

Newsletter – September 2010

Market Recap

Economic and political uncertainty dominated financial markets during the quarter, fueling a continued exodus of small investors from U.S. stocks and a buying binge of bonds and gold. The equity market was like a seesaw with sizeable gains, then painful losses and back to gains. The volatility and memories of 2008 have caused investors to shy away from equities, even as stocks enjoyed their biggest September rally in 70 years with the Dow Jones Industrial Index (Dow Jones) up over 10%. Through September 30th, the S&P 500 is up 3.9% and Dow Jones 5.6%. The ability of stocks to rally came as bulls noted the improving health of corporations flush with cash and able to raise capital at historically cheap rates.

International markets rebounded strongly in the quarter but international developed markets still trail U.S. markets for the year, while emerging markets continue to outperform. As for bonds, interest rates continue to contract and U.S. 10 year treasuries are close to a 50 year low – 2.5% at quarter end compared to 3.5% at the end of the second quarter. The demand for bonds has pushed bond prices higher and interest rates lower resulting in strong returns for bond mutual funds, however, if rates rise – investors will suffer losses - a concept being ignored by many investors.

In the quarter, investors pulled \$43 billion out of U.S. stock funds and have withdrawn \$100 billion since the beginning of 2009, according to Morningstar. Meanwhile, investors stashed nearly \$87 billion in bond funds, according to the Investment Company Institute, extending a run of positive net flows into bonds stretching back nearly three years and over \$620 billion. Investors are pouring money back into the traditional safe haven of money market mutual funds, adding \$14 billion, even at almost 0% interest rates. Gold also saw strong inflows, rising 5% during the quarter and hitting an all-time high. Gold is often considered a safe haven in the event of another financial market meltdown or a distrust of paper currencies. Others are worried about the long-term inflationary implications of additional Fed easing, a declining dollar and massive government budget deficits.

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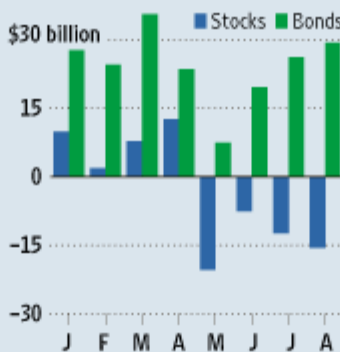
A Quirky Quarter

Stocks rallied during the third quarter despite investors’ love affair with bonds. Some say strong corporate balance sheets should fuel further stock gains.

Stock-market indexes, third-quarter performance



Money flows in and out of stock and bond mutual funds



Cash as a percentage of market value for S&P 500 stocks



Sources: WSJ Market Data Group (indexes); Morningstar (flows); Standard & Poor's

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“Consumer confidence is stabilizing..Durable goods orders are improving.. Price to earnings ratios are low...”

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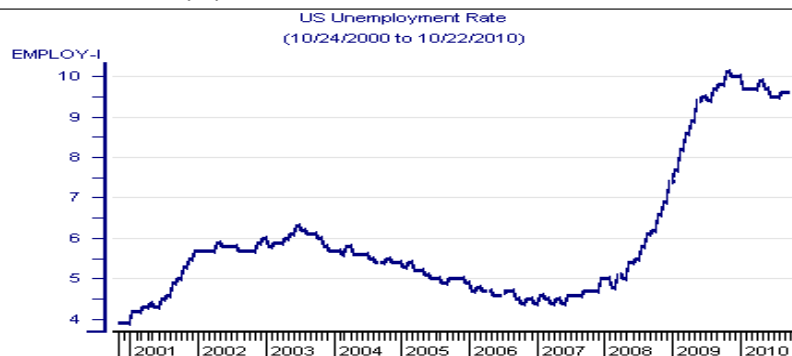
The Global Economy

Providing clients an overview of the economy is challenging for many reasons. First, we are increasingly aware that “the economy” is global and massive. In addition, it is difficult to be thorough and to emphasize trends that actually matter. Add to this the fact that we are living through a historic time of unprecedented government intervention and real-time experimentation by central banks to resurrect their economies. Lastly, one must try to comprehend and communicate the interplay, connections, and possible outcomes of all the various data. Our work has never been more complex and interesting, and we hope you will find the discussion that follows helpful to your understanding of how we manage money and think about the world on behalf of our clients.

As a firm, we spend a lot of time analyzing micro level data like company revenue and earnings to form a macro view of the world that is accurate and somewhat predictive. If we can identify the secular themes of the world economy, we feel we can provide our clients with competitive returns with less risk. In essence, we blend macroeconomic perspectives with the minutiae of ongoing balance sheet analysis to inform our investment decisions.

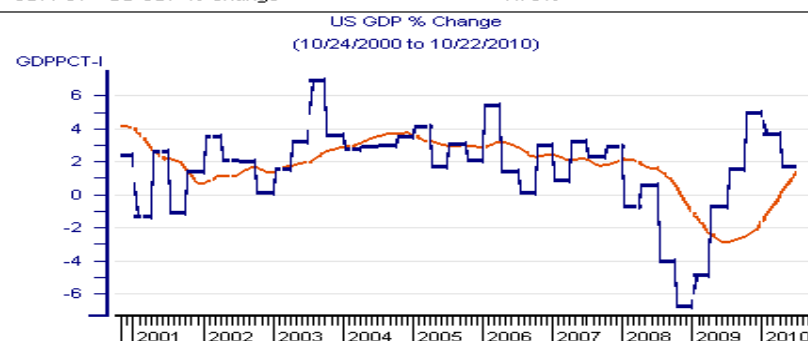
There is good news from this land of minutiae as we open the fourth quarter of 2010. Revenue and profits have generally been better than expected. Companies have large amounts of cash on their balance sheets and have been proactive and ruthless about cutting costs. The big negative from this approach is well-known by now: high and persistent unemployment that is not improving. This pernicious level of unemployment and the ensuing foreclosures continue to dampen the US economic recovery. In our last newsletter, we reiterated our view that **the fears of a double dip recession were overblown and that the sell-off in June provided an opportune time to add to equity positions.** The more illuminating question not addressed by CNBC or the popular press is not whether we will double dip or not. There will be periodic weakness so the question is what to do when it occurs. The life of a contrarian is lonely and long for we ask questions and ponder answers that others do not.

Symbol	Name	Current Value
EMPLOY	US Unemployment Rate	9.60%



Economic growth has turned positive but at a low rate!

Symbol	Name	% Chg from Prv Qtr
GDPPT	US GDP % Change	1.70%



Unemployment has been persistent and may be more structural than cyclical!

MARKET TRENDS 9/30/2010

Total Return

<u>US Stock Markets</u>	<u>12 Mos</u>	<u>YTD</u>
DJIA Index	14.1%	5.6%
S&P 500 Index	10.2%	3.9%
S&P MidCap 400 Index	17.8%	11.6%
S&P SmallCap 600 Index	14.2%	8.7%
<u>Int'l Stock Markets</u>		
EAFE Index	3.1%	1.0%
Emerging Mkts Index	16.8%	8.6%
<u>Fixed Income</u>		
Barclays Capital Aggregate Bond	7.8%	7.4%
<u>Commodities</u>		
SPDR Gold Shares	27.00%	21.32%
Goldman Sachs Commodities	4.22%	-2.82%
<u>Real Estate</u>		
Dow Jones US Real Estate Index	29.25%	18.64%
<u>Fixed Income Yield</u>	<u>12/31/09</u>	<u>9/30/10</u>
90 Day US T-Bill	0.05%	0.16%
2 Yr US T-Note	1.14%	0.43%
10 Yr US T-Note	3.84%	2.51%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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Paradoxically to the grave unemployment picture, consumer confidence is stabilizing. Durable goods orders are improving, so people who have jobs and cash are buying hard goods for their homes again. Price to earnings ratios are low, especially given extraordinarily low interest rates and tepid inflation. The emerging markets economies seem resilient and continue to grow even as China engineers yet another soft landing. There also are mounting concerns about the potential for economically damaging trade wars, particularly in regard to China's restrictive currency policies. Western Europe is the "Ugly Duckling", as concerns have re-emerged about European debt woes, especially in Ireland and Portugal. As we have experienced, global economies are increasingly becoming an interconnected capitalist world with shifting areas of prosperity and failure.

Conclusion

It is easy to get caught up in the daily negativity of CNBC and the financial press. The 2008 financial collapse and losses are too fresh in our minds and may have altered investor psychology for a long time. As we noted in our last newsletter, ***we believe that this is a buying opportunity for stocks and expect stocks to outperform bonds. The positives outweigh the concerns:***

- **The economy is growing** very slowly-at a pace that is insufficient to spur significant job growth.
- **Corporate profits continue to be strong and corporate balance sheets are awash in cash.** Although companies have clung to cash due to uncertainty about economic growth, tax policy and government regulations, the November elections should resolve some of these uncertainties. Companies have begun to increase capital spending, buy back stock, increase dividends, and complete mergers and acquisitions. We expect that eventually the high level of sales and profitability will lead to job creation and a reduction of the unemployment rate.
- **Low interest rates and inflation** are positive for stocks and may result in PE expansion. Low rates are positive for consumer borrowing-if a loan can be secured.
- **Accommodative monetary policy** - with the jobless rate stuck at a lofty 9.6%, many expect the Federal Reserve to again inject money into the financial markets through purchases of U.S. Treasuries. It was a massive round of this so-called quantitative easing that resulted in a "reflation" of stock, bond and commodity prices in 2009 and some investors are now betting on a similar rally.
- **Negative investor sentiment is also a positive as stocks climb a "wall of worry".**
- **Valuation** – the overall S&P 500 is relatively inexpensive but more important to us is that our research is identifying "cheap" stocks. We continue to emphasize high quality global stocks with attractive dividend yields and growth stocks – all with strong free cash flows. We are discovering stocks with dividend yields higher than 10 year US Treasuries-this is not rational in our view. Also, an allocation to growth stocks is important in this slow economic environment as earnings growth will lead to higher stock prices.

We believe this is an opportunity to own stocks at levels that have not been seen since the early 1980's and market dips should be used as a buying opportunity. We have come through a 10 year period of negative returns in the market. Historically, the next 10 year period has produced equity returns significantly better than the historical average of 10%. In addition, we continue to have a commitment to dollar-hedged securities (international stocks, foreign bonds and U.S global companies), inflation-hedged securities (commodities and TIPs), and we are adding to floating rate bonds and shortening bond maturities.