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Dear Client,

I have a front row seat in Naples, Florida, to what may become a concrete problem for the U.S. economy: the commercial real estate market. Along U.S. 41 and many of the main roads that extend off Tamiami Trail (as 41 is also called) sit unoccupied strip malls, bank branches, and office buildings. While vacancies do not exist on every block, there are enough around to give concern.

For much of this decade, commercial property was red-hot, especially in South Florida. Many investors who got burned during the dot-com bust turned to bricks and mortar to reduce their risk. Fueled by cheap money, these investors could borrow at low interest rates to buy buildings or develop, and count on rental income and capital appreciation to cover financing costs.

Today is a different story now that the economy has tanked, cheap financing has dried, and tenants have disappeared. Especially concerning is the decline in property values. In many situations loan-to-value ratios are too high to refinance maturing loans. Consider an office building bought at the peak of the market for \$30 million and financed with a \$24-million loan, for an 80% loan-to-value ratio. If the building is now worth only \$24 million, the owner's equity is gone. A lender isn't likely to refinance the full \$24-million debt since it would amount to loaning 100% of the property's value. Likewise, the owner, down \$6 million already, may not be eager to put in more equity.

Across the country, similar problems exist. *The WSJ* recently reported that the Fontainebleau, a luxury hotel and casino development at the northern end of the Las Vegas Strip, sits more than half finished after falling into bankruptcy in June. The problem is the \$1.2 to \$2 billion required to finish Fontainebleau is more than the hotel is currently worth.

As commercial real estate loans come due, there will be difficulty finding alternative sources of financing. Foreclosures, forced sales, and new equity issuance are the likely result. The potential risk to the banking industry of mounting loan defaults is significant.

Interestingly, today's stock market does not appear particularly concerned with the problems of the commercial real estate market or other potential economic hurdles. In fact, the market does not seem concerned about much at all given its upward trajectory since March 9.

Recently, the Vanguard Group cautioned investors on the current rally. "While it may be gratifying to see these robust gains lift the balances of your funds, the markets have 'come a long way in a hurry,' as the saying goes. At this point, it may be wise to ensure that your asset allocation is in line with your long-term goals."

As usual, the conservative folk at Vanguard are on the money. Vanguard suggests a balanced, well-diversified portfolio, and in our opinion is correct in so cautioning investors. I would add that with the yield on the blue-chip Dow at a historically low 2.8%, stocks are in no way cheap.

James Stewart, a columnist for *SmartMoney* and a weekly contributor to *The WSJ*, cautioned investors in a September 2009 article about trying to make a quick buck in the stock market and buying on margin.

"I've always been leery of leverage. Only once have I owned stock on margin, and the experience was so stressful that I quickly got rid of it. I've never undergone a margin call, and I have no desire to experience it. Of course, I recognize that leverage can greatly magnify gains. You could argue that, if I'm investing only money I can afford to lose, why not swing for the fences? The simple answer is an emotional one: Leverage magnifies losses, and I'm not comfortable with that level of volatility. The rational answer is that margin calls force investors to sell into weak markets."

"Yes, avoiding leverage also means forgoing some high returns. But so what? I don't care whether I beat the S&P 500-stock index. That doesn't mean I don't aim to do well. But as individual investors we don't need to measure our performance by quarterly and annual benchmarks. Investing isn't an athletic contest, even though some commentators treat it like one."

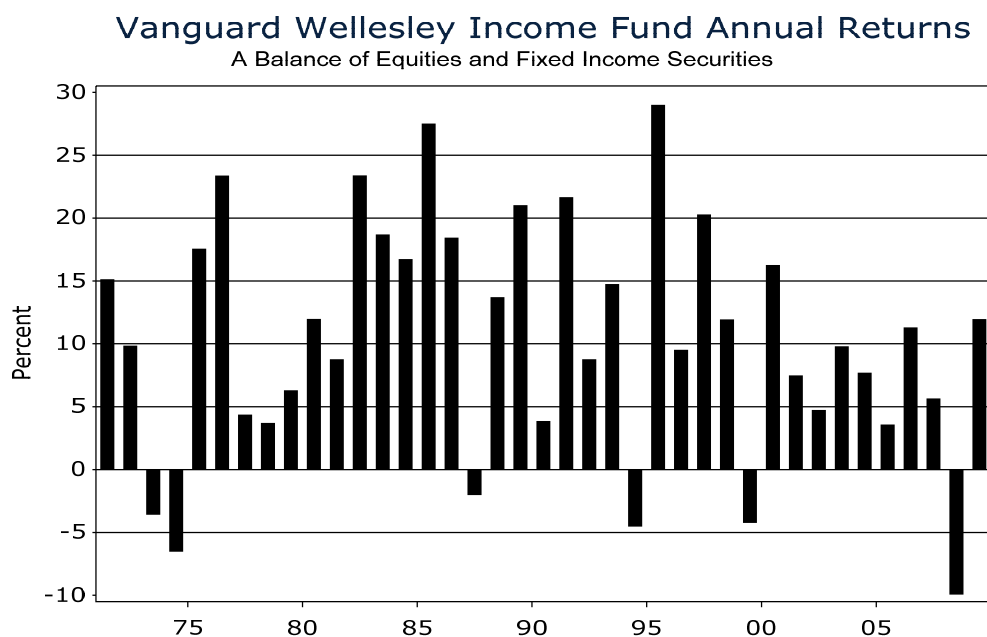
Instead of bringing a competitive spirit to investing, investors may benefit from Vanguard's recommendation of aligning their asset allocations with long-term goals.

Determining a personal long-term goal is an important aspect of investing. As the U.S. population ages and more people begin to retire, I believe many investors will have a similar and simple goal: to be able to annually draw a reasonable rate from their portfolio with minimal risk.

We suggest a portfolio draw in the 4% range. Our goal at Richard C. Young & Co., Ltd. is to achieve a 4% portfolio yield from dividends and interest generated from the portfolio. In today's environment, this is a tricky task. Yields on most money markets, CDs, treasuries, and corporate bonds are at record lows.

To help minimize risk, investors often seek out a heavier concentration of investment-grade fixed-income securities. The Vanguard Wellesley Income Fund, inception 1970, offers guidance as to the benefits of conservative balance. Wellesley has a mix of approximately 65%

high-quality bonds and 35% dividend-paying stocks, making the fund more conservative, and less volatile, than a fund entirely invested in equities.



In charts showing annual returns, investors often focus on the up years. But take a look at the down years. What do you notice? There are not many of them. And until 2008, Wellesley's down years were fairly modest.

While the past four decades are no guarantee of future performance, I do expect Wellesley, based on the fund's current investment policy, to continue to have less volatility than non-balanced equity mutual funds and exchange-traded funds.

Retired and soon-to-be-retired investors with a long-term goal of income and reduced volatility may favor an asset allocation similar to Vanguard Wellesley.

An additional bonus to Wellesley is the low expense ratio of the fund's Admiral Shares. Wellesley Admiral Shares charge 0.23% annually, which is substantially lower than most mutual funds and certainly much lower than A-share, B-share, and C-share funds.

Most investors buy mutual funds through a third party: a stockbroker, a financial planner, or even a company 401(k) plan. When purchasing a fund through this chain, there is often an additional expense on top of the mutual fund's annual expense ratio. The difference between the three share classes is how the third party gets paid.

- A shares charge a percentage of your purchase up front as a commission or "load." These commissions often range in the 4%–5% range.
- B shares lack an up-front commission but have higher ongoing fees than A shares for about six years. Also, during those six years,

investors get hit with a back-end commission when they sell. This back-end load is on a declining scale that goes away. Eventually the B share becomes an A share, which lowers the annual fee.

- C shares have no up-front loads but have higher ongoing fees until the investor sells the fund.

At Richard C. Young & Co., Ltd., we avoid these three share classes altogether. And, with the exception of a few no-load mutual funds, we focus primarily on exchange-traded funds (ETFs), whose expenses are nearly half the industry average.

Three ETFs that we currently purchase—CurrencyShares Canadian Dollar Trust (FXC), CurrencyShares Swiss Franc Trust (FXF), and SPDR Gold Shares (GLD)—charge annual expense ratios of 0.40%. That's it! No front-end or back-end commissions. So for less than one half of 1%, we are able to globally diversify in the Canadian dollar, the Swiss franc, and gold.

Investing in FXC, FXF, and GLD can help hedge against a declining U.S. dollar. The IntercontinentalExchange Dollar Index, which measures the dollar against six major currencies and is heavily weighted to the euro, fell to a 14-month low in mid-October 2009—not far from its all-time low, set in April 2008.

Many factors are contributing to the greenback's decline, including the flood of government dollars and the ultra-low level of U.S. interest rates. High supplies and low yields can drive down an asset's price. Also, with the worst of the recession most likely over, investors are seeking more risk. Investors who loaded up on U.S. treasuries during the crisis are unwinding these positions and heading into the international marketplace. You can bet the Chinese, with \$1 trillion in dollar-denominated securities, are looking to hedge their dollar bets. I would not be surprised if the Chinese are employing some of the same strategies we are at Richard C. Young & Co., Ltd.: investing in hard assets including gold, oil, agriculture, and other commodities that will go up in value as the dollar keeps going down.

As the dollar has declined in value, gold has received a fair amount of attention. Turn on the TV and you'll notice ads rotating between personal injury attorneys and pawn shops or other businesses looking to melt down your scrap metal.

While we are certainly looking to hedge a portion of client assets against a declining dollar, we do not want to go overboard. Last year at this time, the sky started to fall in the financial markets. Uncertainty and anxiety were abounding. The period could have been described as a doomsday scenario. Yet gold only ran up to the \$1,035 range. I'm not saying gold will not continue to rise. But overloading on a volatile asset like gold can bring its own set of potential problems.

I've never been a fan of loading up on what appears to be a can't-miss idea. Most investments go through cycles that can come to an end without notice. When I arrived to Naples in 2001, for example, commercial and residential real estate in this town was a can't-miss investment. It seemed that everyone was getting in on the action. And then... things came crashing down and people got burned.

Caution, as Vanguard advised, can make for prudent investment policy. A healthy mix of high-quality bonds and dividend-paying stocks, as demonstrated by Wellesley, can help reduce volatility and smooth out returns. This type of strategy can also add a degree of personal comfort in uncertain and turbulent times.

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. The current yield environment for stocks is challenging. Earlier this month *USA Today* reported that despite signs the economy and stock markets are on the mend, only 191 companies out of 7,000 increased dividends in the third quarter—down 45% from the third quarter of 2008, which was the worst third quarter for dividend increases in history. Meanwhile, 113 companies cut dividends, the highest number of companies to do so in a third quarter since 1982. Stocks may be zipping along, but companies, as evidenced by dividend activity, do not appear to share the market's enthusiasm. In today's environment I favor a conservative investment strategy.

P.P.S. Fortunately, the dividend environment is not bleak for all stocks. AT&T, Bank of Nova Scotia, and most pipeline companies, by example, offer attractive yields. As does oil company BP with a yield near 6%. BP made a sizable new oil discovery in the Gulf of Mexico that may contain more than three billion barrels of oil. If this estimate is accurate, BP's proven reserves would increase by 17% from year-end 2008 levels.

P.P.P.S. Chocolate, cigarettes, booze, and detergent should be less susceptible to whatever happens to commercial real estate, banking, and unemployment. People are still going to eat, smoke, drink, and clean. We gain consumer staple exposure through individual dividend-paying stocks including Coke, Hershey, and Kimberly-Clark. We also favor a consumer staples ETF offered by Vanguard. Also, as the dollar declines, big U.S. consumer staples companies should get a boost to sales. A weaker U.S. dollar makes U.S. goods cheaper for foreigners to buy.

The Analyst's Corner

The recession is likely over, but that doesn't mean you should expect a rapid recovery in all sectors of the economy. Industrial production is getting a boost from inventory restocking, but employment is still weak. September's employment report was a big disappointment to anyone hoping for a speedy recovery.

Chart 1 shows that during the last recovery, industrial production troughed 20 months before employment. Recovery in industrial production was already well underway before employment finally picked up.

Chart 2 shows that after the 2001 recession, it took the labor market three years to normalize. The 2001 recession was short and shallow. The current recession has been long and deep. What's more, as we came out of the 2001 recession, easy monetary policy ignited the residential real estate market—which gave both construction and consumer spending a big boost.

Consumer spending was of course propped up by people cashing out their home equity and spending it. Today, consumers are over-indebted, bank balance sheets are badly damaged, and there is overcapacity throughout the economy. The Fed's ultra-loose monetary policy is much less effective today than it was in past recessions. Despite a zero-interest-rate policy and quantitative easing, consumer spending has plummeted at rates not seen since the '50s (Chart 3).

Those hoping for a rapid recovery in employment are likely to be disappointed. At turning points in the employment cycle, we often see a divergence between the household employment survey and non-farm payroll survey. The household survey tends to lead the payroll survey. What do the indicators show today? There is a divergence all right, but household employment is still plummeting while losses in non-farm payroll employment are slowing (Chart 4). A turn in the labor market is not likely until we see significant improvement in the household payroll survey.

Jeremy Jones, CFA
Chief Investment Officer

