations. Finally, we continue to believe that stronger global growth in 2011 will stimulate net exports from the US, which represents a great opportunity for both job creation and growth.

We expect that returns on stocks will be positive for the year 2011 as valuations appear reasonable and liquidity is abundantly available. Earnings are expected to increase by 13% in 2011, and the S&P 500 is selling at about 13.3 times this year's earnings estimate. We expect that stocks will provide healthier returns than bonds in 2011 with bond fund investors getting returns in line with current yields over the next two years or so.

There are many questions swirling around as we kick off the New Year. Please let us know if we missed any that you are concerned about.

Question: *How are you handling the current issues with bond funds?* **Answer:** As we mentioned, the actions taken in the last two months to stimulate the economy have caused long-term rates to rise in anticipation of the eventual end of the Federal Reserve's stimulus. We believe these stimulus measures will have the intended effect, but growth in this recovery still remains sub-par. This means we don't see the end of either fiscal or monetary stimulus any time soon. Consumer behavior is undergoing a fundamental change, and while consumer spending will increase, we don't see US consumers going back to their free-spending ways. Also, the condition of state and local government finances means that spending by these entities will continue to go down as state governments continue to tighten their fiscal belts in the future.

These drags on the economy mean that while we are closer to the end of the long bull market in bonds than to the beginning, we do not see a dramatic upturn in rates over the short term. Most investors do not foresee any increase in the Federal (Fed) Funds rate until the fourth quarter of 2011 at the earliest. Then the average expectation is for a Fed Funds rate of about 0.50% vs. the current 0.13%. Some economists don't see any increase in rates by the Fed until the fourth quarter of 2012, nearly 2 years away!

We continue to utilize a strategy which calls for equally weighting our clients' bond portfolios between short-term and intermediate-term bonds. Once we see a change in the upward movement of interest rates, we will re-evaluate our position.

You may have heard that municipal (muni) bond funds have been hit pretty hard of late. Muni bonds were impacted by the same concerns as taxable bonds along with some additional factors. Much of the loss of value in muni bonds which occurred over the past three months reflected a heavy supply of new issues coming to market in advance of the expiration of the Build America Bonds program. This occurred at a time when several other factors were impacting the value of muni bonds including: demand for muni bonds is seasonally low, we found out that income tax rates would **not** be rising for at least two years as a result of the Tax Package, and investors became more concerned about budgetary issues in the wake of the tax compromise. State and local governments face fiscal problems, there is no doubt. These fiscal problems will need to be solved through serious long-term budget reform but will not happen overnight. We do not believe, however, as some have predicted, that there will be municipal defaults "worth hundreds of billions of dollars."

States are expected to lose about $40 billion next year which had been provided to them as part of the stimulus under the 2009 Recovery Act. While this will mean that the effective funding gaps for many states will increase, the impact of losing federal funds should be mitigated by the recent growth in revenues from individual and corporate income taxes and sales taxes on both the state and local levels. With the meaningful increases in economic growth projected as a result of the Tax Package, revenues on the state and local level could provide some surprises on the upside this year given the boost to receipts from income, profit and sales taxes.

It is important to note that the credit fundamentals of the muni bond funds in which we invest have not drastically changed over the past three months. We invest in actively managed muni bond funds from Vanguard and Thornburg. These funds invest in high- quality muni bonds and combined, provide a well-diversified muni bond portfolio. Both firms emphasize revenue bonds of entities providing essential services like sewer and water over general obligations of any state. We expect to see increased demand for muni bonds from institutional investors this year given the very enticing yields currently available on these issues.

Here are some recent comments from Vanguard:

"The recent sell-off in the municipal market has not been driven by a material change in the credit fundamentals of the market. Supply and demand, higher treasury yields, and psychological factors, given the well-publicized financial challenges facing states and cities, have combined to drive up muni yields."

"We do not believe that there is a wholesale crisis in the muni market. We do see some sensationalism in the press. However, when, for example, you look at budgets of IL, NJ, and CA, there is a tendency to extrapolate budget concerns to widespread defaults in the muni market. But there is little strain on muni debt issuance and service within these states. CA being the highest, debt service represents 6% of their annual budget. We don't see a debt crisis like you had in Greece where their debt service represented upwards of 25%."

"That being said, the muni market will likely remain volatile as municipalities will remain challenged given the sharp cutback of federal stimulus aid to states combined with the economic stress over the last two years."

The bottom line is we will continue to invest in well diversified muni bond funds but will also utilize TIPS and corporate bond funds to provide broader diversification.

Question: *Why did you sell my Cohen & Steers Institutional Global Realty Fund (GRSIX)?* **Answer:** We sold most positions in GRSIX in taxable accounts on December 14, 2010, just prior to the payment of a $0.75 per share ordinary income distribution. We did not want to increase your income tax liability as a result of this distribution just prior to year-end. Keep in mind that when mutual funds pay a distribution like this, the Net Asset Value (NAV) or price of the fund is reduced on the day of the distribution by the amount of the distribution. So, in fact, even if we sold your position, you had effectively received the distribution through the price appreciation which occurred prior to the sale of the shares.

It is our intention to return to positions in this fund after 31 days have passed since the date of sale. In this way, we will avoid having any issues with the wash sale rule for those clients who might have had a loss in the original position.

Question: *I thought you liked Harbor Bond Fund (HABDX). Why did you sell it?* **Answer:** We decided that we did not want to take the distribution from HABDX which was paid on December 17, 2010. This distribution totaled $0.79911 per share and consisted of $0.19174 in ordinary income, $0.40109 in short-term gains and $0.20628 in long-term gains. We sold positions where there was a large tax impact and held positions where there was little or no tax impact. We have held HABDX for a long time and still retain it on our recommended list.

At this point, we are also beginning to reduce the size of the HABDX position in many portfolios due to the more aggressive approach to investing they are using. We feel more comfortable right now with an equal weighting between HABDX and the JP Morgan Core Bond Fund select Shares (WOBDX or WOBSZ). The JP Morgan Fund is run more conservatively and suits our desire to emphasize a conservative approach emphasizing preservation of capital in our bond fund selections. So……...when we buy back into HABDX, the purchase may be for a smaller amount than what we sold.

Question: *I have always liked Hussmann Strategic Growth Fund (HSGFX) but John Hussmann has done really poorly this year. Why are we continuing to hold it?* **Answer:** We believe that John Hussmann is a very thoughtful investor and does not hesitate to say what he thinks about market valuation. According to the valuation measure which he uses, the market is expensive right now. He thus continues to hedge his long stock positions with a short position on the market. This strategy has caused the performance of his fund to lag in a stock market which has been very strong.

We continue to hold HSGFX because we believe it is important to hedge our long-only exposure to stocks and other risky assets. His fund may be trailing this year, but HSGFX returned -9.02% vs. -37.00% for the S&P 500 in 2008. Continuing to hold a position in HSGFX is just another example of not putting all of our eggs in one basket. We also believe that it makes sense to stick with an investor whose strategy has worked for us in different markets and whose fund acts to lower the overall risk profile of our portfolios.

We may take steps to reduce the overall allocation to the hedge strategy asset class this year, not because of the fund but because we are reducing our overall allocation to this asset class.

And the Beat Goes On……

There will be many challenges in 2011, including waiting for Congress to deal with health care and financial regulatory reform. Recent announcements concerning studies done on the regulation of financial planning and the fiduciary standard have elevated the need for active discussion of these areas. Stay tuned.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others. Please let us know if you have any questions or concerns. Have a warm and safe Winter! I know we will all be very happy to see Spring arrive!

Diahann

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