SPECIAL REPORT

AN ANNUAL PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT

OUTLOOK 2011

This year's report provides an outlook for each of our internally-managed asset class strategies. We have also included an introduction to Alternative Investments – the most recent addition to our suite of investment strategies for clients.

BY GEORGE HOSFIELD, CFA

Domestic Market

2010 drew to a close with fears of a double-dip recession abating and economic data revealing that the global expansion was intact and gaining momentum. After a mid-year slowdown, the preponderance of economic indicators now point toward a modest re-acceleration in domestic growth. For all that was written about the "new normal," last year looked surprisingly like the "old normal." Looking forward, the extension of Bush-era tax cuts suggests that the pace of activity will likely accelerate in the first half of 2011 and a second round of quantitative easing ("QE2") renders a "double dip" highly unlikely. In our view the cyclical equity bull market is not yet over. The combination of a sustained economic expansion and fiscal stimulus provides a favorable backdrop for domestic equities. The constructive thesis for equities is further bolstered by strong corporate balance sheets, high profit margins, attractive valuations and what we believe will be a record year for corporate earnings.

Favored Themes

- Stocks over bonds
- Large cap over small cap
- Emerging markets over developed markets
- Resource inflation
- Overweight cyclical sectors (energy, materials, industrials and technology)
- Dollar to weaken versus emerging market currencies
- Dollar to strengthen versus Euro

Developed Markets

Volatility related to European debt concerns will likely persist in 2011 … and beyond. However, in large part thanks to strength in Germany, we expect developed Europe to muddle through with modest growth next year. The global recovery that began in the second half of 2009 is now transitioning into an economic expansion that will continue through 2011 and into 2012. A principal driver of this growth will be the emerging market economies. With slow growth in the G7 and a weak labor market in the U.S., capital will likely continue to flow to emerging markets as investors pursue growth.

Emerging Markets

Worries over the sustainability of China's expansion just a few months ago has now given way to concern about how much policymakers will have to tighten in order to slow an economy that has exhibited a meaningful rebound. The developing world now accounts for approximately two-thirds of global GDP growth and we seek to profit from this secular trend in a variety of ways. First is direct investment in businesses that sell to the rapidly growing middle class. In China, India and Brazil, consumer spending is expected to increase at an 8 percent annual rate over the next decade. By comparison, it is anticipated that the U.S. will expand by just 2.5 percent annually. Emerging economies are generally more resource intensive than developed economies and therefore have a proportionally greater appetite for raw materials. Fueled by demand from emerging economies and as a hedge against dollar devaluation, we remain quite enthusiastic buyers of select "hard" and "soft" commodities.

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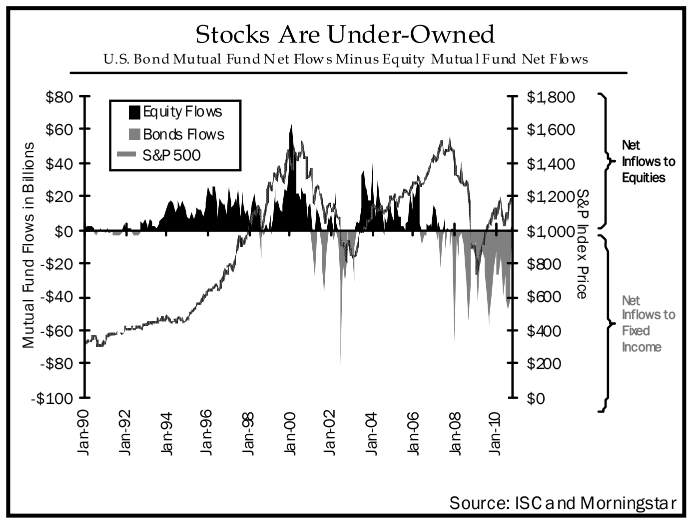
In addition to direct investment in commodities, another way to leverage this secular trend is to purchase equities in resource rich countries —such as Australia, Canada and Brazil—that are well positioned to benefit from exporting to the developing nations.

Emerging market countries have stronger economic growth, rising exports and higher interest rates than developed countries. As such, we expect emerging market currencies to appreciate versus the U.S. dollar and other developed currencies. In addition, emerging market countries have half the level of government debt to GDP as their developed counterparts. In contrast, the U.S. has a substantial trade deficit, low interest rates and an economic growth rate that is likely to remain below historic trend. History has shown that such indebtedness is solved via default, time or inflation … and perhaps the least painful way to address the deficit is for the currency (the dollar) to adjust downward. The factors that propelled the performance of emerging market equities last year (superior growth rates, strong balance sheets and currency appreciation) are likely to continue into 2011. Further supported by attractive valuations, we believe emerging market equities will again outperform those of the developed markets in 2011.

Equity Sector Strategy

As was the case last year, we enter 2011 favoring energy, basic materials, technology and industrials—which are all sectors that are leveraged to rapidly growing, developing markets. We will be particularly mindful of balance sheet quality and free cash flow generation when selecting individual securities. Successful companies often possess these attributes, but we believe they hold even more importance in today's low interest rate, growth-challenged world that is pushing companies to increase their dividend payouts, repurchase stock and seek merger partners.

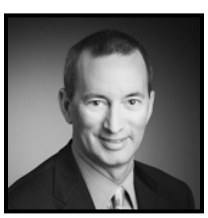


Asset Allocation

Over the last decade the average annual return for U.S. large-cap stocks has been -0.4 percent while government bonds have returned 8.45 percent. Not surprisingly, investors are now overweight fixed income and underweight equities (see accompanying graph). Contrary to mutual fund flows of the past two years, we believe that 2011 will bring an end to the secular bull market in bonds and will continue to be a favorable environment for equities.

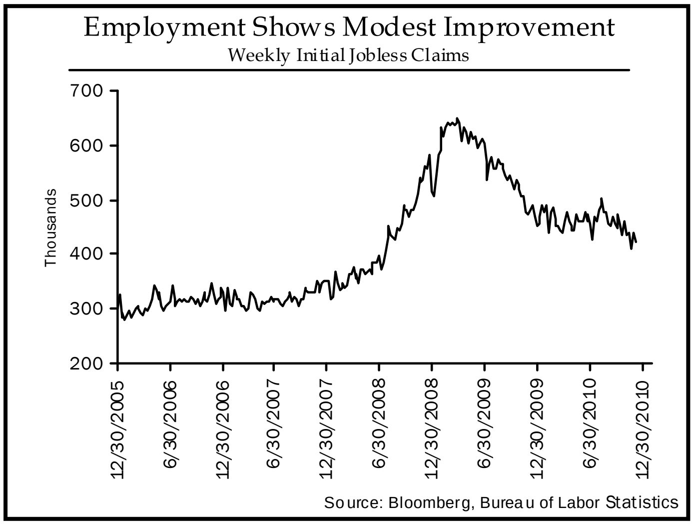
Fixed Income

BY MARC FOVINCI, CFA



After slowly muddling along for months, evidence is now mounting that the pace of economic growth has moved up a notch. The full breadth of domestic economic indicators, from weekly jobless claims to retail sales, is showing some improvement (see chart on next page). The healing of time, low interest rates, and the Federal Reserve's second round of quantitative easing will all have a positive impact on the economy. The two-year extension of the Bush-era tax rates in mid-December reduced uncertainty and headed-off a looming tax increase in the midst of a difficult economic recovery. This gives the markets more confidence in the durability of the recovery, thus popping up bond yields and equity prices. Economists are now revising GDP forecasts up from 2.5 percent to 3 percent or even 3.5 percent for 2011. We concur with this outlook and believe the recovery is moving toward being self-sustaining and self-reinforcing, making further upward revisions to GDP forecasts likely.

With real estate yet to show any meaningful improvement and the debt crisis in the European Union block, significant risks to the economy certainly exist. While the European debt crisis is a challenge for the Euro currency and causing austerity measures for Greece, Ireland, and others—the major economy of Germany is still fortunately exhibiting significant strength. We believe growth in the major European economies will prevent the effects of the crisis from applying the brakes to the U.S. economic recovery.



Inflation should not get out of hand as slow growth and excess capacity is now preventing much inflation acceleration. Given the weakness of housing and the banking system, we do not expect a sudden acceleration in GDP growth, thus giving the Fed time to drain reserves as banks gradually resume lending. This should prevent inflation from moving consistently above the Fed's target of 2 percent. However, against this backdrop of an improving economy, we expect a gradual trend upward in interest rates, but the rise should be tens of basis points, not full points.

Accordingly, we shall keep portfolio durations lower than benchmark in anticipation of rates trending upward. More solid economic growth and good corporate earnings should keep credit ratings strong and cause us to continue to favor corporate bonds over Treasuries. In addition, the lower duration and historical return characteristics of agency mortgage-backed securities makes them a favored defensive sector for us. With the dissipation of the flight-to-quality trade to Treasury bonds in this past recession, Treasuries remain our least-favored sector. With our outlook for gradually higher rates, we are working to keep portfolios defensive and we continue to believe bonds are stable sources of income in the longer-term.

International Equity

BY RALPH COLE, CFA

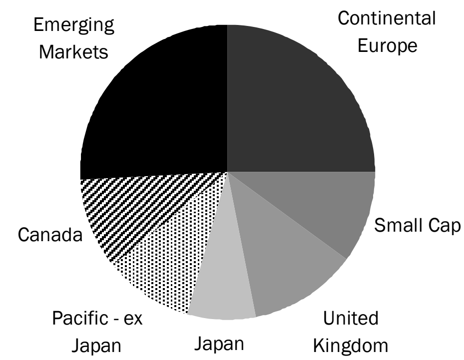
Our *International Equity* strategy continues to evolve and grow with the international capital markets. In 2010, we migrated from the MSCI EAFE benchmark to the MSCI All World Country Index ex the United States (ACWI ex US). The new index is different to the extent that it includes emerging market countries.

Another change that we implemented to our international portfolios was the addition of developed market, small-capitalization stocks. We gained this exposure through a mutual fund and an exchange traded fund. We added this asset class in order to both enhance returns and reduce correlation relative to our other asset classes. We approach international investment opportunities with three criteria in mind: valuation, growth and currency. In short, our ideal international stock would have solid growth prospects, trade at a discount to its global peers and be located in a country with a strengthening currency.

As we look ahead to 2011, many of the same themes, risks and opportunities remain from 2010. Most prominent is that emerging markets will continue to be the focus in the portfolio. The ACWI ex US benchmark contains a 20 percent exposure to emerging markets. Justified by both valuation and growth rate, our current target weight is 30 percent … and growing. The emerging market themes running through our portfolio are not without risks. Specifically, China, India and Brazil are all facing increasing inflation pressures. To stem inflation, they have had to raise rates and restrict lending. The hope is that they can engineer soft landings for their respective economies, but as we know, "sticking the landing" can be tricky.

We continue to underweight many of the major, developed international economies. While valuations may appear to be compelling, we think sub-par growth will continue to hold back markets in Europe, the United Kingdom and Japan. Germany, Canada and Australia are the only developed economies that we are currently overweight. We are emphasizing Canada and Australia because of their abundance of natural resources, and sound financial systems. We are constructive on Germany because it is home to many high-quality, industrial companies whose strong export profile benefits from the weak Euro. We also consider sector weightings when constructing our international portfolios and we integrate several of the same themes that we have in our domestic portfolios. As such, the portfolio is overweight energy, industrials and technology; and underweight financials, telecommunications and utilities.

Ferguson Wellman Current International Equity Allocation



Source: Ferguson Wellman International Equity Allocation as of 12/31/2010

Our *International Equity* strategy is primarily high quality, large-cap American Depository Receipts (ADRs) from both developed and emerging countries. It also includes international small-cap equity and emerging markets through emerging market ADRs and a small-cap mutual fund.

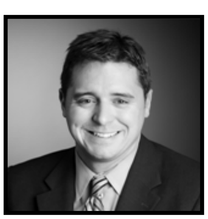
Municipal Bonds

BY DEIDRA KRYS-RUSOFF

Although states and local municipalities will be slow to recover to pre-recession levels, the gradually improving economy should help stabilize municipal revenues in fiscal year 2011. The probable cessation of the Build America Bonds program and advanced refunding activity led to a backup in yields in the fourth quarter. We expect this price volatility to continue.

Municipal issuance in 2010 surpassed the record of $430 billion achieved in 2007, with much of the issuance occurring in the last four weeks. The excess supply and resulting steep yield curve have provided investors with the opportunity to purchase 10-year bonds yielding above 4 percent. This price point usually attracts higher demand, and we believe that this investor class will step back into the market, thus increasing demand for bonds. With excess supply pushed into the last quarter of 2010, we expect to see below average issuance for the first quarter of 2011, which should also serve to correct the supply/demand imbalance. We continue to focus on issuers with predictable and diverse revenue sources, who provide essential services to their communities, and seek to avoid issuers in localities most sensitive to continued economic downturns. The year-end sell-off in the municipal bond market provides opportunities for the knowledgeable investor to purchase strong credits that should continue to pay attractive after-tax income. As such, we remain discerning and active buyers of municipal bonds.

Dividend Value

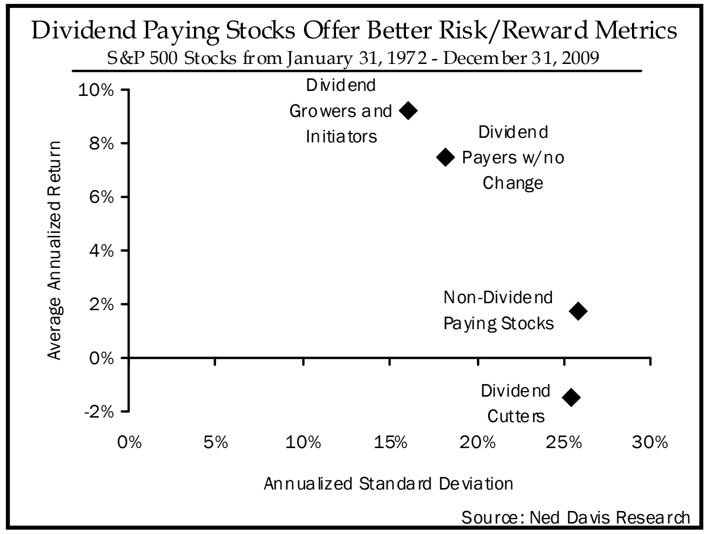


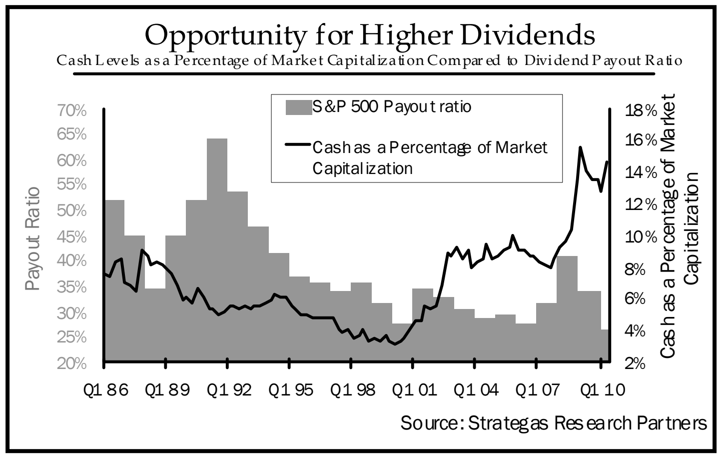
BY JASON NORRIS, CFA

What makes our *Dividend Value* strategy unique is its focus on companies with growing dividends and cash flows—not just "cheap" stocks with a high current yield. The result is a more robust discipline than many pedestrian value/income approaches. We believe that stocks that pay dividends offer a better risk/reward than those that don't (see chart on next page). History has shown that investors receive greater returns with less volatility through owning dividend-paying stocks, rather than non-dividend paying.

While *Dividend Value* owns only dividend-paying stocks, it does not employ a "yield hurdle," thus affording us more flexibility to enhance total return through investing in lower yielding stocks that may have substantial international exposure and cash flow growth.

Looking ahead to 2011, with a compromise on the tax treatment of dividends and corporate balance sheets holding a record amount of cash while maintaining a low payout ratio (see accompanying chart), we believe that dividend-paying stocks should continue to exhibit strong performance with moderate risk. *Dividend Value* will continue to focus on economic growth across the globe and overweight those sectors that will benefit from the economic expansion. Also, we expect commodity prices will remain firm due to strong demand in China, thus we will continue our overweight in the energy and basic materials sectors. Risk to our outlook would be a slowdown in China which reduces demand for commodities and capital equipment. Also, if bond interest rates rise meaningfully, dividends may become less attractive relative to interest payments for those investors looking for income.



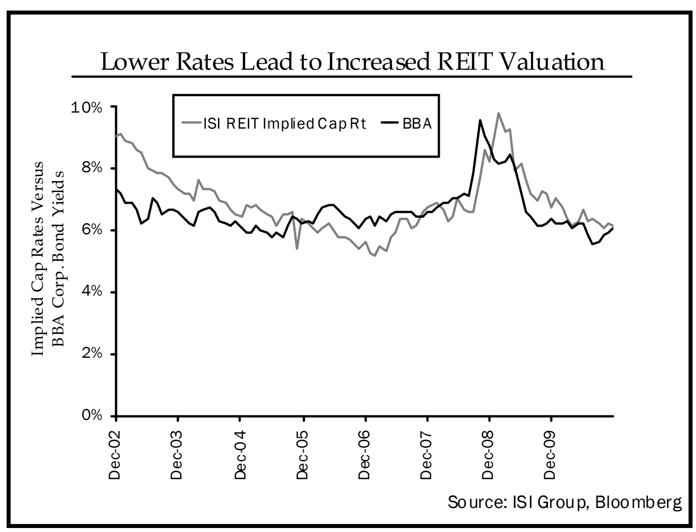


Real Estate Investment Trusts (REITs)

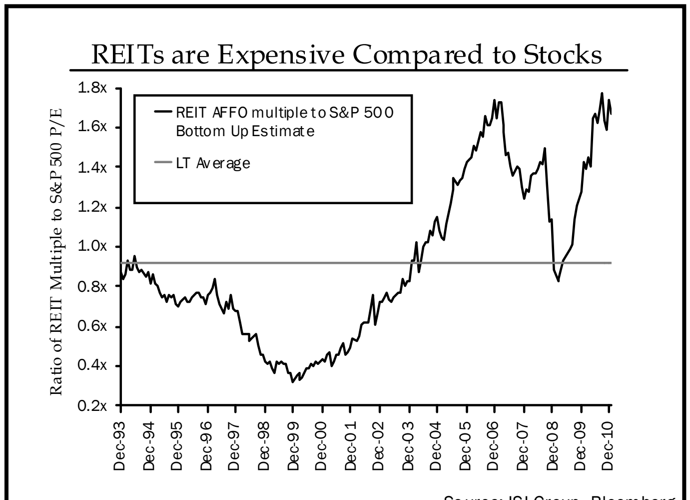
BY RALPH COLE, CFA

We were as surprised as anyone by last year's tremendous REIT rally. With total returns topping 20 percent, REITs were one of the best performing asset classes. Why did REITs do so well in 2010? In a word: rates.

Which rates in particular? As you can see from the accompanying chart, Treasury rates fell throughout 2010. The chart to the right shows just how closely implied cap rates for REIT stocks follow bond yields. The capitalization rate on a property or portfolio of properties is simply the income from those properties divided by the value of the property. The lower the "cap rate" the higher the value of the asset(s). One concern that we have is that when interest rates start to move higher, cap rates will rise, thus dropping REIT values.



On a positive note, REIT fundamentals continue to slowly improve, especially within the residential (apartment) sector. With improving job growth, household formations are starting to pick up again, but the lack of credit is still forcing people into apartments. Throughout 2010 apartment owners were actually able to reduce rent subsidies and increase rental rates 2 to 4 percent. Although it has become more expensive, we still like this sector.



Source: ISI Group, Bloomberg

With regard to other REIT sectors, we continue to like office owners with substantial presence in both the Washington, D.C. and New York City areas. A few trophy properties have exchanged hands in these cities recently at surprisingly high prices which has served to put a floor under office REIT valuations.

As the economy continues to improve, REIT fundamentals should improve as well. Our allocation to REITs remains at the low end of guideline ranges because REIT valuations are back to all-time highs relative to blue chip equities (see accompanying chart) and we believe there is a better case to be made for large-capitalization stocks that have access to growing global markets.

Alternative Investments

BY DEAN DORDEVIC

In the years leading up to the peak of the last economic cycle and the subsequent financial crisis that followed, allocations to so-called “alternative investments” became quite popular. While historically these investment vehicles were more typically the purview of institutional investors (e.g., foundations and endowments), they became much more widely held by wealthy individual investors. While we wouldn’t characterize the level of pre-crisis investor interest as a bone fide mania, it probably came reasonably close.

In the aftermath of the crisis, it became quite clear to us that there was the potential for opportunity from this adversity. With this in mind, we began a process to identify *best-of-breed* investors with whom we could partner. Our interest, research and due diligence began about two years ago, and we are pleased to report that we are now offering our clients access to both private equity/debt investments, and more traditional hedge funds. Below we will provide a brief primer on both private equity and hedge fund investing. In addition, we have also included illustrative background information on the providers we are working with thus far.

What is Private Equity?
Private equity/debt is an investment not commonly available in the public markets. Typically, a manager of private equity will create a limited partnership fund with cash from qualified high-net-worth investors. Those funds are then typically invested in privately held companies, the collateralized debt of small companies, and often the negotiated purchase of large stakes in public securities traded in the secondary markets. In addition, asset-backed securities, real estate loans, trade receivables, and natural resource investments are also the targeted investments of private equity.

Loans and debt are usually purchased at a discount to the manager’s perception of fair value, resulting in the potential for above-average returns as the instruments are either repaid or sold later on for a profit.

Private equity owners often target underperforming and distressed companies burdened by excessive debt. Successfully rehabilitated companies are often worth significantly more than the purchase price, reaping outsized gains for investors upon their eventual sale or initial public offering.

Since most of the underlying investments in private equity funds are not publicly traded, private equity fund valuations are not directly correlated to the capital markets and thus can provide valuable diversification benefits for investors.

In addition to manager quality, the key to realizing private equity's return potential is *time*, since managers typically employ multi-year lock-ups that allow for the underlying investments to reach full valuation. Since the time horizon from initial funding to return of capital usually spans *at least three years*, private equity is appropriate only for those investors who do not require near-term liquidity and return of capital.

What is a Hedge Fund?
A hedge fund is a lightly regulated investment fund that is typically open to a select group of investors. In the classical definition of a hedge fund, the fund employs offsetting "hedges" so that both upside return and downside risk can be managed. While there are many different strategies that are employed, the overarching goal is an absolute return with reduced risk and capital preservation. A common misconception is that all hedge funds are volatile and that they are highly leveraged. In fact, less than 5 percent are designed this way, and many use no leverage at all.

Another variation on the theme is the *fund-of-funds* approach. As the name suggests, this is a fund that is an amalgam of (generally) uncorrelated hedge funds. These funds may be highly diversified, or conversely—sector or geographically focused. These funds can be an excellent source of one stop shopping—providing access to a broad range of investment styles, strategies and managers in a single investment.

Hedge fund (fund of funds) can provide an investment portfolio with lower levels of risk, and can deliver total returns that have comparatively low correlations with common stocks. These portfolios can also deliver more stable returns than a single hedge fund, and can significantly reduce the risks associated with an individual fund manager.

Ferguson Wellman's Alternative Investment Partners
Private Equity: Keystone National Group
Keystone is a private equity and debt fund manager. Keystone utilizes a fund-of-funds approach in building their portfolios. Keystone's managers have an accomplished history in the private equity industry and utilize those skills to select managers to execute their strategies. In a typical fund, their universe of private equity funds is winnowed to a group of 300 outside managers. Keystone then subjects those selected to more rigorous analysis. In total, a seven-stage due diligence process is used to ultimately select 18 to 20 private equity funds, each with approximately 10 to 15 underlying buyouts, asset plays, or debt instrument investments. Thus, in a typical fund, investors will own 200 to 300 underlying private equity investments, well diversified by business type, size and geographic concentration. Keystone's managers align their interests with those of the limited partners through direct ownership interest in the underlying funds.

Hedge Funds (fund-of-funds managers): Lazard Asset Management and Lazard Alternative Strategies Fund
Lazard Asset Management is a global investor with more than 235 investment professionals worldwide. The fund is supported by Lazard's global infrastructure (legal, compliance, operations and marketing). Their *Alternative Strategies Fund* has assets of approximately $1.2 billion. The fund invests in four principal strategies: relative value, long/short, event driven, and tactical trading. The funds three portfolio managers each have over 20 years of capital market experience. They utilize a rigorous process to screen and select the underlying managers. The fund typically has 25 to 35 different constituent funds. The goal of the fund is to achieve capital appreciation on an attractive risk-adjusted basis.

Hatteras Multi-Strategy Institutional Funds

The Hatteras Funds are a leading provider of alternative investment funds. The *Hatteras Multi-Strategy Institutional Fund (HMS)* is a diversified multi-strategy fund-of-funds. This portfolio is uniquely structured to provide investors with the return profile more commonly associated with the alternative portfolios of larger endowment funds. The fund typically invests in 150 to 200 hedge funds which are allocated amongst six asset classes: opportunistic equity, enhanced fixed-income, absolute return, real estate, private equity and natural resources. The secondary objective of the fund is to achieve capital appreciation with less overall volatility than that of the equity markets.

Strategic Opportunities

BY DEAN DORDEVIC

Strategic Opportunities is a well diversified capital appreciation approach that incorporates three distinct investment strategies bundled into one portfolio: a spin-off portfolio, a special situations portfolio, and a global macro portfolio. The spin-off portfolio is based on research showing that companies that are fully spun from their parent company typically outperform in the second and third year following the original spin-off. In our special situations portfolio, we typically buy stocks that may not qualify for inclusion in our other strategies, but are attractive for other reasons. These holdings may be event driven, and our investment time horizons may be quite short. We may choose to buy these positions in a manner whereby our returns are magnified by holding traditional options or longer duration options such as Long-Term Equity Anticipation Securities (LEAPs). Lastly, our global macro allocation is designed to be nimble and market opportunistic, allowing our team to purchase a broad spectrum of attractively valued assets. This may include, but is not limited to, foreign emerging markets equities, soft and hard commodities, bonds, and sector specific exchange-traded funds. Cash is an allowable defensive position.

This portfolio is designed for clients with more aggressive risk/return objectives relative to other Ferguson Wellman products. *Strategic Opportunities* seeks high absolute return relative to the S&P 500 and is not overtly managed to maximize after-tax return. Clients can expect to see the majority of their returns from capital appreciation rather than dividend income in this portfolio. As a stand-alone portfolio, it is more volatile than our traditional strategies.

2010 was a good year for the *Strategic Opportunities* portfolio. The portfolio successfully focused on emerging market growth and commodities, along with global capital investment in technology infrastructure and health sciences. We earned excellent returns in many areas including, gold and silver, soft agricultural commodities, hard commodities/industrial metals, and investments in Brazil and India. We continue to believe these are attractive investments as we enter 2011. The portfolio remains tilted toward global growth, led by emerging market economies and supported by our own domestic recovery. Our special situations and global macro segments of the portfolio capture this market exposure using a variety of instruments. We have direct investments in companies that specialize in mining and health sciences. The portfolio also utilizes broader exchange-traded funds (ETFs) to target emerging market country and region specific investments along with the most attractive segments in the commodities market. We believe that many opportunities for investment will present themselves in the new year especially in our special situations and global macro portfolios. We expect to continue concentrate funds in both of these segments.