

## Commentary - 1st Quarter 2010

We hope you are enjoying the return of sunshine and warmth. The new decade is starting in a positive fashion in the financial markets. Interest rates are near the lowest levels in fifty years, corporate profits are rebounding, and the broad stock market has gained over 50% from the lows last year. The economy's animal spirits are reviving.

Our outlook for the markets remains positive. The economy should continue to recover and profits will boost corporate bottom lines and stock prices. The banking system is dealing with weakness in the commercial real estate sector, but residential real estate has passed the worst. The big money center banks, except for Citibank, have repaid their government capital infusions from TARP. Small and regional banks are earlier in the recovery process than the big money center banks, but the steep yield curve and improving economy will enhance their profitability. It is likely that the recession ended in the third quarter of 2009. Now we are monitoring what could derail the economic expansion.

Last week's unemployment report was encouraging from the standpoint that we saw sizeable gains for the first time since the recession began. Over 160,000 new jobs were created in March and the January and February totals were revised higher. Although in a typical economic recovery, job gains are more impressive. Employers are still reluctant to fill positions until they are more confident that the recovery will endure and that credit is available to finance expansion. After the wrenching recession it is appropriate for companies to be cautious when some of the institutions they relied upon are now wards of the government.

There are two important current issues that will affect the long term performance of the financial markets: government spending and financial sector reforms. Since World War II, the federal government's share of the economy has ranged from 18-22% on average. Government revenues have averaged 18-20% of the economy. Deficit spending by the government has evolved from being a tool to support the economy during recession periods, to an everyday, accepted form of government policy. When the economy collapsed in the fourth quarter of 2008, federal government revenues collapsed too. A federal stimulus package was passed to boost spending by \$800 billion to offset the weakness in the private sector. The concurrent boost to spending while revenues were falling resulted in a federal deficit of over \$1.4 trillion in 2009. And the government expects to run the same size deficit again this year. One point four trillion dollars is equal to ten percent of the total goods and services produced by the U.S. economy. Historically, the government has only run a deficit this large during wartime, when complete mobilization was necessary. Over the last two years, the federal government's share of the economy has been over 25%. During the recession, as the private sector deleveraged, the financial markets found it acceptable for the federal government to boost its borrowing demands. Scared investors wanted the safety of bonds, especially U.S. Government guaranteed bonds. However, as private sector credit demand increases with an improving economy, it is imperative that the federal government lower its bor-

rowing requirements or the worrisome “crowding out” effect will occur and interest rates will rise for all types of borrowing, reducing the growth potential of the economy. It will be interesting to see how this issue is resolved. Do we as a nation want a greater role of government in the economy or do we want a more limited government role and a stronger private sector? The implications for corporate profitability, and therefore long term stock price performance, are very important to us.

Recent history suggests there is a limit to deficit spending and a government’s share of the economy in a free market system. The government of Greece has been under tremendous financial pressures since it was exposed that they had used financial derivatives to hide the size of their deficits over the last decade. The interest rates on Greek government bonds rose over 45% since this news became known. The graph below shows the yield on ten year Greek government bonds over the last twelve months. Since October of last year, the borrowing cost has increased from 4.5% to 6.5%. The markets are now enforcing some spending discipline on the Greek government.

**Graph 1. Ten Year Greek Government Bond Yields, Trailing 12 Months, Source: Bloomberg**



Surely our own government will find a way to reduce the deficits through a combination of higher revenues and lower spending growth. All it would take is one failed Treasury auction to wreak chaos in the financial markets. That is one “black swan” event we hope to never experience.

Financial sector reform is the other major issue facing the markets currently. The package currently being proposed does not meet the requirements we believe are necessary. It focuses too much on regulators and not enough on market solutions. The proposed Financial System Oversight committee would be made up of some of the same policy makers and regulators that missed the housing bubble and subprime mortgage crisis. How are they going to do a better job next

time? Leverage was allowed to grow out of hand in the housing sector and the banking sector. Subprime mortgages were offered to buyers whose income could not support the payments and they were not putting any equity into the property purchase. When you have zero capital invested and are using all borrowed money for a real estate purchase, is that 100% leverage or infinite leverage? Investment banks were allowed to increase their leverage ratios to over thirty to one, though the regulators really had no idea what the asset side of the balance sheet was worth. When Lehman Brothers needed to raise liquidity because their low capital cushion was questioned as insufficient, they discovered that the asset side of their balance sheet was a mirage. Mark to market accounting on Level Three securities worked great when asset values were rising, but when they turned, the regulators were too late in identifying the undercapitalized situations. The big money center banks did not want to be left out of the leverage party so they created off balance sheet entities, termed “special purpose vehicles”(SPVs), that supposedly limited their exposure to the liabilities. These SPVs turned out to be a special way to lose lots of money. The use of leverage magnifies returns on the upside and the downside. We do not need a new committee of regulators; we need the current regulators to enforce realistic rules. Historically banks have been allowed to leverage their capital eight to twelve times depending on the risk level of the assets. Thirty times leverage is ridiculous.

Financial sector reform must deal with derivatives too. The total notional value of private market derivatives now exceeds \$150 trillion dollars. If the total annual value of U.S. gross domestic product is approximately \$14 trillion, does the size of the derivatives market make any rational sense? Warren Buffet has called derivatives financial weapons of mass destruction. Securities backed by subprime mortgages and their derivatives nearly wiped out the capital of the largest money center banks. Risks tied to credit default swaps, a form of derivatives, caused the government to bail out AIG, one of the most profitable global insurance companies prior to the credit crisis. Now hedge funds are betting on the demise of Greece, Portugal, Spain, and Ireland using credit default swaps. Some regulators are recommending that derivatives should be traded on an exchange and cleared through a clearing house similar to futures contracts. This would provide transparency and greater efficiency to the markets. We think this proposal makes enormous sense. Provide the markets with more information regarding these positions and the markets will enforce discipline on speculators who are overextended. The big banks that write most of these derivatives are strongly against any regulation of the products because they make so much money off of them. The profit margins on a private transaction in derivatives dwarf the profits that could be made on a similar size transaction in the futures markets. No wonder this sector is lightly regulated. The question is are the regulators going to continue to risk the public’s capital by backstopping the big money center banks should they get into trouble with their derivatives, or are they going to let the market provide the discipline?

And while we are on the soapbox, why are the SEC and the stock exchange regulators allowing high frequency trading? Some large hedge funds and investment banks use their extremely powerful computers and software programs to make fractions of a cent on trades by using their software to analyze trade order flows to capture small movements in share prices. We have read that up to thirty percent of the daily volume on the stock exchanges is executed by these high frequency trading programs. Since when did owning a stock for a few seconds and capturing a penny on the share price qualify as investing? Is that kind of trading fair to an individual investor

who is trying to buy 100 shares of AT&T online through his discount broker? Do both sides of the transaction have the same access to the same information?

Corporate cash balances are still high by historical standards. When the credit crisis hit, corporate treasurers went into preservation mode, and held onto as much cash as they could. Now that we are six months into a recovery and companies are earning less than 1% on their cash balances, look for more dividend increases and share buyback announcements. Acquisition activity should also pick up as the cash is put to better uses. Individuals continue to reduce their money market cash balances and put the money to work. Unfortunately, the majority of investor purchases of mutual funds are going into bond funds and international funds. Domestic equity funds are still not attracting much interest from U.S. investors. We think bond funds will be poor performers over the next year as the Fed raises interest rates. International funds have been a good place to be invested over the last few years, but they appear overvalued to us and investors may learn the hard way that they should stick to what they know and it is better to be invested in Microsoft and Ford than a Chinese internet company.

Here is how our asset class strategies performed in the first quarter. We have been booking gains recently.

**Blue Chip Strategy:** Our large cap stock strategy rose 4.60% in the first quarter, versus a gain of 5.41% for the S&P 500 Index. Over the last twelve months, the Blue Chips rose 45.46% while the S&P rose 49.71%. The Dow Jones Industrials are flirting with the 11,000 level, but that is still 27% below their all time high. They will benefit from the global economic recovery and the cash they have accumulated over the last two years. The drug companies in the Dow, including Merck, Johnson and Johnson, and Pfizer, rallied strongly after the health care legislation was passed last month. With more people using health insurance, there should be more demand for their products. Boeing was the strongest performer during the quarter, rising almost 35%. Their new 787 Dreamliner began flight testing during the quarter. Once they begin deliveries of the new plane, they anticipate strong demand to continue. Alcoa was the weakest performer in the portfolio in the first quarter, falling 11%. Demand improved for Alcoa but their margins were weak. The companies in the Blue Chip Strategy are reasonably priced. The estimated price to earnings ratio is 14 and the dividend yield is 2.50%. That dividend yield looks pretty attractive compared to money market yields!

**Small Cap Value Strategy:** Our small cap stock strategy rose 5.56% in the first quarter versus 8.85% for the Russell 2000 Index. For the trailing twelve months, the small cap composite rose a meager 133.76% versus the Russell 2000 Index gain of 62.76%. We booked more gains for the strategy in March. We sold our entire position in Brown Shoe Company after it had risen 83% in seven months. We sold half of our position in Cooper Tire and Rubber for a 115% gain during the 21 months we have owned it. Brown Shoe was the strongest performing position in the strategy for the quarter, gaining 67%. Jackson Hewitt, the income tax preparation company, was our weakest performer for the first quarter, falling 54%. Their agreement to put their operations into almost 2,000 WalMart stores was not enough good news to overcome the loss of over half of their refund anticipation loan business. Just before tax season, the banking regulators stopped one of

Jackson Hewitt's primary loan providers from underwriting any refund anticipation loans for this year due to other problems the bank was experiencing in their loan portfolio. We are using the proceeds from recent sales to take positions in the banking sector. Small banks and regional banks have not recovered as much as the money center banks. We can still purchase bank stocks at a discount to book value. During normal times, small bank stocks typically trade at 1.5 to 2.0 times book value. Once the banking sector is back on its feet, there should be some consolidation as the stronger banks with excess capital look to put it to work more effectively. Once we have completed our purchases, we will issue the Research Summary for them.

**High Yield Convertible Securities Strategy:** The high yield convertibles portfolio gained 8.37% during the quarter and 88.45% for the trailing year versus 5.30% for the Merrill Convertible Index and 4.85% for the Merrill High Yield Index during the quarter; and 51.10% and 55.67% respectively for the twelve months. Credit spreads continue to tighten as investors search for higher yields than their money market funds. The improving economy and stronger profits are making it easier for corporations to borrow and the volumes of new issue corporate bonds have been very impressive. Our position in Ford convertible preferred showed the strongest performance for the quarter, rising 16%. Our position in KV Pharmaceutical bonds fell 4.5% for the quarter, as they came under pressure in late March. The company is trying to restart production of their main product, but they have to pass an inspection of their facility by the FDA first. The FDA's inspection was delayed and the company faces a cash flow shortage until they can begin selling product. One of our master limited partnership positions, K-Sea Transportation, fell during the quarter after they suspended their distribution for the quarter to conserve cash and pay down debt. Most of our MLPs exhibited nice gains as energy demand and product prices rebounded. We sold our position in Beazer Homes convertible bonds in January. Beazer appeared to be on life support during the depths of the credit crisis, but the market rally and stabilizing housing sector allowed them to complete a capital raise during the first quarter and we sold our bonds afterwards. We ended up booking a nice gain on the position. On April 1st we submitted our International Coal convertible bonds for repurchase by the company at \$119.133 dollar price. We purchased the bonds in April, 2009 at \$60.00, so that is an impressive gain for a bond. We added a position in Trinity Industries convertible bonds in February. The bond yields 8.15% to the put date in 2018. Trinity manufactures railcars and supplies aggregates to the construction industry. It is not as easy to find bargains in the high yield sector as it was last year. The market has consistently traded higher over the last five weeks. We will be glad to see it take a breather so we can put more money to work.

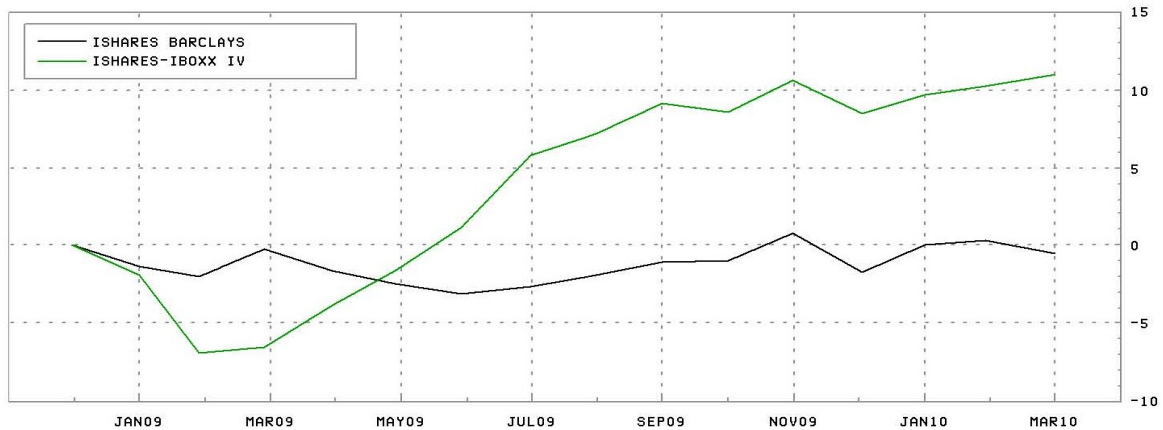
#### **Intermediate Taxable and Tax Exempt Bonds-J.P. Szafranski: Defense Wins Championships**

Our Intermediate Taxable Bond Portfolio rose 1.86% for the quarter, versus a gain of 1.55% for the Citigroup 1-10 Year Government/Corporate Index. Our tax-exempt strategy gained 0.42% in the first quarter, while the Merrill Lynch 3-7 Year Insured Bond Index gained 0.64%.

In 2009, our Intermediate Taxable Strategy outperformed the index largely due to our aggressive allocation to corporate debt. As market conditions improved last year, this offensive strategy paid off. While corporate bonds may pull off a repeat in 2010, we expect that active management of interest rate risk will give us the best chance to beat the index this year since the Federal Reserve will likely begin a series of interest rate increases before the end of the year.

Intermediate Bond Total Return by Sector (12/31/08 - 03/31/10)

Source: Bloomberg



In the first quarter, we played defense by selling two longer term corporate bonds. We currently favor shorter term bonds and floating rate bonds (indexed to CPI as well as LIBOR). We also continue to look for bonds issued by companies with improving fundamentals, since bond prices should eventually reflect a company's improved financial position. Our focus on defense should protect the value of the portfolio and give us the flexibility to extend our average maturity at a more opportune point in time.

Many retirees are finding it harder to generate income from their investments in this low rate environment. Additionally, after the bear market we experienced in 2007-2008, they are reluctant to put money back to work in the stock market. Unfortunately we have come across many instances where cautious investors have turned to annuities for income and safety. We strongly urge you to avoid annuities and if you know anyone that is considering them, tell them to just say NO! We can build a portfolio using zero coupon bonds and high yielding corporate bonds and stocks that will generate more income than an annuity with less risk and substantially lower costs. Most annuity products have annual expenses that exceed 1.50%. They are a very expensive way to purchase insurance, and you may or may not have a survivor benefit. With our strategy, there will be a portfolio value remaining for heirs.

We survived the market turmoil of the last three years in relatively good fashion. Our portfolios declined much more than we expected during the depths of the credit crisis because diversification did not help. But we analyzed and re-analyzed our positions and kept the ones we expected to recover. The recovery in our portfolio values has been more dramatic than the previous decline. Our high yield convertible strategy and our small cap strategy have fully recovered. The Blue Chip strategy still has 20% to go, but that one is not under our control - someone else selects the companies in the Dow Jones Industrials. Our investment grade bond strategies have gained more than the blue chips lost. If you know someone that is disillusioned with their broker or money manager, and you have been pleased with your portfolio recovery, please suggest they call us. Our goal is to provide competitive performance and superior service at a low cost. We appreciate the opportunity to provide our investment management services to you.