Market Letter
Third Quarter 2011

by George W. Hosfield, CFA
Chief Investment Officer

Looking Back

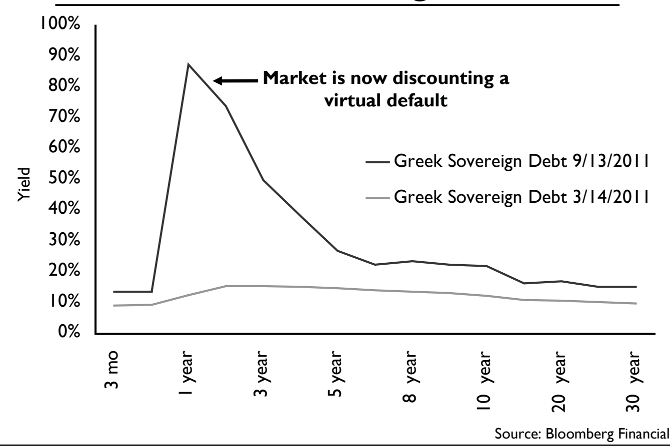
• A loss of confidence in political leadership on both sides of the aisle, and boths sides of the Atlantic, has severely damaged investor confidence in recent months.

• Burdened by an array of flagging leading indicators in many large economies around the world, equities fell fast in late July and have remained in a volatile trading range ever since.

• The ongoing threat of a Greek default continues to weigh on investors. While Greece lacks significant economic scale, the fear is that Greece could be the first domino to fall in a row of contagion spreading to other countries (e.g., Italy, the world's third largest debt issuer) and financial institutions.

• Interest rates fell to record lows and the Standard & Poor's downgrade of U.S. Treasury debt to AA+ underlined the need for fiscal austerity. In essence, "the bill has arrived" for a decade of U.S. deficit spending.

Greek Crisis Coming to a Head



Looking Forward

• The woes of the European Union (EU) are front-and-center in the headlines and accordingly, the markets are wary of dislocation. *We believe the EU will avoid a financial meltdown,* but growth-dampening fiscal austerity will rule for years to come.

• *Never before has the health of the global capital markets been so dependent upon prudent political actions on both sides of the Atlantic.*

• *Though interest rates are at or near all-time lows, we do not see rates rebounding soon.* The high level of public debt precludes any meaningful fiscal stimulus and the Federal Reserve's $400 billion "Operation Twist" is likely to have a minimal effect. Combining constrained fiscal and monetary policy with a multi-year workout for the housing market leaves an economy best characterized as "flying at stall speed." As such, *inflation will likely recede and interest rates remain lower, longer.*

• In a low-growth environment, we believe bonds will be a stabilizing force in portfolios.

• Though valuation is not necessarily a catalyst, equities in general offer value. We favor dividend payers and are emphasizing defensive sectors such as healthcare and utilities, as well as technology in the cyclical sectors.

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius

China Derailed

by Dean M. Dordevic
Principal

" ... China has to get rich, before it gets old ... " - Thomas L. Friedman[1]

This summer, Dean Dordevic traveled extensively throughout China. He visited several of China's largest cities, including Shanghai and Beijing. He also ventured into central China with a visit to Xi'an, and then toured both larger and smaller cities along the Yangzi, including: Zhujiajiao, Yichang, Badong, Wanzhou, Fengdu and Chongqing. The following are his thoughts and impressions.

The Chinese have a saying, *"the sky is high and the emperor is far away."* The meaning is obvious enough: The realities of provincial life are distant from the exercise of power in the Chinese capital. If you only visited Beijing or Shanghai, you would have a very different opinion of China. They are sprawling, cosmopolitan cities. Shanghai is remarkable, but even more so when you realize that this city of 25 or so million was farmland 20 years ago. If modern Shanghai had materialized in 100 years it would still be remarkable. Twenty years is stunning.

What is truly amazing, however, are some of the cities in central China. While you have most probably never heard of Chongqing, quite remarkably, this city in central China has a population of 29 million! This is larger than Australia with its population of 23 million. Perhaps more than anything, China's "demographic math" is both simple and powerful. China's population is now 1.4 billion. Twenty years ago, about 80 percent of the population were farmers. That number is now in the low 60s percentile. Fifteen percent of their people have now migrated from farms to cities. That's roughly 200 million people (the U.S. population is 304 million). Their government's goal is to get their urban/rural population ratio to about 70/30. What we've seen so far is only version 1.0 of this transition. There are two or three iterations of this shift yet to come.

During our visit, the Chinese suffered a horrific crash of one of their new high-speed bullet trains. The government attempted to, quite literally, bury the wreckage the following day. When this story went viral, the government was forced to shine the light-of-day on the disaster. My impression was that this was a monumental tipping point for the Chinese. This was a "page one" story. Page two carried a story about the collapse of the entire center span of a major bridge. China's growth is stunning, but also very "scary." Chinese use that word often to describe what's happening. They say that what they have had is, *"Quantity, not quality,"* and then proceed to then quote Confucius,*"Do not be desirous to have things done quickly."*

China's first derailment produced a curious result very similar to what transpired during the "Arab Spring." That is, technology has fundamentally changed the relationship between China's *government and the governed* — a significant change at the margin to be sure.

Twenty years ago, China had no major highways. Today, with a landmass about the same size as the U.S. (if you include Alaska and Hawaii), China has about the same number of miles of highways. This same paradigm exists for their domestic railway system. China's bullet trains began running only five to seven years ago, and in a government burst of spending, has now built over 10,000 kilometers of track. To put this into perspective, this is four times the length of Japan's prolific Shinkansen lines which have now operated for 47 years without a single fatality from collision or derailment.

Just prior to the crash, a Chinese official bragged that their high-speed rail system was so superior to the Japanese Shinkansen that, *"They cannot be compared in the same breath."*[2] *The Wall Street Journal* was more specific, *"China's high-speed rail system is an apt metaphor for the country's hurtling economy over the past decade: a colossal investment project, born of the state, steeped in corruption, built for maximum velocity, and imposed paternalistically on a public that is amazed and skeptical … in a country whose per capita income ranks below that of Jamaica."*[3]

In order to truly understand the Chinese model, you have to abandon your naturally western notion of government and business as separate entities. The Chinese Government is business. To the extent that private enterprise exists, it functions to expand the goals of the state. Investing in real estate and precious metals are favored choices for investment, although there was not much worry that we could gauge about either "see-through" buildings or buildings that have ceased construction midstream. Many of these empty apartments are owned, but not occupied. With the continuing population transition they envision, the Chinese view these yet-to-be-occupied apartments as a "store of value."

Inflation, especially food inflation, is a significant problem in China. All of the people we spoke with brought it up in one way or another. They all quoted the stated government inflation rate of about 6 percent, but believe that *real* inflation is higher. During our visit the government made front-page news by releasing hundreds of tons of reserves from their "strategic pork reserve" to moderate soaring pork prices.

More recently the government has tried to slow China's economy. While credit for large state-sponsored projects is relatively easy to come by and free flowing, smaller manufacturers are getting squeezed. By some estimates, China's private sector accounts for 80 percent of the country's jobs and more than half of total output. To fill the void, a network of non-bank private lenders has emerged. They have become lenders of last resort to many of these cash-strapped borrowers. China has become what many call a "dual track economy" with a state-owned sector flooded with cash and a private sector somewhat starved of funding.[2]

The Chinese government operates within a grand bargain crafted with their people. The quid quo pro is this: Government will provide jobs and a rising standard of living. In return, her people will honor the power of the state. This bargain is now in question. Since China is a demographic "have not," whose population will grow by less than 6 percent between now and 2050, China must get rich before it gets old. That is, China must move from two parents saving for one child, to one child paying for the retirement of two parents.[1] For China to continue to thrive and prosper, her people must heed the words of the architect of China's renaissance, the late Deng Xiaoping, who famously remarked, *"Getting rich is glorious."*[2]

In many ways, China is a grand example of what psychologists call "confirmation bias." Confirmation bias is the propensity to believe that what you see or read confirms your previously held beliefs. I came away thinking that whatever your opinion of China was before your visit, you'd probably feel more strongly after you left. There's a lot to be bullish about, but there is a decent bear case too. If you were on the fence, I think you might be even more indifferent.

It is difficult not to be compelled by the "math." Moving millions en mass from rural China to new urban centers is the equivalent of an economic tsunami; however, the paradox of state sponsored capitalism is a curious thing. The lack of Schumpeterian "creative destruction" and the unintended consequences that distill from "Red Capitalism" are incalculable. That said, I think if you put the two on a balance beam, the longer-term growth story most probably prevails. To have confidence in your bet, you'd have to believe that China is somewhere in the early-to-middle innings of their development.

My feeling though, is that the nature and timbre of growth going forward may well be different. That's hard to predict, of course, since in China, government is Big Brother and it can really do whatever it likes.

As the Chinese like to say, *"Mao is looking down on us, and he has one eye opened and one eye closed."*

China Derailed footnotes and sources:

1 Thomas L. Friedman, "All Together Now," *The New York Time*s, August 27, 2011.
2 Lingling Wei, "China's New Lenders of Last Resort," *The Wall Street Journal*, September 13, 2011.
3 Jason Dean and Jeremy Page, "Trouble on the China Express," *The Wall Street Journal Weekend Edition*, July 30 and 31, 2011.
4 Ben Levisohn, "Why China Looks Like a Buy," *The Wall Street Journal Weekend Edition*, July 16 and 17, 2011.

Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius

From “Arab Spring” to “Red Capitalism”

by Mary A. Faulkner
Vice President of Marketing

To ensure that our *Market Letter* is useful and informative, we provide definitions for investment and economic terms mentioned in each publication. Some clients may be learning these terms and phrases for the first time, while others may need some *mindful reminders* on their meaning.

“Arab Spring”: A movement spreading throughout the Middle East and Northern Africa. Although the momentum for the “Arab Spring” has been building for decades, revolutions occurring at the end of 2010 marked the beginning. Tunisia, Egypt, Libya, Bahrain, Syria and Yemen are countries most notably impacted thus far. Social media (such as Twitter and Facebook) were credited for helping the Arab world organize effectively and communicate outside of the affected countries. (page two)

Dividend: A distribution of a portion of a company’s earnings, decided by the board of directors, to a class of its shareholders. The dividend is most often quoted in terms of the dollar amount each share receives (dividends per share). It can also be quoted in terms of a percent of the current market price, referred to as dividend yield. (page five)

Dividend-payout ratio: The percentage of earnings paid to shareholders in dividends. The payout ratio provides an idea of how well earnings support the dividend payments. More mature companies tend to have a higher payout ratio. (page five)

“Operation Twist”: On September 21, the Federal Open Market Committee (FOMC) announced what the financial press has dubbed “Operation Twist,” which was the selling of $400 billion short-term Treasury bonds from its portfolio and buying long-term Treasury bonds with the proceeds. While leaving the amount of reserves in the system constant, the action is designed to reduce long-term interest rates, encourage lending and the flow of capital to riskier assets. (page one)

“Red Capitalism”: A phrase from a book title published in 2011 called “Red Capitalism: The Fragile Financial Foundation of China’s Extraordinary Rise.” Written by Carl Roger and Frasier Howie, the book explains the intricate relationship between the Communist Part of China (CPC) and the financial institutions that form the country’s economic foundation. Economic Commentator Jim Rogers, co-founder of the Quantum Fund with George Soros, coined the phrase “red capitalism” in 2005. (page three)

Schumpeterian “creative destruction”: A Marxist economic theory term that refers to the relationship between the accumulation and annihilation of wealth under capitalism. From the 1950s until today, the term “creative destruction” has become associated with Austrian-American economist Joseph Schumpeter, who popularized it as a theory of economic innovation and progress. Schumpeter’s use of the term has gained popularity with supporters of free-market economies. (page three)

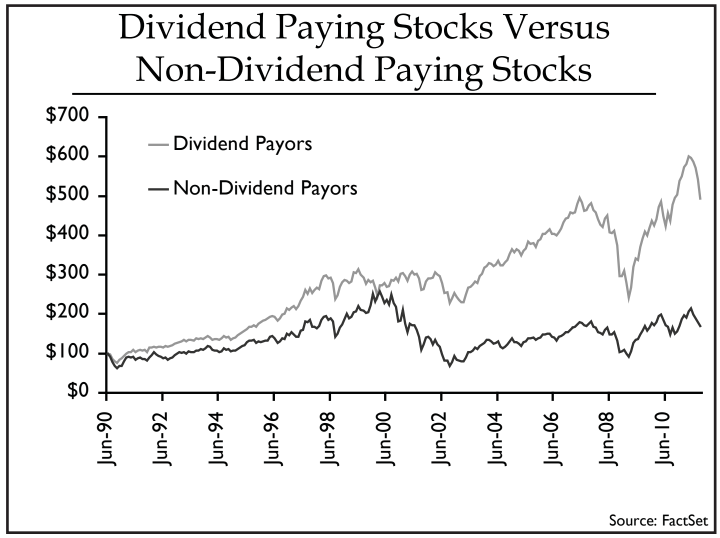
Mindful Reminders sources:
Barron’s Finance and Investment Handbook, Investopedia, Wikipedia

Let not your mind run on what you lack as much as on what you have already. – Marcus Aurelius

Large-Cap Dividend Value

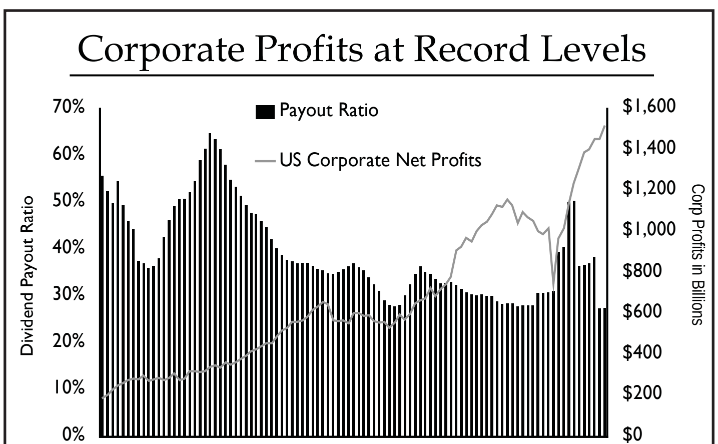
by Jason D. Norris, CFA
Senior Vice President of Research

Increased equity market volatility and interest rates at historic lows have led investors to look for attractive dividend-paying stocks. Historically, dividend-paying stocks have outperformed their non-dividend paying peers. Even during the last 20 years, including the years of the tech bubble, dividend stocks offered a more favorable return (see chart to the right).



Looking ahead, we believe dividends will be even more attractive due to concerns over economic growth and our belief that interest rates will remain lower, longer. Unlike 2008, when we saw record cuts in dividends, we believe corporations will consistently raise their dividends.

Corporate profitability is reaching record highs, (see chart below) creating plenty of flexibility to increase dividends. Over the last century, dividends have been a meaningful portion of total return; however, that has not been the case in the last two decades. *We believe that this will change and a dividend strategy is highly advantageous.*



Investors cannot just buy "yield in a vacuum." Focusing only on high-yielding equities has historically resulted in poor relative performance. According to Morgan Stanley research the "sweet spot" for buying dividend-paying stocks is to focus on yields in the 3 to 6 percent range and healthy growth prospects. *Therefore, not all dividend strategies are created equal.*

What makes Ferguson Wellman's *Large-Cap Dividend Value* investment strategy unique is its focus on companies with growing dividends and cash flows, not just high-yield stocks. The result is a more robust discipline than many value/income approaches. Through our selection within the dividend-paying universe, we have delivered performance that is in the top quintile. This outcome has been consistent since the inception of the strategy.

Change makes our universe. Thoughts make our lives. – Marcus Aurelius

Investment Services

Its Never Too Early to Start Tax Planning

by Mark J. Kralj
Principal

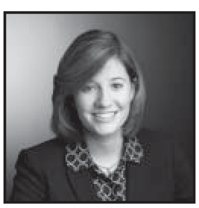
As in past years, we're reading headlines about potential changes to tax laws. With Congress and the White House proposing options for reducing the U.S. deficit, we are all speculating about what lies ahead. Regardless of the uncertainty, there are three areas that our individual clients can focus on right now – and it's never to early to start planning. We are happy to meet with your accountant and pass along any necessary information to help you make year-end decisions. To make tax information reporting easier for you and your accountant, Ferguson Wellman's wealth management committee is developing communication strategies and technologies that will streamline and expedite the process in the future.

Take Three Tax-Planning Steps this Fall

- Determine if you have moved into a higher tax bracket or are subject to alternative minimum tax this year
- Inquire about what gains and losses you need in your portfolio
- Start to identify your year-end gifting and charitable contributions

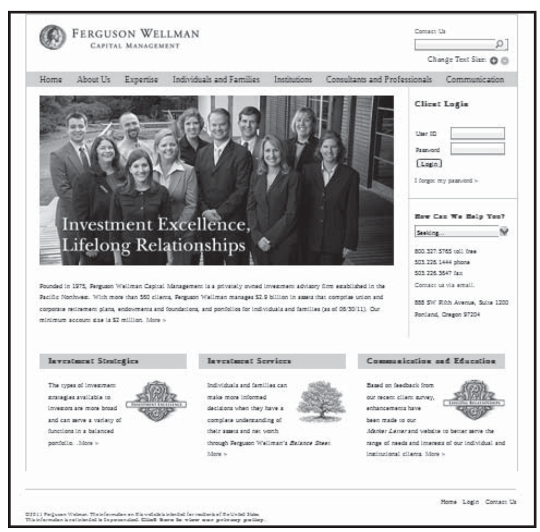
Communication and Education

New Look and Functionality for Our Website



by Natalie E. Miller, Sales and Marketing Associate and
Shawn W. Swagerty, Director of Information Systems

This September we re-launched www.fergusonwellman.com. We embarked on our redesign six-months ago with the objective to modernize our site, refine navigation and functionality, and improve the overall experience for our web visitors.



Our new website now provides a number of resources for users; from up-to-date, in-depth account information and improved security to consolidated communication archives. In addition to the improved functionality, plans are underway to integrate new technologies that our new site can support. We appreciate your patience during the transition regarding client login information and hope users will find the new site easier to use and navigate through.

Our logo features a bronze coin of Marcus Aurelius Antonius, Emperor of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of meditations that reveal a mind of great humanity, natural humility and wisdom.