CRESTWOOD
ADVISORS

APRIL 2010

Perspectives

INSIDE THIS ISSUE

Market Outlook
Our View on the Recovery

Healthcare Bill
Emergency?!

Municipal Bonds
Concern or Opportunity?

Crestwood Advisors' Philanthropic Commitment:
The Gwendolyn Strong Foundation

Market Outlook

Amid continued global economic and political uncertainty, the stock market extended its rally during the first quarter. Continued strong corporate earnings with hints of encouraging economic data helped drive the S&P 500 almost 5% higher. Though the S&P is still 25% below its peak, the gains from the March 2009 lows are an impressive 75%. Many investors preferred the relative safety of bonds and the tremendous inflows into bond funds together with reassuring inflation data, resulting in a further tightening of credit spreads and modestly positive bond returns.

As has been the case since stocks bounced off their year ago low, the best performing stocks continue to be more volatile and generally lower-quality names. Small cap stocks returned almost twice that of larger companies, with the Russell 2000 gaining 8.5% during the quarter. Despite ongoing concerns of real estate related losses and threats of increased regulation, financial stocks also delivered strong gains, returning 11% during the quarter and over 125% from their near-extinction trough 13 months ago.

Our concerns…

The problems within residential and commercial real estate remain a concern. Seriously delinquent home loans are soaring and the threat of additional housing supply via accelerated foreclosure activity looms large. While it is encouraging that the housing market has stabilized, further gains will be challenging given recently higher mortgage rates and the ending of some government support, including the first time home buyer tax credit and the Federal Reserve's purchases of mortgage-backed securities. Commercial real estate remains pressured with high debt levels, rising vacancy rates, and landlords aggressively lowering rents, all highlighting the challenges in this market.

Real estate problems are important as impaired households will continue to focus on paying down debt, leaving less liquidity available for growth-related spending at shopping malls and auto dealers. Significantly, with the prospect of further real estate related losses, banks continue to resist political pressure to extend credit and instead have been responding to regulator demands to improve balance sheets and increase reserves.

While government stimulus efforts have helped, we suspect that our consumer-driven economy will struggle to generate consistent growth in the years ahead. Without available credit, job creation and wage growth become that much more important for consumers. Job losses have thankfully stopped but new job creation remains tepid, and with unemployment likely to remain persistently high for years to come, there seems no near-term pressure to increase wages.

Reasons for optimism…

Encouragingly, households are making progress on reducing debt. Some of this has come from increasing savings and some in the form of debt discharge through bankruptcies or foreclosures. Retail sales have shown surprising strength to start 2010 (+8% in March!)

Continued

Crestwood Advisors' Philanthropic Commitment:

The Gwendolyn Strong Foundation

The Gwendolyn Strong Foundation (GSF) is a 501(c)(3) nonprofit organization seeking to increase awareness of Spinal Muscular Atrophy (SMA), the leading genetic killer of young children, and accelerate research focused on a cure for this cruel disease. SMA is degenerative and terminal with no current treatment or cure. Babies are born perfectly healthy, but within months of an SMA diagnosis, their bodies begin to fail them. Although not a household name, SMA research is extremely advanced and is considered a "gateway" to cures for countless other diseases. Researchers have stressed that a cure is possible within the next five years and the NIH has coined SMA the disease "closest to treatment."

Bill and Victoria Strong founded GSF to fight alongside their daughter, Gwendolyn, who was diagnosed with SMA at the age of 6 months. Since its inception in 2009, GSF has raised more than $400,000, has reached more than 2 million people through social media campaigns, was voted to the "winner's circle" out of more than 500,000 organizations in the Chase Community Giving campaign on Facebook, and has lobbied Congress in support of increased SMA funding.

For more information, please visit www.gwendolyn-strongfoundation.org.

Market Outlook
Continued

perhaps indicating that consumers are better positioned than feared and are feeling more optimistic about the recovery. Time will tell how much of this reflects renewed long-term confidence versus temporarily fatter wallets as a result of tax refunds.

Led by strong growth in Asia, the global recovery is stronger than expected, providing optimism for U.S. exporters. As is typical coming out of a recession, manufacturing is recovering as inventories are rebuilt and the U.S. manufacturing index is registering its highest figures since 2004. So far this year, the gains have been broad based, with consumer durable goods (autos, furniture & electronics) and business equipment (including computers) all showing gains.

What are we doing?

While optimistic that the worst of this recession is behind us, we remain skeptical on the economic recovery sustaining such a robust pace. We view the problems of an impaired consumer, a lingering high unemployment rate and a banking system both unwilling and unable to extend credit as persistent challenges that are likely to cause some bumps along the road to recovery.

As a result, we see increasing risks in the valuations of many stocks, especially smaller company stocks, and some of the sectors leading the ongoing stock market rally. We recently reduced our exposure to small cap stocks in those accounts where gains created larger than desired exposure. We continue to largely avoid the banking sector, as the increased regulation and the need to digest future real-estate related losses will limit opportunities for further profit growth. We have also strived to avoid those companies who are dependent on the growth of consumer spending, since impaired household balance sheets and limited access to credit will prove to be headwinds for many retail companies.

Instead, we continue to focus on companies who are industry leaders with strong balance sheets and superior free cash flow. These are the companies who have gotten stronger during the downturn and who have been able to raise dividends, buy back stock and make thoughtful acquisitions to further strengthen their industry leadership. These are also the stocks that have largely lagged the current rally, yet whose businesses have generally performed well.

Fidelity National Financial (FNF), the country's largest title insurance company, is one such example. Title insurance is required on virtually all housing transactions. As the housing market slowed the past couple of years, FNF's business suffered and the valuation on the stock fell to book value. Despite the slowdown in business, FNF has consistently delivered quarterly profits, pushed through price increases in strategic markets and strengthened their market dominance by buying a large competitor for essentially nothing after cost cuts. With the housing market stabilizing, FNF's broad distribution network and now more dominant 45% market share, they are well positioned for further gains as the housing market slowly improves. In addition, further increases in the current dividend (4.7% yield) are expected.

Investments benefiting from the economic growth outside the U.S., particularly from Asia and the broader emerging markets are also an area of focus. We are pursuing this growth opportunity with both exchange-traded funds (ETFs) as well as many individual companies (i.e. Pepsico, Colgate, ABB) with significant non-U.S. revenue who are capitalizing on the growing consumer and infrastructure spending in these economies.

For income investments, we have been shortening bond portfolio durations in order to reduce sensitivity to likely rising interest rates. While this gives up a few basis points in yield, we prefer to reduce the risk of potentially large losses should interest rates move sharply higher. International bonds and senior-secured bank loans continue to offer relative high yields and enhanced total return opportunities.

With absolute yields low, other investments offer interesting income opportunities. As with FNF, many high-quality common stocks offer attractive dividend yields that are likely to grow in the future. Similarly, exchange-traded Master Limited Partnerships (MLPs) that store and transport our energy resources provide attractive tax-advantaged dividend income and the opportunity for future dividend growth, helping to ease the nuisance of supplemental K1 reports at tax time.

Finally, we continue to believe that gold and other commodities offer opportunities for further gains. As the global economy recovers, the demand for energy, food and other resources will grow and again run into a somewhat impaired supply infrastructure. Gold also offers some protection against ongoing currency de-valuation and potential future inflation.

Healthcare Bill Summary

The ongoing healthcare debate in Washington is finally coming to a resolution. While the votes are in place to create the first meaningful changes to our healthcare system since 1965, the implementation of these changes will likely take years. Many of the details of this bill have yet to be worked out. The current Healthcare Bill passed by the House, formerly known as the Affordable Healthcare for America Act (which was passed by the Senate), will allow 30-35 million Americans to receive health insurance who do not receive it today. These uninsured individuals will be able to purchase insurance through state-based insurance exchanges. These Exchanges will compete with current private insurance companies for individual and family plans. The cost of implementing these exchanges and providing insurance will be $940 billion over ten years and likely higher if prices are not negocticated down from current levels.

Who pays for all this?

Starting in 2012, there will be a 0.9% increase to the Medicare tax rate for families making more than $250,000/year and individuals making more than $200,000/year. Here is an example of the tax changes for single and joint filers (assuming the Medicare tax increase and unearned income Medicare contribution).

Household income	Tax under current law	Tax with Medicare tax and other Obama proposals	Additional cost imposed
Single filers			
$75,000	$9,300	$9,300	–
$150,000	$24,900	$24,200	($700)
$350,000	$81,100	$83,800	$2,700
$5,000,000	$1,361,400	$1,647,100	$285,700
Joint filers			
$75,000	$2,800	$2,800	–
$150,000	$19,800	$16,400	($3,400)
$350,000	$79,700	$74,600	($5,100)
$5,000,000	$1,350,200	$1,637,300	$287,100

* Estimates according to Deloitte, Tax provisions in the Patient Protection and Affordable Care Act, March 21, 2010

Beginning in 2018, insurance companies will have to pay a 40% excise tax on "high-end" insurance plans worth over $27,500 for families and $10,200 for individuals (estimated to raise $150 billion in ten years). The annual fees for medical device and prescription drug manufacturers will begin in 2011 and 2010 respectively. These fees will not be material to most companies' earnings results, but in aggregate should raise over $5 billion per year.

The healthcare bill closes the donut hole for seniors' prescription drug coverage. Currently, Medicare covers 75% of the total drug costs for seniors up to $2,830/year (so seniors pay just over $700 for the first $2,830 of drug costs). After that, seniors pay all of the drug costs from $2,830 to $6,440 per year (essentially, seniors have to cover the next $3,610 in costs for drugs). For any amounts above $6,440/year, Medicare covers 80%. This new healthcare bill will serve to reduce costs for seniors by eliminating the gap between $2830 and $6440 in drug costs per year.

Impact on healthcare holdings

While Johnson & Johnson (JNJ), Novartis (NVS) and Stryker (SYK) will have to pay annual fees, the overall impact to these companies will be negligible in terms of earnings and cash flow. These companies continue to be positioned well for the long term despite the changes. Dentsply (XRAY) is unaffected by reimbursement and other changes. CVS will likely see a modest long-term benefit as a result of more drugs (more insured individuals with insurance) being prescribed in the future. XBI benefits as a result of a risk factor (fewer years of patent exclusivity) being taken off of the table. Biotech continues to look to be an attractive area of secular growth for the future.

Overall, the competitive position for the aforementioned companies is largely unaffected. While the cost of research and development and regulatory costs for several healthcare companies will increase over the next several years, the long term outlook is not materially affected by this bill. There is likely to be a cost/benefit analysis imposed by Medicare/Government in the future, but many industry leaders (JNJ and others) have been anticipating this. As these companies continue to offer products that improve the lives of patients at a reasonable cost, innovation can continue to thrive under the tougher regulation/environment.

Change to the healthcare system in this country is inevitable. With healthcare spending at 16-17% of GDP, and the next closest country at 11% (France and Switzerland), change was imminent. At this stage, the estimated savings to the deficit appear a bit optimistic. The estimated cost savings from the bill will largely focus on the government's ability to pro-actively cut costs over the next ten to twenty years. Time will tell, but it appears inevitable that the government will be directly involved in facilitating a higher degree of competition within insurance. The government is looking to take more of a direct role in bringing costs down, and that could mean a more challenging environment for those companies and products that are involved in the healthcare sector.

Municipal Bonds – Cause for Concern or Reason for Opportunity?

The market for municipal bonds seems at a crossroads. Fears of higher tax rates have increased demand for tax-free income and traditional municipal supply has been curtailed by the success of the taxable Build America Bond program. Together with the easing credit crisis, this has led to a steady improvement in municipal bond prices and brought yields on intermediate-term bonds down to a more normalized relationship to Treasury yields.

The lingering recession has caused the fiscal condition of most municipalities to deteriorate as spending demands have increased and tax revenues have fallen sharply. While near-term creditworthiness has deteriorated, burdensome union and pension obligations suggest that many cities and states face tough budget choices in the years ahead.

Favorable Supply/Demand Characteristics

It seems a foregone conclusion that income tax rates are headed higher and may soon present rates that will be the highest in most American's experience. This has naturally increased the demand for tax free income, as the higher income tax rates are in the future, the more desirable today's tax-free yields are to investors in the highest income tax brackets.

At the same time, the success of the Build America Bond (BAB) programs has made a significant dent in the available supply of traditional tax-free municipal bond issuance. The BAB program was created to ease the financing conditions and lower the cost of borrowing for state and local government issuers during the credit crisis and is now the fastest growing segment of the municipal bond market. Today the U.S. government supports BABs by paying 35% of the interest costs and President Obama has proposed making the program permanent with a 28% subsidy.

BAB issuance has been a success for issuers and expanded the investor universe of municipal bond buyers to include pension funds, insurance companies and other taxable bond investors. However, for the high-income individual investor, the success of Build America Bonds has led to a growing scarcity of tax-free bonds, which has contributed to higher bond prices (and thus lower yields) as the growing pool of high-bracket investors have pursued the relatively fewer tax-free municipal bonds.

Real Fiscal Problems

While conditions in the municipal bond market have improved and there seems to be a favorable technical relationship between growing demand and shrinking supply, overall creditworthiness of most state and local governments has been hurt during the Recession. Spending demands have increased during the slowdown and income, sales and property tax revenues have fallen sharply, leading to fiscal pressures and concerns over filling growing budget deficits.

Of even greater longer-term concern are the generous pension obligations of the estimated 23 million active and retired state and local public employees. Many states, including Massachusetts, are woefully underfunded for these obligations and face tough future choices between raising taxes and cutting essential services. Current and future budget concerns have created fears of future defaults and weigh on the municipal bond market, perhaps causing prices to be lower (and yields to be higher) than might otherwise be the case given current and expected tax rates.

Still a Lower-Risk Opportunity

We believe that municipal bonds still present a lower-risk opportunity for relatively attractive yield and income. For the vast majority of our clients, income tax rates will be increasing, perhaps significantly, making today's current tax-free yield worth that much more when tax rates are higher.

Currently, yields for intermediate term municipal bonds are hovering in the range of 85% of comparable maturity U.S. Treasuries while long-term municipal bonds are still offering yields around 100% of treasuries. We suspect that this relationship will continue to migrate towards the sensible after-tax yield opportunity and move closer to 70%-80% of treasuries (and perhaps lower if tax rates become significantly higher).

The current and future fiscal strains for many municipalities are quite real. However, we are encouraged by the growing awareness of the need to face up to the tough fiscal decisions and, at least in some states (i.e. New Jersey), beginning to make it into public policy debates. Historical default rates are extremely low for municipal bonds and, while supplemental bond insurance and the bond rating agencies are less relevant today, rating agencies will soon adjust to global rating scales, which will have the effect of increasing ratings and expanding the buyer pool on the majority of outstanding bonds. We strive to minimize credit risk by emphasizing general obligations bonds supported by taxing powers and essential purpose revenue bonds of more fiscally prudent issuers. Consistent with our view of likely higher interest rates, we continue to target short-to-intermediate maturity bonds to keep our duration shorter and less sensitive to higher future yields.

This newsletter contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Any reference to the S&P 500 or other index is for informational purposes and does not reflect the deduction of fees. Investments cannot be made directly into an index. For a full list of all recommendations made by Crestwood Advisors LLC over the past twelve months, please contact us. Information discussed herein may not be representative of the investments made in all client accounts.