

CLIFFORD SWAN THE INVESTMENT COUNSELOR

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MARKET OUTLOOK



By Ralph E. Weil, CFA

Wow! What a difference a few months make. As of this writing, the Standard & Poor's 500 stock index is up over 32% since the start of the second quarter—quite a move in a relatively short period of

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Is It Really Different This Time?



By Roger L. Gewecke, Jr., CFA

The first decade of the 21st century is drawing to a close. As of this writing, the Standard & Poor's 500 is 15% lower than it was when the decade began, and while shareholders of American companies have found equity returns unfulfilling, the past ten years have been anything but uneventful in the stock market. Volatility in the stock market and economy, advances in technology, and the proliferation of the financial media have left many investors to wonder whether an investment philosophy which worked for many years is still applicable in a world that seems to be moving quite a bit faster. If one were to start over today and attempt to devise an investment philosophy that would be employable by a tax-paying investor, while still generating good long-term returns, what elements might be included?

Asset Allocation

Numerous academic studies have shown that asset allocation (exposure to stocks vs. bonds in, perhaps, its simplest form) is very important as it is a primary driver of risk reduction and long-term portfolio returns. Events in recent years make it quite easy to forget that, despite their

volatility, large U.S. stocks have done quite well over a long period of time. From 1926 through the end of 2008, the S & P 500 returned over 9.6% compounded annually. This time period encompasses the Great Depression, World War II, the Korean War, the Vietnam War, the stagflation of the 1970s and early 1980s, the rise and fall of the internet bubble, and the economic crisis of 2008.

An investor who has a solid plan of attack is less likely to be at the mercy of the investment markets and less apt to buy and sell at the wrong time.

Despite the fact that stocks have been an excellent performer throughout many economically challenging times over many decades, asset allocation is also quite an individual matter. An investor is well-advised to think again as to whether

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By Peter J. Boyle, CFA, CIC

November will mark our second anniversary as Clifford Swan Investment Counsel. Who would have imagined almost a year ago that our first anniversary would usher in the beginning of the most challenging investment and economic period faced by our industry and our country in decades, if not in our lifetimes? The collapse of Lehman and absorption of Bear Stearns by JP Morgan would signal just the beginning. The events that followed witnessed unprecedented government intervention as the rules were rewritten in the face of a daunting financial challenge.

I find it nearly impossible to fathom the scale of the last twelve months in terms of jobs lost, houses foreclosed, companies declaring bankruptcy, government bail-outs extended and Treasuries issued. The numbers are so big, one loses perspective. But it is also a tribute to both the U.S. economy and the financial markets that both are still standing.

Today, in the aftermath, we are still battling high and rising unemployment, continuing foreclosures and huge budget deficits, but the market is up strongly from its lows and economists are predicting that the worst of the Great Recession is behind us. They believe, in effect, that while it is still cold, the sun has come out. Others continue to argue whether we have yet reached the far side of the chasm. As in most crises, the path across and its implications will be studied for years.

On the political front, while much of

the attention in Washington has turned to the healthcare debate, the Treasury sponsored Investor Protection Act is still being hotly debated. It is hoped that revamping and refreshing the financial industry's regulatory framework, initially established after the Depression, will prevent some of the abuses uncovered during this period. The investment advisory profession has always felt we held the high ground with regard to the standard of care owed our clients. With that said, there is little argument that the services of brokers and investment advisors have blurred in recent years, so a discussion of a consistent application of regulatory standards is appropriate. Indeed, I have recently returned from a meeting of the Investment Adviser Association, where I serve on the Board, and witnessed much concern over the manner in which our industry will be regulated going forward.

In this spirit of reassessment, three of my partners share their thoughts on reassessing other areas of our work in the aftermath of this challenging economy. Maye Albanez discusses a "financial check-up" which all should undertake periodically, most especially after the events of the last 12 months. Roger Gewecke explores whether the basic tenant of investing ought to be rewritten in light of this past year. Finally, Bruce White reviews recent changes to California law and their impact on endowments in this environment.

We continue to hope you enjoy our efforts to create the original content contained within these pages. ♦

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (UPMIFA)



By Bruce C. White

In our work with endowment committees and non-profit boards, we have been fielding some questions about potential changes caused by the adoption in California of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). While there are a number of important issues affecting endowments associated with the UPMIFA, for purposes of this article we will focus on the impact it may have on spending and investment policies.

California adopted UPMIFA (Senate Bill 1329) effective January 1, 2009, applicable to all funds in existence at that time and those to be created in the future. While more than half the states have adopted the Act, there are some subtle differences between states. Again, for purposes of this article we will concentrate on California law.

The Act was originally created by Congress out of concern that some large endowments were not spending enough towards their mission. However, the low return investment environment in recent times may have resulted in a current market value for an endowment's investments that is below the original value of the

Even with conservative spending policies, some board members may be concerned that spending and investing should be further restricted to preserve the value of the fund. The UPMIFA addresses this issue.

gifts received. Even with conservative spending policies, some board members may be concerned that spending and investing should be further restricted to preserve the value of the fund. The UPMIFA addresses this issue.

Historic Dollar Value

The market value of the assets when gifted by the donor is the historic dollar value (HDV), and spending under the old law was restricted if the fund fell below HDV. The new law (UPMIFA) does away with the concept of HDV, except for Restricted Endowed gifts. This Act allows a charity to appropriate for expenditure, or accumulate, so much of an endowment fund as the charity determines is prudent for the purposes for which the fund was established. The charity must consider: 1) the duration and preservation of the endowment fund, 2) the purposes of the charity and fund, 3) general economic conditions, 4) effects of inflation and deflation, 5) expected total return from income and appreciation, 6) the charity’s other resources, and 7) the charity’s investment policy. Importantly, spending over 7% of the average fair market value of an endowment, averaged over the last three years, is presumed to be imprudent.

Restricted Endowments

Restricted endowments are a sum of money given to a charity where the donor has required that only the investment income and, usually, gains may be spent for the purposes specified by the donor, while the “principal” or “corpus” must be preserved. Under the new law, these requirements must be specifically stipulated by written (or emailed, in California) instructions by the donor at the time of the gift, even if that gift was made many years ago. The HDV must be kept and not spent. If the value of current investments falls below HDV, no spending may occur until the market value is above HDV. The donor can

relieve the charity from this restriction later if they choose.

Unrestricted Endowments

These are funds received with no restrictions whatsoever. These gifts may be spent at any time for any charitable purpose of the institution, subject to the investment policy of the institution and the Act’s spending requirements. They can provide a source of funds to make up for losses experienced by restricted endowment gifts which may have fallen below HDV.

Temporarily Restricted Endowments

These are funds that are given with a special purpose or timing restriction. They may or may not have an HDV requirement put in place at the time of the gift. If the purpose or restriction placed on these funds by the donor becomes impractical, and the funds are less than \$100,000 and over 20 years old, the charity can modify the restriction. With the notification to the Attorney General, the charity can then use the funds in a manner consistent with the donor’s initial charitable purpose. An example might be a gift to a hospital specifically for organ transplants which the hospital no longer performs or researches.

Unrestricted Gifts

The largest number of gifts is often unrestricted. These funds have no donor-

imposed constraints on how much may be spent and the HDV is irrelevant. Boards can pool these funds into the endowment fund. Examples may be proceeds from fund raising efforts, such as annual giving, which donors have not directed to the endowment and which the board has chosen not to immediately spend.

What must be done?

Remember the requirement that the donor must restrict the gift in writing at the time of the gift. The charity should identify the amount of gifts to the endowment that were permanently restricted, unrestricted, temporarily restricted, or board designated. The accounting systems of most charities should already be producing a “sub-accounting” of these gifts showing the initial amount received, expenditures made, and investment income and gains allocated to each gift.

If the entire pooled endowment fund falls below the permanently restricted amount, there should be no spending until the pool is above that amount.

Spending on all other types of funds may continue and, indeed, investing in a prudent way must continue.

In the following example, the board can continue to spend for the benefit of the charity as long as the market value of the fund remains above \$4,000,000.

Restricted:	\$4,000,000
Unrestricted:	\$3,000,000
Temporarily Restricted:	\$2,000,000
Unrestricted Gifts:	\$1,000,000
Total Gifts:	\$10,000,000
Market Value of Fund:	\$9,000,000

The Uniform Prudent Management of Institutional Funds Act should be reviewed by endowment committees and board members to ensure their understanding of the distinctions and the effect on spending policies. It would be advisable to review with the organization’s legal counsel. ♦

WHEN WAS YOUR LAST Financial Checkup?



By Maye Albanex, CFA, CIC

Recent economic events have forced many people to look critically at the state of their financial condition. For some, this is the first time they will experience unemployment, either personally or through someone close to them; the first time their real estate investments have dropped in value; the first time their portfolios have fallen significantly; or the first time they have been forced to alter their spending and retirement plans. The following are key issues to consider, not only this year, but at any given time. Some represent situations we run across time and time again; all of them should be covered in your next financial checkup.

Investment Objectives

Based on investment return expectations and the ability to take on risk, an investment plan seeks to establish clear objectives for a portfolio. Restrictions like time horizon, liquidity, taxes, and legal structure help narrow the objectives further. The result should be a portfolio with an appropriate allocation to cash, to fixed income, to equities and to alternative investments. The recent downturn in the market revealed for many people their true capacity to take on risk, irrespective of anticipated returns.

The robust move up in the equity markets since early March may be an opportunity for some to reassess their true ability to tolerate risk. Though part of the job of an investment professional

includes helping clients quantify the level of risk they can afford or are willing to take, many clients may have learned something new about themselves during the recent downturn. Careful thought must be given to whether portfolios need to be repositioned or simply left alone. Even though investments should ideally be based on solid, long-term, informed decisions rather than short-term fears and uncertainty, an investment professional must consider the investor's ongoing peace of mind when determining appropriate investment strategies.

Estate Plan

Is your estate in order? Do you have a will in place? Do you have a living trust? Do you need one? A living trust allows you to specify what happens to your assets upon your death with the least amount of taxes paid. It generally distributes assets more quickly than a will, while offering a higher level of confidentiality as it avoids probate proceedings (if they apply) which are a matter of public record. Depending on your level of wealth and needs, there are ways to structure the ideal plan for you and your family.

Even if you have a plan in place, perhaps your needs, wealth and circumstances, or those of your beneficiaries, have changed and amendments are needed. A good rule of thumb is to revisit your plan at least every three to five years—more often when extraordinary events occur.

Avoid the common mistakes we see time and time again. We run across people who set up a trust and never get around to retitling their assets in the name of the trust. Some couples with sizable estates fail to shelter a significant portion of their assets from estate taxes

because they never get around to visiting their attorney. One of the most difficult decisions trustors make is the selection of the right successor trustee, whether that is a family member, a close friend, a business partner, a corporate trustee or anyone else.

Part of keeping an estate plan up to date involves keeping records organized. Important documents to keep together include your will, your trust, your tax returns, your healthcare directive, a list of your assets, the real estate you own, your personal debts, your loans to others, any mortgages, employment contracts, insurance policies and directives on valuable personal property. If the information is available, include your beneficiaries' names, addresses and phone numbers. Inform the executor where records are kept, and leave him or her the names and phone numbers of your advisors such as your attorney, accountant and/or investment counselor. If appropriate, discuss your estate with your family or those close to you.

Insurance

Everyone understands the need for auto and homeowners insurance. Individuals who still work and believe their families could be hurt by the loss of that income stream due to disability often purchase long-term disability insurance policies. Others own life insurance for similar reasons. Still others have long-term care insurance policies to help fund extended health care at home, nursing homes, or assisted living facilities.

People with large enough estates often look for ways to protect their wealth from estate taxes. One way to provide liquidity for estate taxes is to establish irrevocable life insurance trusts. These are specifically designed to hold, own and be the primary beneficiary of life insurance policies which can provide a quick source of cash to pay the estate tax bill upon your death.

Current tax laws allow the transfer of a \$3.5 million estate free of taxes in 2009. Estate taxes are scheduled to disappear in 2010 and reappear in 2011 with a \$1 million exemption, but not many

believe this will really happen. The recent decline in asset values and increased value of estates exempt from tax over the years has led many to reassess the level of wealth protection insurance they carry. In some cases, they may have more insurance than they need. In other cases, however, one could argue wealth protection insurance is needed more today than ever, since the decline in portfolio assets more commonly used to fund estate taxes may have exceeded the decline in value of less liquid assets such as real estate. It goes without saying that this value relationship depends entirely on where the real estate is located and how much of a portfolio was allocated to stocks.

Stay on top of estate tax law changes or consult with an advisor to decide whether insurance limits you carry are adequate. If, for instance, you are consuming more assets in your lifetime than you thought you would, and insurance premiums represent a burden on your budget, it may be time to decide whether

The consequence of improper use of debt may well be the most important lesson the Great Recession leaves us and one most people will remember.

you really want to continue to own more insurance than you need.

Budget

Has your job changed, did you marry, divorce, have another grandchild, pay the last college invoice, sell a house, or move to a retirement community? If so, it may be time to revise your spending, saving and investing habits.

In light of the current economic environment, some people have chosen to revise the timing or funding of their retirement. Others are revisiting the asset allocation of their 401(k) or even questioning the wisdom of deferring income rather than paying down debt.

With an eye to the safety of their reserves, many have taken a fresh look at large cash balances in saving and checking accounts. Often times, such large balances have built up over time, without any real thought given to them.

It could be wise to spend some time prioritizing your spending. An objective evaluation, from a distance and without emotion, may be called for. In an effort to conserve assets, many have reduced the periodic outflow from their portfolios. Others are learning to differentiate between core expenses, quality-of-life needs and frills. And still others, for the first time, are looking to correct mistakes from the past.

Debt

The consequence of improper use of debt may well be the most important lesson the Great Recession leaves us and one most people will remember. For the first time, many understand this lesson in connection with real estate.

Though interest rates remain at historic lows, property owners find themselves without the required equity to refinance their mortgages. We have seen this situation over and over, especially among those who saw the chance to purchase their

first home, or upgrade the one they originally had. Some families have stepped in to offer refinancing alternatives; others have simply faced the difficult choice of doing nothing at all. In all refinancing cases, the right balance between lower interest rates and higher closing costs must be addressed.

Home mortgages are but one example. Commercial property investors are seeing more vacancies than ever and some have been forced to adapt to the reduction in cash flows. Where significant leverage is involved, the challenge is even greater. An objective assessment of exposure to debt is more important today than ever before.

Taxes

With federal budget deficits rising, many believe income and capital gains taxes are more likely to go up than down, or at best, remain where they are today. One counter-strategy is to invest portfolio assets in the most tax-advantageous manner based on each client's situation. Besides buying non-taxable bonds where appropriate, a close watch on capital gains must be kept.

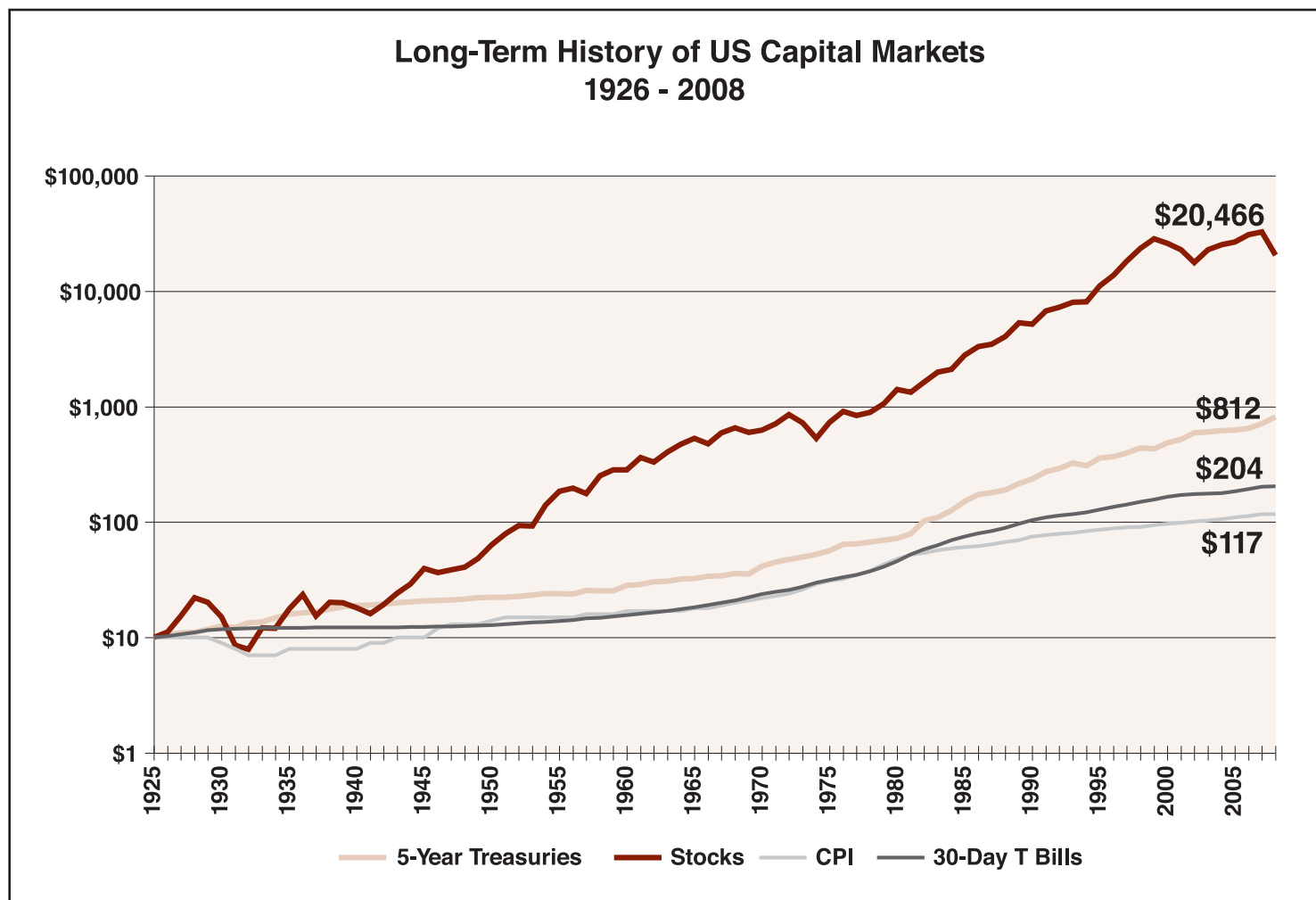
In 2008, for example, in the midst of the market decline, an opportunity presented itself to realize losses and use them to offset realized gains taken earlier in the year, even if it meant repurchasing the same stocks 31 days later. Where no realized gains existed, "banking" those losses for future years made sense. Given the robust appreciation of equities recently, it could be time to offset some of those losses in the "bank" with gains realized in 2009, or simply continue to "bank" them for the future. In all cases, advisors should be kept informed of gains or losses outside their visibility so they can make better financial decisions on your behalf.

On the subject of IRAs, there are three important issues to keep in mind for 2009 and 2010. First, no minimum distributions are required this year due to legislation passed late last year. In 2010, distributions rules will likely return to normal, so computation of required withdrawals for those over age 70-1/2 will once again be needed. Second, tax laws may provide a window of opportunity for some to convert a traditional IRA to a Roth IRA in 2010 when there are no income limits for Roth conversions. Third, IRA owners who are 70-1/2 can transfer up to \$100,000 to a charity in 2009 without having the amount included in their gross income.

In closing, this year more than ever, it may be wise to look critically at the state of your financial condition. Irrespective of whether the outcome dictates changes are needed or not, we believe going through the exercise will enable you to sleep even better at night. Do you remember when you had your last financial checkup? ♦

IS IT REALLY DIFFERENT THIS TIME?

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IBBOTSON, CITIGROUP (S&P), BUREAU LABOR STATISTICS

their current mix between equity and fixed income is appropriate to meet both their tolerance for risk and their financial needs, making adjustments if necessary. An investor who has a solid plan of attack is less likely to be at the mercy of the investment markets and less apt to buy and sell at the wrong time.

Timing The Market

But what about those strategists, analysts, and economists on television who make it sound so easy and appear to deftly switch between asset classes and in and out of various stocks at just the most opportune moments?

A study of investor behavior by Dalbar, Inc., a firm that provides research to the financial services industry, showed that between 1985 and 2004

the average mutual fund investor earned only 3.51% per year while the S & P 500 grew by 12.98% per year over the same period. “Market timers” who made frequent switches between mutual funds did even worse, losing 3.29% per year on average. Dalbar President Lou Harvey said, “This finding is consistent with the well known behavior of investors to brag about their gains, but remain silent about losses. The occasional money makers create the illusion that all timers are winners all the time. The fact is that most timers lose money most often and this data now confirms it.”

Ownership In Companies

So now we’ve discovered that most timers lose money, even in one of the greatest prolonged bull markets. Let’s

move to the equity portfolio: is it possible to lower risk and still generate good after-tax returns over the long term? How might one go about it?

Let’s start with the cost side of the equation. A successful investor’s largest long-term cost is neither investment fees nor brokerage commissions—it is capital gains taxes. Studies on portfolio turnover and capital gains have estimated that an investor might lose two to four percent in annual returns to capital gains. Fortunately, capital gains realization can be minimized by an attentive investor. To do this, one might want to emphasize an approach with low turnover, since every time capital gains are realized, the taxman will take his share, and an investor will be left to reinvest a smaller amount of dollars than those realized by

the profitable sale of a stock. Maybe true long-term investing isn't dead after all—at least while the taxman is alive!

A Business-Like Approach

What type of companies might be suitable for a low-turnover approach? First, it is important to remember that a share of stock in a publicly traded company is a specific share of a specific business. We all know that some businesses are better than others. Before we make a long-term investment in a public company, what characteristics would we like to see?

Solid financial strength is paramount. The last 12 months have shown that companies who appeared to have good balance sheets were unable to borrow money at rates near levels they had previously enjoyed since their lending sources were too frightened to lend to anyone. So, if we were to invest in a business for the long haul, we would prefer that they be able to finance their business needs with cash flow that their own business generated, thereby lowering our financial risk.

The next thing we would look for is an ability to be profitable over various business cycles. If we owned a business for the long term, we would expect such cycles to occur, even if we could not predict exactly when they might. The majority of publicly traded companies don't have this characteristic, but that's not a problem - we can just eliminate them from our list of prospective investments. As Warren Buffett says, "Time is the friend of the wonderful business and the enemy of the mediocre." Since we want to invest only in "wonderful" businesses, we have thus lowered our business risk.

Now that we have thought about and assembled a list of wonderful businesses in which we might invest, how do we know we aren't paying too much? It is very difficult to assess a company without a strong or consistent operating history. After all, if during the course of a busi-

ness cycle a company might make or lose a large amount of money based solely on the general economy (and economic forecasting is very difficult), why would we want to invest in it? Better to stick to companies that are consistent and whose long-term profit growth is easier to forecast. By making conservative forecasts and paying a price below what those forecasts indicate a company's intrinsic value is, we have lowered our overpayment risk.

We also know that we need to be diversified, but there is no need to go through the investment buffet line and pick one of everything. We have already eliminated the mediocre businesses we wouldn't want to own for the long term, but we also don't want our portfolio being too concentrated on any one industry. By balancing our portfolios between these two extremes, we lower our industry risk.

Now, let's suppose we've invested in a diversified portfolio of wonderful businesses. We need to monitor those investments and see whether the businesses and our portfolio are performing like they should. We turn on the television set one morning and see that one of our companies is earning 58 cents in the current quarter instead of the 60 cents that Wall Street analysts had forecast. Is it really the cataclysmic event the financial news anchors are making it out to be? Since we are investing in a business for the long term, our timeframe is certainly not the same one the financial media is using. We know that the intrinsic value of a company does not fluctuate nearly as much as its stock price does. We take a look at our long-term assumptions and conclude that the current quarter does not affect the long-term intrinsic value of our company, and if the price drops sharply enough, we might want to invest

a little more. We have been calm and rational. We have thus lowered our temperament risk.

We then think about when we might sell one of our investments. Being human, our analytical powers are certainly not perfect, and our wonderful business might not be so wonderful after all. Better to get rid of that one and look for something else. Another reason to sell might be that we have discovered another business that seems to have solid financials and attractive characteristics, but short-term concerns have driven a price down to a point that a longer term investor might find appealing. Now our long-term time frame might be working in our favor. But since we are paying

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taxes, the new company needs to be significantly better than the one we might sell if we would need to realize a capital gain, thus forcing us to give up what Warren Buffett calls our "interest free loan from the government."

In Summary

Although the past decade has been a difficult one for investors in U.S. stocks and times certainly seem more challenging, it is heartening to know that the fundamentals and temperament that a successful investor needs really have not changed very much at all. Knowledge of one's own risk tolerance, emotional discipline, an ability to analyze what businesses are worth, and effective diversification and portfolio construction are still important factors in long-term investment success.

May the investment winds be at our back in the decade to come! ♦

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MARKET OUTLOOK

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time. Many of the economic indicators we follow are showing signs of bottoming and, in some cases, even turning up. A number of the programs contained in the stimulus package have had a positive impact on economic activity, and more are planned for next year. There are, however, some stimulus programs that are scheduled to end soon and deserve watching, such as the \$8,000 tax credit for a first-time home buyer that is set to expire at the end of November. We believe this credit has provided a boost for the housing market and are interested in the on-going talk about extending the program. As we have stated in prior newsletters and quarterly briefings, we continue to believe the economy will turn upward sometime in the second half of this year, and the decline in real Gross Domestic Product (GDP) will end in the third quarter.

We have previously discussed the shape of the economic upturn as a saucer recovery and still believe that this is the most likely path for both the U.S. and world economy. If that is the case, the rebound in corporate cash flows and earnings will not be as strong as some investors are hoping. Do current market valuations reflect this same vision? Our feeling is that today's valuations represent expectations of low-to-mid single digit revenue growth and cash flow growth of mid-to-high single digits. During the recent downturn, we saw revenues, cash flows and earnings drop at precipitous rates. On a percentage basis, revenues declined more quickly than either cash flow or earnings, reflecting the fact that corporate managements were generally successful in controlling costs in the face of declining revenues. Over the next one to two years, we believe margin improvement and revenue growth will continue in the manner reflected by current market valuations.

In other words, we believe today's market is more or less fairly valued.

Does this fair valuation apply to all sectors of the equity market? We don't think so. Normally, we do not place big sector allocations, but there are times when some sector valuation work can add to portfolio

In other words, we believe today's market is more or less fairly valued.

returns. We saw this in our earlier underweighting in the financial sector which helped reduce losses in the down market.

Today, two sectors that may have short-term over-valuation are Technology and Materials. In Technology, our exposure is generally in companies that have performed well this year-to-date but which still show up-side potential based on our cash flow analysis. Our limited exposure in Materials should provide protection against potential problems arising from this sector's current over-valuation. Two areas that appear under-valued are Healthcare and Energy. Both of these sectors have underperformed for the year due to outside influences and concerns. We are looking for companies in Healthcare that potentially come through the Healthcare Reform process as net beneficiaries. In Energy, we expect excess inventories worldwide to give us a price break in oil and the chance to add to current positions or add new holdings.

In summary, over the last two quarters most stocks offered positive returns, with companies that were on the verge of bankruptcy (and have survived, so far) providing the highest returns. Going forward, this fairly-valued equity market will be more selective in companies showing positive relative returns. Our analysis of the underlying fundamentals for each company we research and our on-going valuation discipline will help us find those opportunities. ♦