ABSTRACT FROM TALK STRATEGY MEETING:

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NOVEMBER 11, 2010

The current bull market has now been running for roughly 18 months and counting (since March 9, 2009); still investors seem fearful and averse to owning stocks – an asset class perceived as being most risky. As we sit with all clients, we remind them that maintaining a long-term perspective is critical. Most important to one's long-term investment performance experience is the asset allocation decision. It is not market timing, security selection or other factors. And, history tells us that stocks beat bonds, often and by a lot. But, following 10 years of a negative return experience for US stocks, investors feel most compelled to chase the yield of bonds and other fixed income assets.

In our discussion we discussed what we see as the opportunities for investors given the current economic, political and investment landscape. A summary of the slides and discussion follows.

- Year-to-date: The S&P 500 is up +11.57%
  - Performance experience has been choppy;
    - 1Q = +5.4% | 2Q = -11.4% | 3Q = +11.3%
  - Since Quantitative Easing Part 2 (QE2) was first suggested by Fed Chairman Bernanke during a speech at Jackson Hole, WY (August 27, 2010), markets and hard assets have responded by increasing (inflating) in value.
    - The S&P 500 has climbed over +17% since 8/27/10
- Following a decade of negative stock returns for the markets (S&P 500), investors are living in an Era of Fear: Crisis of Confidence
  - Since 2000, investors have suffered two bear markets (March 2000 – October 2002; October 2007 – March 2009)
    - And, have had a negative return experience for the decade if they were invested in the all-stock S&P 500.
    - Technology stocks (NASDAQ 100 chart) remain well below values seen at beginning of the decade.
    - Housing values have also declined
- Emotional Investing is unsuccessful
  - Investing using emotion leads one to buy when it feels good (buying high) and sell when it feels bad (selling low);
    - 1994 – March 2000: Era of Greed | Greenspan called it "irrational exuberance"; investors were buying stocks near the top
    - 2000 – 2010: Era of Fear | Could it be "irrational exasperation???"; investors currently chasing yield and perceived safety of bonds
  - Recall: Did you feel like investing in March 2009?
    - It felt like the "sky was falling". Clients offered other words:
      - Alarming, Pandemonium, Devastating, Relentless, etc…
- Emotional Investing/Uncertainty is driving investors to seek perceived safety assets
  - Bonds, Annuities (with their insurance company "guarantee" label), Gold, Money Market Funds (MMFs), etc.
- Investors are yield chasing for several reasons
  - Desire for lower volatility (price risk) relative to stocks: "rearview mirror" investing

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- High Unemployment – minimal job growth makes income feel uncertain
    - Risk to stream of wages and salary income
    - Threat encourages households to reduce risk in financial portfolio
- Sharply falling home prices
    - Perceived risk is higher and prospective return lower than previous expectations
- Demographics – aging population
    - Baby boomers on retirement doorstep (with depreciated savings) feeling they cannot afford another loss

- Fund Flows Reflect Investor Fear
    - Last 12 months: Era of fear - investors have ignored stock funds and poured money into bonds
    - 10 years ago: Era of greed – investors flooded stock funds and pulled money out of stock funds – opposite of today
- Fear reflected also in bearish (negative) investor sentiment toward stocks
    - In October, just 21% of investors described themselves as bullish about the next year. In March 2009, just 26% of investors were bullish but returns through March 2010 were +63%; very strong!
    - History shows that when investor sentiment is extreme, either bullish or bearish, the following 12 month market performance is often contrary to consensus opinion. Said another way, when sentiment is overwhelmingly bearish, it's actually an indicator that investors should be buying
- Rolling 10-year returns suggest reversion to the mean
    - Only one other time in stock market history (1930's) was 10-year returns negative.
        - Historically, significantly above- and below-average return periods have reverted to the mean of +10% and often overshot in the opposite direction
            - Are abnormally-low 10-year returns a bullish signal moving forward?
- Bonds have enjoyed favorable secular tailwind of falling interest rates for two decades
    - Falling rates cause bond prices to rise
    - If/when interest rates (currently at a floor near 0%) rise, bond prices are vulnerable to decline
    - Low yields = High Prices
        - Current Bond P/E equivalent to 34x; stocks by comparison are around 15x.
        - The great bond bull market is probably over
            - Recommend investors keep fixed income investments short duration (short maturity) to avoid price volatility associated with rising interest rates.
- Stocks look attractive relative to bonds
    - Several valuation measures favorable
        - Stock market P/E is roughly 15.6x (Bond P/E: 34x)
        - Stock yield (dividends) exceed yield on 10-year corporate bonds in growing numbers (currently 13% of S&P 500 companies pay a dividend yield greater than the yield they are paying on debt)
    - Stocks also have capital appreciation potential (rising stock prices)
- Government policy: stocks better protect investors from enemies of inflation and taxes
    - Interpreting the Election:
        - The Economy was the BIGGEST issue (growth + unemployment)
        - Ballooning size of government, deficits and bailouts is unacceptable

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            - Exit polls overwhelmingly indicate that government is too much a burden
            - Result: Expect tighter fiscal policy (not monetary)
                - Big, new spending is off the table
                - Tax cuts very unlikely (but extension of Bush tax rates is likely; aka status quo)
        - Split of political power: historically bullish for stocks – Is History Relevant?
            - Since 1928, stocks have performed better under a split political regime; they have performed best under a Republican Congress and Democratic President.
- Quantitative Easing (QE2)
    - Fed to purchase $600B Treasury securities over 8 months; will increase money supply and stimulate economic growth
        - Goal: to get unemployment trending downward and economic growth above the rate of inflation
        - Effect: inflates asset values stocks, bonds and commodities at the expense of US$ value
            - Causes value of currency to decline
        - Former Fed Chairman Alan Greenspan quoted, "stock rally might be the best economic stimulus" as it creates a wealth effect for consumers and encourages them to spend more money.
        - Fed balance sheet to expand from $2.5T to over $3.0T.
- BLACK AND WHITE: Stocks appear to be the best investment opportunity over coming 5+ years
    - Stocks have better relative return opportunity than bonds
        - Reversion to the mean
        - Dividend yields > bond yields and grow over time
        - QE2 inflates asset values
    - **Bonds remain appropriate in portfolios for diversification/risk reduction; but care is required**
    - Global view to investing is critical; believe that investors should devote roughly one-third of their equity exposure to foreign in pursuit of faster economic growth abroad
    - Remain keenly aware that "bill is coming due" for current stimulative efforts.

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