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August 31, 2009

Dear Client,

Not Normal

Today is not the time to stand around flat-footed. Granted, an array of economic news has been released indicating that the worst of the recession is most likely behind us. The Dow Jones Industrial Average is up 40% from its March 9 low, and the U.S. financial system has not collapsed. If we can just hang in there a little bit longer, some would argue, we will eventually get back to normal.

But the way we see it, it could be a long time before we return to normal. Take a look at this past decade. Investors have endured a manic ten years, ending with a series of events nearly unimaginable 24 months ago. Looking forward, we believe the table is being set for an array of continued challenges, especially for those retired and soon-to-be retired.

Secular bull markets in stocks often arise from a base of both high interest rates and high inflation. Today, the base on both is low. Bull markets in stocks also tend to gain traction when offering high yields. Today, the yield on the Dow Jones Industrial Average is only 3.02%.

Beyond the stock market, commercial real estate has not yet fully unraveled, option adjustable-rate mortgage (ARM) resets will begin in 2010, European banks are undercapitalized and likely to face increasing loan defaults, and although residential real estate has likely bottomed, persistent high employment and low equity-to-value ratios may result in elevated loan losses on prime and subprime mortgages for years.

Also troubling are the implications of the monetary and fiscal policy enacted during the height of the economic panic. The Federal Reserve took unprecedented steps to shore up the financial system, increasing the size of its balance sheet to $2 trillion from $900 billion. Excess bank reserves in the financial system appear to be dangerously high. The Fed indicates it can remove the monetary stimulus before inflation becomes a concern, but I suspect removing policy accommodation in a timely manner will be a politically difficult chore.

Our continued strategy is to make dividends and interest the focal point of our investment portfolios. But we are not playing the waiting game in hopes of a more normalized environment. Instead, we believe a proactive investment strategy is necessary. This strategy includes reducing expenses, shortening maturities on fixed-income securities, identifying changes in secular trends, and boosting the yield on stock portfolios.

My last three letters outlined the strategic adjustments being made to investment portfolios. Our adjustments are, in part, a reaction to an investment landscape that has changed quite dramatically over a short period. In the past, we have been willing to ride out the normal ups and downs of cyclical markets. But in our view, today is not like the past.

In May, I wrote that a majority of our fund investing now centers on exchange-traded funds (ETFs). I pointed out the four big benefits associated with ETFs: (1) low expenses, (2) tax efficiency, (3) specific diversification, and (4) trading flexibility.

We have always been sensitive to expenses and trading costs. In the future, we believe, expenses will have a larger impact on investment returns. ETFs allow us to invest more cost-effectively than most traditional mutual funds. This is especially the case with international and alternative investments. In the past, crafting a diversified portfolio including Canada, Switzerland, Singapore, timber, gold, and currencies would have been expensive. With ETFs, we are able to diversify broadly at a lower cost.

In June, I explained why we believe a strict buy-and-hold investment strategy is not prudent. One simple reason is that secular trends eventually end and new trends begin. Our view is that the secular decline in interest rates is now over, and eventually rates will start to rise. In this scenario, we do not want to own long-term fixed-income securities. Preferred securities are long-term fixed-income securities we have purchased for years. But given our outlook on interest rates, we feel now is the time to prune back preferred positions.

In place of preferreds, we will invest in individual short-term investment-grade bonds. We expect corporate bonds to become our flagship fixed-income program. In the past, we favored bond mutual funds over individual bonds. Today, thanks in part to better accountability and transparency in the bond market, we favor individual corporate bonds. Investing directly in individual corporate bonds will allow us to better control duration, quality, and industry concentration.

In July, I wrote that agribusiness is a trend that greatly appeals to us. We believe we are entering a period where most things related to agriculture will be in high demand, including farmland, fertilizer, and farming equipment. Fresh water will also be a big factor here in what we believe to be a multi-decade trend. Brazil, currently on our radar, is a big agriculture exporter and also has approximately 14% of the world’s renewable fresh water.

As you have probably noticed, our favored areas of interest include Canada, currencies, gold, natural resources (including timber), infrastructure, and consumer staples. You may also have noticed the lack of both the health-care and technology industries.

In general, we do not favor individual securities in the health-care or technology industries. One primary reason is our focus on interest and dividends. Historically, neither health-care nor technology stocks have offered yields that we have found attractive.

Attractive yields, always a foundation of our investment philosophy, are becoming more important to us than in the past. Given our concern that investment returns will be difficult to come by in the future, we are now placing an even greater focus on securities that pay higher dividends.

The strategy for our 32-stock portfolio is to continue to make trades that will increase the overall yield of the portfolio. We are seeking companies that have solid yields and a record of consistent dividend increases. We are looking for solid businesses with a good franchise and cash flow sufficient to cover dividends and dividend increases.

Given that we stick to a strict 32-stock portfolio, we cannot add a name without first eliminating one. Periodically, we will sell a solid company in favor of another company paying a higher dividend.

In May, we started purchasing Bank of Nova Scotia, AT&T, and Verizon. All three met our criteria, as solid businesses with sufficient cash flow. Bank of Nova Scotia had the added benefit of allowing us to diversify in Canada, one of our favorite countries for investment. The current yields on Bank of Nova Scotia (4.51%), AT&T (6.24%), and Verizon (5.78%) are quite attractive.

More recently, we have sold shares in lower-yielding names, including Hormel and McDonald’s, and reinvested the proceeds into BlackRock Real Asset Equity (BCF).

BCF is a closed-end fund that focuses on natural resources and writes covered calls on underlying securities in the portfolio. The fund yields 10% and trades at a discount to net asset value.

We also capture good yield by purchasing publicly traded master limited partnerships that invest in pipelines and storage facilities for oil and gas. Recently, partnerships have offered yields exceeding 6% and higher. The more stable of these firms are unlikely to cut their payouts because the profits of many pipeline operators aren’t tied to the prices of oil and gas. Instead, operators make their money by charging fixed fees for the transportation and storage of energy products. Many have local or regional monopolies and stable cash flows from long-term contracts. The rates that pipeline operators charge their customers are federally regulated and include generous inflation adjustments. In our view, pipelines are a great business model.

Some of our favorite pipeline companies today include Kinder Morgan (current yield 7.92%), Nustar (current yield 7.73%) and TC Pipelines (current yield 7.98%). We also gain broad pipeline exposure through the closed-end fund Tortoise Energy Capital (current yield 9%).

We have made changes to our portfolios during the last year in reaction to an evolving global investment environment. What has not changed is our fundamental investment philosophy. We still adhere to our basic investment tenet of diversification and patience built on a foundation of value and compound interest.

I recently dug out an interview my dad did with Babson College’s alumni magazine. One question asked, “In these uncertain times, where should investors put their money?” My dad’s answer: “The safest place is U.S. Treasury notes, with two- or three-year maturities. I recommend putting 50 percent of your capital in treasuries. Invest 40 percent in common stocks and 10 percent in gold—the best hedge against inflation. I look for stocks with good dividend growth and dividend yield and low price-earnings ratios."

The interview was conducted in the fall of 1987. If you compare my dad's answer more than two decades ago to the general strategy we advise today, you will notice that little has changed. Mostly what we do is fine-tune our strategy. Instead of investing 50% in treasuries, we currently favor corporate bonds. We also have a much greater international, natural resources, and currency focus than we did in the late 80s. But our advice still boils down to this: invest with dividends and interest in mind. Reduce stock market volatility with a decent commitment to fixed-income securities. Seek additional diversification, especially against our nasty foe, inflation, through gold and natural resources.

Have a good month, and, as always, please give us a call at 800-843-7273 if your financial situation has changed or if you have questions about your investment portfolio.

Warm regards,

Matthew A. Young
President and Chief Executive Officer

P.S. You may have noticed that I do not make any mention of bond ETFs. We purposely avoid bond ETFs. With the exception of treasuries and agencies, the securities held in bond ETFs tend to be much less liquid than stocks. When the underlying holdings of an ETF are illiquid, the redemption and creation mechanism of ETFs can break down. The result: ETFs trade at wide deviations from the underlying value of the securities in the portfolio or net asset value (NAV). During the seizing of credit markets last year, certain corporate bond ETFs traded at double-digit discounts or premiums to NAV. If you buy a bond ETF that yields 4% at a 4% premium to NAV, and one year later the ETF trades at NAV, your return is 0%. In our view, unless you are a trader, there is little justification for purchasing bond ETFs that invest in corporate bonds. For fixed-income investing, we continue to favor individual bonds and mutual funds.

P.P.S. In this letter, I highlighted four major benefits of ETFs. A fifth benefit of ETFs is their lack of redemption fees. Many traditional mutual funds tack on redemption fees. In some cases, the purpose of the fee is to discourage market timing. When an investor does not plan to sell a fund, a redemption fee does not pose a problem. However, with investments in more volatile or cyclical asset classes, including gold, currencies and natural resources, selling a position may be necessary. Because ETFs lack redemption fees, they give us more flexibility to fine-tune portfolios.

P.P.P.S. I titled this letter "Not Normal" and presented a few of the challenges facing investors in the future. Check out USDebtclock.org for some clarification of what I mean by "challenges." Your eyes will bulge at the enormity of the numbers shown there.

The recession is likely over. The 1% contraction in GDP in the second quarter is likely the trough of economic output, for now. The financial press and strategists from the big brokerage houses are becoming increasingly bullish on the economy and financial markets. Many see the economy headed for a sustainable economic rebound. The risk of a double-dip recession or W-shaped recovery is discounted as improbable. This view may be a mistake. Wall Street has a short-term mindset. Six months is "long-term" for this crowd. Strategists are notoriously poor at forecasting turning points in the economy even at intermediate-term horizons.

Chart 1 shows the consensus year-ahead forecast of real GDP and the actual real GDP numbers. Air ball. Investing successfully takes a long-term view. Investors should look beyond the next six months and evaluate the economic and financial landscape with a focus on risk. Portfolios should then be positioned to protect capital should these risks materialize.

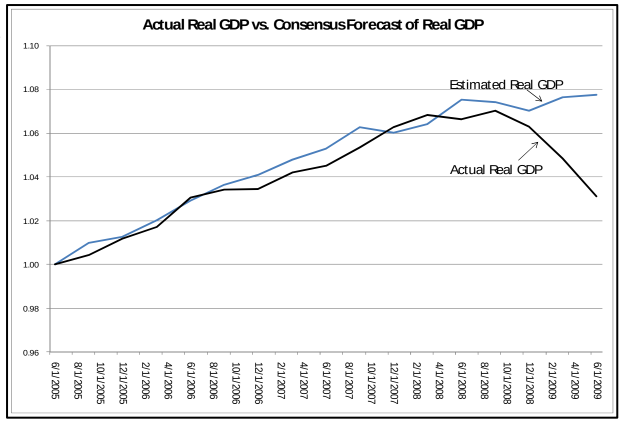
Despite the increasing bullishness from the big brokers, there is significant risk of a W-shaped recovery. There are signs of an economic recovery, as evidenced most recently by strong ISM-manufacturing numbers (Chart 2). But diligent investors should question the sustainability of the recovery.

Chart 3 compares real GDP to the real final sales of GDP. Real final sales are a more precise indication of underlying demand in the economy. Real GDP measures production. The gap between final sales and real GDP has grown increasingly wide over the last 18 months. Production is now far below actual demand. If businesses fully replenish inventories to match final sales over the next two quarters, real GDP could grow at a 2.9% annualized rate in the third and fourth quarters from inventory restocking alone. When you pile on remaining fiscal stimulus, real economic growth may increase through the second quarter of 2010. But then what? When the stimulus wears off and the shelves are restocked, the risk of recession reemerges.

Chart 4 compares real GDP to real final sales in the W-shaped recovery of the early 1980s. Production dropped below final sales, and then the economy emerged from recession as inventories were replenished only to fall back into recession a year later.

Jeremy Jones, CFA
Chief Investment Officer

1



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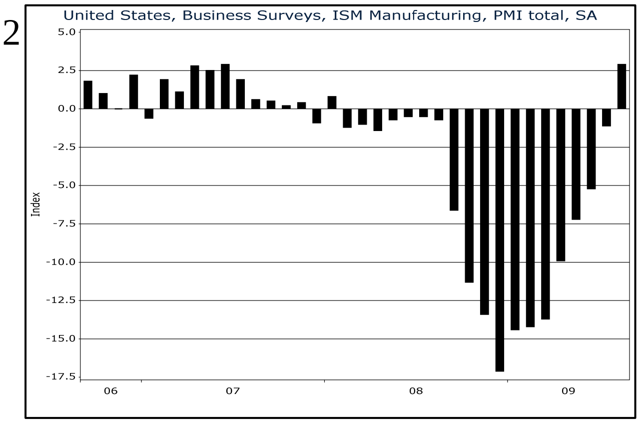

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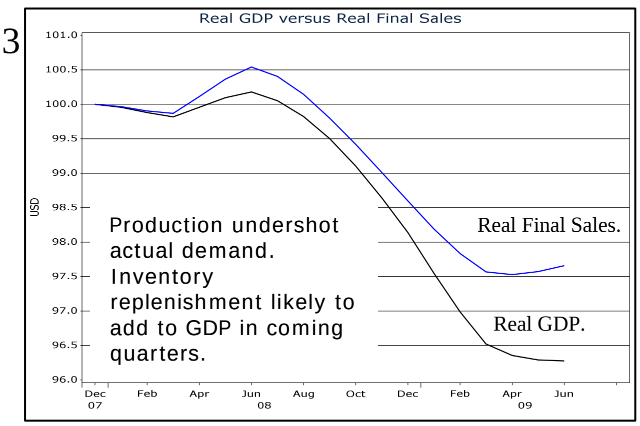

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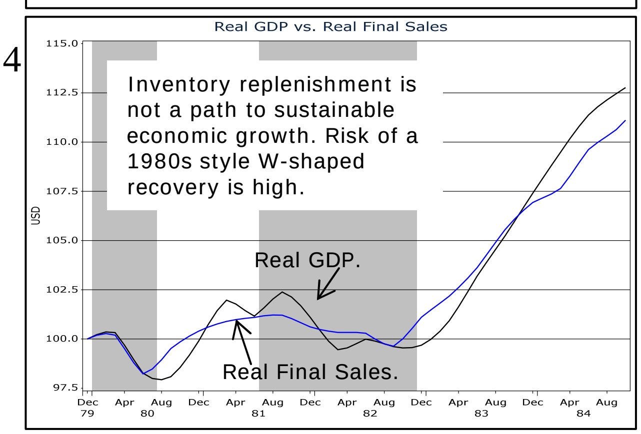
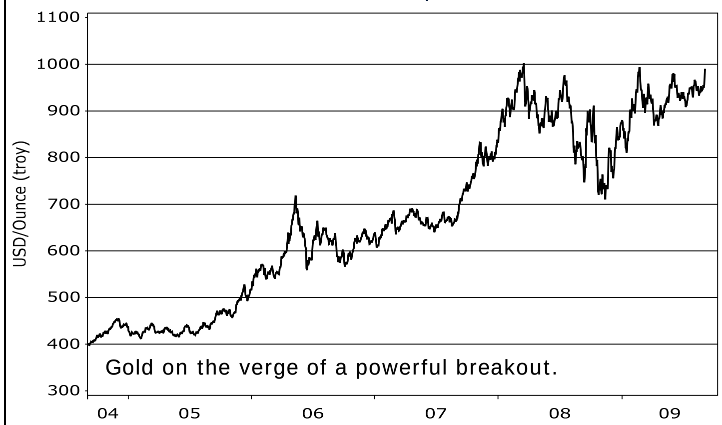


Composite Index of 10 Leading Indicators

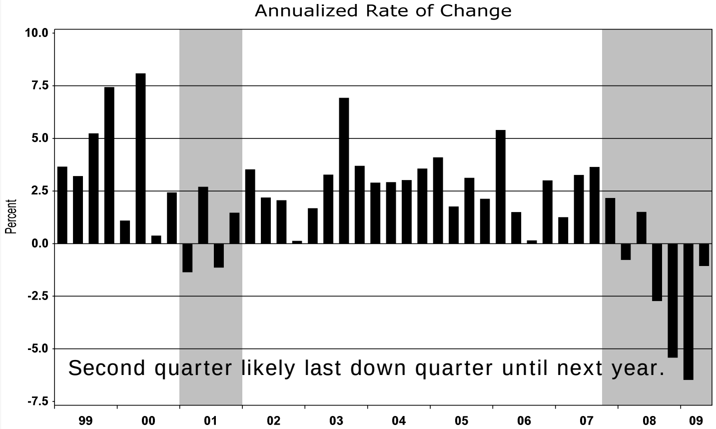
Year-to-Year Rate of Change

Gold Spot



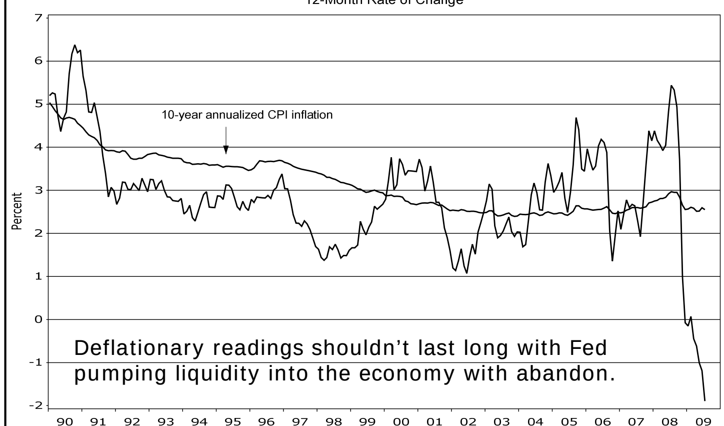
Gross Domestic Product

Annualized Rate of Change



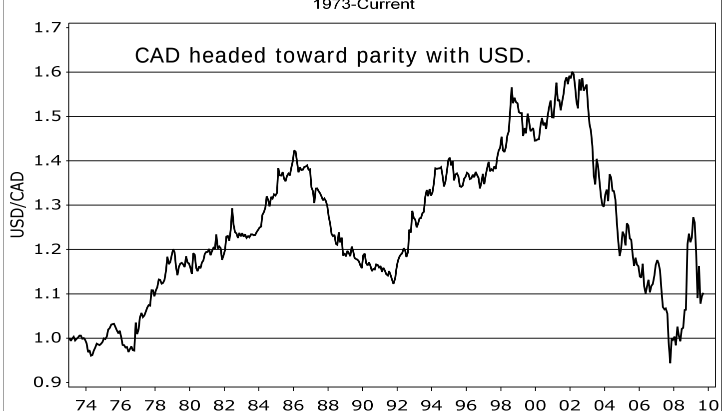
Consumer Prices

12-Month Rate of Change



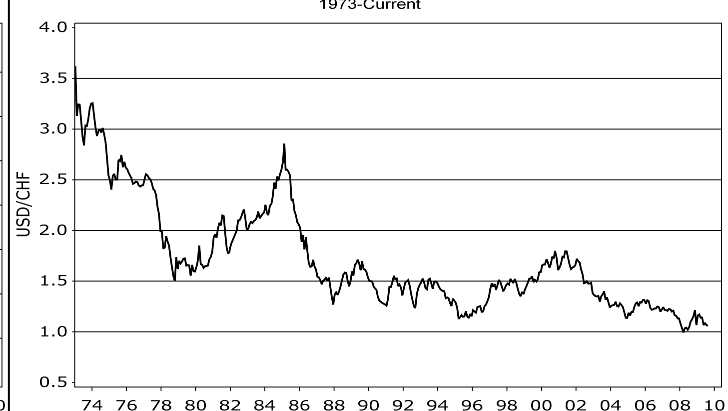
Number of Canadian Dollars One U.S. Dollar Buys

1973-Current



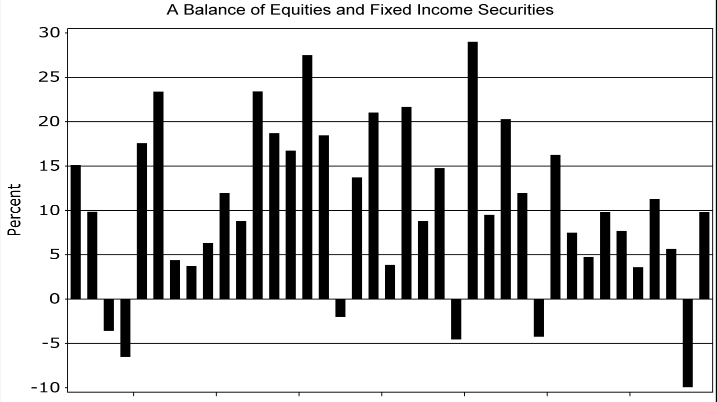
Number of Swiss Francs One U.S. Dollar Buys

1973-Current



Vanguard Wellesley Income Fund Annual Returns

A Balance of Equities and Fixed Income Securities



Risk

Dividend Payers vs. Non-Dividend Payers

(Standard Deviation over 36-month period ending 12/31/08)