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Perspectives

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Crestwood Advisors' Philanthropic Commitment

Big Brothers Big Sisters

For more than 100 years, Big Brothers Big Sisters has operated under the belief that inherent in every child is the ability to succeed and thrive in life. As the nation's largest donor and volunteer supported mentoring network, Big Brothers Big Sisters makes meaningful, monitored matches between adult volunteers ("Bigs") and children ("Littles"), ages 6 through 18, in communities across the country. The organization develops positive relationships that have a direct and lasting effect on the lives of young people.

National research has shown that positive relationships between Littles and Bigs have a direct and measurable impact on children's lives. By participating in programs, Little Brothers and Sisters are more confident in their schoolwork performance, able to get along better with their families, 46% less likely to begin using illegal drugs, 27% less likely to begin using alcohol and 52% less likely to skip school.

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

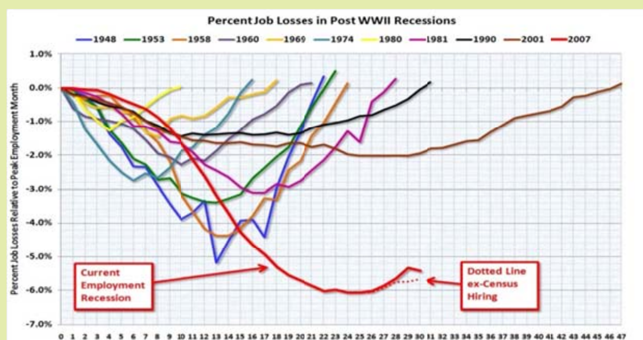
Market Outlook

On the heels of the strongest September for stocks in 70 years, the S&P 500 delivered welcomed returns of over 11% during the 3rd Quarter of 2010. This brought stocks back into positive territory for the year with cumulative year-to-date returns through September 30th of almost 4%. Bond markets continued with steady returns across most risk categories during the quarter with intermediate U.S. treasury notes delivering over 4% and high yield bonds delivering roughly 10%. Commodities also demonstrated strong returns during the quarter as severe weather created rising agricultural prices and gold appreciated another 5% during the quarter, hitting an all-time high in September and bringing year-to-date gains to over 21%.

Economic Update

The economy is showing signs of stabilization but meaningful and persistent economic recovery faces significant headwinds. Perhaps among the most significant is the stubbornly high unemployment rate that continues to hover just under 10%, with the average duration of remaining unemployed almost 40 weeks. Since the start of 2008, the U.S. lost over 7 million jobs and many of those jobs are likely gone forever, either moving overseas or being part of industries that simply will never recover.

The chart below highlights the current "job-less" recovery. While we have always recovered jobs from past recessions it is difficult to pin-point where the jobs will come from today. Healthcare, biotech, technology and alternative energy solutions offer promise but the U.S. has to create 1.5 million new jobs per year to keep the unemployment rate from rising (by absorbing new job entrants and immigration). During the tech boom of the 1990s, over 2 million jobs were created annually, and while that is hard to imagine today, even if this rapid job creation took place, it would still take over 7 years to get us back to 5% unemployment. No wonder so many away from Wall Street are still feeling the pain of the current economic "recovery".



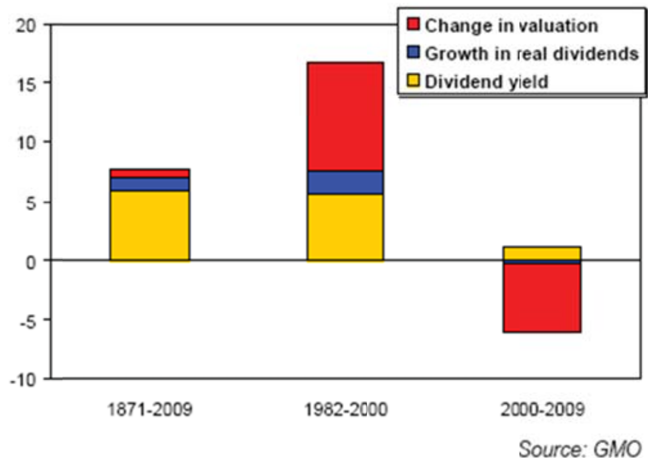
Real estate also remains in the headlines with stagnant prices and rising foreclosures threatening further pricing pressures for homeowners. Current headlines speak to growing problems with banks' ability to foreclose as it seems that at least in some instances, the booming housing market of yesterday was characterized by sloppy paperwork and procedures. While the self-imposed moratorium on foreclosures by many banks is already being lifted, it suggests that the timeline of clearing the housing market will be longer than many expect and the costs to banks in particular will likely be higher as well.

Continued

Market Outlook

Here Comes QE2!

During the 3rd Quarter, the Federal Reserve cited high unemployment, an "unusually uncertain" economic recovery and "below target inflation" to set the stage for a second round of "quantitative easing" (QE2) – essentially the wholesale purchasing of U.S. treasury notes to provide liquidity to the economy. To date, the expansion of the Fed's balance sheet via QE1 has had little impact on credit availability as banks have preferred to invest their excess liquidity into bonds as opposed to making new loans. At least some of the lack of new loans reflects a lack of demand as many consumers and businesses have shifted attention to paying down debt rather than taking on more. This is why some suggest that the impact to economic growth of further liquidity from the Fed will be like "pushing on a string" and not be terribly effective at stimulating growth.



Our Views & Portfolio Positioning

It is our view that while the economic recovery will be slow and protracted, the investment opportunities have selectively become more interesting. Generally speaking, stocks remain relatively attractive versus bonds and other asset classes. Growth in corporate revenues and earnings continues to be stronger than expected and balance sheets are in very good shape, with cash as a percent of assets at record highs. While earnings may yet slow, concerns over the still-anemic economic recovery and upcoming U.S. elections have restrained valuations and P/E expansion. The current gap between earnings yields of stocks and bond yields is wide and approaching rarefied levels that have historically suggested a robust return opportunity for longer-term equity investors.

Comparing just relative income opportunities, the 2.1% dividend yield for the S&P 500 is almost 100% higher than the current yield on 5 year treasury notes. Our research supports our perspective that for the years ahead, we would rather invest in any number of large global companies with solid growth prospects, clean balance sheets, reasonable valuations and managements that are demonstrating their commitment to shareholders by using their strong free cash flow to buy back stock or increase dividends.

The importance of dividends (or at least the ability to pay dividends) has always been an important feature to our equity investments. Over long periods of time, dividends and the growth of dividends has been a dominant portion of the return available from stocks. As the following chart highlights, the significant shifts in valuation through P/E multiple expansion that characterized the two-decade bull market beginning in 1982 was more the exception than the rule.

In Search of Yield

With interest rates near historic lows and the Fed signaling its intent to keep them low for the foreseeable future, income sensitive investors have pursued bonds and other yield-oriented investments aggressively. While this is understandable, especially given the struggling economy and volatile equity markets, we believe that different yield-oriented investments offer different risk/reward scenarios and that discrimination among the alternatives is worthwhile.

As an example, both Real Estate Investment Trusts (REITs) and exchange-traded Master Limited Partnerships (MLPs) have been beneficiaries of investors' quest for yield. Certainly both REITs and MLPs can be attractive alternatives to bonds due to their relatively high yields, room for dividend growth, tax advantages and inflation protection; however, we continue to believe that MLPs have a more favorable risk profile and more attractive risk-adjusted return profile than REITs.

Our basic view has been that REITs carry higher risks due to the ongoing commercial real estate problems and that their access to capital would be more significantly constrained given their uniquely challenged assets. In contrast, while still facing a tighter credit environment, the natural monopolies of MLPs present better quality assets supported by the long-term demand for transporting oil & gas and would therefore be better positioned to sustain and grow their earnings and dividends over time.

Our preference for MLPs has taken the form of investments in both Oneok Partners (OKS) and the J.P. Morgan Alerian MLP Index ETN (AMJ). Oneok is engaged in the gathering, processing, storage and transportation of natural gas and is largely a fee driven business without significant exposure to the underlying commodity prices. AMJ is diversified portfolio of 50 MLPs focusing on oil & gas distribution, with the top 10 holdings representing 60% of the portfolio.

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The relative performance of these asset classes over the past couple years supports our views. While REITs have enjoyed a strong recovery from the market lows, MLPs have delivered even better returns and were much less volatile through the downturn. While OKS and AMJ no longer carry dividend yields in excess of 10%, their dividends are still attractive at 6%-7% and present a more attractive spread to bonds versus the 3%-4% yields of REITs.

As with REITs & MLPs, high yield (i.e. junk) bonds have also captured the attention of yield-focused investors, especially following the 40% returns of 2009 and 2010 YTD returns of roughly 10%. While today's yield of roughly 9% is certainly attractive, high yield bonds give investors exposure to significant credit risk and higher interest rate risks versus alternatives, we believe it prudent to reduce both these risks during the current environment.

To make matters worse, strong inflows into high yield bonds have resulted in weakened covenants of new bond issues making it easier for lower-quality companies to get capital and potentially increasing the risk of future defaults. We continue to prefer the relative security of senior-secured leveraged loans (i.e. bank loans) given their history of lower defaults and higher loss recovery. Their LIBOR-based floating interest rates also offer some protection from any increases in interest rates. Bank loans carry similar credit ratings to junk bonds but they are higher in the capital structure, which means investors in bank loans are generally first in line to receive payment before junk bond holders and other creditors should something go wrong. This greater level of security has not hampered returns as, like high yield bonds, bank loans experienced similar 40%+ returns in 2009 and have delivered solid mid-single-digit returns so far in 2010.

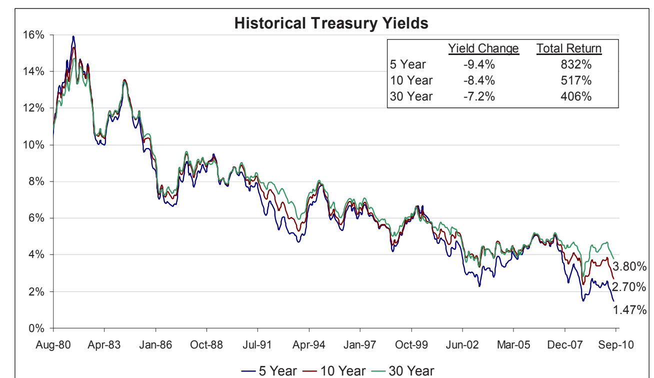
We are constantly striving to find attractive long-term investment opportunities for our clients and our continual review of asset classes and individual securities often does not reap immediate rewards. However, as with the case of REITs vs. MLPs and Junk Bonds vs. Bank Loans, this diligence can test the merits of our current holdings and plant the seeds for future investment. A common theme with regards to our research and investment discipline is the necessity for a "margin of safety" to offer some protection from the unexpected and the unavoidable imprecision of our analysis. We believe that both the strict discipline of our process, including target prices for buying and selling, and insisting on a margin of safety will continue to benefit our clients given the still fragile economic recovery.

Are Bonds Riskier than Stocks?

"Because interest rates have fallen steadily for almost 30 years, few bond investors can recall more than a temporary period when bonds declined in value. Investors who know history, however, realize that the last time interest rates were at today's levels, bonds went on to decline in value for more than 20 years. What's more, on an inflation-adjusted basis, investors in U.S. Treasuries lost more in those 20 years than stock investors did during the Great Depression!"
-- An Update from Christopher C. Davis and Kenneth C. Feinberg, Portfolio Managers, Davis Funds Semi-Annual Review 2010

For many who have grown comfortable with the returns of bonds over the past several years, these types of statements can be eye catching. How could bonds be risky? Take the 10 year treasury for example, the yield was 6.45% at the end of 1999 and it currently hovers just under 2.50%. With this decline in interest rates, investors have enjoyed high single-digit and low double-digit returns from bonds during an environment where the S&P 500 delivered negative returns averaging -2.5% per year. The relatively strong returns in bonds together with recent volatile returns in stocks has led to a flood of money into bond mutual funds. This has caused many investors, both "Mom & Pop" and pension funds, to steer clear of the equity markets.

The headlines today suggest that we are in a very uncertain time in the US, with unemployment high, future economic growth uncertain and taxes likely to escalate. Some parallels



could be drawn to the early 1980s, when unemployment hit 10.8% in 1982. GDP growth was -2% in 1982 and headlines proclaimed "The Death of Equities" (Business Week, August 1979). During the challenging decade to follow, inflation averaged 5.1% per year. This suggests that if your groceries cost $1000 per month in 1980, they cost $1051 in 1981 and $1645 per month by the end of 1990. Inflation is damaging, and when it begins to compound it can have a dramatic impact on cost of living and investment returns.

Over the past 30 years, inflation has averaged a bit more than 3.25% per year. Should inflation average a similar level over the next 10 years, investing in treasury bonds at the current 2.47% ensures that investors will actually lose 0.78% per year of purchasing power (after adjusting for inflation).

Continued

Importantly, Davis and many professional investors are wary of future scenarios of accelerating inflation. This would be a very dangerous scenario for a portfolio made up of bonds, especially bonds with long-term maturities. While no one can predict the future, the probabilities do not appear to favor bonds over a longer term time frame.

So, with all securities facing the risk of inflation, where is there to go? High-quality, high-dividend yielding stocks with strong growth prospects and relatively cheap valuations seem to offer an attractive harbor in an uncertain environment. Some examples of stocks that share these characteristics are Novartis (NVS) at a 3% dividend yield, Pepsi (PEP) at a 2.9% yield, Johnson & Johnson (JNJ) at a 3.5% yield, Lockheed Martin (LMT) at a 4.1% yield and Microsoft (MSFT) at a 2.6% yield. What makes these dividend yields more attractive is that they have all recently been increased by the companies. During 2010, JNJ increased its dividend by over 10%, NVS by 5%, PEP by 7%, LMT by 19% and MSFT by 23%.

These recent dividend hikes (and for some of these companies, a decades long tradition of increasing dividends) provide a growing income stream that offers some protection against inflation. The fixed coupons of bonds simply do not provide this same type of protection.

While we live in uncertain times, it is difficult to tell how much more uncertain this time is from 1982 (or 1929 or 1974). There will always be risks when it comes to investing, and the best investors can do is try to find quality investments where there is a significant margin of safety. This helps to protect downside when times are tough and allows investors to participate in good times when they inevitably occur. High quality, high dividend yielding stocks such as Novartis, Johnson & Johnson, Lockheed Martin, Microsoft and Pepsi provide the qualities of a significant margin of safety (valuations are attractive and pay a nice yield) and the ability to participate in good times (through earnings growth). While bonds may feel safe today, based on historic returns, they face significant risks if inflation rates increase.

Grantor Retained Annuity Trusts (GRATS): A Good Opportunity Today?

GRATs are an estate planning technique that can potentially minimize the tax liability existing when inter-generational transfers of estate assets occur. Under these plans, an irrevocable trust is created for a finite period of time, often 2 or 3 years. Assets (generally securities) are placed into the trust and then an "annuity" is paid out every year based on the IRS section 7520 interest rate. Presently, these section 7520 rates are at historically low levels. For example, the rate for September 2010 is 2.4%. To the extent that the assets held in the GRAT appreciate at a faster rate than the section 7520 rate, this "excess" appreciation passes along free of estate and gift tax to beneficiaries. For example, a GRAT is created and funded with $1 million worth of a diversified basket of equities. If, upon the expiration of the trust, the GRAT grows to $1,200,000 after paying out the "annuity" to the grantor (contributor of the GRAT), $200,000 will pass tax free to the designated beneficiary (ies).

There are several benefits to initiating a GRAT today. First, the "annuity" rate is historically low, therefore the "hurdle rate" is modest by historical standards.

Second, any appreciation in a GRAT does not get utilized against the annual gift exclusion or any significant portion of the lifetime gifting exclusion ($1,000,000). Third, a GRAT can hold liquid, public securities or it can hold a private, closely held business.

There are also a few modest risks to initiating a GRAT. If the assets in the GRAT do not appreciate, the GRAT will have been ineffective but the grantor will not be required to make up any shortfall. Additionally, if the grantor dies during the lifetime of the GRAT, the assets will be includable in the grantor's estate. Finally, once a GRAT has been established, it cannot be terminated early. Under these circumstances, the legal cost of establishing the GRAT will have been the only cost.

Due to the fact that the "annuity" rates for GRATs are at historically low levels, there has never been a more compelling time to consider establishing one or several GRATs. Before taking any action on this matter, we urge you to contact your relationship manager or your estate planning attorney directly to discuss.

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