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CRESTWOOD ADVISORS

Perspectives

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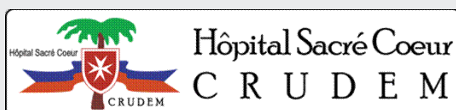

Crestwood Advisors has been familiar with the CRUDEM FOUNDATION for years and their mission to support and operate the Hospital Sacre Coeur in Haiti. The hospital is located in the village of Milot and is the only hospital in northern Haiti to provide quality healthcare to the sick and the poor regardless of religion, economic status or affliction. Though the hospital has only 64 beds, it provides care for 3,000 in-patient admissions annually.

Amazingly, the hospital survived the earthquake that devastated much of Haiti on January 12, 2010. The Hospital is one of the best prepared hospitals in Haiti and perhaps the only facility in the country right now equipped to meet the surgical needs of the most seriously injured in the Earthquake.

For further information, we encourage you to visit www.crudem.org.

Market Outlook

Deficit Spending: The Future is Now

What a year! Only nine months ago we were in the midst of a global financial meltdown threatening a depression and by year-end, all major equity indexes, both domestic and international, were up substantially for the year (the S&P 500 finished up 26%). Even though equity returns were positive for the year, they capped the worst decade for equities in history with the S&P 500 down approximately 10% for the period.

While we have begun to see signs of a recovery we fear that some of the positive data points may be causing a false sense of security. Those forecasting a V-shaped recovery appear to be interpreting improvements in some of the economic indicators as meaningful increases in investment by corporations and consumption by individuals as opposed to recognizing that these improvements are driven by secular increases in government spending. As an example, approximately 90% of the 2.2% GDP growth in the third quarter was attributed to stimulus packages.

Since 2000, the U.S. government has spent more than its revenue, creating annual deficits that have been financed by increasing the government's debt, which now stands at over $12 trillion. Though most have been aware of this problem, it has always loomed beyond the horizon and therefore, has not affected either government behavior or overall economic growth. However, with the recent expansion of government programs and obligations, the U.S. government is currently spending $1.70 for every $1 they collect and the 2009 deficit is expected to be over $1.4 trillion (or 10% of GDP). At this pace, the deficit could reach $20 billion in less than eight years.

The White House Office of Management and Budget anticipates that total government revenues in 2009 will be approximately $2 trillion, suggesting that the $400 billion interest expense will represent just under 20% of collections. Fortunately today's low interest rate environment means that the government is paying interest averaging only 3.25%. Regrettably, these low rates have been caused by factors likely to prove temporary (e.g. accommodative monetary policy driven by the global economic crisis) and the tide may already be turning.

In the midst of the financial crisis, there was great demand by investors and other governments around the world for short-term, safe investments like U.S. treasuries. Additionally, the Federal Reserve quickly reduced short-term interest rates to practically 0% and executed one-time purchases of more than $1.5 trillion worth of treasury bonds and mortgages to provide liquidity and hold rates down. Now, however, with investors slowly shifting money away from bonds and back into "risk" investments with better potential returns (both domestically and globally), demand for treasuries has begun to decline.

Additionally, China (the second biggest holder of U.S. Treasuries) has been hinting for a year that they plan to continue to diversify their reserves. With almost 20% of their holdings maturing in 2010, it appears that their diversification could occur faster than many expect.

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Market Outlook

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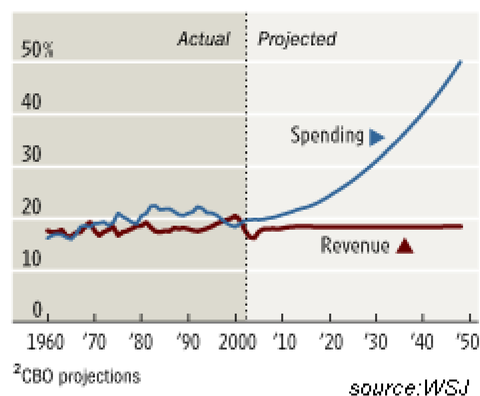
The Federal Reserve and central banks around the globe are facing a delicate balancing act between stimulating economic growth and avoiding creating an inflationary environment. With low capacity utilization, 10%+ unemployment, and a fragile housing and commercial real estate market, there is little evidence that the Fed will have to raise short term interest rates in the next few months. However, the Fed recognizes that the liquidity they have injected must be removed and replaced by private sector investment. The timing and transition process will pose its own risks.

It is clear that the market already anticipates these issues, since the yield on 10 year Treasuries has moved from 3.35% to 3.75% in the last several months and the spread between the long-term bonds and short-term notes are the widest on record. These rising rates will not only affect the ability of consumers and corporations to borrow (hence slowing a recovery), but also the interest expense that the government pays on its debt. If rates were to move up by an average of one percent, the interest expense line in the federal budget would jump close to $550 billion annually (or almost 25% of today's revenues). Compounding these problems over the past few years has been the Treasury's decision to issue bonds with short-to-intermediate maturities (the average maturity is 4 ½ years), as opposed to long-term maturities, creating an environment where they will not only have to issue new debt due to deficits, but also rollover existing maturities.

Most believe that the surge in spending in the last 18 months was necessary to respond to the financial crisis and avoid a deep recession, yet the actions have created a significant economic headwind. With little political will on either side of the aisle in Washington to reduce spending, a greater portion of government revenues will have to be directed to interest expense. Spending on Social Security, health care, education, and national defense will be reduced, or the government will be forced to borrow additional money (i.e. more deficit spending). At some point, the spiraling debt will create an interest bill many fear will only be paid by additional deficits. As the public starts to truly understand the enormity of the problem, the ongoing debate about the size and role of government will become more intense. It appears inevitable that we will be entering a period of higher taxes, declining governments benefits, and potentially slower real economic growth.

With this backdrop, we recognize that it is difficult to predict what shape the economic recovery will look like and we therefore remain cautiously optimistic. We believe that, over time, the headwinds will be bearish for bonds and more bullish for equities and commodities. We also acknowledge even after the strong returns in 2009, equities over the short-term could continue their recent advances driven by liquidity, corporate cost cutting, low short-term interest rates, a weak dollar, and reemerging, though fragile, consumer spending.

Today, the low interest rate environment remains challenging for income-oriented investors. For the reason outlined above, cash and US Treasuries remain unattractive investments though other fixed-income sectors appear likely to generate positive, yet modest, returns. We continue to invest in high-quality short-to-intermediate municipal and corporate bonds given that they offer attractive relative yields and the shorter maturities mitigate inflation risks and provide reinvestment flexibility. Additionally, municipal bonds will offer added benefits by shielding income as structural government deficits eventually lead to higher tax brackets. Finally, other fixed income investments, including bank loans and international bonds, will continue to offer attractive, though perhaps more historically "normal" returns. We have made small investments in inflation protected securities and we will continue to monitor the opportunities in that market.



In the face of rising interest rates and global demand, commodities will likely continue to offer attractive returns. Specifically, emerging market regions like China should spur consumption as raw materials, food and energy supplies are still inadequate. Additionally, though gold finished up 24% in 2009, its movement over the last few years is hardly a bubble in the making. With inflation on the horizon, we believe that there is additional upside and we will become more cautious when there are signs that the government has changed its policy on printing money.

As the following article on our investment process describes, our disciplined fundamental approach to identifying equity investments is focused on growth, profitability and valuation. While the market rally of 2009 has made it more challenging, we continue to find attractive ideas in consumer staples, health care, and technology and remain cautious of industries tied to discretionary consumer spending. We continue to complement our equity holdings with exposure to international markets that have provided non-correlating returns driven primarily by stronger GDP growth. Additionally, though the U.S. dollar could rally short-term depending on the US recovery, longer-term we believe returns on international investments may benefit from further dollar depreciation against emerging and resource-rich nations.

In Search of Value

"If you understand a business – if you can see its future perfectly – then, obviously, you need very little in the way of margin of safety. Conversely, the more things that can happen, the more uncertainty there is, the more vulnerable the business is or the greater the possibility of change, the larger the margin of safety you require…" (Warren Buffet on the "margin of safety".)

After a 70%+ rally in U.S. equities since the market bottom in March, the stock market is no longer an abundant source of bargains. We have remained disciplined and patient with our investment process and, especially in today's uncertain yet recovering economic environment, we continue to take a relatively conservative view of future cash flows as we value businesses for possible investment. Despite the broad appreciation in global asset prices and our cautious views, we continue to unearth what we believe are attractive long-term investment opportunities.

Our Process

We look to invest in industry leading, high quality companies that possess a degree of visibility into the long-term growth of their businesses which is supported by identifiable secular drivers. Other characteristics we desire include a strong balance sheet and robust free cash flow generation (self-funding businesses), a sustainable competitive advantage, and strong or improving returns on invested capital.

Our approach marries quantitative and qualitative analysis to find compelling value across all sectors of the global equity market. Investments are made when the stock is trading at a meaningful discount to our view of intrinsic value per share.

Drilling for Opportunity in the Energy Sector

One example that highlights our approach was our investment in gas drilling company XTO Energy Inc. XTO is a company we identified in early 2009 as an excellent business with attractive fundamentals, but the valuation at that time was about 15% above what we were willing to pay to satisfy our margin of safety requirement.

We remained patient given our estimate of valuation and were eventually able to take advantage of a subsequent 18% correction in the stock price from the time of our original work and our initial purchase of XTO stock was made during mid 2009 when the stock was trading at a more attractive 30% discount to our view of intrinsic value.

Last month energy industry giant Exxon Mobil revealed that it too had identified value in XTO when it announced its intent to acquire XTO for $51.69 per share. The offer price is right in line with our view of intrinsic value for XTO and represents a 44% premium to our original purchase price for the stock.

Opportunities With a Struggling Consumer

Although we continue to believe that the multi-year profligacy of the American consumer is not likely to be repeated for many years, we recently identified an attractive investment opportunity within the Consumer Sector that we added to portfolios in September of 2009 – DirecTV (DTV).

DTV is a leader in the Pay TV industry with 18.3 million U.S. and 4.1 million Latin American satellite subscribers. It is also the fastest growing Pay TV provider in the U.S. and continues to take share from the cable companies. The company has a great long-term track record of creating shareholder value (102% return since 12/03 versus S&P 5% return during that period) as management has grown the business prudently and profitably: returns on capital and free cash flow have both more than tripled over the past 5 years.

DirecTV's business possesses a unique combination of offensive and defensive characteristics that have enabled the stock to outperform in both strong and weak equity markets. DTV's offensive nature is a result of continued strong growth which is driven by opportunities for new subscribers (market share gains), Latin American growth opportunity, higher pricing, and additional services.

Cash flow visibility is a result of the subscription based nature of its customers and we consider DTV a defensive business because consumers don't typically cancel Pay TV services outright during a recession. (DTV revenues grew about 9% in 2009.)

Valuation is attractive and we have been able to purchase shares at a 30% discount to our view of intrinsic value which provides us with a comfortable margin of safety. Importantly, management has a strong record of returning capital to shareholders as they have repurchased 30% of shares outstanding between 2006 and 2008 and we expect they will continue to repurchase billions of dollars in stock over the next couple of years. Given the strong competitive position and growth profile, along with a pristine balance sheet and robust cash flow generation we believe DTV is a strong takeout candidate as well.

Crestwood Equity Portfolio

As a result of our disciplined investment process, our equity portfolio is comprised of investments in high quality businesses that trade at discounts to our view of intrinsic value.

In Search of Value

Continued

In aggregate, our portfolio holdings are cheaper than the broad stock market (e.g. S&P 500) on various valuation metrics (P/E, free cash flow yield) on both an absolute basis and relative to historical measures.

We take comfort in this, particularly given our confidence in the cash flow visibility and predictability inherent in our investments versus the volatility and lack of earnings visibility for many of the companies that comprise the S&P.

In addition, we believe that the quality of the businesses we own is higher than the average for the S&P as measured by much lower debt/capital ratios and higher free cash flow yields. On top of this, the return on capital for our portfolio companies is more than twice the return on capital for the S&P in aggregate.

Planning Changes for 2010

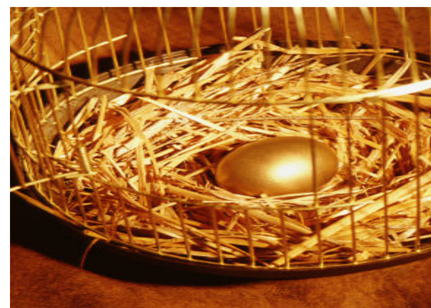
Retirement Plan Contribution Limits

In 2010, the traditional IRA contribution limit is $5,000 and the catch-up provision for individuals over 50 is $1,000. The deductible phase out for traditional IRAs for single filers is $56,000 to $66,000 and for married couples filing jointly is $89,000 to $109,000.

For Roth IRA holders, the phase out for single filers is $105,000 to $120,000 and for joint filers is $167,000 to $177,000.

One of the most significant planning changes for 2010 is the option to convert certain IRAs to Roth IRAs. The adjusted gross income limit of $100,000 is waived for Roth IRA conversions, giving greater access to this provision to higher income households. This can be a complex decision and we invite you to include us in conversations alongside your accountant before you decide to move forward. For SEP IRA holders, the contribution limit for 2010 is $49,000 with maximum includible compensation capped at $245,000.

Maximizing elective deferrals in your 401(k), 403(b), or 457 plans will allow individuals to take advantage of matching employer contributions. Many investors either reduced or cancelled this form of savings due to the market performance over the last few years, missing out on potential employer matching along the way. For 2010, the elective deferral limit is $16,500 with an additional catch-up provision for individuals over 50 of $5,500. Some employer – sponsored plans include a Roth IRA feature. In the Roth plans (unlike the Roth IRA) there are no phase out limits for high earners, and after tax contributions came be made which will grow tax free for your retirement.



Gifting

For 2010, the annual gift tax exclusion limit is $13,000 and individuals can gift this amount to an unlimited number of individuals without incurring gift tax on the transfer of ownership. A married couple will be able to gift up to $26,000 to any one individual under this provision. This annual gifting exclusion also applies to contributions into college saving 529 plans. The 5 year forward gifting provision is still in effect.

Estate Tax

The estate and generation skipping taxes are currently scheduled for repeal in 2010. Since estate taxes can reach as high as 45%, real money is at stake for both investors and the government. We expect to see a change in the current law and a possible extension of the 2009 level of $3,500,000 for estate and generation skipping tax and $1,000,000 for the lifetime gift tax exclusion through 2010. After an agreement is reached in Congress it makes sense to meet with your attorney to see if adjustments to your plans should be made given the proposed changes.

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