CRESTWOOD ADVISORS

JULY 2010

Perspectives

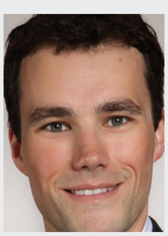
INSIDE THIS ISSUE

Crestwood Advisors Welcomes

Jill C. Kaufman

Jill is responsible for general support of daily operations, client service and administration at Crestwood Advisors. She earned a B.A. from Vassar College and is enthusiastic about beginning her career at Crestwood.

David R. MacDougall



As a member of the research team, David is responsible for originating research and investment recommendations. Prior to joining Crestwood Advisors, David worked as an analyst for TSC ratings, a division of TheStreet.com. David received a BA from Northeastern University and is a Level III CFA candidate.

Market Outlook

How quickly economic perceptions change! At the end of the first quarter, the stock market soared and Wall Street firms tripped over each other to raise their economic forecasts. Since then, U.S. economic conditions have weakened, the debt crisis in Greece has spread across Europe, growth has slowed in emerging markets (specifically China), and deflation has become public enemy number one at the Fed.

Fear of a second recession pushed the S&P down over 11% for the quarter, off over 16% from its April highs. Investors raced to bonds for safety, pushing yields down. The ten-year Treasury bond finished the quarter just below 3%. Though it appears that the markets are pricing in a "double dip" recession, the probability of this occurring is low (especially with the Fed willing to take aggressive actions again). The recent market declines are more reflective of the deceleration in the pace of economic growth over the last few quarters as opposed to signaling the beginning of a new bear market. Investors will have to adjust expectations and anticipate investing in a low-growth, more volatile environment for the foreseeable future.

As we have written for over a year, we believe that this recovery will be moderate and uneven given the challenges facing the U.S. consumer (approximately 70% of GDP is consumption-driven). A combination of a housing market that continues to struggle, high unemployment, deleveraging of consumer balance sheets and potentially higher taxes on the horizon will continue to keep consumer spending muted for an extended period. In addition, the benefits of the government stimulus package have generally been felt and it is now up to the private sector to drive the next leg of economic growth.

In light of the bad economic news capturing the headlines, we continue to find investment opportunities in the equity markets. First, corporate earnings have not fallen as much as the stock market results would have you believe. Several large U.S. companies, including State Street, 3M, and Novartis have already posted strong earnings results and we believe that we will see similar results from other industry leaders over the next few weeks. Over the last 18 months, corporations have restructured and, in turn, have lowered their cost structures. This action has led to robust earnings growth as well as strong cash flow generation and, on average, cash on US corporate balance sheets is now at 60 year highs at close to 13% of assets (Chart 1). With healthy balance sheets, companies now have the flexibility to either pay down debt, boost dividends, accelerate stock buybacks, increase capital expenditures and make acquisitions. Additionally, with the equity market decline and subsequent bond market rally, the 2.2% average dividend of the S&P is almost 20% higher than the 1.85% five-year treasury bond (Chart 2).

Broad stock market valuations are also relatively attractive, with P/E multiples 12-13 x 2010 earnings and free cash flow yields approaching 7%. Given existing fundamentals and the recent market declines, these valuations not only make equities attractive on a stand-alone basis, but also compared to other asset classes, especially fixed income.

As highlighted in the article on Crestwood Research in this newsletter, our disciplined analysis continues to unearth attractive investment opportunities trading at substantial

Continued

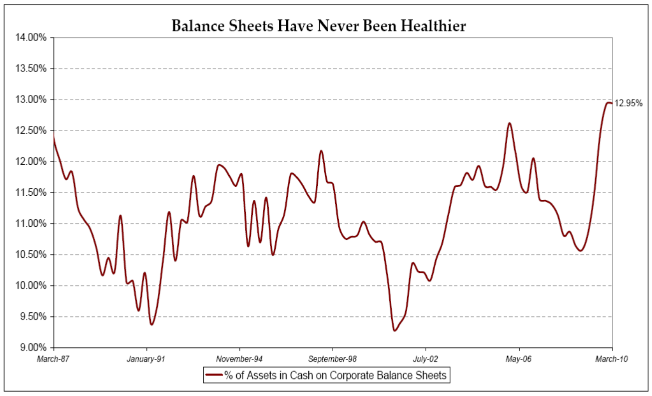
Market Outlook

discounts to their intrinsic values (and to the market as a whole). Additionally, given the vulnerable economy, the Fed will likely remain very accommodative, keeping interest rates low and providing ample liquidity. Finally, though not an indicator we watch closely, retail investors are extremely bearish, often a very bullish indicator. Importantly, we do not think equities are attractive because the economy is reaccelerating, but rather because current valuations are discounting an economic environment significantly worse than the one we are experiencing.

In addition to our large and mid-cap equity holdings, we believe excess returns will be generated by maintaining equity exposure to international markets, specifically emerging markets such as Brazil, India, Taiwan and even China. These countries are experiencing domestic demand growth, demographic growth, and are not constrained by budget deficits. Though the housing market and banking issues in China are troublesome, the central government is taking proactive steps to address the issues. Additionally, the Chinese market has fallen almost 30% from its November high, making the valuations attractive on both an absolute and relative basis.

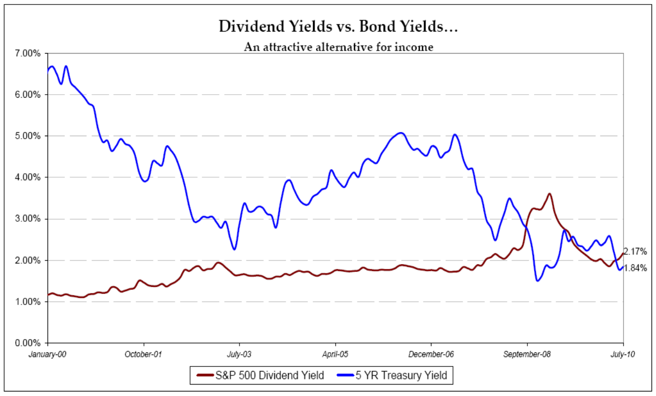
In light of the recent challenging macro economic data, it is clear that fighting deflation, not inflation, is the Fed's current battle. At the last Fed open market meeting, the committee reaffirmed that they would hold the Federal Funds rate at 0% to .25% for an extended period. Ben Bernanke, the Chairman of the Federal Reserve, also recently inferred that he was willing to restart the asset purchase program if necessary. Though we recognize that both actions clearly have broader negative economic consequences longer term (i.e. inflation), they will ensure ample liquidity in the markets which provides a more favorable backdrop for equities. Their actions also make it clear that there is little evidence that rates will rise in the near term. Given the level of absolute interest rates, we prefer not to lock up client capital in long-term, low-yielding US government bonds and prefer to position portfolios in higher quality short to intermediate corporate

Chart 1



and municipal bonds. We have also maintained our positions in both floating rate senior secured debt (ie. bank loans) and global bond funds to seek broader diversification and greater income. Since bank loans are priced off LIBOR and global bonds benefit from a declining dollar, both asset classes provide a cushion in a rising rate environment. Importantly, across our fixed income holdings we are willing to accept more moderate returns in the short-term to ensure we preserve principal. Our fear is that any whiff of inflation, sign of accelerating economic growth, or acknowledgment of our own potential evolving debt crisis will cause rates to spike rapidly, exposing those investing in long-term bonds to capital losses.

Chart 2



Ironically, the financial troubles in Europe led to a strong dollar as global investors sought safety in U.S. treasury bonds. However, this dollar rally will likely be short lived since the US is awash in debt and Washington is forecasting trillion dollar deficits annually for the next ten years. In spite of the comments recently made by the Group of 20 in Toronto to reduce spending, there is very little political will to take any substantive steps (especially in light of the persistently high unemployment). Therefore, the cost of financing these escalating deficits will eventually push rates higher as supply of new debt issuance overwhelms demand.

As for our gold holdings, we have always looked at this exposure as an insurance policy to protect portfolios during turbulent times. Gold proved to be a strong performer (up almost 12% in the quarter) despite ongoing geopolitical issues and the declines in global equity markets in the second quarter. In light of ongoing economic uncertainty, we continue to remain comfortable with exposure to this asset class.

Despite the mixed economic news and lack of visibility, we are comfortable that client portfolios are well diversified and defensively postured to weather any storm. Though we remain defensive from an asset allocation perspective, given valuations and alternatives, we believe it is appropriate to continue to use the present market volatility to gradually increase our investments in equities.

Crestwood Research: Balanced Long term approach

Discipline, patience, and conservatism are key elements of our investment process which continues to unearth attractive long term investment opportunities. A strict and balanced approach to risk management (capital preservation is first priority), as well as an emphasis on capital appreciation, are key drivers of portfolio construction and individual security selection.

Stocks leveraged toward an economic recovery (higher beta) have outperformed high quality (lower beta) stocks during the market rally that started in March 2009. As a result, many high quality businesses are trading at attractive valuations. We have been taking advantage of what the market has been offering and upgrading the portfolio by selling some stocks (Citrix Systems and Teva Pharmaceuticals) that have been strong performers but no longer meet our valuation criteria, while also adding some high quality businesses that should perform well regardless of the macro environment.

In addition, with Treasury Bond yields at a historic low, certain stocks represent excellent long term value versus bonds. This is especially true with regards to long term total return potential relative to inflation. We have recently purchased Wal-Mart and C R Bard in appropriate client accounts given their attractive valuations and future growth prospects.

We seek to manage risk in client portfolios via asset class diversification across non-correlating asset classes and by taking a balanced approach to equities through management of specific sector/industry exposures and individual position sizes. Risk is also constantly assessed and managed at all levels of the portfolio through deep fundamental research and analysis and a strict adherence to valuation discipline in the context of conservative assumptions about the future. Wal-Mart and C R Bard are good examples of our investment process and valuation discipline.

Wal-Mart, Inc

Wal-Mart (WMT) is a business we have been interested in investing in for some time because it is the industry leading low-cost provider in retail. Given our view of ongoing consumer deleveraging and the ongoing paradigm shift in consumer spending attitudes, we expect WMT to benefit in the years ahead.

WMT's business possesses an important combination of offensive and defensive characteristics: it's defensive because it sells items that people need (at the lowest available prices) and it is offensive because WMT should benefit from increasing consumer frugality as well as a significant international expansion opportunity.

Other investment characteristics that we favor in WMT include (a) predictability – WMT has not experienced an annual decline in revenues in the past 10 years (b) above average returns – consistent Return on equity of 20%+, ahead of competitors and the S&P (c) steady EPS growth – expected to be 10%/year for the next 3 years (d) competitive advantage – brand recognition as low cost provider and unmatched scale allows for sustained advantage (e) strong balance sheet and cash flows support a dividend yield of 2.5% vs. the S&P of just 2.1%.

Even though we have been interested in WMT for some time, we have been patient and disciplined, waiting for the market to give us an opportunity to purchase WMT for clients at the price where we view the stock as trading at a sufficient discount to our conservative view of fair value (an appropriate margin of safety).

Wal-Mart's P/E, Price to Cash Flow, and Price to Book value all represent historic low valuations for the company. In addition, WMT trades at a discount to the overall market versus a historical premium.

Given our expectations for WMT's future we think the valuation discount is unjustified. WMT's dividend yield of 2.5% is not only higher than the yield on the S&P 500 (2.2%), but is also significantly higher than the current yield on the 5 year treasury bond (1.8%). Unlike the Treasury bond, WMT is able to grow its yield. The company recently increased the dividend by 11%.

C R Bard

C R Bard (BCR) is an industry leading medical supplies business that generates strong returns and has an attractive product pipeline. The company has an excellent management team and a diversified revenue base that creates attractive and consistent long term organic growth prospects.

BCR has four main business segments consisting of Urology, Vascular, Surgery, and Oncology. The U.S. accounts for 68% of revenues and the rest of the business is international. BCR holds the #1 or #2 market position within virtually all of its product lines which predominantly serve niche markets. Future growth will be driven by increasing demand for medical supplies driven by aging baby boomers' increased medical needs, international expansion, and new product innovation.

Continued

Other investment characteristics that we favor in BCR include (a) predictability – BCR has consistently grown revenues over the past 10 years (b) above average returns – consistent Return on equity of 20%+, ahead of competitors and the S&P (c) steady EPS growth – expected to be 10%/year for the next 3 years (d) competitive advantage – brand recognition as market leader in BCR's niche markets (e) strong balance sheet (net cash position with $500 million) and cash flows support share repurchases and a dividend yield of 1%.

C R Bard is another good example of a quality business trading at an attractive valuation on both an absolute and relative basis. BCR's P/E, Price to Cash Flow, and Price to Book value all represent historic low valuations for the company. In addition, BCR trades at a valuation comparable to the overall market versus a historical 20% premium.

Given our expectations for BCR's future we think the current valuation offers a very attractive entry point for a high quality business.

Here Comes the Tax Man!

The purpose of this brief article is to provide you with an update of proposed tax changes that may likely occur beginning January 1, 2011. While we can never quite predict what our representatives in Washington will do between now and the New Year, we are confident that marginal and capital gains rates will rise for those couples earning $250,000 or more. If legislators do nothing at all taxes will revert back to pre-2003/2001 levels. With a current federal deficit standing at close to $13 trillion, this figure is close to 90% of our country's GDP and unsustainable.

Marginal Tax Rates

There will likely be no affect for those taxpayers in the low to middle income brackets (below $250,000 for couples/$200,000 for single filers). Those in the low-to-middle brackets will continue to pay 10%-28% rates at the federal level. However, for those couples earning greater than $250,000, tax rates will rise from 36% to 39.6% -- a nearly 10% increase.

Medicare & Payroll Tax Rates

Further increases are also expected under the healthcare bill to pay for costs expected to be $938 billion over the next 10 years. Beginning in 2013, this increase in Medicare tax is expected to be 3.8% when adjusted gross income (AGI) exceeds $250,000 for couples. This tax includes capital gains, interest & dividends, royalties, rent and annuity income. In addition, there will be an additional Medicare payroll tax of .9% applied to an already existing 1.45%. For those couples, again, earning greater than $250,000 per year, they could be experiencing a cumulative federal tax burden of 45+%!

Capital Gains & Dividend Rates

In 2011, investors should expect the long-term capital gains rate (those securities held longer than 365 days) to rise to 20% from 15%. Dividends on stocks are expected to rise from 15% to the investor's marginal tax rate which could be up to 39.6%.

What, if anything, can investors do to combat higher taxes? One, owning tax free municipal bonds for those investors in the highest tax brackets will continue to be imminently valuable. Second, investors with highly appreciated securities should strongly consider reducing those positions in 2010 if the long-term intention is to reduce this exposure. Lastly, any tax loss carry forwards realized in 2010 or earlier will have greater value in 2011 and beyond.