

Identifying Opportunity. Navigating Risk.

Newsletter – June 2010

Is this a repeat of 2008? We don't think so! This is a time to increase equities.

Over the years many of you have come to know us as conservative investors. We have offered you maddeningly moderate advice in the face of volatile, often nonsensical market shifts. We have tried to cajole clients to step back from day to day noise, ignore CNBC, and the drum beat of our own hearts when markets plunge. Our advice sometimes takes the shape of doing nothing. We spend a lot of time developing long term strategies for clients who we understand well after thorough conversations, clients we hope will be with us (along with their families in many cases) for life. Usually our long term focus makes it prudent to deploy assets only in small tactical shifts when opportunities arise. As contrarians with a fiduciary responsibility to you, our clients, we have a decided change in tone; we believe a carefully considered but profound strategy shift should be discussed, pursued, and executed incrementally.

The global uncertainty and negative news flow has left investors fearful and too focused on the “glass being half empty”. It's easy to lose sight of long-term goals when markets are as volatile as they've been during the past month. This is a time when investors need to consider their long-term investment goals while factoring in their appetite for risk. So, we write today with conviction that the current market weakness, even if it deepens near-term, is presenting us with a compelling opportunity to commit more funds to the equity markets.

Headwinds:

International Sovereign Debt Crisis – what started with the Greek debt crisis, has spread to Portugal, Spain, and most recently, Hungary. The European Central Bank (ECB) and the International Monetary Fund passed a trillion euro bailout plan for Greece. However, this has not lessened global fears of a severe economic slowdown and the Euro has dropped over 10% since the plan announcement. Investors are pre-occupied with the possible “contagion” impact across the euro zone and the ability for countries to deal with budget deficits which will require tax increases, austerity programs and possible restructuring of debt. While European equity markets are down over 9%, S&P 500 is flat year-to-date; benefiting from a flight to quality/safety and the strong US dollar. Concerns are increasing that US economic growth will be dampened due to Europe and the strength in the US dollar will reduce profits for US multi-nationals – this seems to be a short term issue and the lower equity prices likely incorporate this view; providing an attractive long-term investment opportunity.

Job Growth and Unemployment – unlike past recoveries, the unemployment rate is higher and job growth has been anemic. First, companies were quick to eliminate jobs, reduce hours worked and make deep cost cuts. Second, companies are postponing hiring and are expanding employees' hours and utilizing temporary workers. Third, small business sentiment is extremely negative and by some surveys at 30 year lows. Many small businesses are either in or dependent on hard hit sectors like real estate, construction and food service; they also worry about higher taxes, healthcare reform and new regulations. Since small businesses are the primary engine of job growth, the negative sentiment may defer job creation. Fourth, we face some structural issues that may have a lasting impact such as the obsolescence of workers by technology, a need for improving education and the outsourcing of manufacturing. We need a societal solution and/or a new invention/industry to create major job growth.

A Slowing China? – Chinese policymakers are trying to orchestrate sustainable economic growth while keeping inflation in check and avoiding a real estate bubble. Their actions, tightening of money supply and more restrictive property measures, are causing mounting worries about the impact on global demand from a China slowdown. The prospect of slowing growth in Europe, China's top export destination at 20% of exports, is another factor for policymakers to consider. However, China is still expected to grow in mid single-digits, strong by any measure and dwarfs growth in developed countries, and their ability to enact unilateral policies provides China with an efficiency advantage not available in democratic societies. In addition, the current Washington, D.C. politics can be described as contentious, rife with gridlock and a slow grinding bureaucratic process.

“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”

-Warren Buffett

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Headwinds:

Int'l Sovereign Debt Crisis

"Possible 'contagion' impact across the euro zone"

Job Growth and Unemployment

"Expect job growth to be anemic...high unemployment"

A Slowing China?

"Keeping inflation in check and avoiding a real estate bubble"

Fear & Loathing, Washington, D.C. Style

"US subject to troubling headlines and policy risk"

Mass Psychology

"Investor focus on 'preservation of capital' vs. 'capital appreciation'"

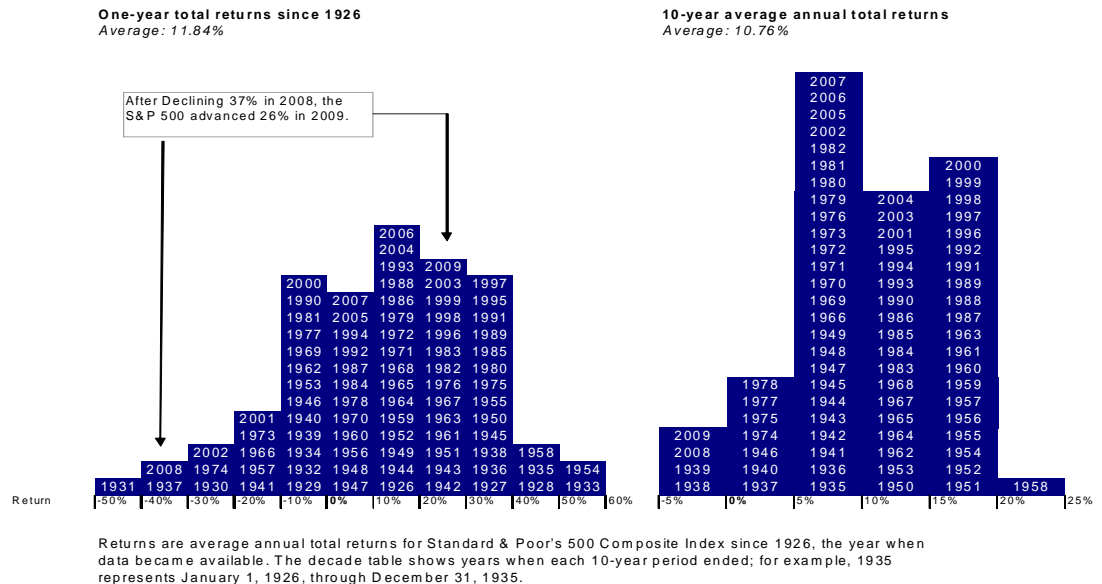
Fear & Loathing, Washington, D.C. Style – the US also faces troubling headlines and policy risk from budget deficits at the federal and state level, runaway entitlement programs, higher taxes, and increased regulations. We have to deal with mounting deficits and it is better to do so before the market focuses on the issue which could force a solution similar to unfavorable actions faced by Europe. However, Europe's problems make us look relatively better and provide us some time to get our house in order. More immediately, the market is waiting on the passage of financial reform regulations so it can determine the impact to financial stocks and the credit markets. The details behind healthcare reform and pending increase in taxes also weigh on the markets.

Mass Psychology – fear is gripping individual investors, thoughts of another 2008 persist, and the unknown impact of the Gulf oil spill leads investors to shy away from risk assets. Also, a disbelief of a sustained and robust economic recovery is prevalent with investors focused on **"preservation of capital"** versus **"capital appreciation,"** resulting in continued cash inflows to bond funds and almost no additions to equities. Although market extremes can persist for longer than expected, "buying high and selling low" is contrary to what investors should be doing at this moment with equities. As a former Wall Street veteran once said, "Stocks are the only thing people don't like buying on sale" – a disciplined investment plan into equities and especially high quality companies is prudent at this point and should benefit individual investors with a long-term investment time horizon.

Why do we not expect a repeat of 2008?

The market can go to extremes, but success is measured over time

The 2008 decline was among the worst in the history of the U.S. stock market, as is shown on the left side of this chart, which tracks one-year total returns for the S&P 500. The right side shows average annual total returns over 10-year periods. As you can see, the market has tended to produce positive returns over the longer time periods, suggesting the benefits of staying the course and remaining invested regardless of short-term results.



As the chart demonstrates, the 2008 decline was the worst in over fifty years and the worst since the depression years. This extreme decline has resulted in US investors experiencing negative returns, as measured by the S&P 500 Index, over a 10-year period ending both in 2008 and 2009 (even with the 26% return in 2009) – these results are unusual and the probability of a continuation is low, if history is any guide. Investor sentiment is a poor predictor of market inflection points. In 2007, as initial concerns were expressed of an overheated real estate and equity market, the investor refrain was, "things are different this time". In 2010, investors seem to feel the same – only this time expecting equities to continue lower and that we are in a depression era. Investors are ignoring history and likely reversion to long-term average returns after a sub-par period.

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Tailwinds:

Repeat of 2008?

“Probability of a repeat of 2008 in the near term is low based on history”

Valuations

“At these valuation levels, the market has averaged over 12% return over 10 year periods”

Economic Growth

“In recovery, albeit a tepid one...Don’t expect a double dip recession”

Interest Rates

“US borrowing rates lowest in decades”

Cash Balances

“High levels, record flows into bonds, contrarian indicator”

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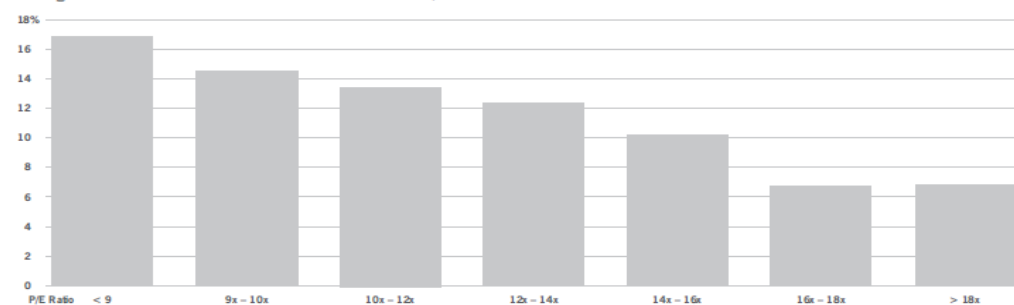
Tailwinds:

Valuations – the S&P 500 trades at a Price/Earnings ratio of 12x to 14x based on 2011 expectations; depending on how bullish or bearish one is about earnings estimates. The following chart indicates at these valuation levels, the market has averaged over 12% return over 10 year periods. This is not a prediction but the market is starting at an attractive point with robust profit growth, low inflation and an earnings yield* of almost 8% compared to zero cash yields and 10 year treasury yields of 3.2%. We understand that fear and the aversion to risk is gripping investors but over the long-term this valuation disparity is not sustainable and may lead to higher equity prices.

- ❖ **Earnings yield is the inverse of P/E ratio - used to compare to other asset classes such as bonds and cash. For example, if stock earnings yield is higher than bond yields, then stocks are undervalued.**

CHART 3 S&P 500 Forward Price/Earnings Ratios and Subsequent 10-Year Average Annual Returns

Historically, the S&P 500 has averaged returns of about 10% per year for the following 10 years when starting from a forward price/earnings ratio between 14 and 16. The current forward P/E is 14.



Note: Returns are 1926 through March 2010. Prior to forward earnings estimates, the forward price/earnings ratios use actual earnings. Source: Ibbotson Associates, FactSet as of March 31, 2010

Economic Growth —we are in recovery, albeit a tepid one—very different than 2008 when growth was weakening, home prices were in free fall, job losses were mounting, and consumer sentiment was plummeting—all seem to be bottoming now and reversing in some cases. The reversal of negative factors has contributed to strong corporate profits with 80% of S&P 500 companies beating earnings estimates in the first quarter. We should continue to benefit from the unprecedented global stimulus (1-2 year lag typically) in the coming months and pent-up consumer and business demand.

Interest Rates —the European crisis has caused money to flow into U.S. Treasury bonds as "safe haven" investments. That has brought down U.S. borrowing costs just as the government is furiously raising money in the global capital markets to fund the U.S. deficit. The Fed has also pledged to keep rates low. The net effects of these actions are that mortgage and borrowing rates are at the lowest levels in decades. The steepness of the yield curve indicates the market expects economic growth to continue and the probability of a double dip recession is unlikely. Even at these lower rates, we are comfortable investing in bonds although we are shortening maturities and increasing the quality of the bonds to defend against a potential rapid rise in interest rates.

Cash Balances – the percentage of cash on corporate balance sheets are at record highs which could lead to mergers and acquisitions, stock buybacks and increased dividends-especially in financials. From an investor standpoint, large amounts of cash balances sit in money markets yielding close to zero. In hope of higher yields, record amounts of cash are flowing into bond funds. Individual investors chasing "good" performance (bond funds) has historically been a good predictor of a peak in the asset class return and demonstrates investors not considering risk. Even as governments deal with high leverage, companies and individuals must ponder what to do with their cash - where to invest!

MARKET TRENDS

Index Name (returns in USD)	YTD 5/31/2010
EQUITIES	
Dow Jones Industrial Average Index	-2.79%
S&P 500 Index	-1.50
S&P 400 Index	5.55
Russell 2000 Index	6.29
MSCI EAFE Index	-12.36
MSCI Emerging Markets Index	-5.47
FIXED INCOME	
Barclays Capital Aggregate Bond Index	3.71%
Barclays Capital 10-year U.S. Treasury Index	6.10
Barclays Capital Global Aggregate Bond Index ex-U.S. (unhedged)	-2.71
JPMorgan Global High Yield Index	0.67
JPMorgan Emerging Markets Global Diversified Index	3.28
COMMODITIES	
Goldman Sachs Commodities Index	-11.58%

Sources: Total Returns from WSJ Market Data Group, Russell Investments, MSCI, Standard & Poor's, Barclays, John Hancock Funds

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Where to put capital and why?

The first step is to ensure your account(s) have the appropriate allocation of equities and bonds/cash factoring in your cash needs, investment time horizon, goals, and ability and/or appetite for risk taking. A review of your current situation and expected changes remains a critical part of our meeting process and in maintaining a flexible plan that addresses your needs. As always, we want to know of changes in your life that we should consider in managing your assets.

We are not advocating massive shifts in your asset allocation. Instead, we recommend staying committed to your long-term strategy and if warranted to gradually increase equities. If the market pulled back further from these levels, we would accelerate the process. This is a good time to establish or increase a systematic investment plan so we can dollar cost average into the market.

We will be focusing, where and when appropriate, on **adding high quality larger cap stocks** that are attractively valued, generate strong cash flow, and in most cases, have growing dividends. Based on the market volatility, low valuations, and the indiscriminate selling of equities, we are generally using more equity positions in portfolios to better diversify your holdings.

Attractive Dividend Yields vs. S&P 500 Index and 10 US Treasuries

This chart is a sample of existing opportunities. Compare yields and potential upside versus 10 year Treasuries, where would you rather invest for the next 10 years?

	Dividend Yield	Price/Earnings 2010 (est.)
Abbott Laboratories	3.65%	11.6x
Altria Group Inc	7.03%	10.6x
Chevron Corp.	3.83%	8.7x
IBM Corp.	2.00%	11.5x
Kraft Foods Inc.	3.90%	14.6x
McDonald's Corp.	3.13%	15.7x
Merck & Co. Inc.	4.22%	10.7x
Procter & Gamble Co.	3.11%	12.1x
United Technologies Corp.	2.48%	14.7x
VF Corporation	3.00%	13.4x
Vodafone Group Plc.	7.46%	8.0x
Waste Management Inc	3.75%	15.9x
S&P 500 Index	2.03%	13.9x
10 Year US Treasury	3.30%	N/A

Source: Telemet data as of 6/15/10

Note: The above list is for illustrative purposes only and does not represent a portfolio recommendation and should not be considered or relied upon as investment advice.

In addition, we will occasionally invest small portions in an out of favor stock or a special situation. We also continue to have a commitment to international stocks and bonds, inflation hedged securities (commodities and TIPs), and are adding floating rate bonds while shortening overall bond maturities.