



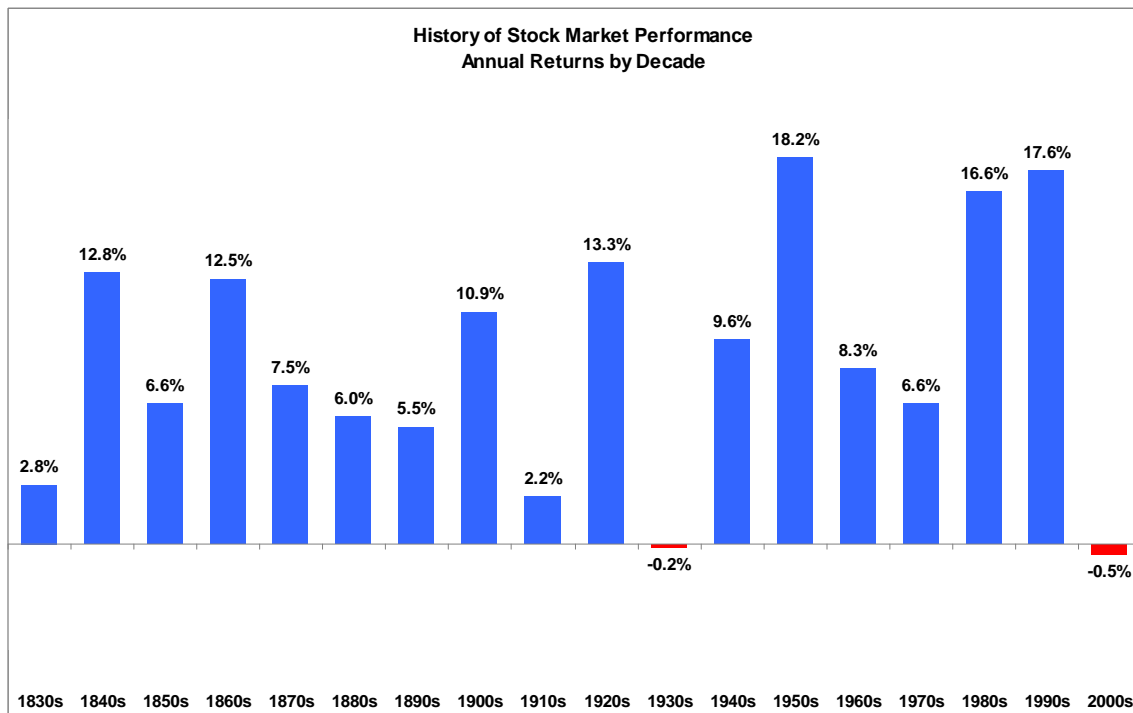
## GLOBAL FINANCIAL MARKETS PERSPECTIVE

JANUARY 2010

### “Giving Financial Markets Another Chance”

The first decade of the 21<sup>st</sup> century has ended with a bang! As 2009 began, the world economy had narrowly averted a financial calamity with the help of central bank lending and government spending leading to the creation of a safety net for global financial markets. The behavior of stock markets, usually good indicators of economic activity, signaled coming problems as early as 2007 and in early 2008 the stock market entered a bear market. From a high of 1565 on October 9<sup>th</sup> of 2007, the S&P index of 500 stocks fell to a low of 673 on March 9, 2009 -- a plunge of 57%. This decline undermined the attractiveness of U.S. equity investing as the annualized performance of the S&P 500 for ten years through the end of 2009 was a disappointing minus 0.95% per year. After adjusting for inflation, the annualized loss was substantially more than that. The following exhibit from the Wall Street Journal depicts decades of stock market performance since the 1830s.

Exhibit #1

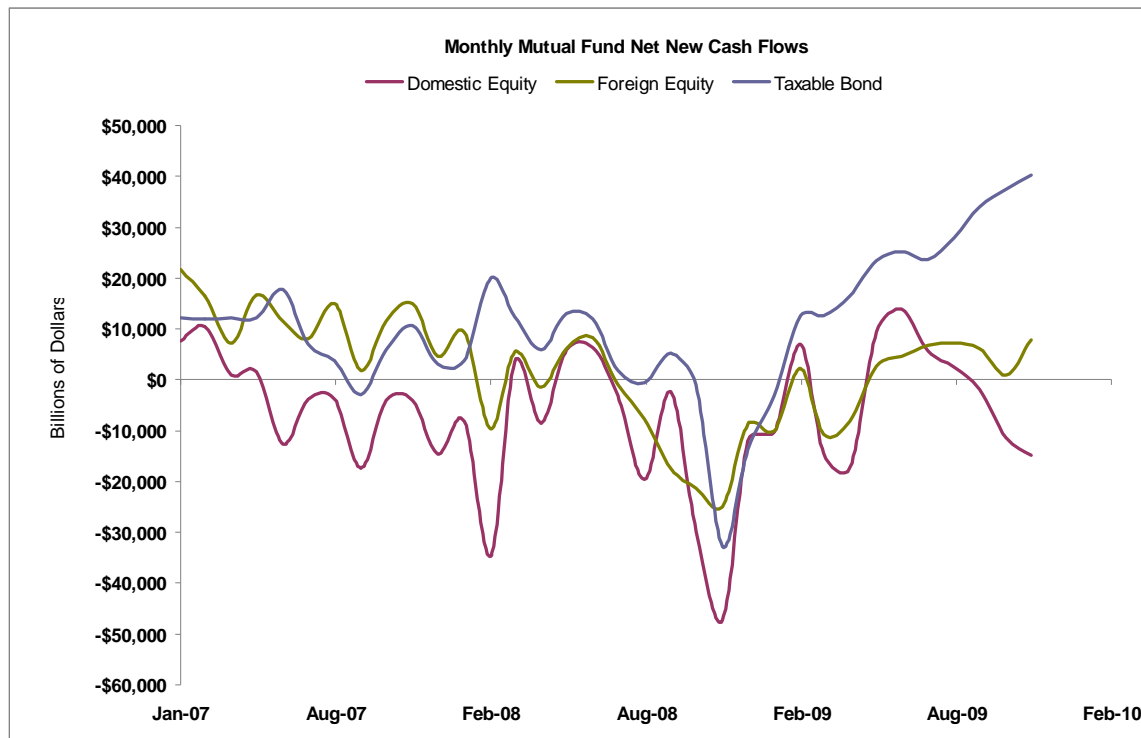


Note that there have been two decades out of 18 where total stock market returns were negative, the 1930s and the 2000s. While there are few investors who remember the experience of the 1930s, virtually all of us have experienced the pain and suffering of the investment environment over the last ten years. The bursting of the technology bubble in 2000 triggered a decline in the S&P 500 of 42%. The terrorist attacks on the World

Trade Center and the Pentagon also had a short-term catastrophic effect on stock markets – the New York Stock Exchange was closed for a week. Corporate misbehavior such as the collapse of Enron and the more recent Bernie Madoff investment scam did little to endear investors to opportunities in financial markets. In our day-to-day business, we had a retired prospect visit us in December of 2008 who decided to liquidate his portfolio and buy CDs – a decision that has not yet been reversed. He is one of thousands of investors who abandoned the stock market near or at the market lows of 2008. After the 1930s crash many individual investors abandoned stock investing. Is there a chance that a similar market decline during the 2000s will lead to a replay of that investment decision? Are there reasons to give the stock market a second chance?

Since March of 2009, the stock market has recovered rapidly. However, the weekly cash flows into or out of mutual funds tell a different story. With the exception of a few months since January of 2007, domestic equity funds have been experiencing a continuous outflow according to the Investment Company Institute. These flows represent the average investor saving for retirement in a 401(k) or other qualified plan and you can see from the chart below that mutual fund investors were selling equity funds into the year-end rally reflecting a continued fear of equity markets.

Exhibit #2



One encouraging sign from mutual fund money flows is the surge in demand for corporate bond funds. The first choice of refuge for individual investors in a panic is safety and fear led to investments in insured money market funds. Investors didn't care about yields-- they cared about maintaining the value of their investments. As fears of a financial market meltdown dissipated, investors began to reflect on a zero-yield portfolio and began looking for stability with some form of dividends and/or interest.

As stocks rose, investors moved more of their money from money market funds and CDs into corporate bond funds where yields were six to seven times more than money market funds. As the price of corporate bonds rose, yields declined and investors sought more income from such investment vehicles as preferred stocks, convertible bonds, convertible preferred stocks and income producing common stocks.

Note: During 2009 we used our investment experience to take advantage of these trends. For our equity-only clients, we began to reinvest on March 25<sup>th</sup>, some 16 days after the market bottom. We also began investing in select moderate quality bonds where yields were upwards of 9-10% in our balanced accounts. We continued to put money to work in equities during the year as the stock market rose and our confidence about an improving economy grew.

Exhibit #1 highlights the fact that there were only two decades of negative stock market performance since 1830 – with the 2000s being the worst. While there are insufficient data to make a statistically significant case for future stock market performance, we can observe that, after the first negative decade in the 1930s, the stock market rose remarkably for six consecutive decades! For the 40s and 50s, the stock market's annual average gain was 9.6% and 18.2%, respectively. Does this mean there is a chance for another wave of above-average stock market returns?

The case in favor of a positive decade for stock investing begins with economic progress made possible through ongoing developments in information technology. Technology is similar to a mutating virus in the sense that breakthroughs can be short-lived and fall prey to new advances made possible by these same breakthroughs – otherwise known as obsolescence. Additionally, once a new technology gains traction other “offspring” form that change the way the world works. A recent example of this occurrence is the Apple iPhone -- a quality device that is both innovative and integrated. The iPhone spawned the development of applications that can be downloaded by users for a variety of purposes from pure entertainment to improved business productivity. The unique “store” with over 125,000 applications differentiates this “Little Mac” from the traditional multi-functional smart phone. (We have had iPhones since last May and cannot live without them – not because of the traditional cell phone capabilities – but because of the applications that help us do business 24/7 from anywhere in the world.) The creators of these applications need little, if any, capital otherwise required by a start-up business. Entrepreneurs who create useful applications can turn them into million dollar programs that benefit a multitude of users. As a result, the competition in this arena has become fierce with many companies such as Motorola and Google introducing smart phones that offer similar applications.

Another development affecting the global economy is the ongoing reliance on fossil fuels to produce energy and the need to find alternatives. Ever since the Arab Oil Embargo and the quadrupling of oil prices fossil fuel users lost their standard of living due to the required reallocation of resources to energy companies. In the mid-70s, oil prices collapsed and then surged again in the early 80s only to fall to depression level prices when President Reagan deregulated gas prices. Opportunities to replace fossil

fuels never got off the ground because of these wild price fluctuations. The energy crisis of the 2000s changed all that.

The global commitment to reverse growth in the use of fossil fuels to generate energy should also contribute to positive investment opportunities over the coming decade. As readers of our past Perspectives know, we have discussed the growing financial commitment to innovation, conservation and substitution when it comes to energy resources. As natural gas, shale oil, tar sands, solar, wind power and nuclear capture an ever-growing share of the energy market, the fossil fuel industry (specifically oil and coal) will find it very difficult, if not impossible, to increase sales – unless prices collapse again. Pessimists see a surge in demand for oil as the global economy expands while optimists point to an ever-increasing number of available and reliable options that will keep oil prices at or near current levels. We would not abandon the idea that an energy breakthrough could be just around the corner – not unlike the early 19<sup>th</sup> century breakthroughs in farm technology that allowed farming to be the source of technological advancement for decades (Today one farmer can produce what one hundred farmers produced one hundred years ago!) The utilization of technology abroad also gives us optimism that global growth will enhance standards of living around the world.

Another factor favoring the idea that the stock market will provide positive returns over the next decade is improved regulation of financial institutions. These improvements should minimize future market turbulence caused by excessive speculation and outright manipulation by crooks. The Securities and Exchange Commission was fooled by many of these charlatans -- especially Mr. Madoff – and should lead to increased scrutiny of key market players that will help “the little guy” who were easy victims of the flimflammers.

Along the way to achieving gains will be bumps in the road that require a shift in short-term strategy. Potholes that we know about are the threat of global terrorism coupled with rogue states such as North Korea and Iran that are an ever-present threat to financial market stability. Attacks on Israel or other Mid-East nations, not by a rogue state but by a terrorist group that is supplied with super weapons by rogue states, will haunt future peace and stability. The latest attempt to detonate a bomb on a transatlantic flight is testimony to this ever-present threat no matter how many billions of dollars we pour into our security establishment.

A bump coming in 2011 is the tax increase due to the expiration of the 2003 Bush tax cuts. Healthcare reform, if implemented, will also increase taxes as will states as they try to close record budget deficits. These tax increases will actually increase the deficits not decrease them. In 1937, the imposition of the payroll tax and higher personal income tax rates triggered the second leg of the great 1930s depression that was not reversed until World War II. Competent professionals will accelerate income into 2010 and out of 2011 to avoid paying higher tax rates. This trend will accelerate as the year progresses leading to better than expected economic activity and higher stock prices. However, the gain for 2010 will become a loss for 2011.

Another bump in the road that could develop into a pothole is the rising chorus of budget deficit hawks in Congress and the Administration who see a need to cut

spending and/or raise taxes. Historically the deficit problem has been resolved through solid economic growth, job creation and rising demand. The present is no different. However, if these hawks reduce government spending before the private sector recovers, we can expect to see renewed economic weakness and volatile financial markets.

Looking back at 2009, we can say that we avoided economic and financial Armageddon. Timely intervention by the federal government provided an important safety net that allowed the private economy to transition through a period of wild speculation in real estate and financial markets. We are encouraged that the surge in the stock market is signaling an economic rebound. As the recovery turns into an expansion in 2010, we expect to see better times for the global economy and especially for corporate America and, ultimately the American consumer. If history is a good predictor, this year should get us off to a good start for the decade ahead.

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