SARGENT BICKHAM LAGUDIS

MARCH 2011

Market Commentary and Review

SUMMARY:

Earthquake and tsunami, war in the Middle East, high oil and gasoline prices, inflation risks, too much government debt – and yet, equities appear to remain the asset class of choice for investors.

Earnings grew 43% in 2010 and are expected to grow 15% or more in 2011. Valuation is still reasonable.

Inflation risks are rising and bonds are underperforming, but we do not see dramatic changes to current interest rates.

In This Letter

"The first rule is not to lose. The second rule is not to forget the first rule."
- Warren Buffett

Dear Clients and Friends,

There has been no shortage of things to worry about lately, so we thought it would be a good time to give you an update. Our goal is to send these letters quarterly and you will note we are a bit tardy, but if we have little to say then it is better to say nothing – something my Grandma LeCroy would be proud of. And, since it has been a while there is plenty to write about. For those of you that like reading this letter, grab a glass of your favorite beverage and prepare to settle in for a few minutes.

The geo-political situation is in a state of flux, so we are prepared to change our views as developments change; but we will comment on the situation in the Middle East, Japan, and Washington, and how it might affect your investments. Further issues include inflation risks and consequent rising interest rates, municipal bond risks, government deficits, the Euro, and real estate values.

But first, an update of returns…the following table summarizes returns for the year-to-date, last 12 months, and the last five years (all returns through March 18th, 2011).

	1st Qtr 2011	Last 12 Months	Last 5 Yrs. Cumulative
Large Cap U.S. Stocks	2.0	11.4	9.1
Mid Cap U.S. Stocks	4.1	20.6	25.8
Small Cap U.S. Stocks	1.7	18.2	12.4
Nasdaq 100	0.1	13.9	32.9
Foreign Stocks - Developed	-0.5	6.3	2.0
Foreign Stocks - Emerging	-5.0	9.0	48.9
U.S. Bonds – Taxable	0.7	5.1	32.3
U.S. Bonds – Tax-Free Municipals	1.7	0.3	19.4
REITs	4.2	28.5	-0.9
High Yield Bonds	2.6	11.4	37.5
Commodities	4.7	41.0	82.1
Hedge Fund Index	0.2	7.8	29.6
Gold	-0.3	27.0	138.2
60/40 Balanced Index	1.7	10.3	23.0

Considering the economic turmoil, it is not too surprising investors would favor gold, but commodities have moved more than expected considering the drop in economic activity and anemic recovery. The move is tied to the economic strength of the emerging/developing countries. Anyone doubting the "decoupling"*(i)* theory should now be chagrined as emerging markets have outperformed developed markets by a wide margin over the last five years. Other surprises are the discrepancies between returns for mid-cap stocks and large-cap stocks; between taxable and tax-free municipals; and the paltry return of developed international markets. This year, we have seen a 5% drop in emerging markets, and even greater drops in certain markets – India is off 13%.

Much of the performance this year is easily explained by world events. For example, the turmoil in the Middle East results in both real and imagined risks to global oil supplies. Oil is up 10%. We are reminded that the emerging markets, while growing quickly, are also volatile politically. The other fact is the growing inflation risk in the developing countries.

Japan

Japan is the third largest economy in the world, a little behind China now. It is included in the developed markets index EAFE, which stands for Europe, Australasia, & Far East. The destructive series of earthquakes and the accompanying tsunami experienced by Japan on Friday, March 11 have had an impact on public and private infrastructure that is without parallel in Japan's modern history. Growth will slow in the near term, but may actually increase over the intermediate term as they rebuild. The nuclear plant is the biggest unknown, but recent reports suggest that the worst-case (nuclear) risks are fading in Japan. The surprise may be not that equities have fallen over the past month, but how little they have fallen. This resilience can be taken as a sign that so long as investors remain confident in developed-world growth, equities remain the asset of choice.

Japan is also the third largest *industrial* economy, and it has very few natural resources. It must import all the metals and energy it uses to manufacture industrial products. Without imports of energy and raw materials, its economy is at great risk. Energy, therefore, becomes a focus point for the implications to Japan of the nuclear plant's problems beyond the current radiation risks.

This takes us to the Middle East and North Africa – the major energy producers in the world, which seems to be getting worse rather than better.

Middle East *(ii)*

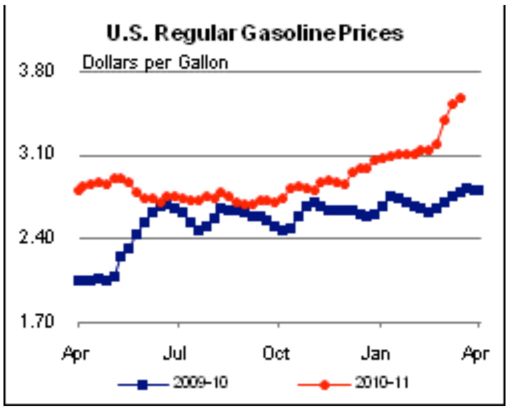
In addition to Tunisia, Egypt, Libya, and Bahrain, a crisis in Yemen is rapidly escalating. A standoff is taking place in the capital city of Sanaa while embattled President Ali Abdullah Saleh continues to resist stepping down, claiming the "majority of Yemeni people" support him. While a Western-led military intervention in Libya is dominating the headlines, the crisis in Yemen and its implications for Persian Gulf stability could be of greater strategic consequence. Saudi Arabia is already facing the threat of an Iranian destabilization campaign in eastern Arabia and has deployed forces to Bahrain in an effort to prevent Shiite unrest from spreading. With a second front now threatening the Saudis, the situation in Yemen is becoming one they can no longer leave on the backburner.

Turning back to Libya, a war has now begun. It pits a coalition of European powers plus the United States, a handful of Arab states and rebels in Libya against the Libyan government. The long-term goal, unspoken but well understood, is regime change — displacing the government of Libyan leader Moammar Gadhafi and replacing it with a new regime built around the rebels. The mission is clearer than the strategy, and that strategy can not be figured out from the first moves. The strategy might be the imposition of a no-fly zone, attacks against Libya's command-and-control centers, or these two plus direct ground attacks on Gadhafi's forces. These could also be combined with a ground invasion and occupation of Libya.

The question, therefore, is not the mission but the strategy to be pursued. How far is the coalition, or at least some of its members, prepared to go to effect regime change and manage the consequences following regime change? How many resources are they prepared to provide and how long are they prepared to fight? It should be remembered that in Iraq and Afghanistan the occupation became the heart of the war, and regime change was merely the opening act. It is possible the coalition partners have not decided on the strategy yet, or may not be in agreement.

In other words, be careful what you ask for. According to *The Wall Street Journal*, the recent Egyptian vote on a new constitution is a sign that leadership of the revolution is passing from youthful activists to Islamist religious leaders.

Where this ends up is total conjecture. Let us re-focus on how this will impact the economy and your portfolio. The most direct impact is on oil prices, and then gasoline prices. Here, you can see a chart of prices for the last two years:



It is clear the turmoil over the last few months has driven prices higher. In fact, we must admit it is reaching a point that we have to worry about its economic effect. Gasoline prices at $4 could slow economic activity. Higher energy prices leave consumers with less disposable income. In the U.S., automobile ownership and use, as well as demand for fuel and motor oil, is especially insensitive to increases in fuel prices. That is, if fuel prices double, household expenditures on fuel tend to double as well. That will lower the amount of disposable income available for other types of purchases, and may lower overall consumption and/or savings.

We are told the economic recovery is fragile, and higher gasoline prices threaten the recovery. It is hard to dispute this, and if oil/gasoline prices continue to rise there will be a few months or quarters of slowing economic growth. We still believe a double dip recession is unlikely. Recent economic and inflation forecasts according to *The Economist* are as follows:

Weekly, we review all major economic announcements. The trend toward improvement is unmistakable. Initial unemployment claims peaked two years ago and have been trending lower, retail sales have increased fifteen of the last seventeen months, and the Empire State Manufacturing Survey has increased nineteen of the last twenty months. Yes, housing is still weak and unemployment is high, but the trend shows an improving economy.

Country	2011 GDP	2011 Inflation
United States	3.3%	2.1%
China	9.0%	5.0%
Japan	1.7%	-0.1%
Europe	1.6%	2.2%
Canada	2.6%	2.3%
Mexico	3.6%	4.2%
Brazil	4.3%	6.1%
India	9.0%	7.4%

Inflation

One of our primary concerns now is inflation. Inflation is a “ravaging pestilence so viral that when let in it can erode the quality of life substantially enough to alter the course of history” – so writes Anthony Crescenzi from PIMCO.

While broad based inflation indicators in the U.S. are showing only modest inflation, it is also true that inflation is accelerating in many parts of the world as evidenced above. Additionally, inflation risks are increasing due to high prices of oil and other commodities. Central banks around the world are likely to change their focus from stimulus to restraint. This is usually negative for stock and bond markets.

China has raised rates three times. The European central bank has indicated it will begin raising rates at its next meeting. The British and Swedish central banks have also signaled higher rates are coming, and several U.S. Federal Reserve Governors have indicated there will be no quantitative easing after June. So, we are in a transition phase. Inflation is not a problem now and may not become a problem precisely because central banks will tighten monetary policy to choke it off. However, from an investment strategy point of view, there is not much difference between rising inflation and rising interest rates to stop inflation. Both are bad for investment returns.

The real difficulty though is timing.

Earnings and Valuation

So far the score seems to be tilted toward the negative. We have a natural disaster in Japan, war and uprisings throughout the Middle East, higher oil and gasoline prices, and rising risks of inflation and interest rates. On the other hand, we have improving economic growth in both retail sales and manufacturing and a gradually improving employment picture. Earnings are another bright spot.

According to Standard & Poor's, S&P 500 operating earnings were $81.18 in 2010, a 43% increase over 2009. In 2011, they are predicted to grow to $94.93. Based on a recent price of 1,300, the P/E on trailing earnings would thus be 16x and the P/E on forward (2011) earnings would be 13.7x. As we have pointed out in the past, during periods of low inflation a P/E of 16x – 18x is normal. We like to use 15x as a rule of thumb in order to be conservative. Applying a 15x multiple to earnings of $95 would imply fair value of about 1,425 – 10% higher than today.

There are other valuation methods that we, and others use but we believe this is a reasonable estimate of the current situation. Another observation is that the earnings yield on the market is about 7%, more than double government bond yields, making stocks much more attractive than bonds.

Sovereign Debt Crisis

The last big negative to discuss is the global sovereign debt crisis. The three largest economic blocks in the world are all now under threat from over-indebtedness: Japan, Europe, and the U.S. We will try to explain the risks and likely outcomes of each as best we understand them.

Japan

In the 1980s Japan was like China today. Their economy was growing rapidly and was referred to as the "Japanese Miracle". It was later revealed it was partly built on sand – overleverage and bad loans. They have spent two decades with sub-par growth, and on the verge of deflation. Their government financial situation has steadily gotten worse, and they have one of the worst demographic situations in the world – a population where the majority will soon be in retirement. This creates more of a burden on government social services at a time when there are fewer productive workers contributing to the system.

Japan's government has tried numerous stimulative policies such as infrastructure spending and tax cuts to generate growth. In the process their debt to GDP ratio has grown to one of the largest in the world. The paradox, however, is that their interest rates are among the lowest in the world; and their currency has recently reached new highs relative to the US dollar. Why? We think it lies in their savings rate. The vast majority of Japanese debt is owned by the Japanese people. Without inflation and without being forced to borrow from others, their interest rates have remained low and borrowing costs have remained manageable.

Europe

Many people still refer to the European currency, the Euro, as an experiment. Europe has thousands of years of history of wars between its various nations – right up to the present. In addition to the economic benefits, part of the reason for the Euro's creation/appeal is to tie the countries more closely together in order to reduce the risk of conflict. The problem with the Euro is that it is a currency without a central government. There are still independent countries looking out for their own good. People in Germany, the most financially conservative country, are increasingly unhappy and unwilling to bail out other countries such as Greece that are bankrupt from overspending and corruption. The problem is that after nearly 20 years since the Maastricht Treaty, there would be massive disruption to the world economy if the Euro would suddenly be tossed aside. Furthermore, many banks and other financial institutions own government bonds issued by Greece, Ireland, Portugal, etc., and if they default there is risk of another financial crisis.

The debt problem began with Greece and other countries that borrowed more than they could afford. For example, their interest cost alone totals 75% of their tax receipts. That means they have to pay everything else – the army, roads, social services, etc. – from only 25% of the revenue. It can not be done. So, Greece turned to the European Union for a loan. The EU collects revenue from all the EU countries and then issues its own debt. Ironically, as a member of the EU, Greece also has to pay money into the EU as part of its obligations.

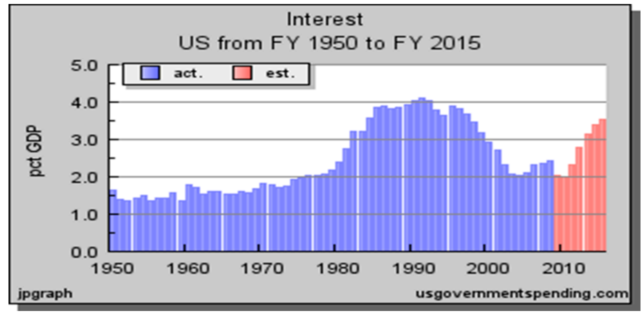
Basically, Europe as a whole is borrowing in order to cover the debt of a few countries, but the countries that save more are bailing out the countries that do not. As long as they are willing to work together this arrangement can work, but the political structure does not make it easy. It is not a United States of Europe. There is no central government with the authority to impose taxes. It is a series of bi-lateral treaties. In the end, it is probably in everyone's best interest to succeed – even Germany.

United States

The U.S. has a budget deficit this year of $1.7 trillion – huge by any measure. The only thing Congress seems capable of agreeing on is handing out more money and then borrowing it. Maybe there are behind the scenes efforts to do something, but it is very difficult to take them seriously. As we write, the tea partiers are forcing a potential $60 billion reduction in spending. This will have serious consequences on many programs, but it still amounts to only 3.5% of the annual deficit.

Do budget deficits matter? Consider the following analysis from Goldman Sachs… "At nearly 4% of GDP on average, the long-term deficit threatens to keep interest rates higher than they otherwise would be, stunt capital formation and productivity growth, and keep the baby boom generation on tenterhooks with regard to the integrity of mandated Social Security and Medicare benefits. We are dismayed, though hardly surprised, that the deficit is not generating more active concern among policymakers than it is." This was written September 18, 2003 when the deficit was $380 billion.

Bill Gross, manager of the world's largest bond portfolio, calls the government borrowing program a "Ponzi scheme", which technically is correct. The government borrows, spends, and never really pays off its debts. Since a government is theoretically perpetual this does not have to become a crisis. It stops working when the interest cost overwhelms other spending, and the markets decide a government is not credit worthy. The "tipping point" is not certain. In a recent study of eight centuries of government defaults, authors Reinhart and Rogoff conclude the tipping point is when debt is about equal to a country's gross domestic product. Other factors influence the exact level, and the size and diversity of America's economy probably gives us more room than many countries. Plus, we have the world's reserve currency and that is not going to change any time soon.



Today, the debt held by the public is approaching 60% of GDP and the total debt including that held by the Social Security Administration is 97% of GDP. We are clearly in the danger zone, but we are also probably not at the tipping point.

Furthermore, as shown on the previous graph, because interest rates have fallen, interest cost as a percentage of GDP is about the same today as it was 30 years ago. If interest rates rise as most people expect, then it will become a larger problem. Again, no crisis today but warning signs are flashing if we do not deal with the issue.

Will Congress deal with the problem?

As mentioned earlier, it is very difficult to be optimistic about Congress doing anything. There are some signs serious conversations are beginning, so stay tuned. We believe any positive movement on dealing with the deficit problem would be a huge positive for the markets. Expectations are very low, so it would seem there is more room for a positive surprise.

Asset Class Recap

U.S. Stocks:

We continue to view the market as reasonably priced. It is no longer significantly undervalued or overvalued. Technically, the market recently underwent a 6% correction. This seems pretty mild relative to problems in the world and the 100% gain since March 2009, so we would not be surprised to see more consolidation. But, there is still a great deal of skepticism about this market and that is bullish (a contrary indicator).

We see a few signs of bubble conditions in emerging markets, but generally the fundamentals are solid.

For example, Facebook and Groupon are two private companies discussing going public at huge valuations. Unlike the 1990s when companies had no profits and little in the way of revenues, these companies have soaring revenues. Last fall, Groupon was in talks to be acquired by Google for $6 billion. When the talks began, Groupon had monthly revenue of $70 million. A few months later, sales were $200 million a month.

Investment-Grade Bonds:
One more time, we repeat that bonds are overvalued. For a year or two we had to say we were early (aka wrong) about this view. We can tentatively begin to say we are now correct. For the last seven months, the Barclay's Aggregate Bond Index has a total return of -1.25%. Municipal bonds have done even worse. They are down 4.8% over the same period. Corporate bonds have been a little better, but their return is only +0.32%. Meanwhile stocks are up 26%.

Municipal bonds are worthy of a little more discussion. There have been a number of articles and pundits predicting mass defaults in municipal bonds. These articles often lump together the current fiscal problems, stemming largely from the recession, with longer term issues relating to debt, pension obligations, and retiree health costs to create the mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown. We believe this is over-hyped.

The large operating deficits that most states are experiencing were caused largely by the weak economy*(iii)*. State revenues have now stabilized but remain 12% below pre-recession levels. At the same time revenues have declined the need for public services has increased due to the rise in poverty and unemployment. While these deficits cause severe budget problems, most states like Colorado have balanced budget laws and are forced to cut spending. This is a cyclical problem that will ease as the economy recovers. The longer term issues relate to bond indebtedness, pension obligations, and health insurance. Much of the problem is exaggerated if not wrong. For example, when projecting pension liabilities, a "discount rate" is used to convert a future stream of payments into a current total liability. State pension plans use what is known as the "risk-free rate" for calculating the liability. This results in an oft-cited $3 trillion liability. In contrast, an analysis based on the historical return <u>actually earned</u> by state and local governments on their pension fund assets would reduce the liability by 75% to about $700 billion. Still large but more manageable.

Furthermore, state and local government debt remains within its historical range relative to GDP. It currently stands at about 17%, similar to the level it was from 1985 to 1993. Similar to the Federal government, interest payments on debt are a quite manageable 4% of state/local budgets and have been declining since 1988. Finally, history shows that defaults on municipal bonds are rare. The annual default rate is a miniscule one-third of one percent.

Alternative Assets & Strategies:
Year to date returns for the AAS are about 2.5% on average. The best performing strategies have been commodities (+7%), and market neutral (+4%). Several strategies fall into the 3% to 4% range including U.S. and global high-yield bonds, REITs, preferred stocks, and balanced funds. The worst performers include high-yield municipal bonds (-1.8%), and gold and emerging markets debt (both about even).

The returns and risk characteristics continue to be what we strive for. We believe this is better than most hedge funds with significantly lower fees and fewer risks. Currently, we are using AAS as an alternative to bonds for part of the fixed income allocation, and the returns have been significantly better.

Beware of quoted hedge fund returns
The CFA Journal recently printed a comprehensive research report studying hedge fund returns. They determined that the quoted returns of 14% per year were reduced to 7% per year when adjustments were made for survivor bias, fees, and backfill. As mentioned in our last letter, we use the Dow Jones Credit Suisse Hedge Fund Index as a benchmark to compare against our AAS Group, but that return may be much higher than most hedge fund investors actually realize. In other words, the index may read 14%, but investors only realize 7%.

Model Equity:

Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.

The model equity account beat the market again last year making it 7 years out of 8. Last year's gain was 16.2% compared to the S&P 500 return of 15.1%. Since 2003, we have a cumulative return of 100.6% vs. 67.6% for the S&P 500. So far in 2011, we are continuing our record with a 6.2% return vs. 4.9% for the S&P 500. The best performing sectors are energy (+14%) and consumer discretionary (+10%). The laggards are consumer staples and financials, both up about 1%.

We are positioned for economic growth and a bull market, meaning we are over-weighted in economically sensitive sectors such as industrials, energy, and technology. We are under-weighted in staples, healthcare, and financials. The last two sectors we also expect to fight battles against regulations. One standout company recently was Big Lots, Inc., which is rumored to be a buyout candidate. This resulted in a 50% increase in the stock.

Foreign Equities and Fixed Income:

Foreign stocks have been recent laggards for both economic and geo-political reasons. As discussed earlier, the crisis in Japan, risks to the Euro, turmoil in the Middle East, and inflation in the developing countries have all raised concerns among investors.

Paradoxically, the Euro and Japanese Yen have been strong. We are at a loss to explain this. While the dollar index is about the same as it was a year ago, it is down 14% from its level last summer.

Through research and experience, we have found the direction of the dollar to be the major determinant of international investment returns. Hedging against dollar weakness is one of the primary benefits of holding foreign stocks and bonds. So, while we have tactically reduced our allocation to foreign investments, it is only a marginal change. Combined, the allocation to foreign equities and bonds (both developed and emerging), totals about 15% of most portfolios.

Strategy

At quarter end, we remain at target weights to equities, so if a client has a long term allocation of 65% equities we are at 65%. However, as we start the 2nd quarter we are beginning to consider a slightly more defensive posture. We have marginally reduced targets to foreign equities and U.S. small caps. We remain under-weighted in investment grade bonds. The allocation to the AAS group is 10% to 15% of most portfolios – higher for many who want to reduce the risk of equities. In fixed income, we believe municipal bonds are attractive relative to most taxable bonds, but we diligently research every municipal issuer and sell any we identify with credit risk. If/when we get more defensive; it will involve an increase in cash or Alternative Strategies, or both and a reduction in equity targets.

These are general guidelines, but one of the unique differences you get at SBL is the direct attention and customization to your portfolio. Please call your Advisor/Portfolio Manager to discuss anything specific about your portfolio.

Financial Planning

As most everyone knows, Congress passed a tax bill just before the end of 2010 that extended the Bush tax cuts for two more years, raised the estate and gift tax exclusion to $5 million per person, and provided a payroll tax cut. As we said before, there seems no limit to the government's largesse when agreeing to spend or cut taxes. It is only the tough choices they cannot make.

From the perspective of U.S. taxpayers, the changes in tax rules are favorable, albeit only through 2012. Some may want to take advantage of the increased estate and gift tax exclusion and transfer assets to children or grandchildren during this window. Others will conclude now that Congress has raised the exclusion amount, they are very unlikely to lower it again. The horse is out of the barn so to speak. Either way, we think it is probably a good time to review your Will and Estate Plan. You may have language in your will that creates family trusts, or titles your assets in certain ways that are no longer necessary and may create complications after your death. We can help by reviewing your documents and coordinating suggested changes with your attorney.

Other issues/questions that are at least temporarily resolved include:

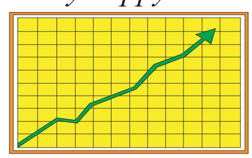
- Annual gift tax exemption unchanged at $13,000 per person.
- The Roth IRA conversion is still available without income limitations.
- Direct charitable contributions are allowed from IRAs.
- Step up in basis to fair market value at date of death is restated.
- Portability of estate exemption for surviving spouse is new.
- Repeal itemized deduction and personal exemption limitation.

Company News:
At the beginning of 2011, we welcomed Trace Welch to our team. Trace comes to us from Alabama and a family of financial advisors – both his father and grandfather are in the wealth management business. He recently graduated from Birmingham Southern College. He is handling trading and other financial analysis projects. He passed Level I of the Chartered Financial Analyst (CFA) program and is currently studying for Level II. He also passed Level I of the Chartered Alternative Investment Analyst program.

We are excited but also saddened to announce that Jenny Trindel is getting married and will be leaving us this summer. She will be moving to the Philadelphia area with her new husband Alan and his two children. We will be searching for a new Client Service Manager soon, but Jenny is going to stay on to help train and transfer responsibilities to the new CSM.

As we previously announced, 2008 was our 20th anniversary so we are now in our third decade of service to our clients. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses, it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or would simply like to receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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Brad Bickham, CFA, CFP®
www.sargentbickham.com

(i) Decoupling refers to the notion that as emerging markets grow to larger economies, then movements in emerging markets returns would correlate only minimally with that of developed markets. Since all markets underwent significant drops during 2008 many pundits began arguing that decoupling was dead.

(ii) Much of the discussion regarding the Middle East is from Stratfor Global Intelligence.

(iii) See "Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm", January 20, 2011, Center on Budget and Policy Priorities