



October 5, 2010

## Market Commentary and Review

**SUMMARY:**

Politics is more of a factor in the direction of the economy, stock market, interest rates, and the dollar than we would like. When will we return to worrying only about corporate earnings?

The economy is barely growing, but it *is growing*. We are not in the double dip camp.

Inflation or Deflation? We do not expect either for the next year. After that... nobody knows.

Corporate earnings are growing, balance sheets are strong, and valuation continues to be attractive.

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*“And it is here under this oak where Evangeline waited for her lover, Gabriel, who never came... but Evangeline is not the only one who has waited here in disappointment. Where are the schools that you have waited for your children to have, that have never come? Where are the roads and the highways that you send your money to build, that are no nearer now than ever before? Where are the institutions to care for the sick and disabled? Evangeline wept bitter tears in her disappointment, but it lasted through only one lifetime. Your tears in this country, around this oak have lasted for generations.”*

*Huey P. Long, 1928*

Dear Clients and Friends,

Having come originally from Louisiana, I have a soft spot for Huey P. Long. In this political season his quote seems especially poetic, and I wonder how his ideas would be received today. He was a man unabashedly in love with his state and his country, and not afraid to use whatever tools he had at his disposal. He proposed new measures in 1934 to curb the poverty and hopelessness endemic nationwide during the Great Depression. To stimulate the economy, he advocated federal spending on public works, schools and colleges, and old age pensions. He was immensely popular and many thought he would run for President against.... (cont. on pg. 2)

*The following table summarizes returns for the third quarter, year-to-date, and the last five years:*

	3rd Qtr 2010	Year to Date	Last 5 Yrs. Cumulative
Large Cap U.S. Stocks	11.2	3.9	2.8
Mid Cap U.S. Stocks	13.0	11.3	18.4
Small Cap U.S. Stocks	9.4	8.7	7.7
Nasdaq 100	15.2	7.8	27.3
Foreign Stocks - Developed Countries	18.1	1.1	9.0
Foreign Stocks - Emerging Markets	20.0	8.6	72.4
U.S. Bonds	2.2	7.8	32.8
REITs	13.0	18.3	3.7
High Yield Bonds	8.3	10.1	35.2
Commodities	13.0	7.0	-11.2
Hedge Fund Index	3.4	4.1	30.1
Gold	5.1	19.2	173.9
60/40 Balanced Index	7.8	5.5	18.8

Franklin Roosevelt in 1936, but he was shot and killed at the age of 42 on the steps of the capital building in Baton Rouge. His last words were reportedly, “God, don’t let me die, I have so much left to do.”

Another great politician, Ronald Reagan, with a different point of view famously said, “Entrepreneurs and their small enterprises are responsible for almost all the economic growth in the United States.” And, “Government always finds a need for whatever money it gets.” These two politicians, decades ago and decades apart, were debating the same issues we are debating today. Both were popular but also despised. The problem today is that the political system has become so polarized it no longer functions.

We do not know what is worse, the politicians or the cable TV pundits. Jimmy Carter was recently interviewed on 60 Minutes and said that during his years as President only 2-3% of the population had extreme polarized views, but today thanks to television shows that spew propaganda that is packaged as if it were news, 20% - 30% of the population has a distorted view of reality. Our politicians have learned how to manipulate both the news and the electorate, and so the moderate majority gets drowned out. The result is a government that is dysfunctional. There is little attempt to govern. Each side simply tries to win points so it can win the next election.

Why are we talking about politics in our investment commentary? For the majority of the last 25 years, we would rarely give Washington much thought. Tax policy and fiscal policy have an effect on the economy, and regulations periodically affect certain industries. Monetary policy has certainly been more important. But today, the fact that we have significant national issues to deal with and do not have a functional government makes Washington an investment factor. Fiscal spending, deficits, taxes, and regulations will affect economic growth. Perhaps as important, the mistrust of the government leads to a lack of confidence for businesses and individuals.

Some people will read into these words a conservative point of view, some a liberal view. It is meant to be neither. Our investment strategy attempts to be apolitical. Our Investment Committee has proponents for each philosophy. What we try to forecast is how current and proposed policies will affect the economy and various markets.

Today, we believe the lack of agreement on tax policy is one factor slowing economic activity. Tax policy, combined with the two major regulatory reforms, healthcare and finance, have created concern for many businesses about increased costs that *might* be affecting hiring and investment.

However, it would be a mistake to blame all the economic malaise on Washington. While monetary policy is generally very easy (low interest rates for example), credit is more difficult to come by and consumers are wisely de-leveraging after at least two decades of over-spending and over-borrowing. Businesses are rightly cautious, and banks are doing what they are supposed to do, lending only to people who can pay them back.

Furthermore, the unemployment problem might have more to do with a labor market that is ill prepared for the current economy. The 9.6% unemployment rate is not evenly distributed. For college graduates the rate is below 5%. For high school graduates only, it is over 15%. Our manufacturing base has declined so much that these jobs are a small percentage of the economy. Consider these statistics from the Department of Labor:

Year	Mfg. Jobs (000s)	Total Private Jobs	% of Total
1960	15,438	54,296	34%
1980	18,733	90,528	21%
2009	11,883	130,920	9%

Construction and housing are likely to remain slow for another couple of years, so it is also likely to take some time to make meaningful progress on employment as we re-train a workforce that does not have the education or skills needed for our 21st century economy.

Currently, the economy is not as bad as you might think, and it is much better than anyone expected a year ago. In June of 2009, the consensus according to *The Economist* was for 0.9% GDP growth in the U.S. for 2010. The actual growth will be about 2.7%. Europe and Japan are also doing better than expected, and China continues to grow at 8% or more. Overall, global GDP growth exceeds 4%. Corporate profits are at record levels, which should translate into increased capital spending, and hopefully employment growth. In February and even earlier we told you the recession

was over, and a few weeks ago the NBER economists finally got around to declaring it over as of June.

### **Inflation or Deflation?**

There is currently a debate among economists and market strategists about the direction of future inflation. One school of thought is that there are only a few ways out of the government debt debacle we find ourselves in. According to a paper written by Harvard professor Niall Ferguson, there are only six possible ways out of a debt crisis:

1. Higher GDP growth.
2. Lower interest rates on the public debt.
3. A bailout from abroad.
4. Raising taxes and/or cutting expenditures.
5. Inflation.
6. Default or re-structuring of the debt.

We might add a seventh, which would be some combination of the above. His opinion is the first four are unlikely, and therefore inflation is the most likely outcome.

His argument is persuasive. However, the empirical results do not prove his point; especially when looking at developed rather than emerging economies. According to research from Goldman Sachs, inflation in developed economies has been only moderately higher in countries running large deficits, and has been no higher than average in countries with high debt levels.

How about deflation? It is true that our current situation is similar to that found in Japan before a long period of deflation. But Japan is the only country in history that had full monetary independence yet suffered deflation. Looking at 180 countries since World War II, and defining deflation as three consecutive years of declines in CPI, only 0.6% of the occurrences resulted in deflation in developed and emerging economies. Anything is possible, but deflation is very rare.

We are then left with a rational theory that is not proven by historical results. Our conclusions, therefore, remain unformed. In the near term (next year or so), we do not expect inflation. Beyond that we are less confident. For planning purposes, we believe it is only prudent to plan for the risk of inflation. Looking at U.S. history, the last time we had government debt levels similar to today was after World War II.

Also like today, short term interest rates were near zero. Over the next three decades (1940 – 1970), inflation averaged 3.3% which does not sound all that bad. But, the average return on intermediate term government bonds was only 2.4% meaning that after 30 years an investor in bonds lost money in “real” terms.

### **Earnings and Valuation**

Earnings were up 31% in 2009, are expected to rise 24% in 2010, and another 12% in 2011 according to Standard and Poor’s. Based on these estimates, we continue to view the market as inexpensive relative to history. During prior periods where inflation ranged from 1% to 3%, the market P/E averaged 20x. Today, it is 13x – 14x. Our explanation for this disconnect is the level of fear among investors about the economic recovery. If the recovery becomes stronger, we would expect a sharp increase in valuations.

### **Strategic Allocation Decisions**

Early this year we moved to neutral equity targets in our models, meaning if the model called for 65% equities then we wanted to be at 65%. Our conviction was challenged this summer as the market underwent several corrections of 7% or more, but we were rewarded last month with the strongest September on record for the stock market.

We have been underweight bonds, which has been wrong. With a total return of nearly 8% bonds have outperformed many equity indices. We have not changed our view that bonds, especially U.S. Treasury bonds, are overvalued. We are not in the camp calling them a bubble, but at 2.5% for 10 years we see little long term attraction and significant risk in the event inflation does return. Most of our clients are invested primarily in tax exempt municipal bonds, which are more attractive than Treasuries but also have low yields. Bonds are targeted at roughly 70% to 85% of long-term targets.

Our underweight to bonds is allocated to our Alternative Assets Group, which as discussed later has had a solid year. Most portfolios have about 10% allocated to this sector. We strive to make as few changes as possible to this allocation to avoid getting whipsawed, but we added to our real estate strategy and trimmed some profits from gold as it soared above \$1,300/ oz., as well as from high yield bonds and TIPs.

## Asset Class Recap

### U.S. Stocks:

As mentioned above, we believe the market is undervalued. Our model puts the current level at a 16% discount. Another way of looking at valuation is to compare the earnings yield to the yield on bonds. Using \$80 of earnings the earnings yield is currently 7%, compared to 2% - 3% available from bonds. This is bullish for stocks and suggests they will outperform bonds going forward.

Technically, the market had several whipsaws this summer, but the S&P 500 has rallied above its 200 day moving average and above the range it was mired in for several months. This is bullish. However, the volume has been light and the follow through is weak, causing many to question the strength of this rally.

Sentiment seems to vacillate very quickly this year. It is a contrary indicator. If too many people are bullish, the market tends to go down and vice-versa. Currently, the bulls outnumber the bears, which is a bearish indicator, but this can change quickly. Probably more important is the movement from equity mutual funds to bond funds. This has been going on all year and is another contrary indicator. Individual investors are too often performance chasers, and after a decade of outperformance people are flocking to bonds at probably the worst time.

### Investment-Grade Bonds:

We have been saying for months (maybe longer) that bonds are overvalued. Despite being wrong during previous periods, we are not about to change our tune now. Rates are not likely to rise until the economy shows more strength, but that does not make 2.5% bonds any more inviting. Corporate and municipal bonds are slightly more attractive, especially municipals if/when tax rates go up, and bonds have a place in most portfolios for their defensive characteristics but we continue to be nervous about longer term returns.

### Alternative Assets Group:

Year to date returns for the AAG are about 7.5% on average. The best performing assets have been gold (+20%), real estate (+16%), and emerging markets debt (+18%). Other international and aggressive bond funds were also up 10% to 11%. The worst performers were some commodities (oil -15%, base metals -4%);

and several balanced and hedged funds were also lackluster with returns of around zero.

At the risk of being a broken record, the returns and risk characteristics of this asset class continue to be what we strive for. We believe this is better than most hedge funds with significantly lower fees and fewer risks.

We have long searched for an appropriate benchmark for this strategy. It is easy enough to say you want an absolute return, but in reality there is no real way of achieving it. We strongly believe in having some appropriate metric for evaluating performance, so as shown on page one we have included the Dow Jones Credit Suisse Hedge Fund Index. This is meant to represent the performance of all the hedge fund strategies. It can be thought of as a "fund of funds". Considering the hedge fund index is before fees, which can be 20% or more of the return, we are happy with our relative performance.

**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 is outperforming the market again this year through the first nine months. The portfolio is up 5% vs. 3.9% for the S&P 500. The third quarter was extraordinary for many stocks. Apache rose 60% after the BP oil spill was finally stopped, Amazon gained 60%, and Potash gained 61%. The worst performer was Colgate, but it fell only 0.8%. As a group, industrials and consumer discretionary performed best as investors became more optimistic about the economy; and safe havens such as staples and healthcare performed worst with 5% and 7% gains respectively.

It has been almost ten years since we described in this letter our process for selecting stocks. Following is an updated description written by our newest team member, Kreighton Bieger, CFA. Kreighton was most recently an equity research associate with Janus and is performing both equity analysis and portfolio management for us.

## Investment Philosophy & Process

*Better than Value:* Investment philosophies are variously categorized as “growth” or “value” or some combination of both, such as “Growth at a reasonable price” (GARP). At SBL, we employ a style that we believe exploits the best of these two approaches.

We are not pure “value” or “growth” investors; rather we are rigorously focused on purchasing stocks at a price that provides ample room for our thesis to be realized in a higher price.

This means that, unlike rigid value investors, we may pay what might appear to be high valuations for stocks if we believe there is substantial upside to the price based on our understanding of a firm’s business model, competitive advantage, or financial performance.

Likewise, unlike traditional growth investors, we acknowledge that a firm which is improving its margins and earnings growth from very low, even negative levels, has the potential for substantial share price appreciation.

One might reasonably ask how we find opportunities along the ‘growth’ and ‘value’ continuum, and thus earn attractive returns via our *Better than Value* process. We believe that our process, which is unconstrained by any ideological leanings, gives us the flexibility to pursue both growth and value situations.

Our approach centers on identifying companies meeting our criteria which we can purchase at attractive valuations. This philosophy emphasizes several key elements:

- *High quality companies:* We seek only to invest in companies that are relatively debt free, with strong balance sheets and with best in class or rapidly improving financial fundamentals.
- *High return franchises:* We focus much of our attention on understanding a company’s return on invested capital. Simply put, we expect companies to consistently earn a return that is above their cost of capital. We look for companies generating high levels of free cash flow, year after year, and which have a moat around their business. We expect our companies to earn industry leading profit margins and grow earnings

more quickly than competitors.

- *Fundamentally mispriced companies:* We employ a variety of quantitative tools to derive a fundamental intrinsic value for a company. When we identify companies we believe are mispriced, we invest with conviction.
- *Technical analysis:* We cross-check our thought process with what technical indicators tell us about a stock’s price, its potential price resistance levels, and whether other investors may share our view.

## The Process In Detail

*Screening:* We begin our work by constantly screening the universe of the thousands of public companies traded in the U.S., including the depository receipts of certain foreign companies, with market values greater than one billion dollars. We use Standard & Poor’s Capital IQ database to streamline our screens.

We analyze growth and return potential, as well as qualitative factors such as competitive advantage. We add attractive prospects to our Selection List of approximately 150 companies. Our Investment Committee reviews the Selection List weekly and decides to add or remove potential investments.

*Research:* Once we have added a stock to our Selection List it is part of our ongoing research process. Weekly, our Investment Committee reviews the earnings of our Selection List companies, prepared by Senior Analyst Denis Nock. Our quantitative process is overseen by Senior Analyst Dick Stebbins, together with three CU interns. Each quarter we take a detailed quantitative look at each of the companies on our Select List. Additionally, each week Dick’s team updates the intrinsic valuation of any companies whose earnings we review.

*This means that as each company on our list reports earnings, we review the intrinsic value, our thesis, and whether we believe the opportunity has changed in any way.*

Finally, any stocks under consideration for purchase are researched in more detail. We dig into the fundamentals, the company’s model, and the qualitative details. This work, together with the rest, informs us whether to buy or sell a security.

It is at this point that our list is winnowed to the 50 or so stocks on our Focus List. These are the stocks we endeavor to own in our Model Equity portfolio and client portfolios, and which represent our best ideas.

Our current 8-12 best ideas or stocks up for reconsideration are reviewed alongside our Focus List weekly, and in this way we percolate new ideas that end up in our portfolios, and also identify stocks we should be selling.

#### *Better than Value or Growth alone*

Our process is unconstrained by investment dogma, and designed to maximize our return seeking ability for clients. We want to be flexible first and stylish last, in the interests of our clients. To summarize, our process includes several steps:

- *Utilize screens to identify high quality, high return companies that are growing and which we believe to be fundamentally mispriced.*
- *Build quantitative models to understand company fundamentals, test scenarios, and compute intrinsic valuations.*
- *Regularly monitor earnings, returns, competitive dynamics, and technical price movements.*
- *Invest with conviction when the risk-reward is skewed in our favor and we have confidence in our thesis.*
- *Ongoing monitoring, modeling, and valuation analysis on the portfolio.*

#### **Portfolio Management**

- *Sector weights:* We invest primarily on a sector neutral basis, but we will from time to time adjust sector weights to our view of the macro outlook, our available idea set, or simply due to sector performance. In general, we expect to deviate by no more than 20% from the S&P 500 sector weights. Currently, we are modestly underweight financials and consumer discretionary, and modestly overweight in healthcare, industrials, and technology.
- *Model Portfolio:* This portfolio includes our best ideas for stock selection and drives investment decisions across the firm. We benchmark this 100% stock portfolio against the S&P 500.

- *Tax Sensitivity:* Individual stock ownership is more tax advantaged than mutual fund investing, and our portfolio management process seeks to minimize taxes at all times.
- *Opportunistic positioning:* While we tend to invest in stocks that are more mid and large cap in nature, we are free to invest as we see opportunities. Further, we can tilt the portfolio to fit our view of the investment landscape. Currently, we are seeking higher dividend yielding stocks for the portfolio, those with lower individual volatility, and with clear exposure to global growth dynamics.

#### **Model Equity Deviation**

With a process this detailed, it is reasonable to ask why one's portfolio might differ from the model portfolio. There are several reasons:

- *The transaction costs of including 40-50 stocks in a smaller portfolio can be high. Here we will select from the ideas we believe are most suitable for your portfolio.*
- *In purchasing a new security we may be faced with tax or other suitability choices unique to each portfolio. Our Model Portfolio is not tax-constrained.*
- *Timing: In the interest of our clients we will only invest where the risk-reward continues to be favorable.*

#### **Foreign Equities and Fixed Income:**

Foreign stocks came back in a big way in the third quarter, in both developed and emerging markets. Emerging markets are the strongest, reflecting their stronger economies and better fiscal positions. Investment alternatives continue to grow in emerging markets, and we have increased our portfolio allocation targets. For example, Matthews – a company that specializes in Asian investments – has an emerging markets dividend fund. We like the idea of investing in companies that have the financial strength and discipline to pay dividends, but have the growth potential these fast growing economies provide.

### **Financial Planning:**

Gary Powell, our Financial Planning Director, when asked about what to expect regarding tax policy is fond of saying “This is a helluva way to run the country.”

We discussed planning ideas, but there is no way to handicap what Washington will do. Some people expect them to change the tax law during the lame duck session, but that is pure guesswork. We can not in good conscience recommend realizing gains or otherwise bringing income into 2010 in anticipation of higher taxes in 2011, because Congress may extend the Bush tax cuts.

The estate tax is currently zero, but that is the type of planning most people find unacceptable. For large estates (over \$20 million), you may want to consider taking advantage of the difference between the gift tax rate of 35% in 2010 and the expected estate tax rate of 55% in 2011.

In a previous newsletter we discussed Roth conversions. The only advantage this year that disappears is the option of spreading the income over two years: 2010 and 2011. This advantage could be offset, however, if tax rates go up. At the other end of the spectrum, there is a child care tax credit that expires this year. This will only benefit low income taxpayers. There is an energy tax credit for improvements made before Dec. 31st.

Depending on whether or not Congress attempts to pass a tax bill in November – December, there may be a flurry of year end questions or transactions that clients need. Gary, Meagan, and Viki stand ready as your financial planning team to answer any questions; and Steve, Lieschen, and Jenny are prepared as your service team to complete any year end gifts, transfers, etc. Please give them as much time as possible and try not to wait until December 31st to call. ☺

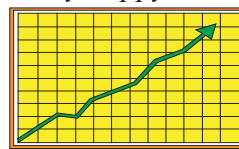
### **Company News:**

As mentioned earlier, Kreighton Bieger, CFA joined us this spring. In addition to his years at Janus, Kreighton also worked on private equity valuation, fixed income analysis for a large corporate credit union, and accounts receivable for GE Capital. All this experience is applicable in his role as portfolio manager and analyst at SBL.

5280 magazine has once again recognized members of our team as Colorado’s best Financial Advisors. And we were ranked by Investment News as one of the fastest growing Registered Investment Advisors in the country. We have also been ranked by both the Denver Business Journal and the Boulder County Business Journal as one of the largest asset managers in Denver and Boulder County respectively.

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 that we receive 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](http://www.sargentbickham.com).

*Many happy returns,*



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