



Value Equity Perspective

Markets May Fluctuate, But We'll Follow Value – NOT Economists and Technicians!

By David B. Anderson

Value investors are naturally inclined to feel rising levels of caution because of the near vertical rebound in stocks during September, on the heels of a very depressing August, which followed a wonderful July that was preceded by a complete spring meltdown—and all of this has brought a very paranoid market back to levels just slightly above where 2010 began.

“As always, our primary focus is on value.”

A long list of (9) concerns are spearheaded by a gut-wrenchingly slow recovery that is thus far lacking in 1) job creation and is further dampened by 2) a housing price hangover and the concomitant 3) accumulation of financial leverage built up over the last decade. Market technicians, who seem to have gained more credence than normal in this vacillating market environment, are quick to point out that 4) the historic September rebound “lacked conviction” as it occurred on very low trading volume and 5) the overall market has been “devoid” of any clear leadership groups, while 6) the S&P 500 has failed to convincingly breach its mid-May overhead level of 1150. Finally, contrarians look at this recovery as merely 7) a pre-election victory celebration based on the likelihood of a more balanced and “business friendly” Congress (and the belief that the Government which governs least governs best). Meanwhile,

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Economic Perspective

Inflation, Jobs and the Fed

By Val Schaff, CFA

The Federal Reserve came to the conclusion at the last meeting of the Federal Open Market Committee that inflation was below the level it considers consistent with, over time, its charge to promote maximum employment and price stability. Historically, inflation has risen in times of economic growth as the pressures of greater utilization of materials and labor have contributed to higher prices. During the current economic recovery there have been some pressures on raw material costs, due in part to demand emanating from countries such as China. However, there have not been pressures on wages due to the lack of a sustainable and relatively-strong job market. It is almost a Catch-22: without job growth, consumers are hesitant to spend; without spending, companies are averse to hiring. In an effort to raise the rate of inflation to a level it's more comfortable with, the Fed is considering additional ways to stimulate the economy.

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The situation in the job market continues to impact many segments of the economy. Although the housing market seems more stable, the number of foreclosures does not appear to be declining and in some areas is even increasing. The lack of jobs may contribute to the foreclosure rate in some cases as some may pay their mortgage only after addressing other essential bills, knowing that they can continue to live in their home in the near term. They also feel they may be able

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8) CBOE-VIX volatility levels have receded to the low 20s, which is typical of investor complacency, and 9) the latest sentiment readings are rapidly regaining a plurality of bulls.

However, as always, our primary focus is on value, and in those terms it seems to be too soon to be an aggressive seller, due to the following:

- 1) Price-to-cash flow ratios remain acceptably low despite the recovery in stocks (as fundamentals have improved, as well).
- 2) The dividend yield on the Dow Jones Industrials (2.7 percent) is still above the 10-year Treasury yield (2.5 percent).
- 3) And, while legal insiders have ceased aggressively buying, they also have yet to sell in a rampant fashion.

Therefore, this may become a “ho-hum” market after the election. We still believe that the greatest values are in health care, utilities and industrials and we prefer to remain underweighted in financials. The newest area of opportunity, in our opinion, is the *underappreciated* technology sector. As a prime example, the same Microsoft (MSFT) that everyone just had to own at 100 times earnings in the first year of the new millennium (2000), now trades at 10 times earnings (\$24 per share on consensus fiscal 2011 estimated earnings of \$2.40 per share) with a recently increased dividend yield of nearly 3 percent—and *now* anybody investing in this stock is considered an “old fogey”. 🍷

Fixed Income Perspective

Can the Fed Deliver on the Dual Mandate?

By Gary Cloud, CFA

The U.S. high-grade bond market posted positive returns during the third quarter, led by the 5-year portion of the curve’s response to renewed quantitative easing prospects. The Barclays Government/Credit Index returned 3.28 percent during the period, with yields on 5-year Treasuries declining approximately 0.50 percent. With both employment numbers and non-farm payroll growth persistently weak, double-dip recession concerns have helped foster the view that the Fed would be buying even more Treasuries to stimulate the economy.

From the Fed’s perspective, a muddle-along economy with high unemployment is an unacceptable forecast/outcome. Congress has given the Fed a dual mandate to foster maximum rates of employment and maintain a stable-to-fairly-low rate of inflation. Unemployment rates at 9.6 percent and core consumer inflation numbers below 1.0 percent (on a trailing 12-month basis) miss the mark on both scores. One of the debates within the Fed is: Over what time horizon are these two policy goals to be measured in terms of compliance and policy stance?

“**Risk assets should outperform ultra-safe government obligations.**”

The “doves” take a hard and fast interpretation that dictates an immediate and forceful second round of quantitative easing (i.e., buying Treasury obligations in the open market) in order to drive down yield levels across the curve. The “hawks” believe monetary

policy should be viewed with a multi-year lens and allow deviations from Congressional mandates that achieve longer-term inflation, employment and growth goals. It seems as if the doves are in charge and the next phase of quantitative easing may be launched after the next Fed meeting on November 3. We recommend staying long investment grade corporate and high-yield bonds versus Treasury and Agency obligations, as risk assets should outperform ultra-safe government obligations. 🍷

Core Equity Perspective

You Can’t Manage What You Can’t Measure

By Bill Courtney

Our Core Equity team is constantly measuring. We start with measuring levels – how high or low is any given economic or market indicator. We then move to directions – what direction is that metric headed? In our opinion, directions trumps levels, but both are important.

From a macro perspective we are frustrated with high unemployment rates. While the level of unemployment is high, we think the direction is sideways. We believe unemployment will start to improve when we get clarity from our government regarding tax policy. If you don’t know what your tax bill is going to be, you don’t know how much cash you actually have



available. Once companies can quantify what their cash outflows for taxes will be, they can start investing the huge piles of cash sitting on their balance sheets that presently earn very little. There are other major factors like health care and regulatory expenses, but we believe a lack of defined tax policies are a major deterrent to investment and hiring workers.

Without clarity, volatility increases. Judging by the last five months of equity price movements, the market has been volatile relative to historical norms. Volatility breeds fear and fear usually prevents stocks from reaching their full upside potential. Until we achieve more clarity from our government, we may be in a grinding, choppy equity market that makes for a bumpy ride and lower potential total returns.

Our team is working hard at identifying high-quality companies to purchase, but also measuring when these companies have become pricey and profits need to be realized, thus taking full advantage of opportunities that may arise in a range-bound market. 🌟

Equity Income Plus Perspective

Yes, Dividends Still Matter
By Charles Simko, CFA

As investors continue to revise (read: lower) their investment return expectations in the current environment, serious consideration should be given to investing in quality companies that currently pay dividends and have the ability and commitment to increase their dividends in the future. Historically, a significant portion of total equity returns have come from dividends. Also, over long periods of time, the stocks of companies that pay dividends have outperformed the stocks of companies that do not pay dividends. According to a recent study by Ned Davis Research covering the period from January 1972 to August 2010, S&P 500 dividend-paying stocks have returned 8.4 percent per year, versus a return of only 1.1 percent per year for non-dividend-paying stocks. In addition, dividend-paying stocks typically exhibit less volatility than the market as a whole. Dividends can also be an indicator of a company's financial strength and management's commitment to creating shareholder value.

Now might be an appropriate time to consider dividend paying stocks. The 2008 to 2009 time frame was one of the worst periods in history for dividends—there were 140 dividend cuts by companies in the S&P 500. As we have seen improvements in company fundamentals in 2010, we have also seen great improvement in the dividend environment, with only three dividend cuts so far this year by companies in S&P 500. In that same time frame there have been 185 dividend increases among the 368 companies in the S&P 500 that pay dividends. There are approximately 100 companies in the S&P 500 with a current dividend yield of 3.0 percent or greater, and many of these companies have consistently increased their dividends over the past 20 years. In addition, many high-quality, dividend-paying companies are currently trading at attractive valuations.

Dividends have always been an important part of the equity market's total return. In the current environment of low interest rates and anemic economic growth, dividends may assume an even larger role in an investor's total return, even if the favorable tax rates currently applicable to dividends are not continued. 🌟

“Now might be an appropriate time to consider dividend paying stocks.”

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to get some relief on their mortgage at some point, an opportunity they don't have with other items.

In the end, even though the manufacturing side of the economy is expanding, it is not expanding fast enough to significantly help the job market. Until there is a meaningful improvement in consumer confidence, helped by a better job market, the economy will most likely be stuck with anemic gross domestic product growth of 1.5 percent to 2.5 percent annually. This means relatively low inflation, or perhaps even deflation. In normal phases of the economic cycle, this environment would not be bad. However, after a deep recession, the Fed is positioning itself to do whatever it needs to improve growth. A higher inflation rate would be more consistent with its goal for more robust growth in employment and the economy. 🌟



Asset Allocation Perspective

Buy Dividend Payers Instead of Short-Term Bonds

By Brian Perott, CFA

Almost 40 percent of stocks in the S&P 500 have a dividend yield higher than 2 percent. This compares favorably to both a 5-year U.S. Treasury Bond yield of 1.3 percent and a 5-year investment-grade corporate bond yield of 1.8 percent. Yields on shorter-term bonds are even more meager. Interest rates have declined significantly over the last several weeks, partially on news that the Federal Reserve would reinvest principal payments from its “quantitative easing” securities holdings, and may even increase the size of its balance sheet a second time (so-called “QE2”). With a 65-year low in interest rates and relatively attractive equity valuations, we believe it is a good time to consider reallocating some short-term bond exposure to high-quality, dividend-paying stocks. “High quality” takes into account many variables such as low to no corporate debt, above average return on equity, excess cash, a history of dividend growth and a reasonable payout ratio.

We acknowledge that stocks are typically riskier than bonds and that a reduction in bond allocations

in favor of stocks will increase overall portfolio beta. However, we believe the current environment, as outlined above, represents an opportunity that is too attractive to pass up.

In short, we believe that high-quality, dividend-paying stocks currently offer better return prospects than short-term bonds.

With regard to satellite asset classes, we continue to recommend an overweighted position in emerging market stocks and some exposure to both high yield bonds and commodities (gold).

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Tactical Asset Allocation *(Weighting relative to strategic allocation targets)*

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT		UNDERWEIGHT	NEUTRAL	OVERWEIGHT
EQUITIES			●	FIXED INCOME	●		
EQUITY INCOME			●	SHORT-TERM INVESTMENT GRADE		●	
GROWTH			●	INTERMEDIATE-TERM INVESTMENT GRADE			●
VALUE			●	LONG-TERM INVESTMENT GRADE	●		
LARGE CAP			●	CASH	●		
MID CAP	●			COMMODITIES			●
SMALL CAP		●		HI-YIELD		●	
INTERNATIONAL	●			REITS		●	
EMERGING MARKETS			●				