Managing Risks in a Global Recovery
Stembrook Investment Commentary – February 2011

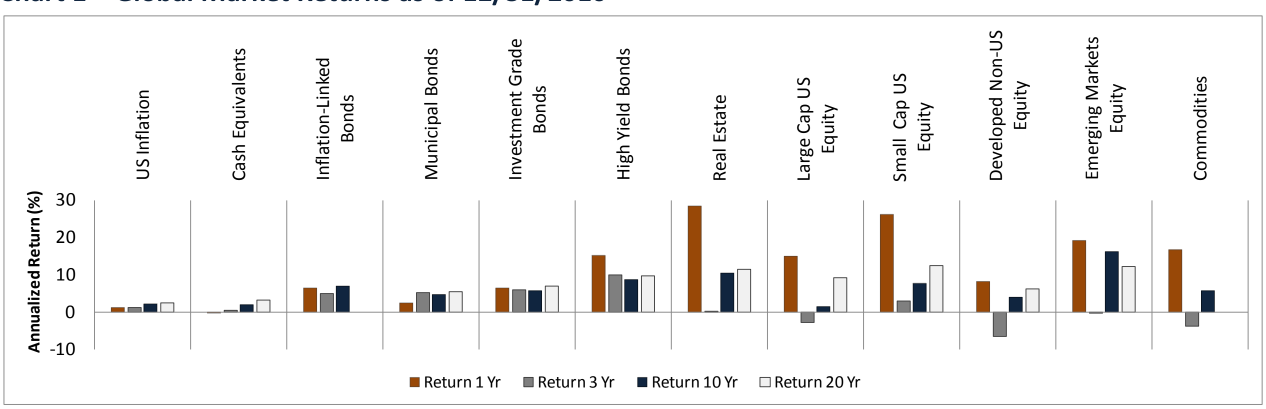
A sometimes challenging, but almost always rewarding exercise when sailing is traveling to your destination with a fickle wind as your motive power. In the same way, we are dependent upon corporate profits to drive employment which ultimately leads to a growing economy and improved investment returns. Currently, the economic outlook is improving and the fundamentals for our investments look strong.

> Our investment in bank loans provides both protection from rising interest rates and relatively high yields

Financial Markets in 2010

The financial markets in 2010 were generally favorable to investors. The orange bars in **Chart 1** show that asset classes across the risk spectrum rose in value in 2010. Taxable investment grade bonds rose approximately 6.5% while municipal bonds rose slightly less than 2.5%. High Yield bonds continued to outperform with a 15% return, as fear in the financial markets continued to subside and credit spreads narrowed. In the equity-like asset classes, small caps outperformed large caps by a large margin as is often the case in the early years of an economic recovery. International developed markets were hurt by fear of instability in Eurozone economies and their common currency, the Euro. Emerging market equities continued to grow with a total return of over 19% in 2010. Commodities also saw dramatic growth as food and energy prices rose in response to faster economic growth in the developed and emerging economies, coupled with weather-related shortages.

Chart 1 – Global Market Returns as of 12/31/2010



Source: Thomson Reuters, Stembrook Research.

Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones UBS Commodity (Total Return) Index.

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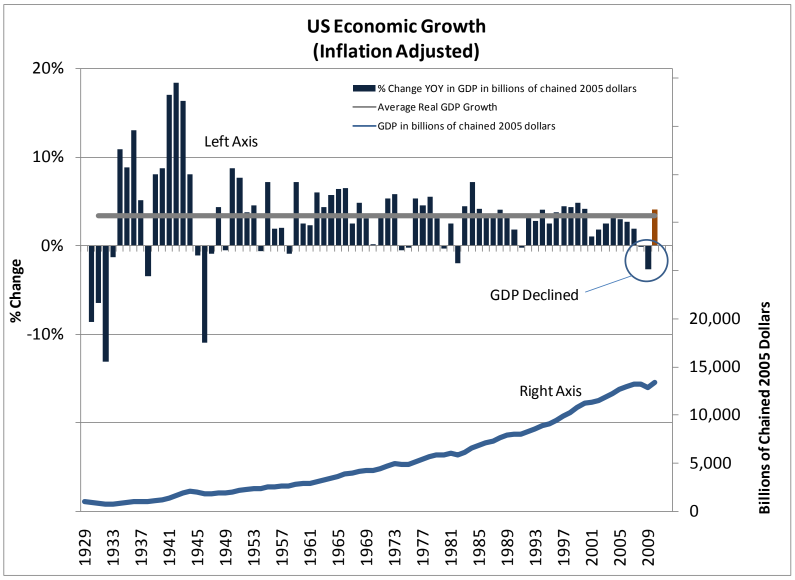
Chart 2 – US Economic Growth

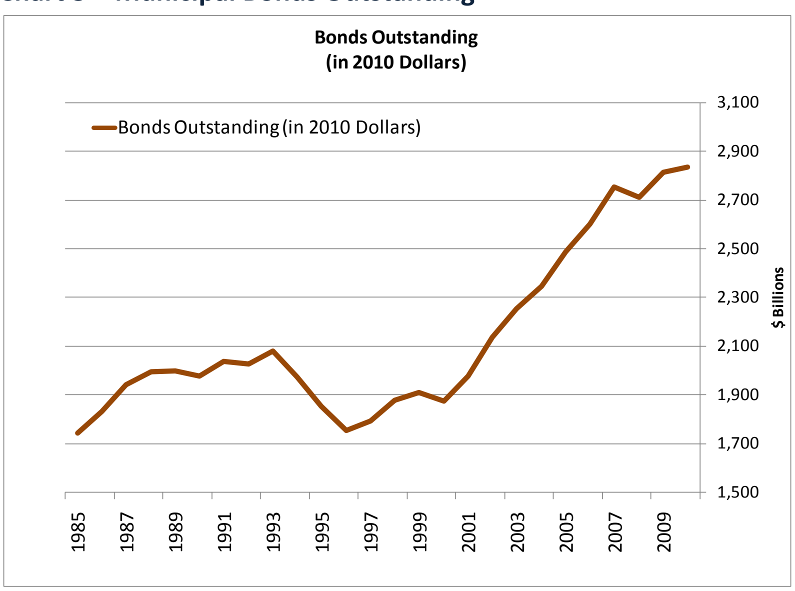


Source: Bureau of Economic Analysis, Stembrook Research

The US Economy is Growing

One of the broadest measures of economic growth in the United States is the gross domestic product or GDP. GDP is the value of final goods and services a country produces within its borders.[i] As the grey line in **Chart 2** shows, the US economy has grown by roughly 3.5% per annum since 1929, after inflation is taken into account. The vertical bars show the percentage change in GDP year by year. There is no doubt that the recent recession was massive in scale and had a tremendous negative impact on economic growth; this is evidenced in the rare observations of GDP actually contracting in 2008 and 2009. The light blue line at the bottom of the same chart shows aggregate GDP in billions of dollars, also adjusted for inflation. The takeaway is that while we had a large dip in economic activity, the US is back on the path to increasing its economic output.

Chart 3 – Municipal Bonds Outstanding



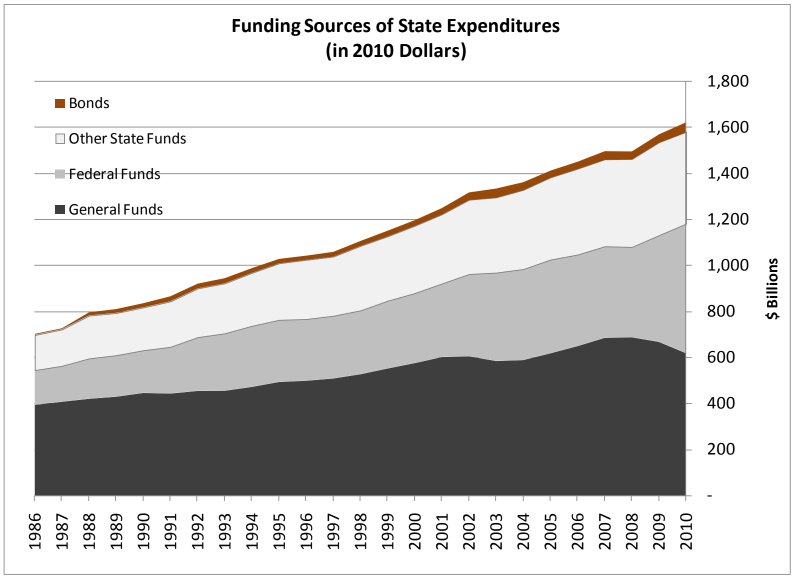
Source: IHS Global Insight, the Bond Market Association, Securities Industry and Financial Markets Association, Stembrook Research

Municipal Bonds

An increased focus on the financial condition of state and local governments in the latter part of 2010 stirred up volatility in the usually quiet municipal bond market. With intermediate-term munis yielding 3.6% and 5.5% on a tax-adjusted basis[ii], munis are still attractive for taxable investors relative to other fixed income investments. The operative phrase here is "relative to other fixed income investments." As we will discuss later, the fixed income market continues to present cyclical risks that we continue to address in the portfolios.

In our November Investment Committee meeting we did a deep dive into the state of the municipal bond market and followed up on this discussion in our February meeting. A look at the data provides a big picture view of a few of the numbers underlying the municipal bond market.

Chart 4 – How Do States Fund Their Budgets?



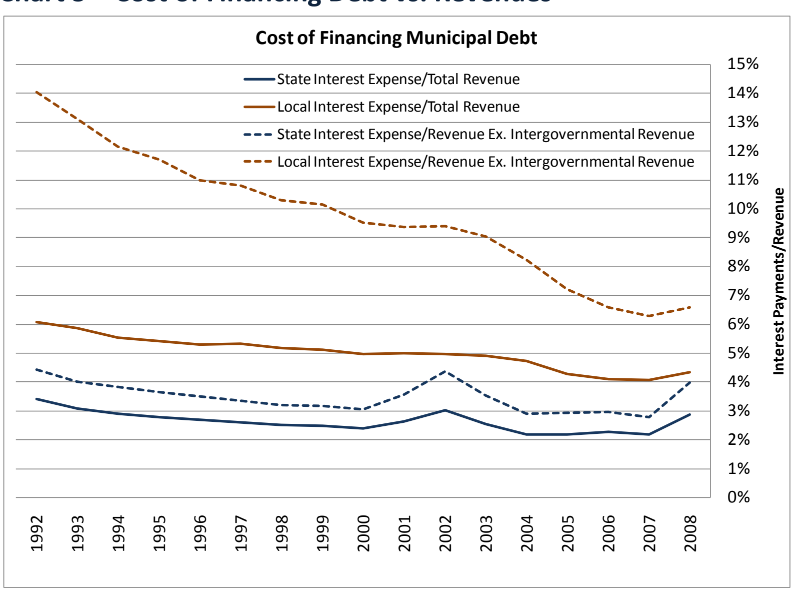
Source: National Association of State Budget Officers, Bureau of Labor Statistics, Stembrook Research

The value of municipal bonds in the marketplace has grown after adjusting for inflation. **Chart 3** shows the extent of that growth.

Funding sources can be broadly grouped into four categories. General Funds, which include primarily tax revenues and are used to fund states' day-to-day operations, Federal Funds, which are transfers directly from the Federal Government to states, Other State Funds, which include revenues that are mandated by law to be used for a specific purpose, such as Medicaid taxes and borrowing in the form of municipal bonds. As can be seen in **Chart 4**, municipal bonds make up a small fraction of the overall funding equation. Also evident in **Chart 4** is the increased proportion of funding coming from the federal government. This funding, which has accelerated in recent years as part of the overall effort of the federal government to provide economic stimulus, is expected to be reduced in the near future, leaving states with the challenge of closing the gap.

Another metric to consider is the cost of financing state and local debt as a percentage of revenues. In **Chart 5**, we analyze state and local financing costs versus revenues. The chart also contains a variation where the same financing costs are shown as a percentage of revenues excluding intergovernmental transfers, or funds from federal and state governments. It is interesting to note that through 2008 - the latest data available from the Census Bureau - local government financing costs as a percentage of revenue (excluding state aid) had declined rather dramatically. This is due, in part, to falling interest rates.

Chart 5 – Cost of Financing Debt vs. Revenues



Source: US Census Bureau, Stembrook Research

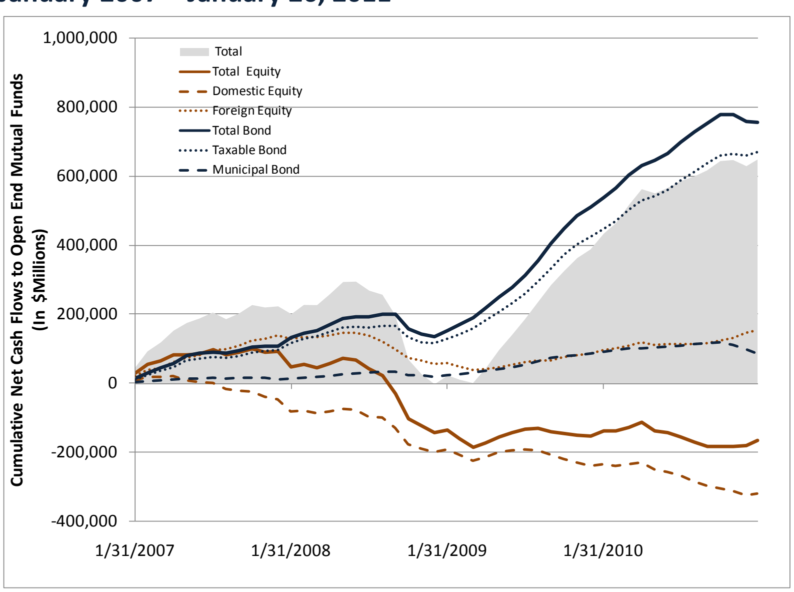
Attention to state and local finances has helped to shine a light on spending, pension benefits, retirement ages and other issues that, when addressed, will result in more solid state and local finances in the future.

From an investment perspective, our view is largely unchanged. We view the primary risk to holding municipal bonds coming from interest rate risk associated with owning bonds, more than the risk of states or municipalities defaulting. Municipal yields are relatively high versus similar grade taxable bonds, particularly on a tax-adjusted basis.

In order to reduce the risk of default, our selected bond managers construct portfolios that are well diversified by state and by obligor, while maintaining a focus on credit research in efforts to avoid problem issuers.

We continue to own municipal bonds for taxable investors, where bond exposure makes sense. In our opinion, the risk of rising rates – and falling bond prices – is a significantly greater risk than the risk of default. For that reason, we have purchased bank loans as part of our overall effort to reduce interest rate exposure and increase our exposure to credit.

Chart 6 – Flows to Equity and Fixed Income January 2007 – January 26, 2011



Source: Investment Company Institute, Stembrook Research

Bank Loans

With historically low yields and high investor demand for fixed income investments, we continue to view the risk of rising interest rates and falling bond prices as significant. **Chart 6** shows an update to the chart we originally published in our [last commentary](), where we made the case that significant flows into bond funds and out of equity funds contributed to the likelihood of a future decline in bond prices. **Chart 6** shows what could be the beginnings of a change in sentiment regarding fixed income and equity investments. Flows in recent months have reversed, and we are now seeing assets moving out of bonds and into equities. Since a few weeks do not a trend make, we will keep an eye on this dynamic.

We continue to seek out opportunities to diversify away from interest rate risk. In the past, we have held additional cash, invested in more actively managed bond portfolios and invested in higher yielding investments with shorter duration. Bank loans are floating rate, short-term loans made to companies with sub-investment grade ratings (less than BBB). Bank loans are typically the most senior part of a company's capital structure, meaning that in case of financial problems, lenders (investors) are close to the front of the line to be repaid. Bonds with floating rates and short maturities are helped by rising rates. This is opposite the dynamic of a longer maturity bond with a fixed interest rate, where rising rates translate into falling prices. As of year-end, the bank loan portfolio yielded 5.4%. With increasing demand and waning fear, yields have been drifting downwards in the early part of 2011. It is important to note that this high yield comes with certain risks. Our primary risk is a retrenchment in economic growth which would reduce borrowers' ability to repay the loans. Refinancing risk is also a consideration, as most high yield issuers do not pay off their debt at maturity and thus could experience a, "cash crunch" should liquidity in the new issue market suddenly disappear. The allocation to bank loans was funded from our investment grade bond allocation.

Large Cap Equities

The data continues to point towards large cap US equities as an attractive area of investment for patient buyers. The initial boost to profitability from falling inventories and productivity growth seems to be behind us, and we are now seeing corporate profits rise increasingly due to consumer demand, export growth and increased capital expenditures. A number of factors indicate that this out-of-favor asset class is poised for strong returns.

- Corporations continue to have significant excess cash on their balance sheets.
- Reversion to the mean. Meaning, underperforming asset classes such as US large cap equities tend to outperform in the future.
- Valuations (see our last commentary)
- The Presidential election cycle

Commodities

Across the board increases in the prices of raw materials have been reflected in the rising prices of our commodity investments. As you recall, our commodities exposure serves a dual purpose; to gain additional exposure to economic expansion, and to hedge against inflation. Thus far, inflation has been seen more in the emerging markets than in the US, and we continue to hold our position. However, in light of the dramatic increase in prices and increased interest in the asset class, we have trimmed our commodity positions, on the margin.

Investment Planning

The foundation of every client's investment strategy is their *Stembrook Strategic Investment Plan*. This plan takes into consideration your current portfolio values, your expected spending and savings and various scenarios for market returns given your high level asset allocation. Please contact me if something has changed significantly with your unique situation so that we may adjust your plan accordingly.

As always, I welcome your comments and questions, and appreciate your continued confidence in our investment advice and management.

Sincerely,

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[i] $GDP = Private\ Consumption + Gross\ Investment + Government\ Spending + (Exports - Imports)$

[ii] *Intermediate-Term Municipal Bond Yield based on the Yield to Maturity on the Vanguard Intermediate-Term Tax-Exempt Bond Fund as of 1/31/11. Tax-equivalent yield is adjusted based on the highest federal income tax rate.*