CRESTWOOD
ADVISORS

JANUARY 2011

Perspectives

INSIDE THIS ISSUE

Crestwood Advisors' Philanthropic Commitment

Bridge Over Troubled Waters

Bridge Over Troubled Waters' mission is to enable high-risk, runaway and homeless youth to achieve a healthy and productive adulthood through prevention, intervention, and education services. Serving 2,433 youth ages 14 – 24 each year, Bridge offers a comprehensive range of health, career and housing services. Bridge is the only agency in the Boston area to provide a continuum of age-appropriate services.

Bridge can help with basic survival services such as food, healthcare and a safe place to go to get off the streets. Additionally, the agency offers transitional living services for homeless youth that emphasize responsibility, personal growth and communication.

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

Market Outlook

What a year! The Dow finished up 13.5% while the S&P finished up almost 15%. While the end result was impressive, the returns were far from linear. The S&P started the year up over 10% through March, declined over 15% through July, and recovered up over 20% through December. Hence, for most investors it has only recently felt like a good year. Bonds also delivered positive returns, with the Barclays Government Credit index up 6.6% for the year, despite experiencing a 2.2% decline in the 4th quarter as interest rates rose.

Economic Update

Though recent economic data offer hope that the US economy is beginning to regain some momentum, we are wary of media highlights that these data are early signs of a strong economic recovery. With high unemployment, housing struggling, and consumers reducing debt, we see economic growth in 2011 as moderate at best. At this point in an economic cycle, the economy should be experiencing sustainable growth in the mid-single digits. What many investors (and policy makers) don't emphasize is that the economy needs GDP to grow at least 3% to begin to reduce unemployment and absorb some of the excess industrial capacity. It is clear that the fragile housing market will take years to recover because of significant excess inventory and the recent rise in mortgage rates. Recent data has shown improved consumer spending, yet after this recession, most consumers are trained to be selective and not pay full price. It is encouraging to see upticks in the sales data, but after 25 years of expanding credit card debts and big mortgages, it is likely that the US consumer will remain in "deleveraging mode" for years and saving rates will move back to historical averages (see chart on page 2). Since over 70% of US GDP is driven by consumption, it is difficult to correlate these challenges with the belief that we are in a strong and sustainable economic recovery.

Importantly, it is not all bad news as GDP is improving. Though not dramatic, recent unemployment claims have improved, inventories are replenished, business spending is gradually improving, and the Federal Reserve has held down short-term rates to provide ongoing liquidity. Additionally, the recently agreed-upon tax cuts provided not only clarity for two years but also included a one-year reduction in payroll taxes which should provide some ongoing stimulus.

Given this backdrop, we are finding attractive investment opportunities in high quality, globally positioned companies and believe they offer attractive return potential, relative to other asset classes. Over the last two years, these corporations have aggressively cut costs and increased productivity, which has led to attractive margins and strong cash flows. The average S&P company now has over 12% of its market cap in cash. With these strong financial positions, we believe that companies will continue to buy back shares, raise or initiate dividends, invest in plant and equipment, and remain acquisitive. Specifically, we are finding values in consumer staples, insurance, and technology and see greater risks in consumer cyclicals, real estate, deep cyclicals, and lending banks.

The low yields from cash and bonds have encouraged investors to reallocate to more risk oriented assets, including equities, to seek higher returns. This increase in equity demand, combined with some positive economic data points, drove much of the end of year market

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Market Outlook

rally where almost ½ of the S&P's return for the year came in the month of December. Our concern is that much of this recent performance has been driven by overly optimistic investors pushing valuations in anticipation of earnings acceleration (i.e. the trailing P/E of the market is now above 16x). With overall profit margins close to prior cycle peaks, significant top-line revenue growth must be forthcoming to sustain this rally. Importantly, even though market valuations appear rich, we are finding interesting investments with strong free cash flows and compelling valuations. We are comfortable that our equities will not only participate in any market growth, but will also weather any continued volatility or possible market corrections.

International Exposure

While the developed world struggles to attain mediocre GDP growth, the recovery in emerging economies is underway. Therefore, we tactically increased our allocations to these countries throughout the year by adding to our exposure in emerging market equities and fixed income. Even with strong 2010 performance, most emerging markets continue to trade at valuation discounts compared to developed markets. Though we are sensitive to the fact that policy makers in a number of these countries are shifting from encouraging growth to restraining inflation, we are convinced that return opportunities remain favorable. Though China still remains a component of our international exposure, we are more concerned with the increasing risks in their banking and real estate markets and, therefore, have tactically shifted some of our exposure to other emerging markets including Brazil, Taiwan, and India.

The economic troubles in Europe have been advantageous to the dollar, at least in the short term, and have deflected the focus from similar structural problems in the US. The European debt crisis is far from solved and economic growth (away from France and Germany) will struggle in the face of broad deficit problems and untested austerity measures.

Real sovereign yields in the US remain low despite a growing federal deficit (outstanding treasury debt is now over $14 trillion). It is only a matter of time before investors will demand higher yields to be compensated for funding these deficits (similar to what is occurring in Europe). While almost all of the European countries are slashing government budgets, the US just passed another stimulus bill (i.e. the tax bill) which will add another trillion dollars to the deficit. Though the debt reduction commission has presented some promising, though controversial, suggestions, there appears to be little political will to move forward in any bipartisan way. Given the sacrifices that will be required by so many, hard political choices will probably not occur until real economic pain is upon us (possibly in the form of much higher interest rates, a collapsing dollar, or a tax increase that is universally unacceptable). We also fear that there is a sense of complacency as it pertains to higher interest rates in the future. Since the "published" inflation data remain benign and the Fed is artificially holding down short-term rates, investors sense that there will be plenty of time to sell their long-term bonds and mutual funds before real rates rise. Ironically, and surely to the surprise of the Federal Reserve, the ten year Treasury Bond Yield moved from 2.39% to 3.53% between October 7th and December 15th. Though this doesn't seem significant given the absolute level of yields, it resulted in over an 8% principal loss for investors.

Personal Saving Rate

%

	1.	2.
1.	1950's	7.9
2.	1960's	8.3
3.	1970's	9.6
4.	1980's	8.6
5.	1990's	5.5
6.	2000's	3.2
7.	December 2007	2.3
8.	June 2008	4.8
9.	December 2008	5.7
10.	June 2009	6.7
11.	December 2009	5.8
12.	June 2010	6.3
13.	November 2010	5.3

Source: Bureau of Economic Analysis.

We are shying away from high yield bonds, as we don't believe that investors are appropriately compensated for the risks given the current spreads over treasuries. Investor demand for higher yielding bonds has encouraged record issuance and allowed companies to loosen traditional covenants, both historically signs of a market top. We favor senior secured floating rate debt (ie. bank loans) for their relatively high current yields, strong position in the capital structure, and their ability to protect investors from rising rates. Additionally, in the short-term, higher quality municipal and corporate bonds offer attractive relative returns (see the municipal bond article in this newsletter for more specifics). Finally, Treasury Inflation Protected Securities (TIPs) remain interesting though they are currently discounting inflation over 2% so we have been cautious in adding to positions.

Although there is speculation in the commodity markets, much of the recent price appreciation was driven by improvement in global demand combined with shortages in supply. Persistent high unemployment and low capacity utilization historically have kept inflation in check. Raw materials such as food, oil, and metals continue to rise globally, leading to price increases for consumers. Though this inflation isn't showing up in government statics yet, it is clearly showing up in household budgets.

We view gold as an insurance policy in portfolios since it

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tends to perform well during periods of political and economic uncertainty. We also view gold as a currency with a constrained supply which should allow it to appreciate as central banks continue to debase their currencies and gradually destroy their purchasing power.

Though 2010 was a good year for the capital markets, as witnessed by the enormous gyrations throughout the year, it was a challenging year to predict their success. Many of the economic and structural uncertainties which existed last year still persist, making investment decisions based on economic forecasts very difficult. We remain disciplined as investors and confident in the diversification and posture of our portfolios as we enter 2011.

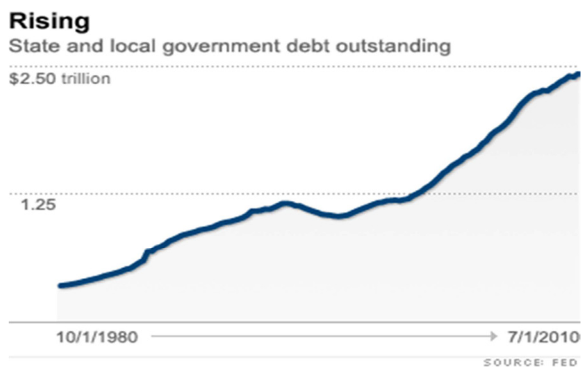
The Municipal Bond Market: Rumors of Death are Greatly Exaggerated

Shaky municipal finances across the country have led to a wave of bad press for municipal bonds over the past few months. Prominent banking analyst Meredith Whitney was recently on 60 Minutes projecting unprecedented defaults in 2011 totaling into the hundreds of billions of dollars, far in excess of the previous record of $8.2 billion set in 2008.

The rationale behind these grim default numbers comes from the massive spending needs that states are facing created by deferring billions of dollars of pension and health-care funding costs into the future, creating a mammoth deficit between what is owed and what is actually saved for public-sector workers. This liability will increasingly come due as baby boomers retire. The case for default assumes that states begin to deal with this problem rather than kicking the can down the road for a few more years. These projections are understandably alarming for investors holding municipal bonds in their portfolio; however, it is important to understand that there are a wide range of municipal bonds and not all were created the same. While defaults may occur in 2011, the types of municipal bonds that would most likely default are vastly different than the type of municipal bonds purchased by Crestwood Advisors for client portfolios.

Since the primary goal of holding municipal bonds is to achieve a stable stream of tax-exempt income, we are very sensitive to risk when selecting securities in which to invest. As a result, we hold highly rated essential purpose revenue and general obligation (GO) bonds, which are the highest priority bonds for the issuing body and therefore are the first to receive payment. Due to this strict discipline the average municipal bond we hold carries an AA credit rating, implying that the issuing municipality is in good financial shape.

Even under the nightmarish scenario of hundreds of municipal issues falling into default, it is highly unlikely that these types of bonds would default. While lower quality issuers such as Illinois and California which have the lowest credit ratings of all state governments, will certainly feel strain, defaults will most likely be focused among special purpose revenue bonds. Such bonds are often linked to a specific revenue stream such as a fuel tax or collections on a toll road and are therefore more closely tied to the state of the economy than GO bonds. Even still, at-risk states such as Illinois and



California have tools at their disposal which make their default risk far smaller than many make it seem. A default at the state level is unprecedented in the post-1930s world and state governments will certainly take heavy evasive actions to avoid breaking that streak. The consequences of a default are too great for any government, no matter how divided, to allow.

After a default the offending municipality would be cut off from the bond market, making operation nearly impossible. With most debt service requirements comprising only a few percent of most state budgets the price of default greatly outweighs the cost of servicing the debt. Before a state allowed a default to happen it would certainly raise taxes, sell assets and cut expenditures until a balanced budget was achieved.

In a recent report by Moody's, the agency calculated that a 2 percentage point increase in Illinois state income tax could essentially close the state's $13 billion 2011 budget gap. That would mean that the state income tax would increase from a 3% flat rate to a 5% flat rate, only slightly higher than the lowest state income tax bracket in neighboring Wisconsin,

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and well below the rates charged in New York and California. Recently, the Illinois State Senate decided to do just that, voting to increase the state income tax by 67%. This action in the face of a massive budgetary shortfall is exactly why widespread defaults are unlikely for municipalities that have the ability to raise taxes, sell assets and cut spending.

Taking tax hikes further could do even more for highly indebted states. By increasing the Illinois state income tax rate to 5.3%, the flat rate charged in Massachusetts, Illinois could theoretically bring in about a $2 billion surplus, which could erase the states accounts payable balance in four years.

Since a default at the state level is very unlikely due to their abilities to raise taxes and slash spending, the defaults that Ms. Whitney projects must come from other portions of the municipal bond market. Defaults could exist among non-profit organizations that borrow through the state in order to access the vast pool of liquidity in the tax-free municipal market. These borrowers are institutions like schools, hospitals, or nursing homes which can default on their own without the state or local government falling with them. While these count as municipal bond defaults, they are very different than a GO bond default.

Other likely candidates for default are smaller communities since they do not have the ability to raise taxes as effectively as states. Towns that have been hit hard by the housing bust will likely be hurting due to lost property tax revenue and could therefore be primed for a default. Communities facing these problems are a far more speculative investment than we are comfortable with for this part of a portfolio which is supposed to be stable.

Although Massachusetts has its own budgetary problems, it is in far better standing than many other highly indebted states. Many of the Massachusetts bonds we hold are issued by affluent cities and towns in the state with a stable tax base and no imminent threat to their finances such as Wellesley, Andover, Newton and Weston.

Regardless of the relative safety of the issuances we hold there are likely to be unrealized losses as liquidity in the market dries up. This is due to fears about default and widening spreads. It is important to remember that unless we sell these bonds, or they actually default, investor's losses are only paper losses, meaning that there is no permanent impairment of capital.

Since the goal of these investments is income rather than price appreciation, temporary unrealized losses won't feel good but will not impact the long run performance that was anticipated when the investment was made. As long as investors hold these bonds to maturity and there is no default, then the return on the investment will be equal to yield on the bond when it was purchased.

The headlines are scary and 2011 may bring a lot of volatility in municipal bond prices, as defaults occur in the weakest parts of the market. However, due to our defensive approach, clients should feel comfortable about the safety of their investments.

2010 Tax Act: A Primer

In the final days of 2010, Congress passed, and the President signed into law, several significant tax initiatives. Among the tax laws approved were a continuation of the Bush Tax cuts that were enacted in 2001 & 2003, but there were also enhancements.

Firstly, federal marginal tax rates for all taxpaying Americans will remain the same for 2011 & 2012 as they were in 2010. Marginal tax rates currently range from 10-35%. In addition, the federal capital gains rate will remain at a very attractive 15%.

Secondly, the gift exemption has been favorably adjusted. Before 2010, when there was zero federal estate tax, the estate tax exemption was $3.5 million. In 2011, it is $5 million per spouse or $10 million per couple and indexed for inflation in 2012. The law also includes a provision of portability. This means that a surviving spouse may add the deceased spouse's unused estate tax exemption amount (as reduced by lifetime taxable gifts) to the surviving spouse's own federal estate tax exemption amount. Any estates over these amounts will be subject to a flat 35% estate transfer tax.

While it is uncertain what type of tax reform will occur over the next 24 months, it is our view that the presently favorable tax environment will not continue post 2012. We believe it is important to review all present tax opportunities with an accountant and take advantage of the opportunities as appropriate to each client circumstance.