

SPRING 2010

After the market roller coaster of 2008 and 2009, the first quarter of 2010 has been blessedly uneventful by comparison. The US markets gained about 5% in the first quarter, the best start to the year since 1998.

That said, there is still a cloud of uncertainty that is making many investors nervous.

Causes for concern . . . and for optimism

Even with the stabilization of the global economy, there's no shortage of short-term causes of concern:

...continued questions of the direction and timing of the economic recovery in the United States and Europe and the timing of higher interest rates

...US housing prices that are staying stubbornly low and unemployment levels in North America and Europe that are stubbornly high.

...and in late March the deputy director of the International Monetary Fund made headlines as he talked about the need for advanced economies to cut spending in order to reduce deficits.

The 'Good News' is still good news:

...There is a moment in most economic and market cycles when the stock market ceases to be comforted by good economic news because it fears Fed tightening. The market strength on the back of positive economic news suggests we have not reached that point.

...The 'good news' includes positive purchasing manager surveys and employment figures. Despite being below consensus expectations, the jobs report for March was actually stronger than the headline disappointment would suggest. Although 'only' 162,000 jobs were created against a consensus of 184,000 expectations were that most, if not all, of the increase would be the result of government hiring of temporary census workers. In fact, census hiring was just 48,000 (government as a whole was actually 39,000) whereas private sector job creation of 123,000 was much larger than expected. Moreover, the previous two months were revised 62,000 higher.

...Job gains are still being led by temporary and health care workers, but other sectors are starting to contribute as well. Notably, goods producing industries – such as manufacturing, construction and mining - added 41,000 jobs during the month, its first increase in three years. Also supporting the view of a broadening job recovery is the fact that aggregate hours worked have risen to new highs for the cycle after a weather-related dip in February.

...The main question for investors is whether job growth can continue. I believe it can. Companies are enjoying strong earnings growth and an increase in revenues, which is an encouraging recipe for further hiring. The health of the corporate sector is reflected in purchasing manager surveys. The Institute for Supply Management manufacturing index rose 3.1 points to 59.6 in March, its highest level since 2004. Not only do purchasing manager surveys in the US continue to strengthen, measures of manufacturing activity have risen world-wide to their highest level in nearly six years, underscoring the global nature of the economic expansion, a favorable environment for profits and growing business confident.

...On Monday March 22, the Wall Street Journal ran a story about dividend hikes as a result of rising profits by US companies. The article also mentioned that cash on hand on US corporate balance sheets was at the highest level since 2007.

...The same day the Financial Times ran a similar story about dividend increases in Europe

Forecasting the future

Whether you choose to focus on the positives or the negatives, there's broad agreement that the steps taken by governments stabilized the financial crisis that we were facing a year ago – and there is almost no talk today of a global depression.

So the issue is not whether the economy will recover, but when and at what rate - and whether there might be another stumble along the way.

If you look for investing advice in the newspaper or on television, the discussion tends to revolve around what stocks will do well in the immediate period ahead ...this week, this month, this quarter.

I refuse to participate in that speculation – when it comes to short-term predictions, whether about the economy or the stock market, there's one thing I can say with virtual certainty: Most of them will be wrong. Quite simply, no one has a consistent track record of successfully forecasting short-term movements in the economy and markets.

Historically the great investors throughout history center on two things to invest successfully – having a sound plan and sticking to it.

I try to apply that approach as well – putting a plan in place for each client that will meet their long-term needs and modifying it as circumstances warrant, without walking away from the plan itself.

Boom times such as we saw in the late 90's and scary conditions such as we've seen in the past two years, can make that difficult – but those conditions can also represent opportunity.

Six core principles that shape this approach

In the meantime, here are five fundamental principles that I look for in money managers and that drive the portfolios that I believe will serve clients III in the period ahead.

Concentrate on quality

The record bounce in stock prices over the past year was led by companies with the weakest credit ratings. Some have referred to last year as a “junk rally”, with the lowest quality companies doing the best. That's unlikely to continue – that's why I'm focusing my portfolios on only the highest quality companies, those best able to withstand the inevitable ups and downs in the economy.

Look to dividends

Historically, dividends have made up 40% of the total returns of investing in stocks and have also helped provide stability through market turbulence. Two years ago, quality companies paying good dividends were hard to find – one piece of good news is that today it's possible to build a portfolio of good quality companies paying dividends of 3% and more.

Focus on valuations

Having a strong price discipline on buying and selling stocks is paramount to success – history shows that the key to a successful investment is ensuring that the purchase price is a fair one. Investors who bought market leaders like Cisco Systems, Intel and Microsoft ten years ago are still down 40% to 60%, not because these aren't great companies but because the price they paid was too high.

Tax Efficiency

Municipal bonds have performed very well since late 2008, when yields reached record highs relative to Treasury bonds. Such attractive tax-free yields did not escape notice, and demand for municipal bonds ran at a record pace through the third quarter of 2009.

At the same time, tax-exempt municipal bond supply was sharply curtailed by the Build America Bond program, a federal government program intended to lower borrowing costs and improve access to capital for municipalities. Record demand and limited

supply combined to send municipal bond prices higher. Put it all together, and 2009 was the best year ever for municipal bond performance relative to Treasuries. As the federal government turns its attention to addressing massive debt, higher taxes seem a virtual certainty. State and local governments are also likely to seek additional tax revenues at some point.

Incorporating tax harvesting to offset and realized capital gains across portfolios is another tool incorporated to enhance net returns.

Stick to your plan

In the face of economic and market uncertainty, another key to success is having a diversified plan appropriate to your risk tolerance – and then sticking to it. It can be hard to ignore the short-term distractions, but ultimately that's the only way to achieve your long-term goals with a manageable amount of stress along the way.

Remain diligent under adversity

This is perhaps the one message that should resonate the loudest. Time and again, experience has shown the folly of market timing. If an investor pulled out of the markets in 2008 – and many did – he or she risked missing the largest market rebound in nearly 80 years.

Additional evidence can be found in a comparison of 2003, when the economy came out of the last recession, with 2009. Both years recorded strong double-digit returns and both were marked by leadership in cyclical sectors like information technologies, materials and consumer discretionary.

In closing, let me express my thanks for the continued opportunity to work together. Should you ever have any questions or there's anything you'd like to talk about, I am always pleased to take your call.

Sincerely,

Gary J. Najarian

