

Investment Outlook

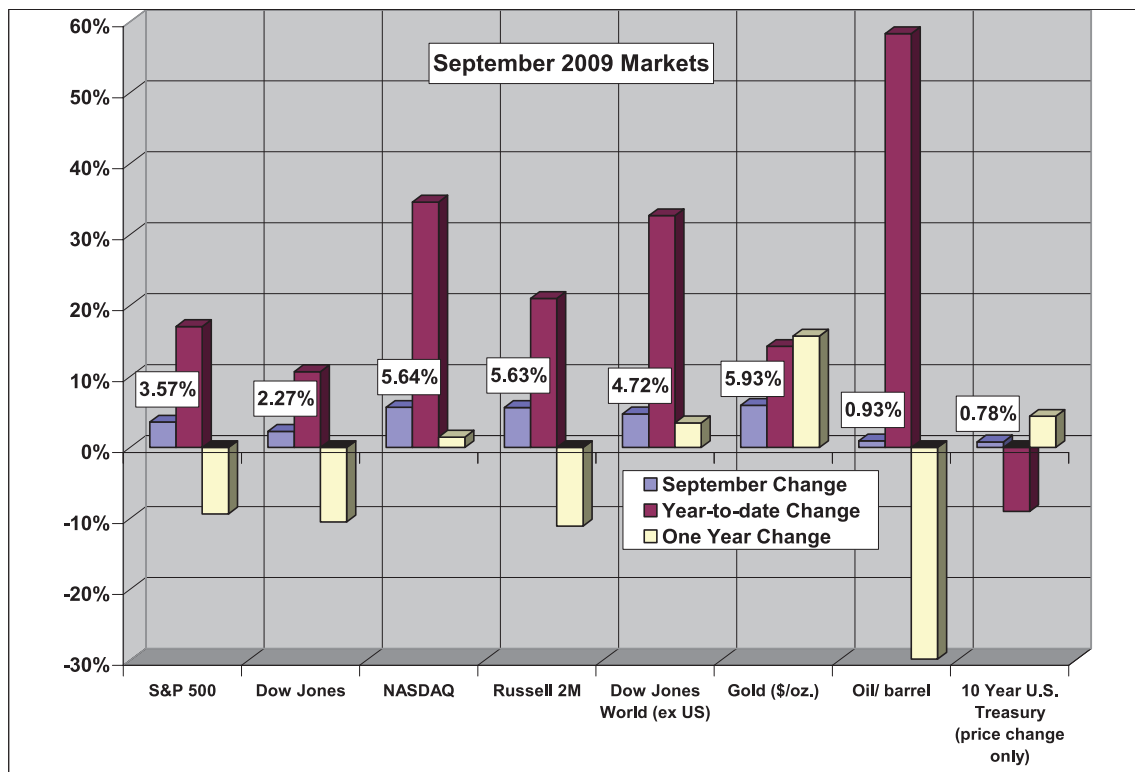
October 2009

Paths to prosperity



September Markets ...three laps down, one to go

Investors fearing that September would retain its image as “the cruelest month” were pleasantly disappointed when the equity markets rallied to produce the seventh consecutive monthly gain this year and the best calendar quarterly results since 1998. Equity performance seemed to be driven more by momentum than improving fundamentals as investors seeking to catch up with the rally and some need for quarter-end window dressing prevailed.



The inability of equities to maintain their peak prices coupled with a strengthening dollar and worse than expected economic reports, stalled the rally in mid-month with the last two weeks turning downward. Regardless, all of the investment classes measured on our chart closed with respectable gains, including Treasury bonds as measured by the 10-year note. As an indicator of the improved investor sentiment from the depths of early January and the increased “appetite for risk”, Treasurys had the smallest September gain among these assets and remain the only asset with a negative return for the year to date period.

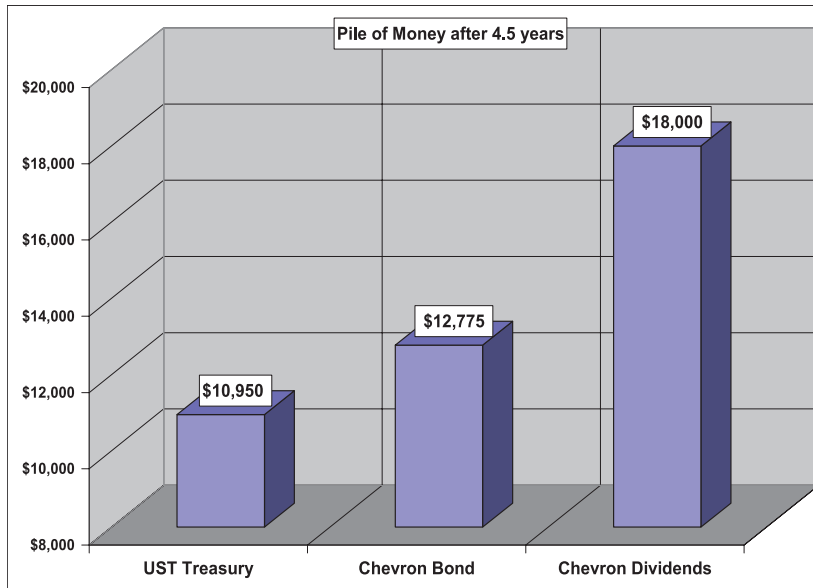
Commentary

Buddy can you spare some income...?

We are delighted with the recovery in asset values from the Depression-like depths we experienced during the angst of this past spring. Although equity markets have captured the attention of most of the popular press it is the bond market that has virtually returned to its pre-meltdown “normal”. The double digit bond yields that were available from high quality corporate names are long gone and have been replaced by profits in our bond portfolios (bond prices rise when yields fall).

Rising asset values are one of the consequences of stress leaving the various credit markets. Falling interest rates and reduced income opportunities are others.

Stock dividends have always been an important component of returns for equity investors. Current conditions may cause them to be considered by fixed income investors as well.



The adjacent chart plots the cash that could be expected from three differing investments of \$105,000 over a four and one half year time period (the significance of the period will be evident shortly). We'll refer to it as a “Pile of Money” as all cash spends equally well; consequently the larger pile is generally better.

The alternate investments are a “risk-free” U.S. Treasury note due in five years, a Chevron corporate bond due in March 2014 (4 ½ years, hence the time period chosen) and shares of Chevron’s common stock. Some background here is appropriate.

Bond prices rise as interest rates fall. This “bids up” the price of the Chevron bond to 105; i.e. 105% of its par value, or \$105,000 to buy a \$100,000 bond. This difference is transferred from the “income”, in this case the 3.95% coupon payment. Because this rate is higher than the market demands for this corporate credit sellers demand, and buyers will pay, a higher price; in this case 5% higher. Consequently even though the investor will receive \$17,775 in interest payments over this time period that income should be reduced to \$12,775 to reflect the \$5,000 (5%) “premium” that will not be repaid when the \$100,000 bond is redeemed in March 2014.

The good news here is that the Chevron bond interest is \$2,433 more than one would receive from the Treasury investment. This should be considered the "premium" demanded for taking the additional investment risk. Expressed as a percentage this premium is 14%.

A feature that is exclusive to bonds is the certainty of a future "sale price"; i.e. if the bond is held to maturity it will be redeemed at its face value, or par. Consequently the total return of a quality bond investment is known from the time of purchase, assuming the bond is to be held until maturity. The value of this feature cannot be overestimated for investors that require certainty in cash flows or risk mitigation.

Investors in need of income who can be a bit more flexible may want to revisit our pile of money and examine the dividends from the Chevron stock more closely. At its present rate of \$2.72/share the stock dividends will amount to \$18,000 over the same time period. This is a \$5,225 dollar gain over the Chevron bond income and \$7,050 gain over the Treasury note; or premiums of 29% and 39% respectively.

While it is certainly possible that the value of the stock may decline the price would need to be 5% lower at the end of the time period before the return is less than that of the corresponding bond. Similarly there is a risk that the dividend might be reduced during this period, however understanding that the company dedicates only a modest 32% of its income to paying dividends (known as the dividend pay-out ratio) would suggest that the existing payout is relatively safe and future increases might be expected as well.

We remain cognizant that past performance is never a guarantee of future investment returns but would also note that Chevron has increased its dividend consistently over the past 29 years at an annualized rate of 9%. Concurrently the stock price has also compounded at a rate of 9.2% over the past five years compared to the -1% annualized rate of decline in the S&P 500.

Given the benefit of diversification we note that similar income opportunities are present in a number of stocks that we generally hold in our equity portfolios. Among these are Bristol-Meyers, Home Depot, Kinder-Morgan and ATT, as well as many of the exchange-traded funds that we commonly use.

At a time when the longer term outlook seems more certain than the shorter view dividend income may make waiting for confirmation of the economic recovery more pleasant. This is especially true when the income received exceeds the interest available from related bonds. We can certainly imagine some future time when improving economic conditions may reverse these circumstances resulting in bond yields that exceed the dividends of their related stocks. That would be the perfect time to revisit this strategy to determine how one might reinvest to benefit from this change in prevailing conditions.

Outlook & Strategy **...but can they do it without the net?**

Equity markets seem to have entered the long-heralded correction with a 4% decline from the levels reached in late September. As this is being written the best quarter for the Dow in eleven years has been followed by the market's worst single day since the second of July.

The most recent economic data is giving credence to the notion that the recovery will be prolonged and ragged. The most nagging question continues to be what catalyst will propel the expansion with sufficient energy to replace the global stimuli in the form of increased government spending and loosened central bank monetary and credit policies.

As noted in previous issues, investing for improving conditions seems appropriate now that the risk of a systemic failure has abated. It also seems prudent to do this on a measured basis in order to insure against any newly emerging risks while capitalizing on apparent opportunities.

Broadly diversified holdings of quality assets remain the best offense here. Dividend paying equities can provide a source of income while participating in the recovery as it develops. Both stocks and commodity exposure can compensate for inflation and, in the case of international equities, dollar weakness. In the meantime we will retain some of our existing bond positions until it is clear that the risk of sustained deflation has clearly passed.

Companies will be releasing their third-quarter report cards soon. We expect this year's trend of better than expected results to continue. We will be looking for evidence of improving revenue that marks a budding recovery rather than earnings growth from continued cost cutting. The safety net of increased government spending has served to ease the pain of economic decline, however it will need to be reduced before ever increasing budget deficits become counter-productive.

In the meantime questions and comments from investors are always welcome.

S&P 500: 1029.85
10 Year U.S. Treasury Yield: 3.194%

Mark Fingerlin
October 1, 2009