QUARTERLY COMMENTS

1st Quarter 2011

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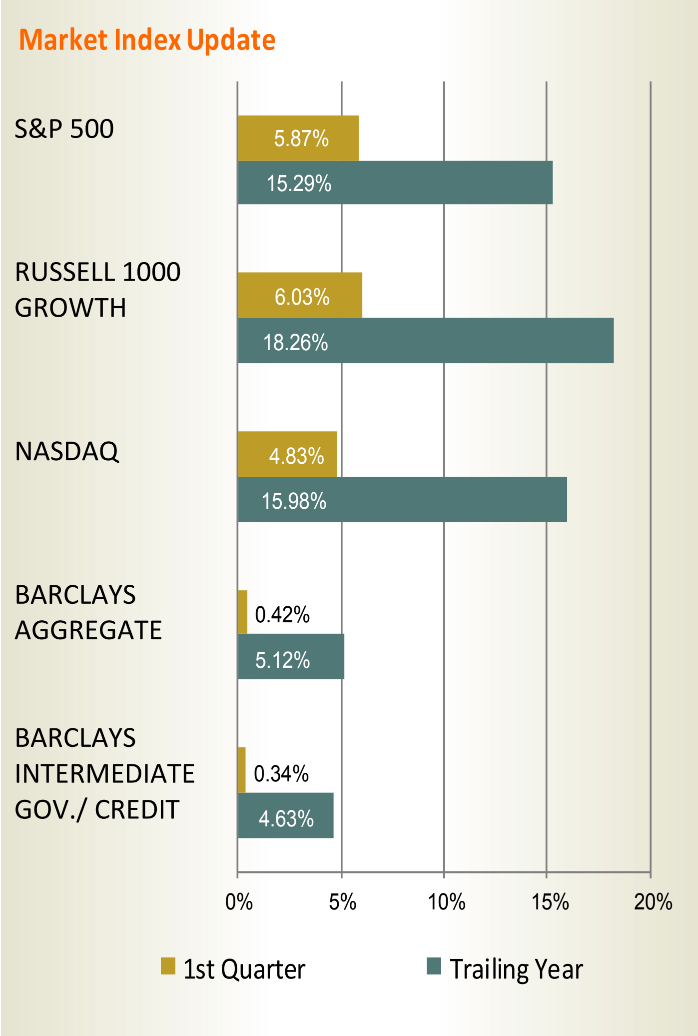
Home Runs, Walks… And Some Errors

Last week's four-inch snowfall notwithstanding, spring fever is at hand in St. Louis.



"This song describes the events of a lovely spring day. The sky is a cloudless blue, birds are singing, and out at the ballpark the grass is an emerald green. It's the top of the fourth, there are two out and runners on first and second. The batter hits a slow roller down the third-base line. The third baseman scoops up the ball barehanded and tries for a force play at second . . ."

Here in the Gateway City, spring is synonymous with baseball, and local fans are thrilled to see our Cardinals back on the diamond at Busch Stadium. Over the past decade, the Cards have been led by (arguably) the greatest baseball player in history. "Prince Albert" has been the only player in history to deliver at least 30 home runs and 100 RBI in each of his first 10 seasons. With what could be as much as a decade of solid production still ahead of him, Pujols has already knocked in 408 home runs, won two Gold Gloves and been awarded three MVP awards during his career.

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And yet loyal Cardinals fans begin the 2011 campaign under a cloud of anxiety. One of our star pitchers, Adam Wainwright, suffered a season-ending arm injury in spring training. Matt Holiday, our second-best player and a star in his own right, underwent an emergency appendectomy following Opening Day and will be out of the lineup for an indeterminate period.

And most importantly, as everyone who even remotely follows baseball knows, Albert Pujols is now in the final year of his contract. Pre-season contract negotiations during last winter failed to result in a new deal, and Albert has vowed to suspend any further contract talks until after the season concludes. Thus fans are faced with the unappealing prospect that Pujols could become a free agent after this season, leading to an unwinnable bidding war for his services (apparently the 10-year price tag is in the neighborhood of $30 million per year – yikes!), ultimately resulting in a premature post-Pujols era in St. Louis baseball. Hence the palpable fan angst as spring blooms.

Away from baseball and back in the real world where most of us make our living, the stock market has generated "home run" stock returns since March 2009. The just completed first quarter represented the best first calendar quarter for the S&P 500 Index since 1998. More impressive yet is the fact that the benchmark index's 72.6% return for the 24 month period ending 3/31/11 ranks in the top 7% of all 1000 rolling 24 month periods for the broad U.S. market since 1928. To push the baseball analogy forward, these statistics put recent stock market performance in Hall of Fame territory.

Meanwhile, bond investors continue to draw "walks" in the form of extremely meager coupon income. Short-term CD's, money market funds, and Treasury bills all yield much less than 1%, and ten-year Treasury bonds ended the first quarter yielding only 3.42%. Right, wrong, or indifferent, low prevailing bond yields are due in very large part to our Federal Reserve's ongoing commitment to ZIRP (Zero Interest Rate Policy) which is intentionally keeping Fed Fund rates at the so-called "zero bound" in an attempt to drive capital investment and support the economy's recovery.

Where is inflation headed?

As any investment strategy must involve uncertainty, there are several fair questions we should ask about the near and intermediate future:

1. Can equity prices continue to rise?
2. Can interest rates stay this low?

And, perhaps the most important question of all – because the answers will likely have significant impact on the return prospects for all financial assets:

3. Where is inflation headed?

What follows are summaries of our current views on all three of these questions. As always, feel free to contact us with questions or to request more detailed information.

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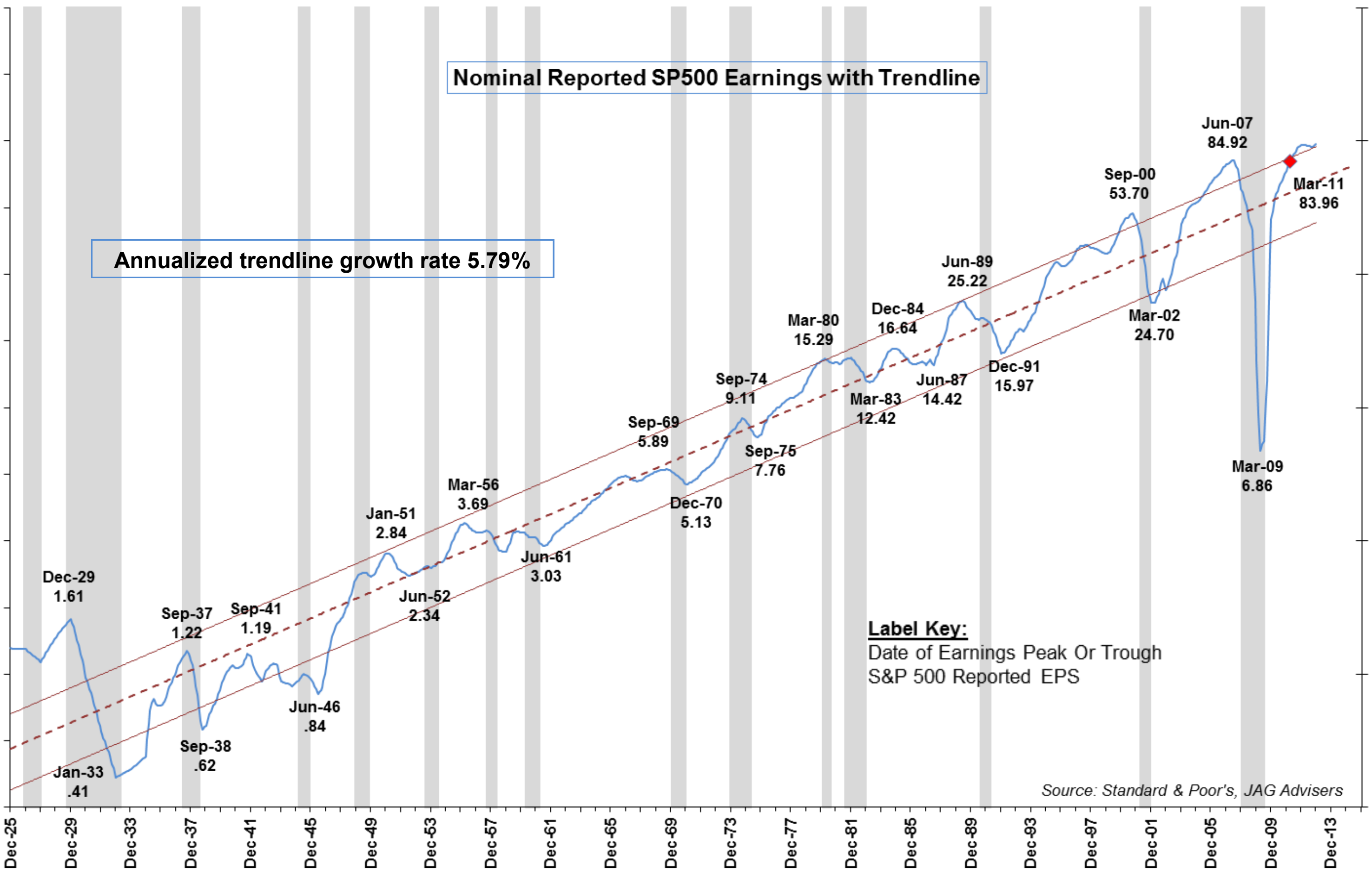
Equity Market Outlook: Still Batting for Average

We continue to remain generally constructive on the domestic equity market. As the chart below details, S&P 500 earnings growth continues to exhibit cyclical strength. If the profit cycle continues to march forward, higher corporate earnings could provide a potential tail-wind for stock prices in the coming quarters:



Note: S&P 500 earnings growth has displayed strong cyclical tendencies over the entire history of available data. Given their cyclical nature, earnings have regularly reverted to a trend value that has increased at a 5.79% annualized rate over time (represented by the dashed red line in this chart). Using trend earnings to calculate P/E ratios and earnings yields smooths the cyclical fluctuations allowing us to better evaluate the degree to which stocks may be over or under valued.

We are now in the 2nd quarter of the 3rd year of President Obama's term. In previous commentary, we have noted the historical correlation between average stock market re-turns and various points of the Presidential Cycle. As detailed by the next chart, the cur-rent quarter in the cycle has been the third-best quarter for cumulative S&P 500 returns since the Hoover Administration:

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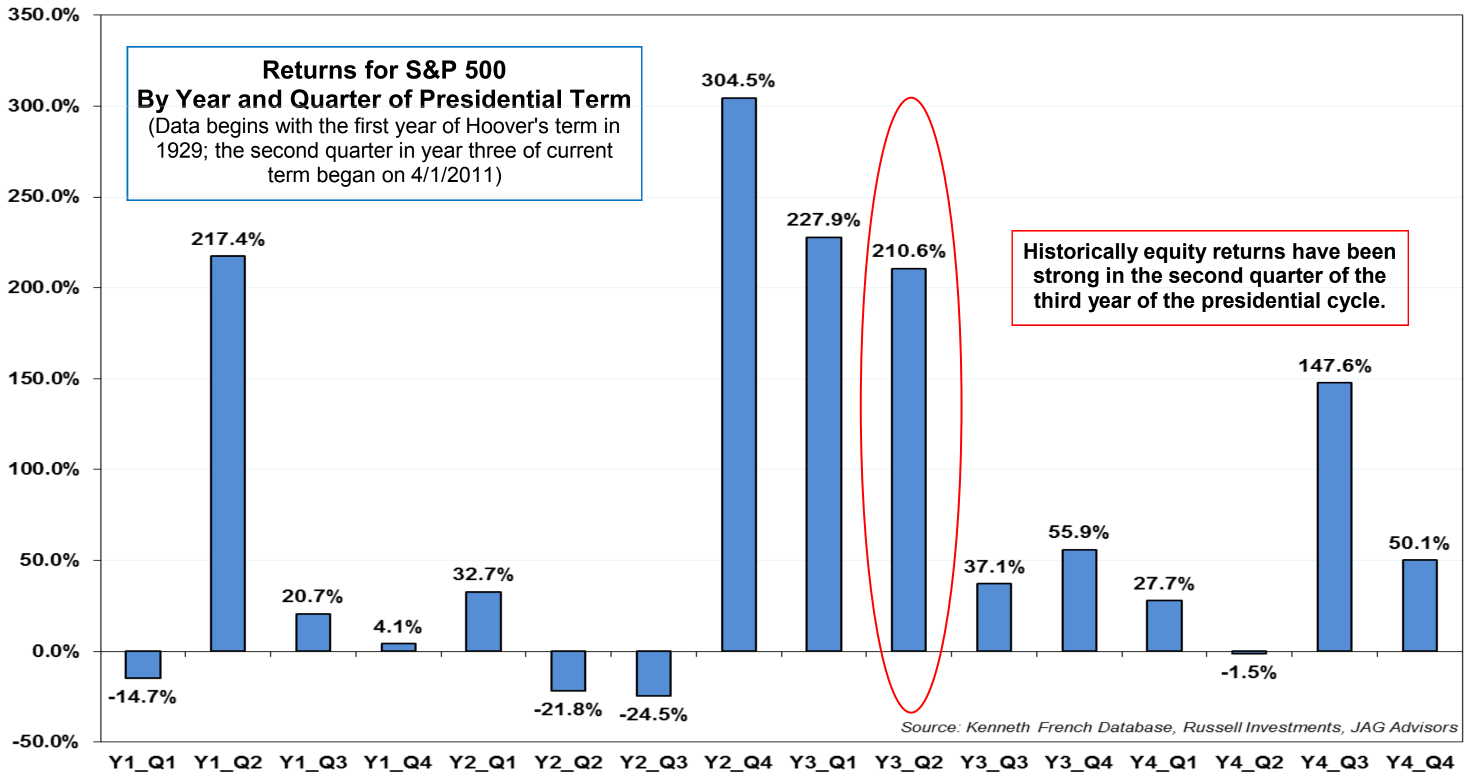
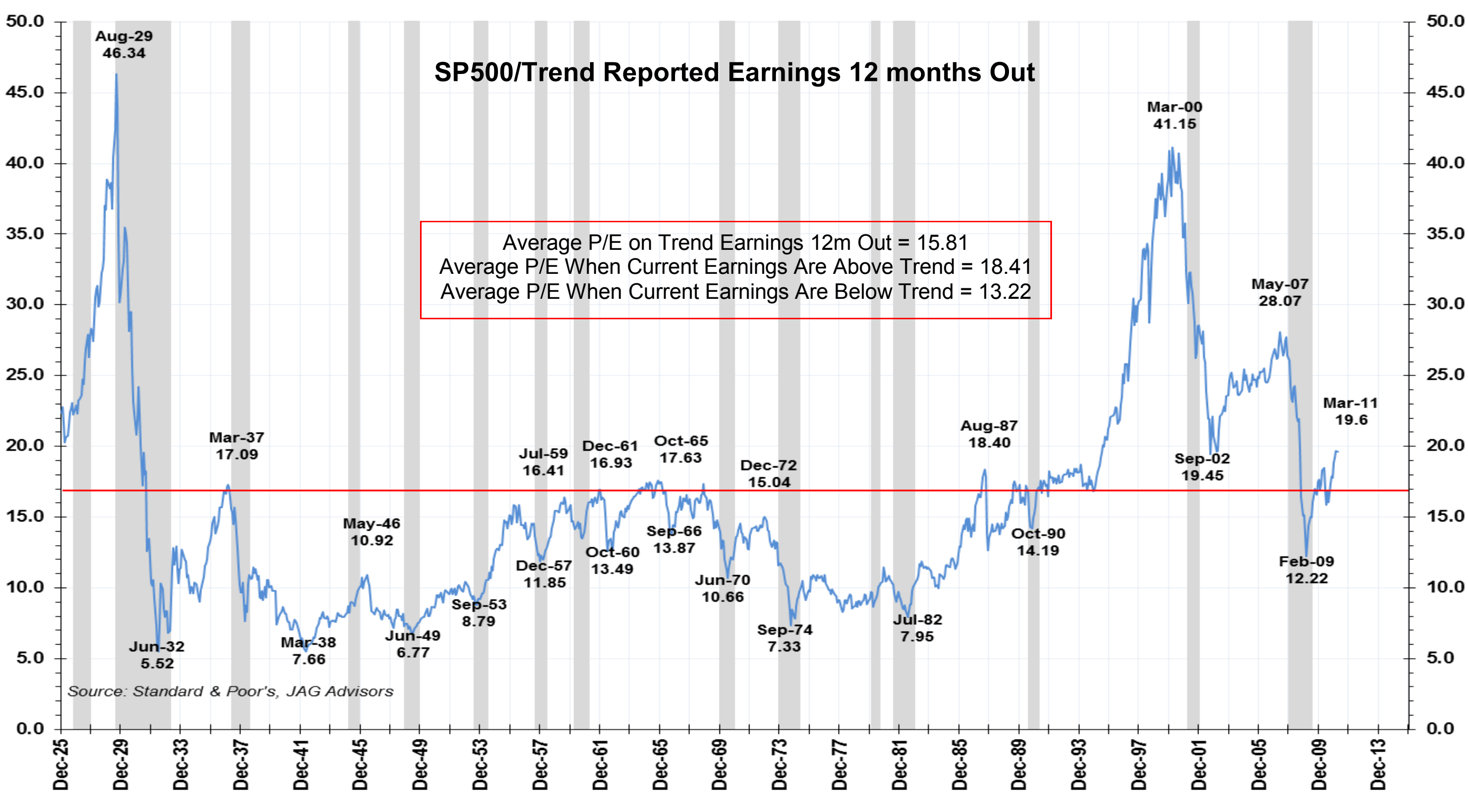


On a forward price-to-earnings basis, stocks are neither extraordinarily cheap nor outrageously expensive. Using trend earnings rolled forward 12 months, the S&P 500's forward P/E ratio is currently 19.8. This is above the long-term trend of 15.8, but well below the highest levels seen over the past decade:



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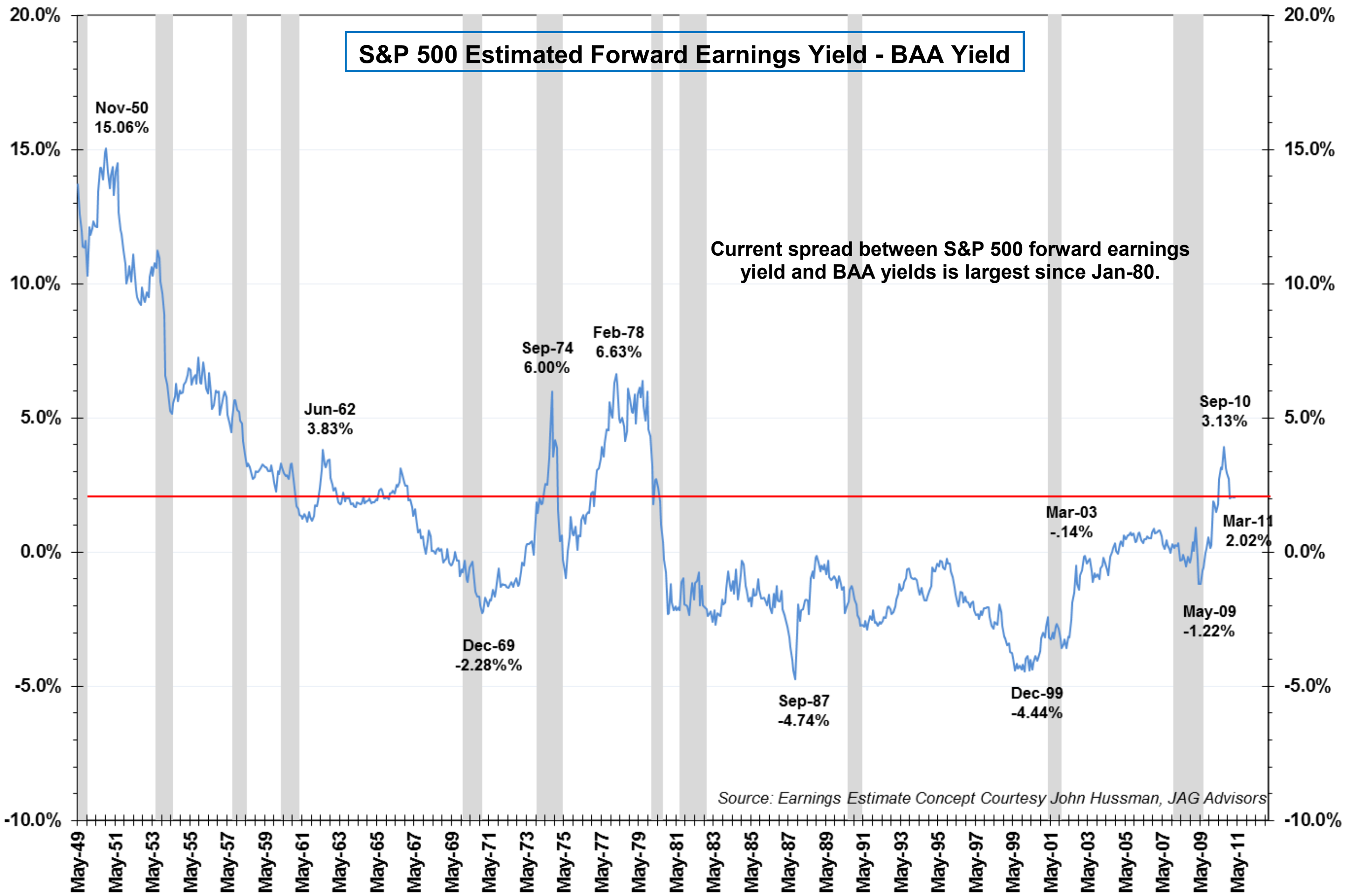
Stock valuations look more attractive when we examine S&P 500 estimated earnings yields relative to BAA-rated bond yields. By this measure, S&P 500 forward earnings yields ended March 2011 at a 2.02% premium to BAA yields - implying that stocks could be valued as inexpensively as we have observed since the early 1980's:



Note: Forward Operating Earnings Estimates are simulated using a regression equation that is highly correlated with actual estimates. Using the simulation allows us to analyze a much longer history than would otherwise be possible.

Putting all the pieces together, we are moderately bullish on the outlook for the broad market over the intermediate term. In terms of individual stocks, industries, and sectors, we are proactively positioning client portfolios to benefit from a number of cyclical and secular themes.

As examples, we continue to believe that selected areas of the technology sector are benefiting from secular momentum (mobile platforms, cloud computing, and data storage). We are also constructive on energy stocks (natural gas and domestically-oriented oil drillers) and commodities (agricultural commodities and selected chemical companies).

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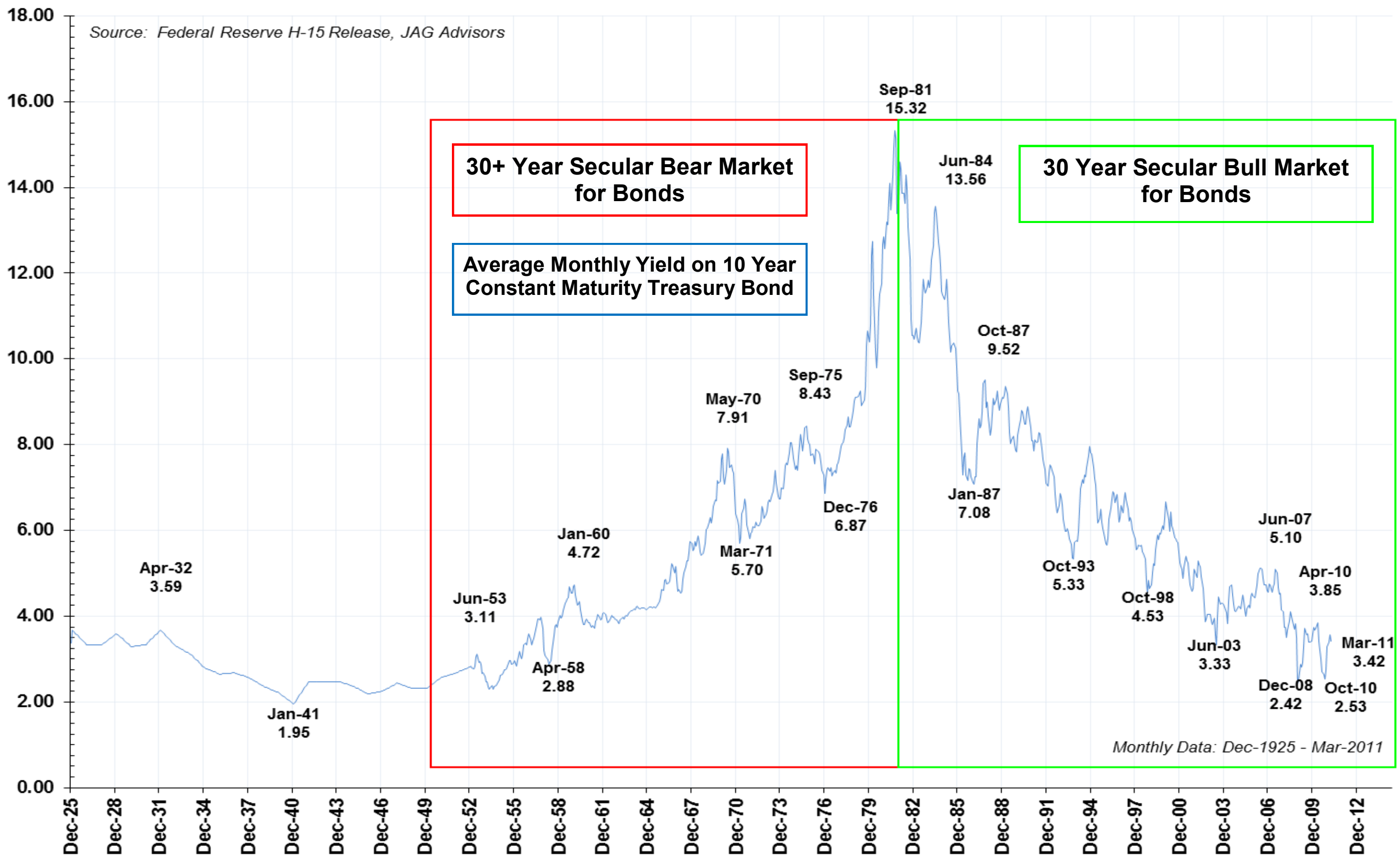
Bonds & Interest Rate Outlook: "Bunting" in 2011

We continue to believe yield-oriented bond investors should "bunt" their way through conservative game plan in 2011. While the Fed's aforementioned ZIRP approach has arguably helped drive the economic recovery, it is likely that interest rates will move higher when the Fed begins to tighten policy. Note in the chart below that interest rates (as measured by 10-year Treasury yields) remain near historical lows. In our estimation, this and other data imply that higher rates could be in the offing later in 2011 or 2012:



Long-term, we think moderately higher interest rates would be favorable for fixed-income investors and for the overall economy. But like many things in life, the process of rates moving to a higher (and healthier) plane could be painful for some investors – particularly for yield-hungry investors who have positioned themselves in longer-duration securities. While it is true that longer-term bonds pay higher yields, longer maturity bond prices are much more sensitive to movements in interest rates than are short- or intermediate-term bonds.

Therefore, we remain steadfast advocates of a cautious approach to bond portfolio management in 2011. We continue to believe that intermediate-duration bond portfolios with laddered maturity structures are likely to weather any potential uptick in rates quite well – while producing competitive (if not eye-popping) coupon income all the while.

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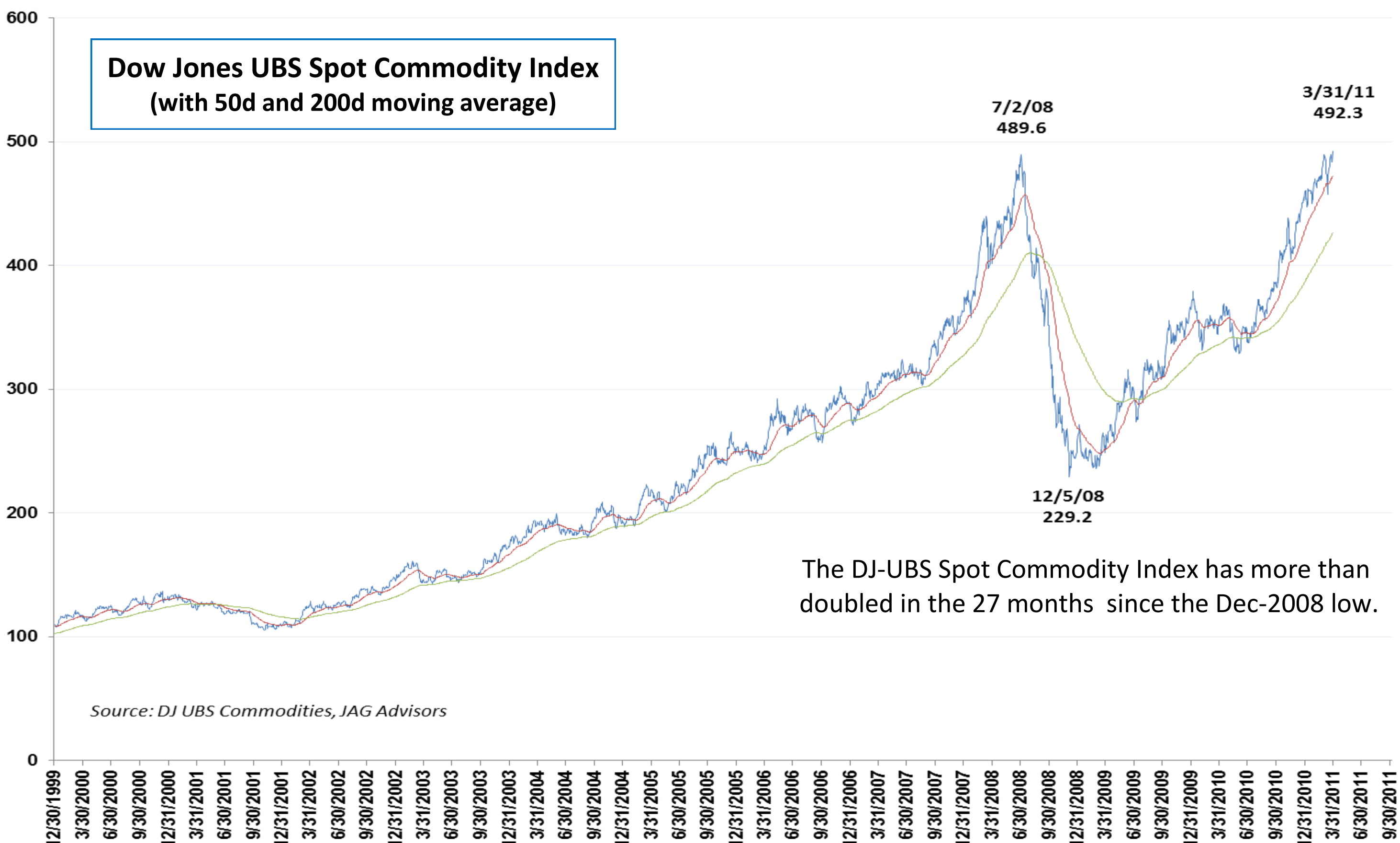
Inflation: It Would be an "Error" to Think it Remains Dormant Forever

No discussion of interest rates or equity prices would be complete without a nod to the prospects for inflation. It is true that the Consumer Price Index remains subdued (the Index tagged the inflation rate at 2.1% for the 12 months ending in February 2011). But as the chart below shows, and as anyone who pumps gas or buys groceries already knows, many commodity prices have spiked over the past two years:



While the calculation of CPI is complicated and more than a little controversial, there is little disagreement that persistently higher commodity costs will eventually work their way into reported inflation figures.

Investors concerned about inflation might consider taking on some exposure to inflation protected bonds such as U.S. Treasury Inflation Protected Securities (TIPS), hard assets like precious metals, or shares in commodity producers.

More broadly, inflation focused investors should consider holding meaningful allocations to common stocks in their portfolios. We think history shows that equities can provide

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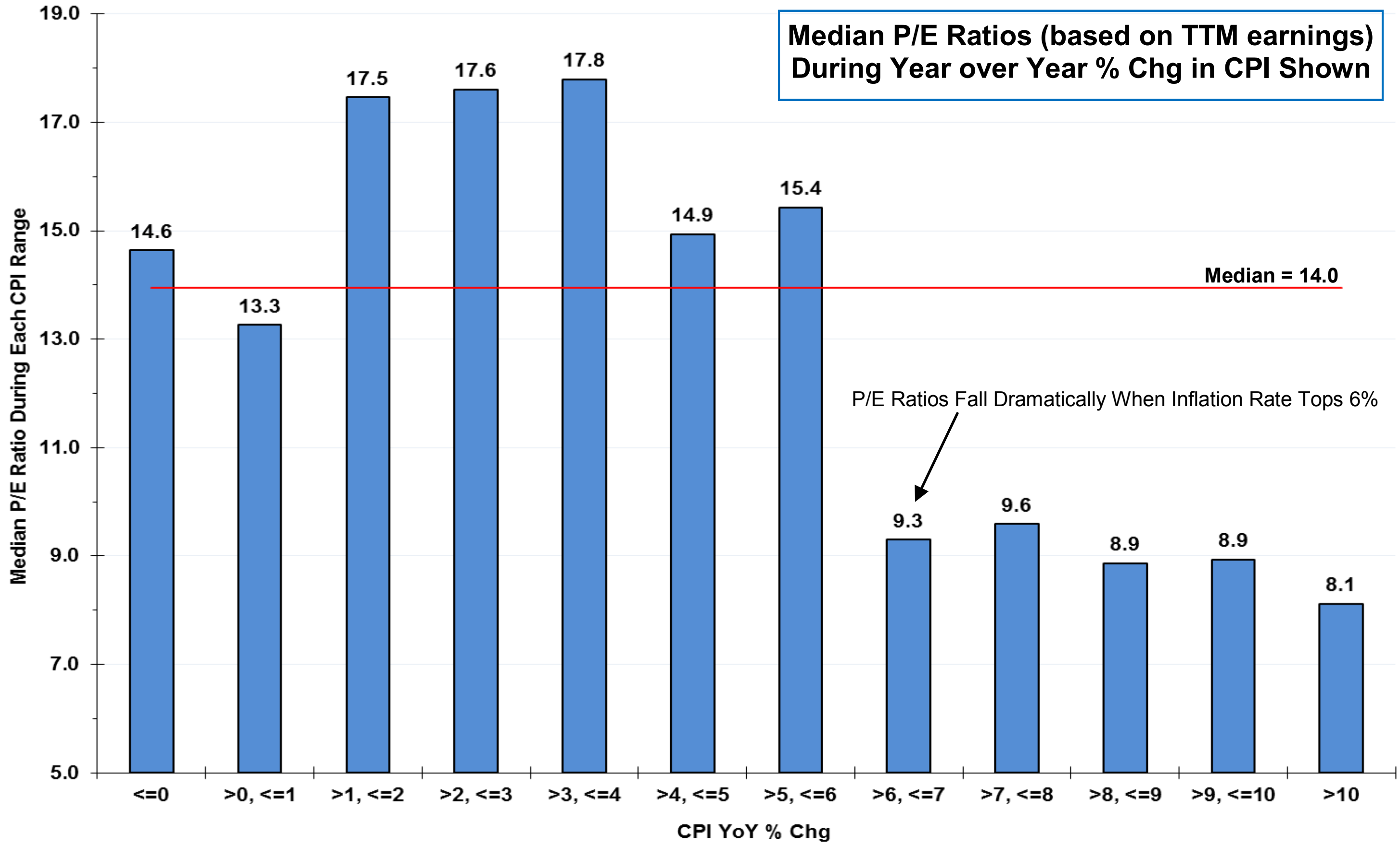
investors with an effective hedge against moderately higher inflation. As the chart below illustrates with historical S&P 500 data, stock valuations tend to hold up quite well during periods of greater inflation. In fact, the highest average market P/E multiples have historically been seen when the CPI is between 3% and 4%. Note, however, that equity multiples tend to compress when the CPI is above 6%. Barring a return to late-1970's double-digit inflation rates, which we do not foresee as likely in the short or intermediate term future, domestic stocks should not suffer unduly from a controlled ascent in CPI.



All of us at JAG wish you and yours a wonderful start to spring. Go Cards!

Norm Conley

CEO & CIO

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