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CRESTWOOD PERSPECTIVES

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MARKET OUTLOOK: A VERY STIMULATING ECONOMY

The U.S. stock market continues to reflect the growing optimism regarding the end of the "Great Recession" and a return to modest expansion. The 3rd Quarter marked the second in a row of 15% plus gains for the S&P 500 as investors discount a "V" shaped recovery for both the economy and corporate profits. While we welcome the opportunity to participate in the global stock market rally, we view the nascent signs of economic recovery with some trepidation and the expanding stock market multiples with a significant degree of caution.

Government Distortion?

Certainly, the rebound in the economy reflects greater business and consumer confidence following the near implosion of the global financial system. In the wake of the credit crisis, businesses slashed inventories, orders and payrolls to reduce costs. While the jobs picture remains bleak, business have begun to spend and place new orders to rebuild depleted inventories. Similarly, rising spending figures and easing savings rates reflect how consumers have again somewhat loosened their purse strings.

However, at least some of this rebound in spending is a result of the enormous government stimulus, which will someday have to be curtailed. The government now plays a major role in many businesses and the massive liquidity injected into the system is creating distortions throughout the economy. The "cash for clunkers" program perhaps provides the best evidence of this as auto sales surged on the overwhelming response to the program and then fell precipitously once the cash incentives ended. Likewise, the $8,000 first-time home buyer credit is stimulating demand for housing and the FHA is now providing as much as 80% of mortgage financing.

Real Estate Still an Issue

Encouragingly, lower home prices and low mortgage rates, together with the tax credits, have slowed the pace of housing decline and lowered housing inventory in a way that may be more than seasonal. However, over-leveraged homeowners still face significant problems. With subprime mortgage problems largely behind us, job losses and interest rate resets are contributing to accelerating delinquencies for "prime" and other mortgagors. Sadly, delinquency "cure" rates (the percent of delinquent loans that return to good standing) have

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INVESTING IN HEALTHCARE… UNCERTAINTY AND OPPORTUNITY

"In the middle of every difficulty lies opportunity."

-Albert Einstein

While recent headlines paint a picture of great uncertainty for our financial and economic future, they have also focused on another issue that is just as important - the future of our healthcare system. With most of the talk in Washington focusing on healthcare reform, many wonder what this all means and what changes will result. This uncertainty has spilled over to the financial markets, where the Healthcare sector has been a laggard over the short and long term. As of 9/30, the healthcare sector had a 9.83% return YTD. This was the worst performing sector with the exception of consumer staples and utilities. On a three and five year basis, the healthcare sector returned -2.92% and 1.58% respectively.

Again, the worst performing sector with the exception of consumer discretionary, financials and industrials – the three sectors most

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MARKET OUTLOOK...(CONTINUED)

fallen to all time single-digit lows and foreclosure filings are surging.

The commercial real estate market, which already suffers from a lack of credit and falling prices, is similarly troubled. Declining office rents and five year high vacancy rates suggest more troubles for commercial real estate and more losses for the banks that own the mortgages on the properties.

> *"The real estate problems are acute because of still fragile bank balance sheets. Banks have raised over $1 trillion of capital to absorb recent losses but estimates for future losses are at least $1 trillion more."*

The real estate problems are acute because of still fragile bank balance sheets. Banks have raised over $1 trillion of capital to absorb recent losses but estimates for future losses are at least $1 trillion more. Anticipating these future losses are certainly one reason that banks have been reluctant to take risks and make loans. Lending standards are incredibly tight right now with many banks content to invest in bonds and earn the modest available spread offered by the relatively steep yield curve.

Future large banking losses are all but certain; however, fortunately, we are unlikely to repeat last year's liquidity crisis. Accounting rules requiring mark-to-market accounting on mortgage backed securities inflamed the severity of the credit crisis resulting in almost immediate insolvency for many in the financial system. Much of the remaining exposure, particularly in commercial real estate, is in loan portfolios where there is much more flexibility of when to recognize losses. This flexibility gives the banks the luxury of time to earn their way out of some of their capital impairment and gives the Federal Reserve more incentive to keep short-term interest rates low.

A Bleak Jobs Picture

With banking losses likely to be a drag on credit availability for years, job creation and income growth will have to fill the gap to achieve sustainable growth in our consumer dependent economy. Unfortunately, it will likely be years before there are

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INVESTING IN HEALTHCARE...(CONTINUED)

affected by the credit crunch and economic downturn.

This lackluster performance has created some intriguing valuations for quality healthcare companies. The S&P Healthcare Index (HCX) now trades at 12.4x trailing earnings and 9.7x trailing cash flow. On a trailing price to earnings basis, the HCX trades at 0.7x the S&P 500 multiple of 18x. This relative multiple is the lowest on record when compared with historical data through 1996. In the middle of the healthcare reform difficulty, we are indentifying good long term opportunities.

> *"Our healthcare system is similar to that nagging knee or back pain we all experience at some point in our lives. We can try to forget about it while running, biking, playing tennis or just getting up in the morning. However, at some point we have to deal with it."*

Our healthcare system is similar to that nagging knee or back pain we all experience at some point in our lives. We can try to forget about it while running, biking, playing tennis or just getting up in the morning. However, at some point we have to deal with it.

The reality is that U.S. healthcare spending will be $2.5 trillion in 2009. This represents almost 18% of GDP. We spend, by far and away, the most of any country on healthcare. The next closest country is Switzerland at 11% of GDP. By 2017, Medicare and Medicaid will begin running deficits for its Hospital Insurance Trust Fund (this pays for inpatient care for Medicare recipients). The current workforce cannot pay for the baby boomers' healthcare, and we need a solution.

We have already had a glimpse into the future as the government has focused on cost savings to the system. This has led to a focus on more generics (lower cost than branded drugs), reimbursement for devices and healthcare procedures, affordable insurance and disease prevention/early intervention. The government will likely continue to evaluate ways to deliver a similar level of healthcare at a lower cost.

This focus by the government and regulatory bodies creates

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Crestwood Advisors' Welcomes

James C. Bacon, CFA

James is primarily responsible for originating research and investment recommendations based on Crestwood Advisors' strict investment discipline.

Prior to joining Crestwood, James worked as a healthcare analyst at MFS Investment Management. James began his career at Eaton Vance where he was responsible for covering small-cap growth equities. James observes that "Crestwood combines a disciplined investment process with a patient approach. When you add a group of people that truly care about their clients and each other to that discipline, it creates a long term sustainable competitive advantage that is incredibly difficult to match."

James earned a BS from Boston College and an MBA from the University of Chicago Booth School of Business. James holds the Chartered Financial Analyst (CFA) designation, and is a member of the CFA Institute and the Boston Security Analysts Society.

MARKET OUTLOOK... (CONTINUED)

any meaningful income gains. Over 7.5 million jobs have been lost over the past 2 years and unemployment is now near 10% and still doesn't fully reflect the discouraged or underemployed. Work weeks are at record low hours and there is a record number of people unemployed over 6 months.

> *"This lack of inflationary pressures during the recovery provides the opportunity for interest rates to stay low for some time and the opportunity to extend maturities of bond investments to take advantage of the steepness in the yield curve."*

Given the uncertainty concerning job growth and security, households have made adjustments, preferring to pay off debt over expanding spending. The credit-enhanced spending boom prior to the recession is a thing of the past and the recent focus on thrift likely represents long-term shifts in shopping habits and highlights the risks to consumer spending growth in the years ahead.

Opportunities in Credit Remain

While expanding government spending and the need to finance growing deficits foreshadow higher future inflation and interest rates, high unemployment and industrial capacity utilization hovering at 40 year lows is evidence of meaningful economic slack. This lack of inflationary pressure during the recovery provides the opportunity for interest rates to stay low for some time and the opportunity to extend maturities of bond investments to take advantage of the steepness in the yield curve. With money market yields near 0%, even extending into three or six month bonds can meaningfully boost yields on cash.

As the economy and credit markets have stabilized, corporate balance sheets have become stronger and rating agencies suggest a near-term peak in corporate defaults. Yield spreads over treasuries have tightened significantly but high-quality corporate bonds still offer relatively attractive yields for investors. Finally, with both Federal and State income taxes likely to rise, municipal bonds still offer relative value and tax free yields today will be that much more attractive in the future.

Selectively Seeking Growth

Led by China, global economies have stabilized faster and are further along the path to economic recovery than the U.S. Unlike the U.S., the Chinese have focused their stimulus efforts on both consumers as well as on building infrastructure and other longer-lasting initiatives. This has expanded consumer demand and had favorable implications regionally as well as created surging demand for commodities.

The economic progress in China resembles that of many emerging markets and highlights the future growth oppor-

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INVESTING IN HEALTHCARE... (CONTINUED)

an opportunity for generic pharmaceutical companies (close to $100 billion in branded drugs come off patent over the next five years), Pharmacy Benefit Managers (more generics leads to higher profits), certain pharmaceutical and biotech companies (good quality companies can be found cheap as concerns affect all stocks in the area), companies not affected much by reimbursement (eye care, dental and other areas have little reimbursement risk) and companies with solid secular growth (although some impact may occur from reform, long term trends are still strong). We are finding good quality companies at reasonable valuations that have prospects for long term growth.

> *"Johnson & Johnson (JNJ) is a recent addition to the portfolio that demonstrates the qualities of a sound company selling at a reasonable price and a solid growth profile. Other holdings benefit from trends such as generics, low reimbursement risk, and secular growth..."*

Johnson & Johnson (JNJ) is a recent addition to the portfolio that demonstrates the qualities of a sound company (28% return on equity), selling at a reasonable price (7.5% free cash flow yield and almost a 3.5% dividend yield) and a solid growth profile (estimated earnings growth after 2009 in the 7-8% range). Other holdings benefit from the trends mentioned above, such as generics (**TEVA** the generic market leader and **CVS** benefits from generics as well through higher profits), low reimbursement risk (**XRAY** is the leader in dental and **ACL** is the leader in eye care) and secular growth (**SYK** is a leader in the orthopedic space which will benefit from baby boomers getting hip and knee replacement surgery). We are also starting a position in **XBI** (S&P Biotech ETF) as long term expectations for double digit growth appear reasonable, valuation is close to historic lows (the price to book ratio is approaching six year lows), larger pharmaceuticals are purchasing biotech companies as a way to fill their drug pipelines and the sector has proven defensive (significant outperformance versus the S&P 500 and Russell 2000 Growth over the past couple of years).

While debate and headlines will continue, change to the healthcare system is inevitable and necessary. This change will hopefully create a more efficient and viable solution for our healthcare system over the long term. While nothing is certain, very good investment opportunities seem to be presenting themselves in healthcare. Over the long term, we believe these opportunities provide our clients with solid prospects for downside protection and above average growth appreciation.

MARKET OUTLOOK... (CONTINUED)

tunities of rising per capita incomes in developing economies. Stock market valuations in these countries certainly reflect some of the near-term benefits but we remain bullish on the long-term opportunities created by the economic development of China and other "emerging" markets.

"Escalating concerns regarding U.S. fiscal policies have led to weakness in the U.S. dollar pointing to other opportunities, including foreign bonds that continue to offer yield and currency translation advantages."

The U.S. stock market's 60% bounce off recessionary lows is without precedent and current valuation levels now seem to reflect a "V" shaped recovery in the economy and corporate profits. The trailing P/E multiple of the S&P is about 28x operating earnings and multiples using forward earnings are about 18x. Coming out of this recession earnings have grown largely through cost-cutting and job cuts and we will become more confident in the sustainability of current valuations when revenue growth is more readily achievable.

While equity markets valuations are vulnerable to any future earnings disappointments, we are finding attractive opportunities among the globally-oriented, high-quality companies that have not fully participated in the current rally. Johnson & Johnson (JNJ) is just one example of a quality growth company that has lagged the near 20% returns of the S&P in 2009 but, as our analysis suggests, has a much more favorable mix of current valuation and future growth opportunities. JNJ is poised for accelerating earnings growth led by a drug development pipeline that more than replaces potential lost revenue from patent expirations and their global footprint also provides the opportunity to benefit from the growing consumerism outside the U.S. Despite this, JNJ trades near historical low valuations and pays a likely growing dividend that rivals current bond yields.

Escalating concerns regarding U.S. fiscal policies have led to weakness in the U.S. dollar pointing to other opportunities, including foreign bonds that continue to offer yield and currency translation advantages. Surging demand from emerging markets and weakness in the U.S. dollar also benefits commodities, which are traded globally in dollars and thus will rise in price when the dollar falls. Finally, the impressive recent gains in gold reflect almost entirely the relative weakness in the dollar but gold prices could rally further once inflation arrives as gold prices are still well below prior inflation-adjusted prices.

ROTH IRA: TO CONVERT OR NOT TO CONVERT?

Individuals who choose to convert a traditional IRA into a Roth IRA can enjoy a number of tax advantages. As long as Congress does not change current law, the $100,000 restriction on modified adjusted gross income (MAGI) will disappear at the end of 2009, and even high income taxpayers can convert a traditional IRA into a Roth in 2010 and beyond.

Why might this be a great opportunity? Roth IRAs have a few distinct advantages over traditional IRAs. While traditional IRAs allow for tax-deductible contributions, Roth IRAs begin with after-tax contributions. While both types of accounts grow tax-free until retirement, qualifying withdrawals from traditional IRAs (in retirement) are treated as taxable income. Unlike traditional IRAs, qualifying Roth withdrawals are free of federal income taxes and usually state income taxes too. Roth IRA "qualifying" withdrawals generally involve those taken after the Roth account has been open for more than five years and the owner reaches age 59 ½.

Another advantage for Roth account owners is the lack of minimum required distributions (MRDs) for account owners at age 70 ½ (unlike all other IRA accounts). A Roth balance can remain untouched for the length of your life, which makes a Roth an ideal asset to leave to heirs if the owner does not need the money herself.

Besides the impending disappearance of the MAGI ceiling, Roth conversions are particularly relevant for many to consider in the near term as account values broadly remain depressed. Converting a traditional IRA to a Roth IRA triggers a taxable event because the IRS deems the owner to have received the converted amount in a taxable distribution. A lower overall balance means that the conversion will result in lower taxable income. It is this relatively low cost for converting, combined with the chance to avoid higher future taxes on additional wealth that accumulates in the Roth account as the economy recovers that makes converting a particularly attractive option for some.

The "extra" taxable income triggered by a conversion is added to salary, self-employment earnings, investment income, etc. Converting a large-balance IRA could actually bump the owner into a higher tax bracket and make her ineligible for some tax breaks. To avoid this, the IRS allows IRAs to be converted in stages over at two years. This multi-year conversion can spread the tax impact over two years and prevent a large conversion from increasing an individual's tax bracket.

It makes sense to begin to consider whether a Roth conversion may make sense in 2010 and we are actively having these conversations with clients. There are several variables to consider and we are eager to consult with clients and their tax advisors to ensure that our clients benefit as appropriate from the changing IRS rules in 2010 and beyond.

The information in this publication is from sources that Crestwood Advisors believes to be reliable. Notwithstanding, Crestwood Advisors does not guarantee the accuracy of the data.