CRESTWOOD
ADVISORS

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Perspectives

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Market Outlook: Sustainability Concerns

During the first quarter of 2011, numerous economic and geopolitical events threatened to destabilize the world's economies and investment markets. The sweeping revolutions and civil wars in the Middle East and North Africa, the tragic earthquake, tsunami and ongoing nuclear disaster in Japan, continued financial problems in the European Union and skyrocketing oil and food prices across the globe were all individually threatening and collectively, potentially disastrous.

Despite these obstacles, investment markets were remarkably resilient during the quarter. The Dow Jones Industrial Average added 6.4%, which was the largest first-quarter gain in 13 years and its second largest Q1 gain ever. This moved the DJIA almost 90% higher than its lows in March 2009. Similarly, the S&P 500 was up 5.9% and the Nasdaq index rose 4.8% in Q1, bringing the gains off their March 2009 lows to 96% and 119%, respectively.

The bond market stabilized a bit following the spike in interest rates in Q4 2010 but bond yields continued to drift higher. The yield on the benchmark 10 year U.S. Treasury Note rose from 3.29% to 3.74% in February before settling down to end the quarter at 3.47%.

Rising stock prices and climbing interest rates during Q1 continued the trend from the start of the fourth quarter of 2010 as the Federal Reserve kicked off the second round of so-called "quantitative easing" (QE). The $600 billion QE2 was intended to stimulate the U.S. economy by essentially printing money and followed the earlier $1.3 trillion QE effort that came to an end in March 2010.

At the very least, these stimulus efforts have stabilized the U.S. economy and led to modest gains in growth and employment. The Commerce Department recently revised Q4 2010 GDP growth higher to 3.1%, and many economists are suggesting that GDP growth will accelerate in 2011. While millions of people are still looking for work, the Labor Department reported a better than expected 216,000 new jobs created in March and revised higher the jobs created in February and January. New claims for unemployment have fallen recently and the unemployment rate has declined in each of the past 4 months to 8.8%.

Despite these positive developments, the economic recovery remains fragile. Housing prices have begun to stumble anew and the Case-Shiller composite of the 20 largest cities is within a couple percent of its low in May 2009. While job growth has improved, some of the gains are the result of statistical adjustments and some of the fall in unemployment has been the result of people simply leaving the workforce. Millions of people remain under-employed and wage gains remain virtually non-existent, making the rising food and gas prices especially painful. These factors have dragged down consumer confidence and led to slowing retail spending towards the end of Q1.

What Happens After QE2 Ends?

With this mixed picture for the economic recovery, the scheduled end of QE2 in June looms large. Soon after the first QE ended in the Spring of 2010, the stock market began

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Crestwood Advisors Welcomes

Roy D. Treible

We are pleased to announce that Roy D. Treible joined Crestwood Advisors in March 2011. Roy's primary responsibilities include managing the firm's SEC compliance, operations and technology infrastructure.

Prior to joining Crestwood, Roy was a Partner and Chief Compliance Officer/Chief Information Officer at North American Management Corp. in Boston. Roy earned a BA from the John Jay College of Criminal Justice, and an MBA from Pace University's Lubin School of Business. He currently sits on the Finance Committee for the Town of Chelmsford.

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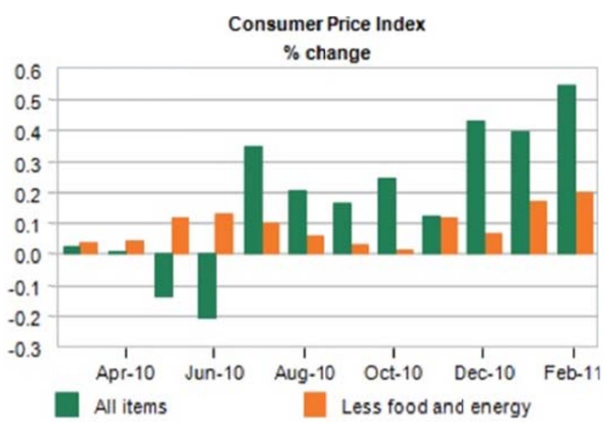
Market Outlook

to stumble and eventually fell 15% from April to June of last year amid talk of a double-dip recession. It was only after the Fed hinted at plans for another round of stimulus in late summer 2010, that the stock market began to recover. The rapid ascent of stock prices since last fall has led broad stock market valuations higher and, in our view, has increased the vulnerability of many stocks should the economic recovery not be self-sustaining once QE2 has stopped.

Inflation Looming?

In the meantime, increasing demand resulting from the recovering global economy has led to a sharp rise in commodity prices and renewed fears of broader inflation. Since the start of QE2, the consumer price index (CPI) is running at over 5% on an annualized basis.



Source: www.economy.com

Producer prices have also risen sharply and are up almost 40% in the past six months. This essentially signals future inflation as companies have to choose between protecting market share by absorbing rising costs or risking market share to protect margins by raising prices. Despite the struggling consumer, many companies are trying to raise prices to offset at least some of their rising costs. Companies like Kimberly Clark, Hershey's, Colgate, Proctor & Gamble and others have all announced prices increases of 5-7% in the past few weeks. This was no doubt the reason that Wal-Mart's head of U.S. operations was quoted as saying that they believe that inflation is "going to be serious" later this year.

So far, the Fed seems unconcerned by the rising costs of everyday budget items for most households (i.e. food, gas, consumer staples) and has insisted that "core" inflation (that is without the impact of food & energy costs), is well contained and not a threat to the economy. In a March 11th public Q&A session, New York Fed President William Dudley awkwardly showed just how tone deaf the Fed seems to be when said how the new iPad2 is an example of the lack of inflation since it was released with many more bells and whistles yet was available for the same price as the lesser-featured original iPad. This led one audience participant to sarcastically highlight how he could not eat an iPad!

Impact on Profit Margins

These inflationary pressures are adding to our concerns about the sustainability of corporate profits. Over the past few years, corporations have aggressively reduced costs, largely through layoffs and deferring capital spending. As a result, earnings growth has been strong and profit margins are near record highs.

Rising costs threaten these margins and especially in the current tough economic climate, most companies simply cannot raise prices fast enough to offset the rising costs. We met with a client recently who runs a successful manufacturing business north of Boston and cotton is his largest raw material. Cotton prices have recently hit record highs of over $2.25 per pound, which is up 40% over the past few months and up over 170% in the past year. This client is one of the fortunate business people to be able to raise prices but even with a recent price increase of 20%, his profit margins will no doubt decline given the spike in one of his largest input costs. Already, companies such as Nike, Federal Express and Delta Airlines have cited rising commodity and other costs as factors in disappointing earnings results.

The ongoing tragedy in Japan could further threaten the profitability of some companies. Not only will there be at least a short-term drop in demand coming from the world's third largest economy but there will likely be an even bigger impact from the disruption in the supply chain for electronic components and other goods. Sony makes 10% of the world's laptop batteries and manufacturers in Japan produce 30% of global flash memory, 20% of semi-conductors and 40% of electronic components. Fears of scarcity of these items have already driven prices higher, erasing the benefits to profit margins from their previously falling prices. Likewise, parts

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shortages have led automakers from around the world to shut down production lines, which will likely negatively impact future GDP growth.

So What Are We Doing?

With current stock market valuations implying continued robust profit growth and the end of QE2 drawing near, falling profit margins are indeed a big concern and something to which we are paying close attention. We have been building declining profit margins into our scenario analysis for the companies we're considering for purchase and we continue to insist on a wide "margin of safety" to our estimate of intrinsic value given the uncertain path of the evolving recovery. We remain biased towards finding attractively valued companies with global revenue sources, achievable earnings growth, unencumbered balance sheets and the opportunity for dividend growth. With significant problems remaining in both residential and commercial real estate and our views of ongoing challenges for consumers, we continue to avoid money center lending banks and those businesses we deem too dependent on the resurgence of consumer spending.

We strive to broaden exposure to the faster-growing emerging markets, with a particular emphasis on Asia (ex-Japan) and Brazil. While the pace of economic growth will ebb and flow, it is our belief that the tide of industrialization and rising middle class consumerism in many emerging economies is long-lived and irreversible, providing a terrific long-term growth opportunity.

We continue to position bond portfolios to protect against the ongoing threat of higher interest rates. This includes not only emphasizing shorter-duration portfolios but also maintaining exposure to floating rate bank loans and non-dollar international and emerging market bonds, both of which are likely to continue to benefit from rising rates and a weakening U.S. dollar.

In sum, while we are encouraged by the stabilizing U.S. and global economy, we are concerned about sustaining current valuations given the risks of eroding profit margins and the ending of the QE2 stimulus. Therefore, we continue to pursue a diversified portfolio strategy, preferring to remain fairly defensive in structuring portfolios and in our analysis and evaluation of individual companies.

Care Free Attitudes: Opportunities and Challenges

The S&P 500 is up almost 100% from its March 2009 lows, US private employers added over 226,000 jobs during the month of March 2011 and optimism about the US economy and corporate profits has returned. The past several months have been good, if not great, for stocks, and it has led to an almost care free feeling on Wall Street. For many, the financial crisis of 2008-2009 is a distant memory and permanent lessons from that incredibly challenging time may be few and far between.

One of the most remarkable aspects of the two year rally for the S&P 500 has been the lack of a meaningful correction. The only pull back of 15% or more came during the April 2010 to July 2010 time frame. Other than that, the move has largely been straight up. However, the S&P 500 is still over 10% below its peak in early 2000. This is stark reminder that valuation (the S&P 500 was trading at close to 30x trailing earnings in early 2000) is one of the most critical aspects to generating positive absolute returns in the stock market.

As the S&P 500 valuation has moved up, the prospect for strong absolute returns has decreased. In a presentation recently released by Grantham, Mayo, van Otterloo (GMO), entitled "Waiting for the Fat Pitch, or, the Joy of Cash" (February 2011), GMO cites its expectation for mediocre returns for the broader stock market over the next seven years. This reflects above average valuations and a market that is reflecting an optimistic outlook.

As the recent tragedy in Japan and the ongoing hostilities in the Middle East have proven, the future is always uncertain and likely to come with its share of challenges. If GMO is correct, future returns for the S&P are likely to be challenging and investment decisions made today should come with a fair amount of caution. While we approach the current market environment with a large degree of caution, we continue to find some attractive investment prospects. Two of the more attractive investment opportunities today appear to be in high quality US equities and emerging market equities. High quality US equities are attractive due to healthy growth prospects, strong balance sheets, above average dividend yields and impressive free cash flow. Many of these high quality names trade at multiples well below the S&P 500, despite historically trading at healthy premiums (typically around a 20% premium). Emerging markets are compelling as valuations are attractive from an historical perspective, growth prospects are sound and balance sheets are healthy.

Specific examples of high quality US equities are Johnson & Johnson (JNJ), Exxon Mobil (XOM), Travelers (TRV) and Microsoft (MSFT). Despite the fact that these companies generate very high returns, the stocks are trading at discounts relative to the S&P 500 and historic levels. In emerging markets, Brazil, China and Korea are trading at substantial discounts to the US and select developed markets.

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We have recently added modestly to our position in VWO (Vanguard Emerging Markets ETF), and believe the long term prospects for our emerging markets equities positions are favorable (direct exposure to Brazil through GML, direct exposure to India through EPI and diversified exposure to emerging markets through VWO and DEM).

While a rising market environment makes it more difficult to find high quality stocks that adhere to our valuation discipline, we have found some new opportunities in 2011. John Wiley & Sons (JWA) is a global publisher of print and electronic products, providing content and digital solutions to customers worldwide. JWA owns a significant amount of the content it provides, and is in the early stages of converting this content from written (lower margin) to digital (higher margin). JWA has been trading at valuation levels well below historic averages. Whirlpool (WHR), another name we recently purchased, is the world's leading manufacturer of major home appliances. WHR is a market leader, generates nearly half of its revenues outside of the United States, has strong returns and trades at levels well below its historic averages.

While we continue to find some high quality investment opportunities, we remain cautious with regards to the risks we can see and are aware of the risks that we cannot see. While we believe our discipline and patience will reward us in the near term, we are confident our approach will generate superior long term returns.

2010 Gift Tax Changes

The historic tax legislation signed in December allows a temporary gift-tax exemption for $5 million (from $1 million) for individuals. This means that a married couple can gift up to $10 million (up from $2 million) in 2011 and 2012 without paying a cent in taxes. Additionally, the tax rate on gifts above these amounts fell to 35% from a planned 55%, which may also present an attractive opportunity for those looking to reduce sizeable estates over the next few years.

The gift tax has been linked to the estate tax for a long time, and existed mainly to prevent the wealthy from gifting the bulk of their assets before death to avoid the estate tax. Gift tax rates have therefore historically tracked estate tax rates. The lifetime exemption (previously $1 million dollars) is separate from the annual gift tax exclusion, which is currently $13,000 per individual recipient. Over the past few years, there have been four changes to the estate-tax rules including the individual exemption jumping from $2 million in 2008 to $3.5 million in 2009 to unlimited in 2010, and now to $5 million in 2011.

One factor to consider when looking to reduce a sizeable estate is the potential growth of the asset in question. The faster an asset is appreciating, the more it may make sense to gift it, thereby removing it from the estate. While the possibility exists that Congress may in the future "claw back" gifts greater than the exemption of the gifts at time of death, they will not be able to claw back any interest or growth associated with the gifted asset. This offers some protection against future gifting law changes. Reviews of current estate plans may prove especially prudent given what is known as "formula clauses," which tie bequests to the amount of the estate tax exemption and are used to maximize the amount that a couple could gift tax-free. Through 2009, the value of one exemption was lost if assets passed directly to the surviving spouse. Because this temporary $5 million dollar exemption is so much higher than in the past, without revisiting formula clauses, some surviving spouses could end up with all their assets (if under $5 million) flowing into Trust. If your will contains formula clauses, it might be time to revisit this with your estate planning attorney.

Another change in the new estate rules is called "portability" and allows each partner of the married couple to use the rest of the other's estate-tax exemption. This extra flexibility can be particularly beneficial if one spouse has a large, illiquid asset (and therefore a split in the equality of assets between spouses – for example, a business interest).

Importantly, there are also emotional issues to consider when gifting assets of any size and certainly those assets built over a lifetime. While there is great benefit to maximizing tax savings, it remains important to be sure that assets are first preserved to last the rest of the donor's lifetime. Secondly, all forms of gifting out of an estate mean a complete cut of ties with the asset in question. Because of that, it is important that the use of the asset by the heirs going forward is not critical to the donor.