CRESTWOOD ADVISORS

OCTOBER 2011

Perspectives

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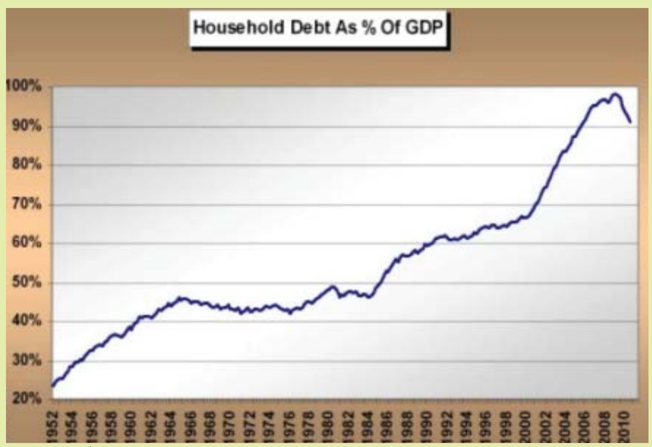
Market Outlook: Navigating a Deleveraging World

Dictionary.com defines "deleverage" as 'to decrease financial leverage by paying off debt' (as in *Their balance sheet significantly improved after they deleveraged*) or 'to reduce the debt of' (as in *He drastically deleveraged the company to make it profitable*). In our view, this is a word we will be hearing quite a bit more of in the years ahead.

The three decade expansion of ever-easing credit abruptly and painfully stopped in 2008 and has only begun to subside. Many businesses are further along the path to fiscal responsibility and hold record amounts of cash with arguably the strongest balance sheets in decades. Individuals and households have begun to increase savings and pay off personal debt. Lower interest rates have brought household debt service levels closer to longer-term averages and household debts as a percent of GDP are back down to pre-housing boom levels of around 90% - though at least some portion of this decline is the result of debt erased through foreclosure.



www.contraryinvestor.com

Exploding debt levels have been a global phenomenon and governments (i.e. sovereign, federal, state, etc.) have been among the most expansive with their indebtedness over the past 30 years. Unlike businesses and individuals, governments seem to have only begun to recognize the severity of the problem and so far have taken very limited steps to meaningfully deleverage. This summer's debt-ceiling debate highlighted the risks in the U.S. and further potentially disruptive fiscal debates in Washington D.C., including the sequel to the debt-ceiling discussions that remain ahead.

The enormous debt problem in Europe continues to dominate the headlines. The nature of the European Union and interconnectedness among EU countries and banks make any solution incredibly complex. While Greece understandably gets a great deal of attention, it is not just a problem with Greece. The EU is very concerned about a domino effect that would severely impact the larger economies of Italy, Spain, France & Germany. Despite the various actions and proposals already floated, it seems that some version of a Greek default is inevitable.

The Impact of Deleveraging

We have no clairvoyance on how the European situation will be resolved in the months and years ahead. Nor do we have perfect vision of how U.S. politicians will tackle our enorm-

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Crestwood Advisors Welcomes

Tyler R. Lewis

We are pleased to announce that Tyler R. Lewis joined Crestwood Advisors in September of 2011. Tyler is primarily responsible for investment policy implementation; including monitoring, management and rebalancing of client portfolios.

Prior to joining Crestwood Advisors, Tyler was a fixed income sales associate within the Fidelity Capital markets division of Fidelity Investments in Boston, MA. Tyler earned a BA in English from Union College in Schenectady, NY and is currently pursuing an executive MBA at the F.W. Olin School of Business at Babson College.

Tyler can be reached at tlewis@crestwoodadvisors.com.

Market Outlook

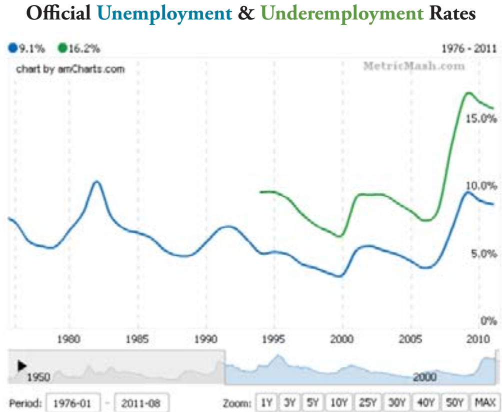
ous fiscal challenges to rein in deficit spending and the continued build-up of our national debt. Finally, with generally high unemployment and anemic wage growth, our crystal ball is cloudy on the path to sustainable and stable fiscal conditions for many households and consumers. What is pretty clear to us, however, is that there are no magic formulas or immediate solutions to these challenges and the efforts to manage deleveraging will likely be felt for years.

It is abundantly clear that during this process of deleveraging, economic growth is likely to be lower as credit will remain constrained and funds are either redirected to pay down debt or absorbed as losses. We all understand the "paradox of thrift" in that greater savings or debt repayment is good for the household (or government) balance sheet but not good for generating broader economic growth. For businesses, this environment is likely to lead to lower economic returns and less incentive to invest in research thus potentially crimping innovation.

Already, U.S. GDP growth has been running below expectations this year (around 2%) and economic activity weakened significantly over the summer. Persistently high unemployment, stagnate housing and poor stock market performance are undermining consumer confidence and elevating the risks of a "double dip" recession.

It also seems very likely that unemployment will remain persistently high for years as slower economic growth does not allow for full absorption of the displaced and ever-expanding pool of workers. The excess global capacity in labor will also keep pressure on real wages in the U.S., further pressuring households and curtailing their contribution to economic activity.

Official Unemployment & Underemployment Rates



U.S. Bureau of Labor & Statistics - Latest Data Aug. 2011

The combined factors of lower growth, spending and investment together with the excess labor and productive capacity will also amplify deflationary pressures. Presently the U.S. economy is generating growth well below an efficient level and even the Congressional Budget Office expects this negative "output gap" to last for years. Capacity utilization remains soft, suggesting little need for significant corporate investment to handle future growth.

This excess capacity in labor as well as the negative "output gaps" are a global phenomenon and suggest little risk of near term inflation. The Japanese experience over the past 20 years highlights the resulting persistently low inflation and extended periods of deflation as their economy ran below potential. A similar experience for the U.S. and other developed economies – along with the episodic spikes in inflation resulting from bursts of money printing – could be in store as debt issues are digested in the years ahead.

What we are doing!

Given our view that the impact from deleveraging will last for years and lead to a choppy economic recovery at best, we continue to strategically position portfolios to ensure broad global diversification. We are actively expanding exposures beyond the U.S. and other developed economies to include a broad mix of stocks, bonds and currencies in order to take advantage of growth opportunities and reduce risk.

We are also emphasizing income and greater certainty of returns today versus promised future growth and income opportunities. Though yields are lower, the certain income from bonds still play an important role for portfolios and we continue to seek stocks with visible and strong free cash flows, which often leads to higher dividends.

As we evaluate investment opportunities, we are also incorporating a conservative view of future growth opportunities to reflect the challenging economic times still ahead. We want our potential investments to still be worthwhile under scenarios where revenue growth is slower, profit margins are slimmer or valuation multiples lower.

Finally, given the current and expected future volatility, we are proactively managing portfolios to control risk by selling investments no longer supported by valuation, managing position sizes of new and existing investments and remaining willing to hold larger cash balances and be patient for opportunities.

What we are not doing!

Importantly, we are not panicking or making dramatic changes to client portfolios in reaction to the ongoing volatility or the constant headline of unfolding macroeconomic events. We have anticipated economic weakness and stock market volatility for some time and have made adjustments months ago to remain defensive in our portfolio posture as well in our investment research.

For bond investments, we are not reducing quality or stretching out to long-dated maturities in search of higher yield.

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While tempting given low interest rates, we do not think the possibly few extra basis points of yield are worth the additional risks. We continue to avoid U.S. Treasuries & High Yield bonds in favor of stronger corporate bonds with better balance sheets and municipal bonds with secure taxing power.

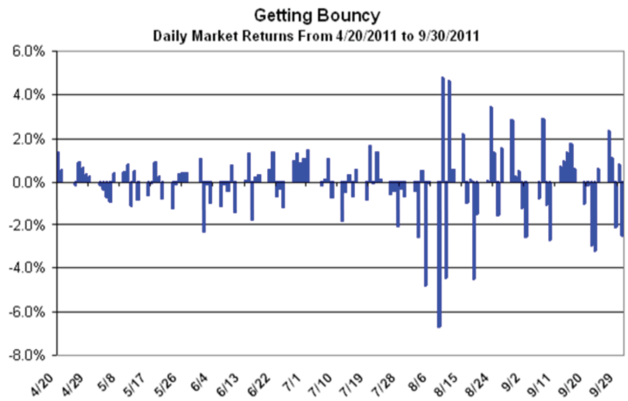
For equity investments, we are not anticipating a strong economic recovery and not willing to pay up for promised future earnings. We continue to avoid those companies dependent on a strong rebound in consumer spending and are avoiding temptation to buy high yielding equities with limited growth opportunity (i.e. REITS, Utilities & Telecom) simply for the relatively high current income.

Opportunities Remain

While the economic recovery remains fragile, investment opportunities do remain…though much depends on the time frame of expected returns. Generally large-cap U.S. equities are inexpensive relative to other investments and we are identifying many market-leading companies with solid growth prospects, especially in the industrializing emerging markets, that offer attractive return opportunities given their current valuations. We remain optimistic of the long-term growth opportunities of the broader emerging markets and are emphasizing countries such as Brazil where natural resources are plentiful, the middle-class is expanding and valuations are attractive.

Volatility as an Ally

As the chart below highlights, the stock market experienced significant and increasing volatility during the third quarter. According to Investment News (9/2/11), 50% of mutual fund managers were underperforming their respective benchmarks by over 2.5% as of the end of August, and over 70% were underperforming their respective indices. It is a challenging environment, to say the least, and the actions we have taken for clients ahead of this volatility are just as important as the actions we are taking today. Importantly, we are not panicking. Many of the decisions we made six, twelve, and even eighteen months ago positioned portfolios defensively to handle this environment. In addition, we are taking advantage of opportunities the market is giving us today amidst the volatility.



Decisions Past

Just over a year ago, we recognized opportunity in defensive sectors such as Consumer Staples and Healthcare. These two sectors were attractively valued and contained high quality franchises such as C R Bard and McCormick, companies that we added to client portfolios. Over the past year, or so, we have increased our weightings in the Consumer Staples and Healthcare sectors. These were two sectors that were offering value, and did not offer the exposure that most investors wanted to the economic recovery. As 2011 has unfolded, and confidence in the economic recovery has faded, the Consumer Staples sector is +2% year to date. Healthcare is also +2% year to date. This is versus the S&P 500, which is -6% year to date through 9/30/11.

This example speaks to our process of purchasing high quality franchises at attractive valuations. Adding to Consumer Staples and Healthcare was not a popular move in the middle of 2010, as droves of investors were adding economically sensitive names to their portfolio. However, the sentiment has now completely shifted and several stocks we own in Healthcare and Consumer Staples are generating positive returns year to date (ie. Johnson & Johnson, Colgate-Palmolive and McCormick) in a down market.

Another example of past decisions positively affecting portfolio returns is our sell discipline in the Industrial and Energy sectors. Given investor confidence in an economic recovery, several Industrial and Energy stocks hit our sell price and became unattractive due to valuation. Companies we have sold over the past year in these sectors include ABB, Newfield Exploration and ITT Corporation. By taking advantage of what the market gave us, we ended up with relatively small weights in the Industrial and Energy sectors entering 2011. While we continue to hold several well positioned companies in these sectors, our sell discipline allowed us to exit several investments at attractive prices for clients.

Decisions Present

Given the weakness in the market year to date, and faltering confidence in an economic recovery, we are beginning to see more attractive opportunities in Financials and Energy. Due to concern about the European Debt crisis, several stocks in the Financial sector are trading at or below book value. The market is not discriminating, as several very high quality businesses in financials are trading at similar prices to lower quality names. This allowed us to recently initiate positions in both Wells Fargo (WFC) and Berkshire Hathaway (BRK), which we view as two of the highest quality businesses in Financials.

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WFC is the leading producer of mortgages in the United States, generates over $12B in cash flow and has one of the highest capital ratios in banking. We recently began purchasing the name under book value. The most encouraging thing about WFC is that it became stronger during the recent financial crisis. The company's conservatism and strong financial position allowed it to purchase Wachovia (one of its larger competitors). This purchase was made at a very cheap price, and puts WFC in a position to double earnings and cash flow and gain significant market share. WFC is as well positioned in the market as it ever has been.

BRK is run by Warren Buffett, arguably one of the best investors of all time. Concerns about a weak insurance market, a weakening economy and Buffett's ultimate departure allowed us to purchase BRK at close to book value. Over the past thirty years, there have only been a few times that BRK has traded near book value, and each time has proven to be a good time to buy. With an exceptional collection of high quality businesses, a top notch insurance operation and an unmatched investment portfolio, we feel this time is no different. Shortly following our purchase of BRK, the company announced its first share buyback in history, sharing our view that the stock is attractively valued here.

While stocks in the Financial sector have been weak, stocks in the Energy sector have been as well. Concerns about a weakening economy have created a buying opportunity in some high quality Energy names. One recent purchase we made was in Devon Energy (DVN), a leading North American oil and natural gas exploration and production company. Approximately 60% of DVN production is natural gas and 40% is oil/liquids. The company recently completed a series of $8 billion in asset sales as part of a strategic plan to reposition itself as a high-growth, high-return onshore company with exposure to key resource plays and a focus on oil/liquids production growth. DVN has used the sale proceeds to buyback stock and strengthen the balance sheet to an industry leading level. DVN pays a 1.1% dividend yield and valuation is attractive.

While anxiety is on the rise in the current market environment, and some investors are making wholesale changes to their portfolio, we see long-term opportunity. Decisions we have made several months, or even years, ago allow us to be on our toes rather than our heels. Our sell discipline has allowed us to generate cash at opportune times, giving us dry powder to deploy into attractive buy opportunities today. Additionally, client portfolios have a diversified mix of asset classes, such as gold, domestic stocks, international stocks, bonds and cash. While we are not totally immune to a falling market, we have several assets that generated positive absolute returns year to date. We are cautious and concerned today, but we are also prepared and willing to take action when we see opportunity.

Secure Online Reporting

We are pleased to share with our clients and friends that we recently embarked on a mission to improve reporting to keep our clients even better informed on their portfolios. Our aim is to provide account information that is relevant, up-to-date and useful. We also wanted delivery of this information to be easily accessible and secure utilizing state of the art security.

With that in mind, our clients have been provided with their own secure online portal for daily account reporting. This new online reporting platform will not only allow users the ability to view accounts individually, but also in a consolidated manner (rolled up to total account position with market values).

In addition to the daily reporting module, the site will be able to house documentation (also called "vaulting"). This enables us to securely upload documents to our clients for their review; conversely, clients are also able to upload documents they wish to share with us. And finally, instead of us preparing and mailing large quarterly packages, we will now upload a single performance page per account.

This new daily online reporting is only the first stage of our commitment to this project. Starting in early 2012, we will continue to build out the variety of reports we make available online to include performance reporting on individual accounts. Eventually, our goal is to provide performance reporting on a consolidated basis. Most of the reports have hyperlinks to provide even more detail. For example, by clicking on some of the graphs, clients can retrieve specific information on securities. By clicking on securities, clients can retrieve position data, market data, and tax lot information.

We designed the site to be intuitive and user friendly. However, if you are a client and would like to view a tutorial that demonstrates how to navigate the site, please contact us. Tutorials are also available on the bottom of the welcome page when you log into the portal. We are very excited to provide these new services to our clients and we remain committed to delivering useful, relevant and comprehensive information in the most timely and convenient way possible.