

Portfolio Insight

2nd Quarter 2011

The US stock market provided barely positive performance in the second quarter as the S&P500 posted a total return of only 0.1% and the Russell 1000 Growth Index came in with a slightly better 0.8%. Economic data early in the quarter led to concern among investors that the second quarter would show disappointing growth, just as the first quarter did. Supply-chain disruptions resulting from the earthquake and tsunami in Japan, as well as rising gasoline prices due to political unrest in the Mid-East, did create a drag on the economy. Investor bullishness was also tempered by the fiscal problems in the European Union, and the anticipated end of the Fed's QE2 and the US federal debt ceiling issue.

As we head into the second half of the year the economy may indeed show more strength than it did in the first half. Just prior to the close of the quarter the Greek parliament passed a vote authorizing austerity measures which enable the EU to defer their problems for a while. The supply-chain issues in Japan appear to be dissipating and gasoline prices are slowly drifting lower. In addition, special tax rules that provide maximum tax breaks to US businesses which purchase capital equipment in 2011 will undoubtedly compel many businesses to accelerate capital spending in the second half.

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The wild card for the markets in the near-term is the issue of raising the Federal debt ceiling, the vote for which must occur by August 2. While media reports indicate agreement is far from assured, we are guardedly optimistic the debt ceiling will be raised, with both sides giving a little but telling their constituents they got a lot in return.

2012 Election: Early Takes

High unemployment, large budget deficits, and a weak economic recovery are hurting President Obama's standing in polls. Unless the economy shows clear signs of stronger recovery,

his reelection may be in doubt. The policy options available to him are limited. A stimulus program similar to American Recovery and Reinvestment Act of 2009 (ARRA) is out of the question with Republicans in control of the House of Representatives. Monetary policy in the form of QE1 and QE2 has been largely ineffective according to many economists, including Alan Greenspan. While the second half of 2011 will likely be somewhat stronger than the first half, it will probably not be enough to have a meaningful impact on unemployment and the budget deficit.

We believe that President Obama will need to take bold steps to improve his chances for reelection. He recently made two such moves. He announced the drawdown of troops in Afghanistan and a plan for the release of millions of barrels of oil from the Strategic Petroleum Reserve. Both actions appeal to his natural constituents. However, we believe these will not be sufficient to help the economy accelerate and ensure reelection in 2012. Bolder economic moves are likely required. For example, Mr. Obama may push for major corporate tax changes, structured to enhance the competitiveness of US corporations, to encourage new employment at home which would be revenue neutral to the US treasury. Fiscal conservatives might find it hard to vote against these without appearing obstructionist. If major corporate tax changes, such as lower tax rates were to be proposed, the economy and investors likely would respond positively. In yet another vein, reversing the trend in regulation would be bold but less effective in the near-term. Time is too short.

The Economy Beyond Near-Term

While the US economy may strengthen somewhat into the second half of 2011, we maintain our long-held opinion the US and global economies are in a prolonged period of below-trend growth. Regardless of the Congressional vote on the debt ceiling, US fiscal policy will tighten over the next year with Republicans controlling the House. Beyond that, federal debt levels are at risk of rising parabolically unless spending is controlled or GDP growth accelerates. According to studies by Reinhart

and Rogoff, as well as McKinsey and Co., high public debt levels have historically served to impair GDP growth. So, controlling costs over the long-term will be an important factor in resolving our debt situation. Some pundits see inflation as an acceptable solution. Most economists don't agree. Besides, in our reading on the history of high public-debt countries, we recall little comparison to the unique situation faced by the developed countries today: i.e., high public debt levels coincident with aging populations. Aging populations are fundamentally deflationary.

The international economic environment is not poised for significant growth, either. Clearly, Europe is also encumbered by high debt and will likely spend many years dealing with fiscal problems among the EU members. If Greece is the model, austerity will spread in Europe. In addition, Europe also faces the problem of an aging population.

Japan has suffered with low growth for two decades, and there seems little reason to believe they will not continue to do so. Their fiscal position, terms of trade and demographics portend more of the same.

It appears possible that even the biggest star among emerging market countries may face lower growth. Since it moved toward its version of capitalism in the early 1980's China has experienced robust growth. Entrance into the World Trade Organization a decade ago solidified its position as the world's dominant high-growth economy. Over the past two decades, China benefited from rising consumption in developed economies, particularly the US and Europe. It built an economy heavily dependant on exports for growth.

When the financial crisis of 2008 thrust most of the world into recession, which was peculiarly a consumer recession, China responded with a massive \$586 billion stimulus package to support its economy. This stimulus, funded by a large amount of state-backed lending, was invested in massive infrastructure programs. But now much of this investment has resulted in over capacity in many industries and in developed property.

According to Moody's, the head of China's national audit office recently warned of a sharp rise in local government debt and poor controls over borrowing and lending. Additionally, after recently analyzing never-before-released financing information, Credit Suisse analysts opined that China's credit-to-GDP ratio has risen to alarming levels in the past two years due to massive off-balance-sheet financing.

This practice of too many assets, poorly financed, has spoiled other economic parties. In addition, the Chinese economy is also now experiencing inflation. Rising wages and various commodity costs are forcing the government to raise interest rates significantly to contain those pressures. Couple the issues of possible excess capacity, high debt levels, and inflation with a rapidly aging population demanding an enhanced social safety net, and China may find maintaining robust growth to be difficult.

Investing in a low-growth world

A low-growth economic environment will result in modest long-term returns for most asset classes. The near record low current returns on fixed income are perhaps early indicators of this. In the past several years, commodities have been good performers benefitting from the high growth in emerging market countries, most notably China. However, as the saying about commodities goes, "the best remedy for high prices is high prices". We believe this limits broad-based commodity returns in the future.

The returns on stocks are likely to be asymmetrical. Some no and low-growth companies will primarily offer income returns to investors. However, companies that can grow their revenues and earnings faster than global GDP will sell at a premium in a world where low growth is the norm.

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What makes a real growth company? We believe one of the defining characteristics is innovative products and services. Such companies can command a loyal customer base, take market share from competitors, avoid price competition and, on occasion, create entirely new industries and markets. While investors may assume these companies come only from the technology sector, we find innovation across industries as discussed below:

Health Care

The health care and life sciences sector, overall, continues in a structural transition period facing a variety of issues: branded drug patent expirations, the impact of health care reform, Congressional changes in intellectual property laws, evolving FDA guidance for approvals of devices and drugs, price compression and overall declines in patient utilization. Despite these headwinds, health care has been a top performer in the broader market year-to-date. Our views on key positive drivers in health care and

life sciences were expressed in our first quarter Insight. We continue to believe in the increasingly positive innovation loop in the sector.

Health care cost cutting primarily affects services where approximately 80-85% of the health care spending occurs, especially with Medicare and Medicaid. Increasingly, the focus is on health care quality over quantity. In view of the shift toward quality metrics and patient outcomes, novel drugs and devices, initiatives in the health insurance industry, and necessary healthcare IT remain attractive investments. Identifying companies with innovative technologies such as immunotherapy (boosting the body's intrinsic immune system to combat disease), specialty pharmaceuticals targeting specific body systems, and technologies and devices that improve efficiencies and health care quality at the point-of-care are examples of growth in a transitioning sector.

In the US, recent reports state that nearly 70% of adults and 32% of school age children are either overweight or obese. Only 20 years ago, the same numbers were 10% for school age children and less than 50% of adults. Over the past few decades, a few companies worked with organic farmers to create a market for natural and organic food, catering to a small number of consumers dedicated to eating healthier. Now the number of those consumers is growing rapidly, as chronic diseases, such as hypertension, diabetes, and heart disease, have been conclusively linked to poor dietary habits. With healthcare costs rising, an increasing number of consumers are focused on an 'ounce of prevention', rather than a 'pound of cure'. Higher demand for tasty, 'better for you' foods shows in the results of leading natural and organic products in the US and Europe. One company is now partnered with an experienced Asian distributor to provide organic baby food and natural formula to Chinese parents, anxious after a tainted milk scandal in late 2008.

Energy

Energy services companies are providing a suite of technologies down the wellbore to "unlock" previously inaccessible reserves. For example, the development of unconventional shale resources only recently became economic with technological advances in horizontal drilling, 3D seismic imaging and hydraulic fracturing. The adoption of new technologies by the industry is directly responsible for the creation of the current abundance of shale gas in the U.S. As seen in the chart below, the United States recently reversed a 25 year decline in oil production, driven entirely by the utilization of new production technologies which helps reduce our dependence upon imported oil.

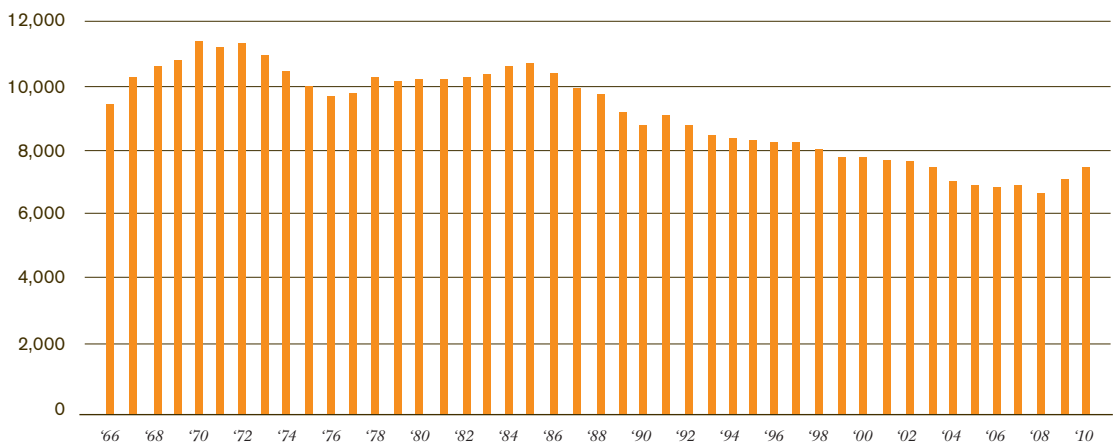
Conservation

The least expensive form of new energy is conservation. For the automotive sector, governments worldwide are mandating drastically higher fuel efficiency standards, driving the need for increased traditional engine performance. Innovations such as advanced turbochargers, direct injection fuel systems, stop/start technology and dual clutch transmissions improve engine performance—and reduce fuel usage.

The movement towards an electrified auto fleet via hybrid vehicles is increasing the need for innovative, higher efficiency batteries. Lithium is a natural candidate to serve in places where weight is important as it is the lightest metal on the periodic table. Lithium is used today in batteries for laptops, cell phones and similar mobile electronic devices. Hybrid electric car batteries offer promise for another sizable end market as the new plug in hybrid models are using lithium ion batteries.

Electricity generation consumes about 40% of total U.S. energy, much of it wasted as generators create significantly more power than is actually consumed. Utilities have begun a long-term migration to building a "Smart Grid" with intelligent, two-way networks that allows consumers to better manage energy consumption and utilities

U.S. OIL PRODUCTION (MBBLS)



to optimize power delivery. “Smart Meters” are the cornerstone of building the digitally-controlled intelligent electricity delivery system that is replacing the existing electro-mechanical grid.

Agriculture

Innovation in bio-agriculture is increasing crop yields to meet the increasing demand for grain as rising standards of living and a transition towards Western diets occur in emerging markets. Advances in seed technology are improving yields for corn, soybeans, cotton and other vital crops, while also increasing conservation. Innovative bio-agriculture products reduce the amount of water, energy and fertilizer needed.

Wireless Data

Smartphones, tablets, and other wireless devices are driving an explosion of wireless data. Smartphones are about 58% of new handsets sold but are only 30%+ percent of all units now outstanding. Smartphone users access a 5-10X multiple of data compared to users of traditional handsets. If current purchasing trends are sustained for 2-3 years, this development alone should lead to 100%+ growth in wireless data traffic. LTE, the next generation of wireless network build, is optimized for data traffic and at least 3x faster than prior cell standards. In the US, the LTE introduction is ongoing at Verizon wireless; AT&T is just starting their rollout. The widespread availability of LTE is likely to favor an even higher use of smartphones and thereby generate more data traffic. Rising data traffic benefits certain semiconductor companies, wireless service providers, and cell phone tower companies among others.

The aging of populations in the developed world and the need for governments and consumers to reduce debt loads are deflationary factors that will take many years to bring into balance. Furthermore, there is little that can be done to speed up the process. Therefore, we are in for a lengthy period of below trend economic growth and investment returns. The key is that there will be economic growth, albeit slow, and in such an environment, there will be opportunities for diligent investors to discover areas in which to invest where returns will be superior to market averages.