CRESTWOOD ADVISORS

Perspectives

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INSIDE THIS ISSUE

Market Outlook: Volatility Behind & Ahead

After a year of unprecedented volatility, investors were surprised to learn that the S&P 500 finished up 2.1% (including dividends) and the Barclays Cap Aggregate Government Credit Bond Index finished up 8.75%. Though a 2.1% return seems modest, investors should be relieved as almost all the other world indexes finished the year in negative territory (the MSCI World Index was down -9.41%). In hindsight, it was a year where political strategists rather than economists might have had more success forecasting markets, and where returns were awarded to those taking the least amount of risk.

Much of the volatility in 2011 can be tied to economic uncertainty caused by the ongoing, and unmatched, global deleveraging. Since this "leverage bubble" was created over the last 30 years, the rapid global deleveraging process sadly makes economic hardship unavoidable. In addition, the impact of this deleveraging has been exacerbated by the lack of credibility in government leadership (and policies), the tragic tsunami in Japan, the Arab spring, and the slowing Chinese economy. It is this uncertainty and fear that has driven behavioral change, including muted consumer spending, underinvestment by corporations, and, most clearly, the lack of willingness by investors to take any risk.

Though most economists peg US growth at 2% for 2012, it looks as if the risks to these forecasts remain to the downside. The drivers of volatility in 2011 remain firmly in place as it is now apparent that there are financial consequences to deficit spending. The "can" is now too large to continue to be "kicked" down the road.

Though the US has recently seen some mildly positive economic data, the current situation in Europe remains dire. Politicians have taken too long to understand and appreciate the depths of their issues and the failings in having a common monetary policy without a common fiscal policy. The social contract that has existed in Europe for decades has been broken and it will take many years to pick up the pieces. As for the paths to a solution, economists agree that there are basically four options: first, countries can encourage higher savings rates which would allow them to gradually pay down their debts; second, countries can grow their way out of the problem; third, the debt can be restructured and; fourth, countries can inflate their way out by holding down interest rates and maintaining a policy of easy money (i.e. devaluing their currency).

Given the enormity of the problem and the lack of meaningful action to date, the first two options are no longer viable leaving default/restructuring and inflation as the only remaining, politically palatable options. Therefore, a component of the solution will be defined as "voluntary restructuring" (really a default with a nicer name) while policy makers will also pursue the path of least resistance by creating unprecedented liquidity. The initial moves by European leaders have followed this script as the European Central Bank purchased the bonds of weaker nations while also holding interest rates below natural levels. The reluctance to aggressively go down this path is the fear that, if unchecked, hyperinflation is on the horizon. Of course, this risk has been disregarded as central bankers believe that "this time it is different" and the risk of creating inflation is muted given the excess labor and manufacturing capacity. This approach, combined with the restricting (i.e. default) of Greece (and its eventual exit from the EU) will ensure more politically-driven volatility in 2012.

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Crestwood Advisors' Philanthropic Commitment

Crittenton Women's Union

Crittenton Women's Union (CWU) is an innovative nonprofit organization dedicated to helping low-income women and their families attain economic self-sufficiency.

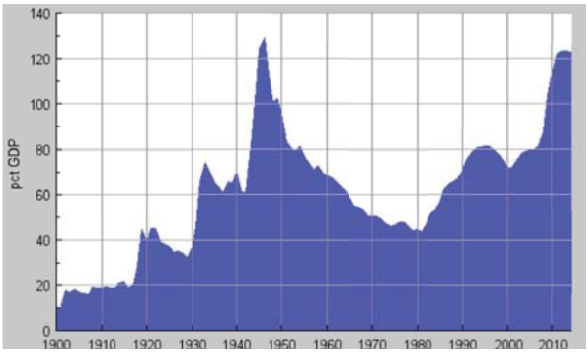
Its unique approach—combining direct service programs (housing, alternative education, workforce development, and family stabilization), independent research, and public advocacy—helps 1,400 people a year break the cycle of poverty and build more secure futures for themselves and their families.

For further information about CWU, please visit www. liveworkthrive.org.

Market Outlook

In addition to taking these actions, a number of members of the EU are being forced to embark on severe austerity measures to balance their budgets. These steps will not only have enormous social consequences but this fiscal restraint will be one more drag on economic growth. Economists are no longer debating whether Europe is in recession, but rather how deep it will be and how long it will last. In addition, with many European Banks technically insolvent and much of Europe's growth financed by bank lending, the lack of bank capital will also act as a significant hurdle to economic growth. Recent steps by the Europe Central Bank to provide short-term loans to financial institutions has been welcomed and has alleviated the probability of a financial meltdown, but the problems are far from over. Given that US debt is approaching 100% of GDP, we can only hope that policy makers on this side of the Atlantic appreciate the consequences of unchecked deficits and act before the US finds itself in a similar position (see chart below).

Total National Debt - US from FY 1900 to FY 2014

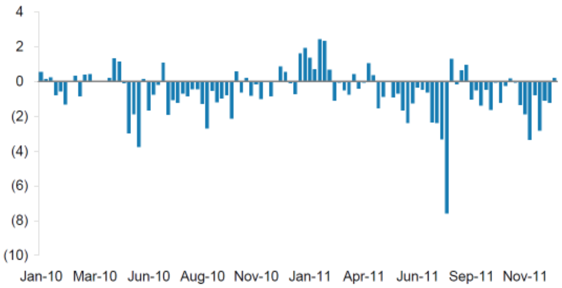


Source: www.usgovernmentspending.com

In light of the crisis in Europe, the American economy has, surprisingly, remained resilient. Recent economic data has been encouraging, though the path to economic recovery remains uncertain due to ongoing housing and unemployment problems. Households are entering their fourth year of deleveraging and individuals continue to gradually increase their savings rates. While this is good for personal balance sheets, it will limit economic growth (especially as real wage growth remains stagnant). Fortunately, corporate profits remain strong and companies are using their healthy balance sheets to return capital to shareholders via increased dividends and buybacks.

In the face of this uncertainty we believe it is important to remain disciplined and unemotional. Our portfolios are well diversified to mitigate volatility and we have been willing to maintain higher than usual cash balances to ensure that we are positioned to take advantage of the opportunities that present themselves. We also recognize that we are potentially in an environment where significant volatility will continue and moderate returns should be expected. Much of the volatility we have witnessed recently has been caused by investors responding to fear and panic and adjusting their time horizons to weeks and months rather than years. This has been most apparent in the unprecedented flows out of equities over the last few years into low return fixed income alternatives as investors focus on preserving their principal (see chart below). That said, we believe that equities offer attractive returns for longer-term investors. We continue to identify attractive companies in stable business (with solid cash flows) and we have been able to use the market volatility to enter (and exit) positions as valuations push extremes.

Domestic Equity Fund Flows ($B):
1st weekly inflow after 8 straight weekly outflows



Source: Morgan Stanley Research, excludes ETFs

While economic growth in the developed markets remains subdued, emerging markets continue to offer attractive growth characteristics for both bond and stockholders. It is ironic that the developing world is in better financial shape with stronger balance sheets, improving domestic demand, favorable rate environments and attractive valuations (especially given the recent adverse volatility). Though China is the world's second largest economy, the consequences of its slowdown and its transition to domestic consumption are unclear, so, as investors, we have preferred to concentrate our exposure to regions where we have greater confidence in the economic fundamentals (i.e. Brazil, South Korea, etc.).

Though we think equities remain more attractive than fixed income, we recognize that bonds have a place in client portfolios, as they reduce overall volatility and provide stable income streams. Since interest rates will remain low for the foreseeable future, we believe that investors are best positioned in short to intermediate bond maturities. However, we avoid US treasury bonds as 1.85% yields on ten year bonds do not provide a healthy margin of safety given that the Federal Reserve will not hold interest rates at artificially low levels indefinitely! We believe that higher quality corporate and municipal bonds look attractive on a relative basis, and, in the case of the latter, continue to yield in excess of 100% of treasuries (making their tax advantage favorable).

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Finally, we continue to take advantage of floating rate bank loans as well as emerging market sovereign debt as we believe that the attractive yields more than compensate for the additional credit and currency risk.

Gold continues to act as an insurance policy during these uncertain economic times. Its historical role as a store of value will continue until we see greater fiscal and monetary prudence by governments and central banks. We do recognize that the recent dollar strength could prove to be a headwind short term for gold though we remain believers that the ingredients are firmly in place for a weaker dollar over time. Finally, we have also started to see a number of central banks purchase gold to diversify their reserves away from the euro and the dollar. We remain cautious towards other commodities given the global economic slowdown (and, specifically, in China). However, we believe oil is attractive as demand has stayed consistent and tensions in the Middle East heighten the risk of a supply disruption.

Looking Ahead

Given the headwinds of mounting US debt, ongoing paralysis in Washington, a presidential election, expiring tax cuts, a slowing China, and a continuation of the crisis in the Euro zone, investors might have more success forecasting volatility rather than market return. Investors have grown accustomed to central banks "saving the day" and unforseen events in 2012 could force the Federal Reserve to implement more quantitative easing (QE3). Of course, after two significant easing events, the impact of this action is now unknown. This all leads us back to the importance of constructing portfolios that are able to weather these "unknown" events. Simply put, we will remain cautious and focus on fundamentals as they eventually drive long-term returns.

Crestwood Research: Why We Like Stocks In a Volatile World

Given the ongoing global challenges, numerous impediments to economic growth, and a long-term deleveraging process, why do we continue to favor stocks for long term investors? The answer is that history has demonstrated (regardless of the economic backdrop) that well run businesses, with sustainable above average returns on capital, purchased at attractive valuations, deliver solid returns to shareholders over time. The next several months or quarters will likely continue to be volatile, but we are confident about the long term prospects of the stocks we own.

If that is true, then why has the S&P delivered such meager investment returns (less than 3% annualized returns) over the past 10 years? Because (1) the S&P was overvalued 10 years ago, trading at 25x its price to earnings "P/E ratio" and (2) the S&P is comprised of 500 companies, not all of which have good returns. As a result, many of the stocks in the index have generated handsome returns over that same 10 year period despite a weak overall market.

Stock picking matters in a volatile environment

2011 offers a similar lesson in divergent returns between the overall stock market and those of high quality businesses purchased at attractive valuations. Despite double digit EPS growth for the S&P in 2011, the index price was flat for the year with the entire shareholder return (+2.1%) coming from dividends. The trailing P/E for the S&P contracted from 15x to 12.5x during the year as investors grew skeptical of the sustainability of peak margins and global economic growth.

While the overall market offered little in the way of returns in 2011, many of our stocks performed quite well. Several stocks in our portfolio generated total returns of 10% or more despite the S&P returning just 2.1%. In a volatile, range-bound market, stock picking and judicious management of risk (sector exposures, position sizes, conservatism in earnings estimates and valuation assumptions) are paramount to delivering good investor returns.

As always, these are key tenets of our investment process that provide some comfort in our ability to buy assets that we view as attractively valued even in the context of our cautious world view. This conservative approach informs what we buy, what we sell, and what we avoid. In aggregate, we believe that our stocks have less exposure to margin/EPS risk, cheaper valuations, and consistent economic returns versus the S&P.

Volatility and correlations create opportunity

We expect continued volatility in stock prices during 2012 and we will take advantage and be opportunistic in increasing

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client exposure to quality businesses at attractive valuations as we did during the volatility in 2011 - we purchased Berkshire Hathaway, Wells Fargo, Devon Energy, and added to McCormick positions during the heightened volatility in the 2nd half of the year.

In addition to volatility, the historically high (stock price) correlations that we have been witnessing in the past couple of years are likely to continue as the ongoing structural challenges of the world drive the "risk-on/risk-off" market action. This dynamic creates an advantage for dedicated stock pickers as it provides opportunities to buy new positions (and add to existing ones) when stocks are selling off broadly and indiscriminately. Conversely, when stock prices are broadly increasing with high correlations, it offers us opportunities to take gains and sell stocks when they reach full valuations.

Low interest rates are supportive of equity valuations

The Federal Reserve has promised a low Federal Funds rate through mid 2014, which is a positive for equity valuations as the low return opportunity from cash and bonds (with no inflation protection) makes certain equities more attractive - particularly those offering current income via dividends. In addition, strong businesses with solid balance sheets, robust cash flow generation, above average returns on capital, and pricing power are poised to deliver superior investment returns (regardless of inflation, deflation or macro outcomes) than most asset classes.

Dividends Matter

Over the past eight decades dividends have accounted for approximately 50% of the total return from stocks. Many of the stocks we own pay dividends that are well supported by strong balance sheets and cash flows. In addition, these dividend payers have increased their dividends by 10% per year on average over the past 5 years versus just 0.5% growth for the S&P. Given the strength of our company's balance sheets and cash flows, we expect further dividend growth and share repurchases to help drive future returns even without higher valuations. The compounding of significantly higher dividend growth can drive substantial outperformance over time.

What about inflation or deflation?

Our base case assumption with regard to inflation versus deflation is that we are in for a prolonged period of low inflation. We do, however, expect episodic spikes in inflation driven by easy monetary policy (ie QE2) with the potential for much higher inflation over the longer term.

With this backdrop over the next couple of years, we feel confident about the real (after inflation) return prospects for our stocks which, in aggregate, offer a dividend yield of over 2% plus upside from the equity price and future dividend growth. This compares quite favorably to 5 year treasuries which yield less than 1%, resulting in a negative real yield. In an inflationary environment we also favor the stocks we own versus treasuries or cash as they offer more protection via dividends, pricing power, dominant market positions, and stable excess cash flows to mitigate the effects of broad based inflation.

Why not go to all cash or all bonds and wait for stocks to get cheaper?

Investors often wonder if the time is right to "time the market." Our fundamental view is that being disciplined in our purchase and sale of individual equities, maintaining a long time horizon, and employing a dynamic risk management and portfolio construction approach will yield the best results over a full market cycle (3-5 years). Increased cash levels are a by-product of our investment process or stocks reaching full valuation. Long term average annual equity returns (8% after inflation) are evidence that one need not attempt to time the market to make great returns over the long term, regardless of market cycles and volatility.

Despite the challenging economic environment and volatility over the past three years, the S&P has delivered a 48.6% total return while investors have pulled approximately $87 billion from stock funds since the spring of 2009. This recent period is a great example of the challenges of timing the market no matter how obvious the economic evidence may appear in support of selling stocks.