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Dear Client,

Normally I'm leery of new financial products. Unfortunately, the financial industry has grown into a giant marketing and sales machine with the goal of generating fees and keeping things complicated. Browse through the prospectuses of most annuity offerings and you'll get a feel for what I mean.

New does work well in many industries. Apple Inc. is a great example. Its technology advances and innovation with the MacBook and iPhone make computer use, entertainment, and communication easy. The business partner at our Apple store in Naples, Florida, told me that Apple makes computers the way computers are supposed to work. The store is always loaded with people receiving one-on-one instruction from the Apple staff. And it's not just younger people doing the buying; it's people in their 50s, 60s, and 70s. By the look of it, there are a fair number of grandparents queuing up to learn how to use Apple to better communicate and share pictures with family and grandkids. With Apple, *new* works.

With a long-term investment strategy, I'm not sure how much benefit consumers receive from *new*. Ben Graham long ago advised investors to make dividends a central component of their investment strategy. In *A Random Walk Down Wall Street*, first published in 1973, Burton Malkiel recommends that investors increase their fixed-income component with age. Malkiel suggests that investors in their mid-50s allocate 50% to equities and 50% to cash and bonds. For decades Vanguard founder Jack Bogle has preached the benefits of diversification and low-cost investing. All of these principles have formed the foundation of how we invest for clients at Richard C. Young & Co., Ltd.

In reviewing your quarterly portfolio holdings reports, you may have noticed a different mix of names in your equity fund holdings. Long-held names from Dodge & Cox and Third Avenue have been replaced with less familiar names like iShares, CurrencyShares, and SPDR. You may ask, "Aren't these new?"

"Diversification and patience built on a foundation of value and compound interest."

The answer is not really. iShares, CurrencyShares and SPDRs are all types of exchange-traded funds (ETFs). ETFs operate much like index funds in that ETFs invest in a pool of securities held within a particular index. By example, Utilities Select Sector SPDR (XLU) invests in the utilities sector of the S&P 500. By investing in XLU, we are able to tie down a current yield of 4.8%, receive diversification from the 34 names held, and benefit from an investor-friendly low expense ratio of 0.20%.

So, while the names of some securities on your statement may look unfamiliar, the securities themselves offer many features that we have favored for years.

I believe ETFs will continue to become more popular with investors as time passes, resulting in the downfall of many mutual funds. ETFs offer benefits that will make it difficult for mutual funds to compete.

To me, the four big benefits associated with ETFs are: (1) low expenses, (2) tax efficiency, (3) specific diversification, and (4) trading flexibility.

Most ETFs have low expense ratios compared to traditional managed mutual funds. Select Sector SPDRs, a group of nine sector-index funds, describes its expense structure as follows: “Select Sector SPRDs are designed to be cost efficient. Unlike active mutual funds, whose objective is to beat a respective index, Select Sector SPDRs are managed passively, with the objective of matching the performance of their underlying sector index. Consequently, Sector SPDRs are able to eliminate many of the operating, research, and transaction expenses incurred by active money managers. These cost savings are then passed along to you, the investor, in the form of lower expense ratios.”

Awareness of investment expenses will be particularly important in the period ahead. The recent run in the stock market over the last three months will not be sustainable. Moving forward, investment returns will be more difficult to come by, which means investment expenses will have a greater impact on performance.

ETFs are tax efficient for two reasons. First, portfolio turnover, a major factor in generating capital gains for actively managed mutual funds, occurs when managers buy and sell securities. Since many ETFs track an index, transactions only occur when changes are made to the underlying index, which is infrequent. Infrequent trading reduces the potential for capital gains. Second, unlike conventional mutual funds, ETF shareholders are protected from taxable events generated by other shareholders in the fund. When conventional mutual fund shareholders redeem shares, they are paid directly by the fund company. To raise cash to pay for shareholder redemptions, mutual fund companies may need to sell securities, potentially triggering a taxable event for other shareholders. Since ETFs are bought and sold on an exchange, similar to common stocks, a transaction initiated by one shareholder does not affect other shareholders.

ETFs target specific sectors of the market, allowing investors to zero in on favored areas of interest. With the purchase of XLU, for example, we were able to focus on just the utilities sector of the S&P 500 and avoid less favored sectors, including technology and healthcare. We

are also able to target specific countries and currencies while omitting others. For example, we can invest in Singapore and avoid China and invest in Swiss francs and avoid the euro.

Last on my list is trading flexibility. Unlike those who invest in traditional mutual funds, ETF investors do not have to wait until the end of the day to buy or sell a position. ETFs are listed on many stock exchanges and can be traded in the same way as shares of publicly held companies.

Canada is currently one of our favored investing themes. iShares MSCI Canada Index Fund (EWC) and CurrencyShares Canadian Dollar Trust (FXC) are two of our current favored ETFs. A combination of a wealth of natural resources and a strong banking system makes Canada an attractive destination for investment assets.

The key for Canada's banks has been their limited exposure to toxic assets and their conservative mortgage lending. Canadian banks have more stringent regulatory requirements than banks in the U.S. In Canada, regulatory constraints stopped leverage ratios from going too high. As recently noted in the *Wall Street Journal*, "Not long ago, Canadian banks were considered slow-footed, provincial and too conservative to flourish in the global boom for financial institutions. Now that banks in the U.S. and Europe are reeling from loan losses and face growing government scrutiny and ownership, Canada's six major banks are seen as a potential model for battered financial institutions. Canada is the only Group of Seven industrialized country that hasn't rescued its banks since the financial crisis erupted, and Ireland's government has announced it will restructure its financial sector based on the Canadian system."

In an interview posted at Kudlow's *Money Politic*⁵, Canadian Prime Minister Stephen Harper told readers, "We have, I think, the only banks in the western world where we're not looking at bailouts... We haven't got any TARP money... We don't have a Fannie Mae or Freddie Mac equivalent mucking around the system." Seems like good sense to own some of Canada's currency. Also keep in mind that when you hear about the potential for the U.S. dollar to depreciate, the dollar will be depreciating against another currency. We believe the U.S. dollar will depreciate against the Canadian dollar in the years ahead.

On the resource front, Canada is the second-largest country on Earth by total area. The country is rich in natural resources, including oil, diamonds, timber, and base metals. The Canadian tar sands contain an estimated 1.7 trillion barrels of oil, more than six times the reserves in Saudi Arabia. Lastly, Canada is home to 20% of the world's fresh water supply.

CurrencyShares Canadian Currency offers benefits similar to owning Canada's dollar. iShares Canada lists Royal Bank of Canada, EnCana Corp, Toronto-Dominion Bank, and Bank of Nova Scotia in its 10 largest holdings. Both ETFs have investor-favorable expense ratios of 0.40 and 0.52.

Speaking of favorable, what a nice run the stock market has had since its March 9 low of 6547. A nice change of pace to be sure.

I'm asked often these days for a market prediction for the rest of the year. I'm not a fan of market predictions because I have no idea how things will turn out. In fact, I'm quite positive that no one knows the events of the future. With that said, here are my thoughts on the market.

Two things the stock market dislikes are inflation and rising interest rates. Today we have neither. At the beginning of the year, many were concerned about a total collapse of the U.S. financial system and the second coming of the Great Depression. Neither happened and there seems to be a collective relief throughout the universe. With short-term interest rates essentially yielding nothing, some investors will seek higher-yielding stocks and at least earn a rate of return on their money. Recently, Morgan Stanley, Wells Fargo, and Bank of America raised billions of dollars selling additional shares to this group of investors. Additionally, "Helicopter Ben" has the presses working three shifts. (An investment in printing press lubricant may be a good play.) Where is all this money going? A certain chunk will be headed to the stock market. And finally, the *Wall Street Journal* reported on May 21 that "most forecasters and governments see signs that the current quarter will be better than the first, and the rise in global stock markets suggests investors believe the worst is past."

Given all this, I think an assumption can be made that a balanced and diversified portfolio can end the year on a positive note. While many securities are up YTD, I have the feeling that today's environment could be the eye of the storm. There is a rather lengthy list of potential problems that could cause the markets more grief. Commercial real estate loans could generate significant losses similar to what occurred in the residential real estate market. The condo market could rip apart. When adjustable-rate mortgages start to expire, people may have to walk away from their homes depending on the future interest rate environment. The array of tax increases proposed in Obama's budget, if enacted, would make a sustained recovery difficult. And, there is the ever-present and likely threat of another terrorist attack.

I look at today's environment with caution while keeping in mind that I do not know how future events will unfold. The fact that I believe there are many challenges ahead does not necessarily translate to poor performance on all asset classes. I have a hard time believing there are no investment opportunities on the horizon. We live in a world where individuals and governments seek opportunity and advancement. Individuals want to gain wealth to pay off their homes, buy things, and live comfortably. Governments want progress so they can keep constituents happy and remain in office.

For now, our standard recommended allocation is similar to what Burton Malkiel advised. Most retired and soon-to-be retired investors will be most comfortable with at least 50% of their portfolio in fixed-income securities. Most fixed-income securities reduce the volatility associated with the stock market. As importantly, fixed income pays a predictable stream of income that helps portfolios keep up with inflation. On the equity side of things, we focus on dividend-paying securities and now heavily favor exchange-traded funds. Our goal is to gain broad exposure to a variety of natural resources, countries, and currencies.

Next month, I'll preview our new corporate bond program and let you know what some companies are doing with their dividends in this sluggish economic environment. In the

meantime, if your financial situation has changed or if you have questions about your investment portfolio, please call us at 800-843-7273.

Warm regards,



Matthew A. Young
President and Chief Executive Officer

Themes: I have said before that it's important for investors to nail down big, broad themes. I cited Canada as one of our favored themes today. Agriculture is also on our radar. Investment banks and Wall Street were among the big themes of the 80s and 90s. I think we'll see farming and the folk who produce real things take on greater importance in the decades to come.

Low Fees: *The Wall Street Journal's* Rob Wheery wrote, "Even as investors get sidetracked by dismal earnings and banking woes, it's still important to remember that low fees are one of the most important elements of (mutual) fund-picking. There is a powerful incentive to pay attention to fees. Over the life of a retirement account, expenses can eat up tens of thousands of dollars." This further emphasizes my bias for ETFs over traditional mutual funds.

ADV Part II Disclosure: When you originally opened your account, we sent you a copy of our SEC disclosure document Form ADV Part II. If you require an updated copy, please call us at 800-843-7273. A copy of our Code of Ethics is also available upon request.

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An economic recovery now appears to be underway. Chart 1 shows that weekly jobless claims peaked in late March. Historically, recessions end soon after initial claims for unemployment peak. Chart 2 shows the ratio of coincident indicators to lagging indicators. You can think of the coincident to lagging ratio as where the economy is now compared to where it was. The current level of the ratio is at a historical trough point with indications that the ratio has bottomed. Another uptick here will provide further evidence that a recovery is underway. Chart 3 shows the ratio of the Dow Transports to the Dow Industrials. The relative performance of the transports is a leading economic indicator. Transportation companies are the first businesses to feel the effects of an economic recovery. Investors often sniff out a recovery in transportation stocks before it is evident in the economic data. The ratio troughed in the first week of March, indicating a possible recovery is now underway. But check out Chart 4 before you get too excited about a recovery.

In our view the most likely source of today's recovery is inventory restocking. Businesses slashed production in the first quarter in anticipation of a significant decline in demand. Businesses were too conservative in the first quarter. Chart 4 shows the ratio of real GDP to real final sales. The current depressed level of this ratio indicates that inventories have been depleted to unsustainable levels. Current signs of a recovery are most likely a result of inventory restocking—a fleeting source of growth. Sustainable economic growth requires an increase in demand. Today, there is no obvious source of demand growth. Consumers are retrenching and there is excess capacity in industry and housing. We see a 1980- to 1982-type double-dip recession as the probable outcome.

Jeremy Jones, CFA
Chief Investment Officer



