

CLIFFORD SWAN

THE INVESTMENT COUNSELOR

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SECOND QUARTER 2010

CONTENTS

- Disruption And Volatility:
The Effect of Today's
Market Automation 1
By Maye Albanez, CFA, CIC
- Market Outlook 1
By Anil Kapoor, CFA
- Giving Retirement a
Second Chance 2
By Peter J. Boyle, CFA, CIC
- Gift Annuity Payout Rates
Increase Slightly 3
By Ken Dike, Esq., CPA
- 2010 Repeal of Estate Tax:
Testamentary Charitable
Remainder Trust Implications 5
By Ken Dike, Esq., CPA

MARKET OUTLOOK



By Anil Kapoor, CFA

Volatility is Back

The second quarter of 2010 reminded us all that equity markets can be choppy. After four straight quarters of gains, the Standard & Poor's 500 (S&P 500) index fell 12%

continued on page 4

Disruption and Volatility: THE EFFECT OF TODAY'S MARKET AUTOMATION



By Maye Albanez, CFA, CIC

May 5th of this year was a relatively uneventful day on Wall Street, with the Dow Jones Industrial Average (DJIA) closing at 10,868.12. The following day, Thursday May 6th, the market spent much of the morning and early afternoon in moderately negative territory declining 161 points by 2:00 p.m. (ET). Shortly after 2:30 p.m. (ET), the decline began to steepen. Within twelve minutes, the DJIA had fallen an additional 261 points to 10,445.84. Five minutes later, it had dropped an additional 573 points to 9,872.57, for a total plunge of 9.16% from the previous day's close. As quickly as the market dropped, it suddenly reversed itself, recovering 543 points in approximately a minute and a half, to 10,415.65. The DJIA closed at 10,520.32, down 347.80 points, or 3.20%, for the day.

Investment markets date back to 1790, when the federal government, upon strong recommendation from Alexander Hamilton, issued \$80 million in bonds to repay Revolutionary War debt. It took 176 years, until 1966, for the New York Stock Exchange (NYSE) to move into the age of computers, although living, breathing people continued to supervise all proceedings. As lawmakers directed the Securities and Exchange Commission (SEC) to

reduce the NYSE's near monopoly during the 1970s, Nasdaq and other electronic rivals came into existence, gradually eroding the NYSE's dominance. Still, human beings continued to intervene any time things got out of control (e.g., October 1987 market crash).

In the late 1990s, new rules by the SEC opened the door to the formation of electronic trading platforms to compete with the NYSE and Nasdaq. These new, virtual systems provided liquidity and the opportunity for willing brokers to post electronic bid and ask quotes. A "bid" is the price quoted on a security for an immediate sale; "ask" refers to the price quoted for an immediate purchase. The difference between the bid and ask prices in a given security is a measure of its liquidity and the cost of transaction. Unfortunately, the new systems lacked specialists and market makers who, in the past, had the responsibility of maintaining a fair and orderly market in assigned stocks, even if it meant buying stocks when those companies' shares were falling.

Until 2005, the NYSE controlled nearly 80% of all equity trades in the United States. By 2007, its dominance had fallen to 50%. Today, it represents less than 25% of equity trades in the country, with high-frequency traders (also referred to as

continued on page 6

Giving Retirement a Second Chance



“A major enjoyment in life is playing basketball, touch football and various water sports with my seven grandchildren.”
—Ed Ogle, from www.cliffordswan.com

By Peter J. Boyle, CFA, CIC

Ed Ogle’s website quote will soon more accurately reflect the new realities of his life than the previous seven years Ed spent at Clifford Swan. We should have been suspicious when he uttered it.

Effective July 31, Ed will give retirement another try; this time, he will likely succeed. Ed joined Clifford Swan after a brief retirement (his first) from a 17-year career at Brown Brothers Harriman. The timing of his return and our integration of his vast fixed income experience could not have been more fortuitous for our firm

and clients. Ed has aided our fixed income efforts during the recent tumultuous market period—an era which included the demise of financial institutions and the collapse of mortgage insurance, effectively changing the face of conservative fixed income investing.

While his retirement will present a professional loss to the members and clients of the Clifford Swan community, we all know that our personal relationships will persevere. On behalf of the firm and Ed’s clients, we wish Ed and his family the best in his retirement.

Financial Overhaul Update

Oil flowing into the Gulf of Mexico, and

financial challenges in Europe and our own economy, have pushed financial reform legislation off the front pages of the newspaper. Yet, Congress and, specifically, a Conference Committee, have been hard at work on the largest financial overhaul since the Depression. At a recent board meeting of our trade association, the Investment Advisor Association (IAA), my fellow board members and I received an update on the backroom compromises reconciling the House and Senate versions of the legislation. While this reform is far-reaching, from credit cards and derivatives to bond rating agencies, I am limiting my comments below to those changes directly affecting our industry and clients.

Issue	What We Promoted	Current Proposal
General Comment		Instead of overseeing the adoption of specific language, Congress left much to studies and SEC rule-making. This means that critical details were either not addressed or will be assessed inside the SEC and not on Capital Hill. Congress gets a C-grade in this area.
Fiduciary vs. Suitability Standard	Since our founding, Clifford Swan has promoted and touted a single, fiduciary standard, providing a clear and—from the investing public’s perspective—superior standard of care. This principle exists in strong contrast with the separate and lesser “suitability” model used by broker and insurance industries.	While the conference committee indicated a preference for the fiduciary standard, they adopted an odd compromise. The agreement directs the SEC to conduct a six-month study, providing them the authority to extend fiduciary responsibility to brokers that provide investment advice to retail customers, but not mandating them to do so. The ultimate rulemaking will be subject to continued lobbying.
Supervision of Investment Advisors	IAA has promoted full funding of the SEC to provide sufficient resources for the proper regulation of federally-registered advisors.	While not to the level we had hoped for, the legislation did increase the asset threshold for SEC oversight. While small investment firms are already regulated by states (versus the SEC), this threshold will now increase to \$100 million in assets under management. With a smaller pool of investment advisors falling under SEC inspection, the greater oversight directed at these advisors should be a win for the investing public. ♦

Gift Annuity Payout Rates Increase Slightly



By Ken Dike, Esq., CPA

For the first time in seven years, the American Council on Gift Annuities (ACGA) has increased, although slightly, the recommended payout rates for charitable gift annuities (CGA). Since July 2003, there have been two rate reductions. The first reduction was effective for CGAs issued after June 2008, and the second rate reduction became effective in February 2009. The most recent increase to the recommended payout rates apply to gift annuities received after June 2010.

A CGA is an arrangement whereby assets are given to a charity in return for the charity's promise to make payments of a fixed amount to a beneficiary designated by the donor. The gift annuity payout rate is the amount of the beneficiary annuity payment as a percent of the assets given to charity. These annuity payments are a general obligation of the charity and often continue for the beneficiary's life.

The ACGA is a nonprofit organization that publishes suggested CGA payout rates used by many nonprofit organizations. These payout rates are based on life expectancy assumptions (currently the Annuity 2000 mortality table for females with a 2-year setback in age), investment return and expense estimates (discussed below), and an anticipated residuum of 50% of the gift amount going to the issuing charity upon termination of the gift annuity.

The most recent ACGA gift annuity payout increase resulted from an increase in the projected return on gift annuity investments. The current and historical ACGA investment return assumptions follow:

Effective Dates	Gross	Fees	Net
7/1/2010	5.50%	1.00%	4.50%
2/1/2009 to 6/30/2010	5.25	1.00	4.25
7/1/2008 to 1/31/2009	5.75	1.00	4.75
7/1/2006 to 6/30/2008	6.25	1.00	5.25

As the above table shows, the ACGA reduced their estimate of gift annuity investment returns by 50 basis points, twice, from

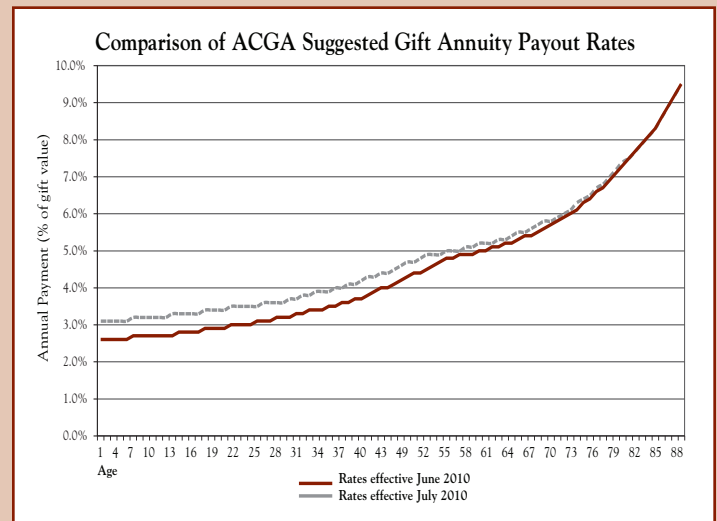
July 2006 thru June 2010, followed by a 25 basis point increase effective July 2010.

The following table shows the current and historical suggested, immediate (payments start when the gift is made) CGA payout rates at various life beneficiary ages, and the cumulative change in these rates since 6/30/2008:

Single-Life Beneficiary Age					
Current Suggested Payout Rates					
	50	60	70	80	90+
7/1/2010	4.8%	5.2%	5.8%	7.2%	9.5%
Historical Suggested Payout Rates					
	50	60	70	80	90+
2/1/2009 to 6/30/2010	4.4%	5.0%	5.7%	7.1%	9.5%
7/1/2008 to 1/31/2009	5.1	5.5	6.1	7.6	10.5
7/1/2003 to 6/30/2008	5.3	5.7	6.5	8.0	11.3

Although the July 2010 increase is slight, it is a change in direction from prior years. As this table and the following graph show, the effect of the increase declines as the age of the life beneficiary increases.

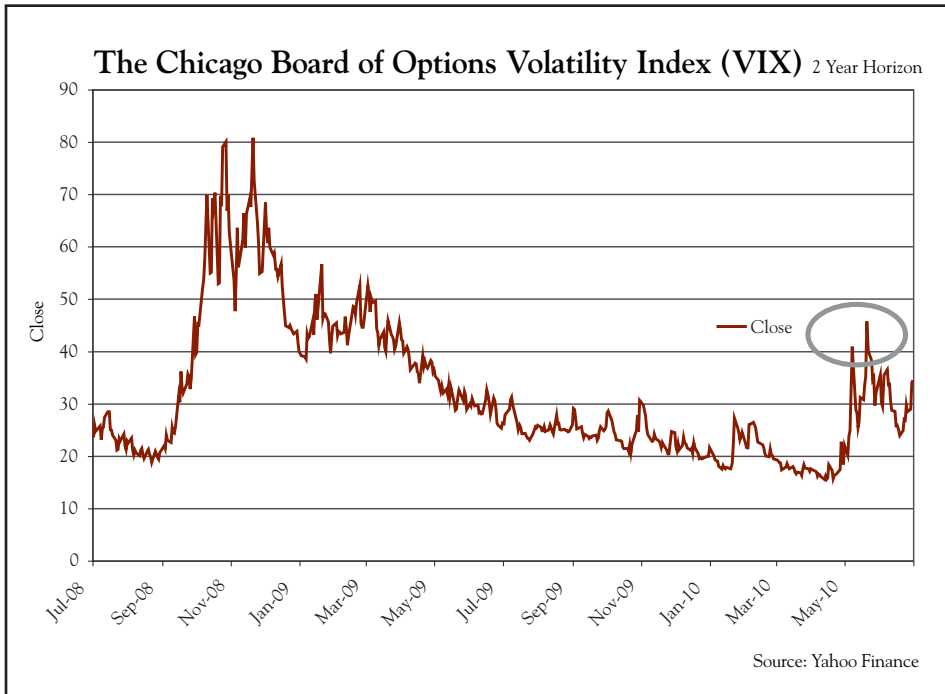
The following graph shows the June 2010 and July 2010 payout rates for all single-life beneficiaries:



In order to qualify as a CGA and receive the related tax benefits, the present value of the payments to the beneficiary must be less than 90% of the gift value. This test will be met when the ACGA recommended rates are followed and the discount rate used in the present value calculation is no less than 3.2%. The discount rate, which changes monthly and is based on the federal midterm rate, was 3.4% in May 2010 and 3.2% in April and June 2010. If this discount rate is ever less than 3.2%, the gift annuity payout rate will have to be something less than that recommended by the ACGA in order to qualify as a charitable gift annuity. ♦

MARKET OUTLOOK

continued from page 1



during the quarter. The Chicago Board of Options Volatility Index (VIX), which is a broad measure of volatility for the S&P 500, spiked to levels not seen since early 2009 (see chart above). In addition, the yield on the 10 year Treasury fell from 3.83% to 2.93%. This decrease in yield further indicates that investors are looking for safety. In this outlook, we'll discuss a few reasons for these recent market gyrations and how they might impact your portfolio.

Recently, there has been considerable concern about European economies and, ultimately, the viability of the Euro as a currency. As the adjacent chart illustrates, the Euro has fallen approximately 19% versus the dollar since the fourth quarter of 2009. Although we cannot predict with certainty if the Euro will collapse, we can estimate portfolio exposure to the European Union, particularly to the weaker nations. Many on the Street refer to these weaker countries as the "PIIGS" (Portugal, Ireland, Italy, Greece, and Spain). Taken in sum, Clifford Swan companies have some exposure to "PIIGS" but not to the point where

continued weakness would significantly impact the value of portfolio investments.

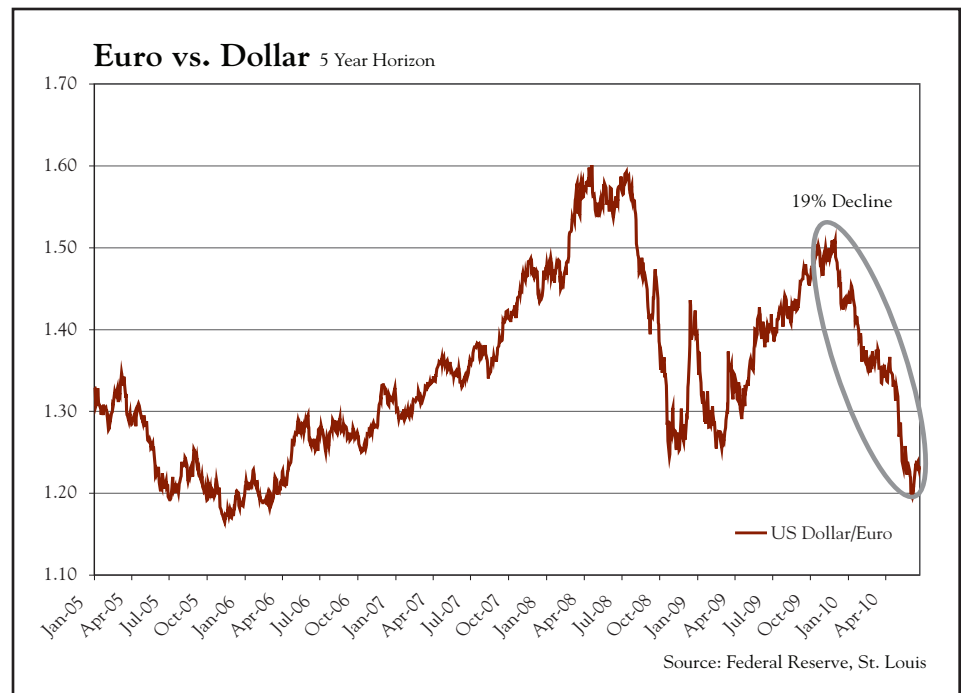
The real issue would be if a sovereign debt (bonds guaranteed by a government) crisis created a domino effect whereby credit markets stopped functioning effi-

ciently. This is what occurred in late 2008 - early 2009, as bonds and derivatives backed by the U.S. residential mortgage market collapsed. Although the amount of debt representing the U.S. residential mortgage market dwarfs the debt load of many of the "PIIGS", a default by any one nation could cause ripple effects in credit and equity markets. Under this scenario, equity prices would suffer regardless of exposure to "PIIGS" as the market undergoes an adverse liquidity event. Many times, stocks are more liquid, are easier to trade than bonds, and are, therefore, the first to be sold.

Another event that caused panic and volatility was the "flash crash" that occurred on Thursday May 6, 2010, which my colleague, Maye Albanez, discusses in her article on page 1 of this newsletter.

Thirdly, the BP oil spill, which began on April 20th, has caused exaggerated price movements in energy-related companies. Many of our clients have exposure to energy, and we have not changed our thesis on the sector as a result of the spill.

continued on page 5



Although rules and regulations may make drilling more costly for companies, the supply and demand dynamics for oil are as robust as ever, and we continue to be bullish on the sector. As a firm, we have maintained, and in some cases increased, exposure to various industries and companies within the energy sector.

In conclusion, I'd like to clarify that an increase in volatility means a perceived increase in risk, and we all know that perception can be different from reality. It is in times like these that active management is most valuable, and we at Clifford Swan stand ready to help our clients take advantage of stock prices that differ from the long-term intrinsic value of the businesses they represent. ♦

YOUNG STEWARDS PROGRAM

September 12, 2010 • 1-5:30pm
At the Huntington Library,
Art Collections and Botanical Gardens

Clifford Swan Investment Counsel invites you to attend the Young Stewards Program, designed to give teenagers, ages 15-19, **an introduction to family and community stewardship and practical financial skills.**

A separate program for parents, offered during the final two hours of the Young Stewards Program, coaches parents on how to best communicate with their teens on financial matters.

Questions? Interested in attending?
Call Sonja Weich at (626) 792-2228

2010 Repeal of Estate Tax

TESTAMENTARY CHARITABLE REMAINDER TRUST IMPLICATIONS



By Ken Dike, Esq., CPA

In our first quarter, 2010, newsletter, an article by James Gamb discussed a few of the unintended consequences of the estate tax repeal for 2010. This article will discuss the unintended consequences involving charitable remainder trusts (CRTs), created by a decedent's will (testamentary CRTs). The repeal of the estate tax for 2010, however, has no effect on CRTs created during the donor's life (inter vivos CRTs).

As it stands, there are no estate or generation-skipping transfer taxes for estates created, or transfers made, during 2010. Gift taxes remain intact, however.

The problem arises due to the current tax code which gives tax-exempt status to CRTs *only if they qualify for an income, gift, or estate tax deduction*. Testamentary CRTs, which are created by a decedent's will, obviously do not qualify for an income or gift tax deduction since they are made after the donor's death. Additionally, since there is currently no estate tax, testamentary CRTs do not qualify for an estate tax deduction. A literal reading of the tax code suggests that testamentary CRTs, created during 2010,

will not qualify as tax-exempt entities. This may mean that such CRTs will be taxed on any income they receive, and their beneficiaries will not be taxed on payments received under the usual, four-tier provisions.

Additionally, beginning in 2010, testamentary CRTs will hold a carryover basis (donor's basis) in the securities transferred from the estate, which has always been the case with CRTs created during the donor's life. If CRTs are not considered tax-exempt entities as explained in the prior paragraph, they are subject to taxation on any capital gains realized by the trust upon the sale of its transferred securities. Capital gain, in this case, is the difference between the sales price and the donor's original cost basis. Historically, these capital gains were only taxed to the private (non-charity) beneficiary upon receipt.

Congress has known of the 2010 repeal of the estate tax for several years, yet has done nothing to rectify these unusual—and what must be unintended—consequences. Although there appear to be rumblings of a 2010 repeal of the estate tax, nothing has been initiated by Congress. If a law is signed that retroactively affects estates that anticipate avoiding taxes during 2010, due to the estate tax repeal, constitutional issues are sure to arise, making the situation even more interesting. ♦

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DISRUPTION AND VOLATILITY: THE EFFECT OF TODAY'S MARKET AUTOMATION

continued from page 1

“HFT”) accounting for up to 70% of daily trade volume. High-frequency traders move enormous quantities of stocks in fractions of a second and use computer software to identify miniscule increases between the bid and ask prices for a given security, exploiting slight price differences in stock prices across the various exchanges. Trading speed has become so significant that some firms locate their servers near their exchange computers, in order to shorten the distance orders have to travel through cables.

Most people agree that the proliferation of high-frequency trading has resulted in greater efficiencies in trading and much lower commissions. Mutual fund companies might argue that high-frequency trading has helped reduce the impact of large trades in the market by breaking them into many, smaller trades while maintaining efficiency. Those who disagree would argue that there is little point to improved liquidity when trades occur too quickly for the reaction of, or participation by, the average investor. Whether high frequency trades destabilize the market altogether remains an open question, as does whether they bring true improvements or mainly manipulation to the existing system.

There are 40 trading venues today, including traditional exchanges, new exchanges, automated trading systems and dark pools (a venue where huge institutional orders can take place, without disclosing the price or identity of the trading company, in order to avoid price disruptions in a given security). There is so much fragmentation in the market that no one has enough information to really know what is going on, much less to attribute blame for occurrences such as the flash crash of May 6th. Ultimately, it may be that the only lesson learned from May 6th is the need for better coordination across national trading systems.

If 70% of daily trades in the market originate with high-frequency traders, long-term investors are trading in a much less crowded market.

Two proposals have been put forward by the SEC, as a result of these recent events. The first, already approved and in place for a six-month test run, relates to new circuit breakers built to pause trading when markets are in freefall. The second, which is still under discussion, seeks to create a unified and predictable policy for breaking erroneous trades, as exchanges are currently allowed to write their own policies. Once the second has been approved, it, too, will undergo a six-month test run.

At Clifford Swan, we believe price dislocations and increased volatility in the market represent opportunities for long-term investment, or to reduce or eliminate our exposure when needed. Our clients expect us to isolate emotions from buy and sell decisions, and to trade based on fundamentals and not the use of algorithms. As owners in the companies we purchase, we prefer to operate under the rules of capital formation rather than quick trips to gambling halls. If 70% of daily trades in the market originate with high-frequency traders, long-term investors, such as Clifford Swan and our clients, are trading in a much less crowded market. We believe this presents an advantage—one that highlights the importance of being disciplined and patient about investment values and the need to wait until the right opportunities present themselves. ♦