Market Letter

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

Second Quarter 2011

by George W. Hosfield, CFA
Chief Investment Officer

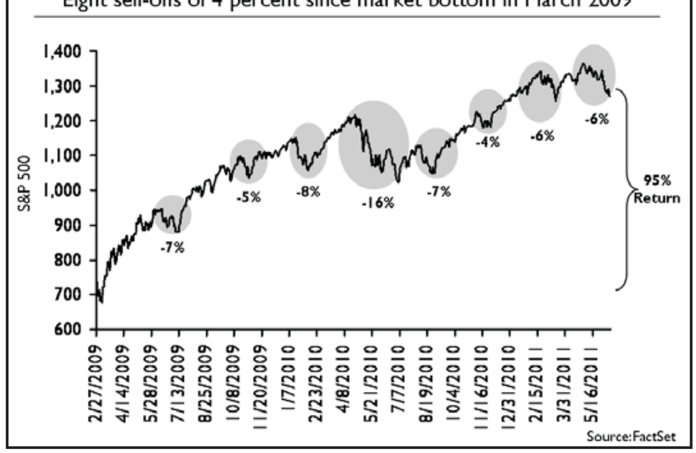
In This Publication

Looking Back

In what appeared eerily reminiscent of June 2010, the economy and equity markets endured a “soft patch” during the quarter. Some of the same factors impacted both periods, such as a higher unemployment rate and the slow-motion train wreck of Greek sovereign debt. Slower manufacturing growth, rising inflation and China’s resulting interest rate hikes also gave global investors reason to pause in this last quarter. The silver lining here has been commodity prices—from corn to copper to oil—prices dropped by more than 10 percent for a wide range of inputs.

After retreating 7 percent during the quarter, the S&P 500 rallied to erase its losses, continuing a pattern of small corrections within the bull market that is now up almost 100 percent since its cyclical low in March of 2009.

While equity investors hit turbulence, fixed income investors prospered. Led by the rally in U.S. Treasuries, broad-market bond indexes registered 2 to 3 percent returns for the quarter. Municipal bonds did even better as tax revenues rebounded and states worked to close budget gaps.



Corrections Are Quite Common In Bull Markets
Eight sell-offs of 4 percent since market bottom in March 2009

Looking Forward

- Moderating energy prices and diminished supply chain disruptions following the Japanese earthquake auger well for an economic rebound in the third quarter
- Record exports, cash-rich balance sheets and growing sales should extend the boom in corporate profits to record territory
- With earnings up and valuations down, equities are compelling at current levels
- The U.S. economy is growing, though expansion is slower than in past cycles. Corporate profits surged in the first stage of recovery and should ultimately lead to a second stage recovery in employment. The third stage is harder to predict and likely years off, but should ultimately lead to a housing recovery
- As the economy moves beyond the soft patch, intermediate and long-term interest rates are likely to rise
- The Federal Reserve will continue to hold short-term rates close to zero until employment shows consistent and solid gains, likely late in 2012
- We continue to tilt portfolios toward riskier assets, with allocations favoring equities over bonds and emerging over developed markets

Weapons of Reason

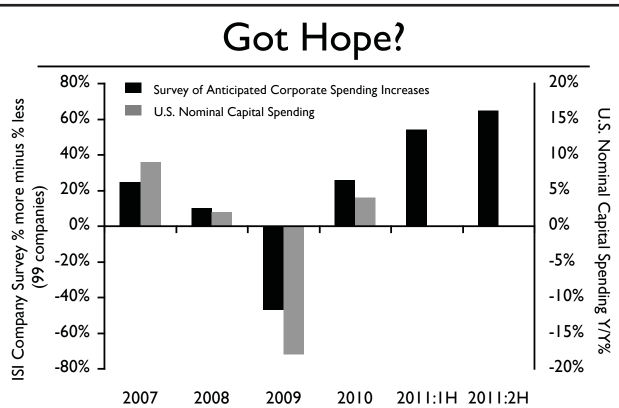
Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius

Why Should We ... "Stay the Course"... ?

by Dean M. Dordevic
Principal

In the quarter just passed, the market experienced a sharp correction, at one point relinquishing about 6 percent of its value. While never pleasant, history teaches us that corrections like these are by far the rule and not the exception. The most recent occurrence has been true to this historical pattern. We have now had eight corrections of at least 4 percent since the lows reached during the nadir of the financial crisis.

This heightened volatility is most likely not behind us, but the market is reaching levels where we would expect a fairly robust bounce. From trough to most recent peak, the market has advanced nearly 100 percent and over that same period, corporate profits are up a like amount. What we've found most interesting—particularly over the last few weeks and months—is the disconnect between the macroeconomic data (which has been decisively soft in the U.S. and globally) and what we are hearing directly from our company managements.



There's a 94 percent correlation between this survey and actual capital spending

Source: ISI Group and Ferguson Wellman Capital Management

Specifically, companies have been more constructive and optimistic than the recent economic data would otherwise suggest. Perhaps they are somewhat intoxicated by their robust levels of profitability. Interestingly, they have expressed a greater interest in hiring and are generally more inclined to make capital investments than has been the case in recent months. This has admittedly been a head-scratcher for us, particularly in light of the macroeconomic data. The earthquake and tsunami in Japan had an enormous, incalculable impact on the supply chain, especially in auto manufacturing and technology. Perhaps what we're seeing is related to that event, but we believe there are other issues at work.

After a fairly dramatic run, we think we are experiencing a "*pause that refreshes*"—both for the markets and the real economy. In addition, almost every commodity we track has been on a tear and we believe that some moderation in prices would be a good thing. Additionally, the market is coming to terms with the end of the Federal Reserve's process of "quantitative easing," which we believe is impacting the financial markets as well.

While the negatives are well known and, in our view are amply discounted, there is a laundry list of positives that have bubbled to the surface more recently. We believe that these factors will both calm the nerves of investors and serve as a potential catalyst in the near term.

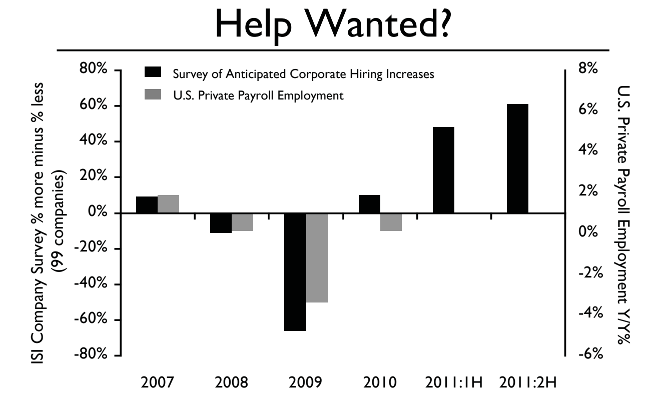
While the situation in Greece is clearly a mess (and we are being kind), it looks like the EU will, nevertheless, "*solve Greece.*" That is, they will ... kick the can down the road. While this certainly is not helpful longer term, at least for the foreseeable future, the political will of the Europeans has coalesced to attempt to defuse this problem. The situation in Japan is improving and, more importantly, appears at this point to be fully discounted in prices.

Through our contacts in Washington, it appears that a substantive deal on the budget will come in early-to-mid-summer and will yield several trillion dollars in deficit reductions. We do not believe this to be widely anticipated and therefore this event would be a positive for both bond and stock prices. In addition, the American Association of Retired Persons (AARP) dropped its longstanding opposition to cutting Social Security benefits. In the words of Senator Alan Simpson, this is the political equivalent of the "Arctic icecap cracking."

If there was one crucial variable that we hang our hats on, it continues to be profits. After all, if you cut through the fog, corporate profitability has been *the* key to the market's advance since the depths of the financial crisis. The rebound in profits that we have experienced has been the most dramatic since the late 1940s. Companies continue to raise profit forecasts, increase dividends, and have either already increased capital spending or have indicated a greater propensity to do so.

JP Morgan economists Bruce Kasman and Robert Mellman, who recently authored a special report on profitability, point out that, *"Corporate profits have plenty of room to run, as returns on investing and expanding are high. This makes companies want to grow (their) business. As profitability remains strong, they'll increase hiring."*

Earnings have surged at an average annual rate of nearly 30 percent in the eight quarters ended 2010 and have accrued with little help from the economy, according to Kasman and Mellman.[1] In fact, operating profits have increased six times faster than the rise in nominal GDP.



There's a 94 percent correlation between this survey and actual hiring plans

Source: ISI Group and Ferguson Wellman Capital Management

What's more, a recent survey of 99 companies, performed by New York-based International Strategy and Investments (ISI), concluded that businesses are more optimistic about capital spending for this year than they have been since 2003. The report also pointed out that hiring plans are at the highest levels in five years (see charts).

Some of this optimism is undoubtedly the result of fortress-like balance sheets of Corporate America. Companies included in the S&P 500 now have accumulated almost $2.6 trillion in cash and equivalents. According to Joseph Carson, director of global economic research at Alliance Bernstein L.P. in New York, *"The corporate sector is in much better shape than in previous cycles. Liquidity is the lifeblood of all cycles. The U.S. has the foundation for a strong recovery."*[1]

In our world, the dichotomy we have outlined is often called the difference between "bottom up" and "top down" forecasting. With time and experience, we've come to give the benefit of the doubt to boots on the ground versus the financial press and lofty prognosticators. We will, of course, continue to monitor the myriad of economic variables that flow through our office each day. We will not hesitate to change our stance if we believe that is what is in the best interest of our clients and their portfolios.

Until then, we are staying the course.

Weapons of Reason footnotes and sources:

[1]*Bloomberg*, "Profits Seen Increasing Jobs as Earnings Grow Most Since 1940s," June 13, 2011.

Mindful Reminders

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

by Mary A. Faulkner
Vice President of Marketing

To ensure that our *Market Letter* is useful and informative for all of our clients, we've defined a handful of investment and economic terms that are mentioned in each publication. Whether you are an executive, family member or trustee—staying informed on the economy and capital markets provides context for your own decision making regarding your investment goals. Some clients may be learning these terms for the first time, while others may need some mindful reminders on their definitions.

Our recent client survey indicated that—beyond providing investment management—about 75 percent of institutional executives and trustees listed investment education as the most important service our firm could offer. Ninety percent of all of our clients indicated they were interested in more information about investment topics in the news.

In addition to our *Market Letter* publication, we also provide *Capital Markets Update* emails, *Investing Essentials* programs and our *Glossary of Investment Terms* for clients. Don't hesitate to contact our firm if we can provide any of these resources to you.

Bottom up: An investing approach where managers look for outstanding performance of individual stocks before considering the impact of economic trends. This approach assumes individual companies can do well even in an industry that is not performing well. (page three)

Dividend discount models: A procedure used to determine the price a stock should be selling at based on the discounted value of anticipated future dividend payments. This process is used to find prospective capital gains by identifying stocks that are undervalued. (page five)

Fair market value: The price that a buyer is willing to pay to a seller for an asset or service. It is assumed that both buyer and seller are rational and have reasonable knowledge of the details of the purchase and sale. (page five)

Leading stocks: High quality, growth stocks that typically "lead" the market up. These are the stocks that investors generally purchase first when investing in the market. (page five)

Macroeconomic data: Aggregate data pertaining to a nation's economy as a whole. Examples include price levels, unemployment, national income, inflation and industrial production. (page two)

Moving average: The average value of a security or commodity prices shown over a period of time. (page five)

Sovereign debt: Debt issued by a national government in order to finance the issuing country's growth. (page one)

Value traps: A stock, which due to a considerable drop in price, may appear like a value stock, but in reality is not actually undervalued. (page five)

Mindful Reminders sources:
Investopedia, Barron's Finance and Investment Handbook, Investor Words.com

Investment Strategy Spotlight

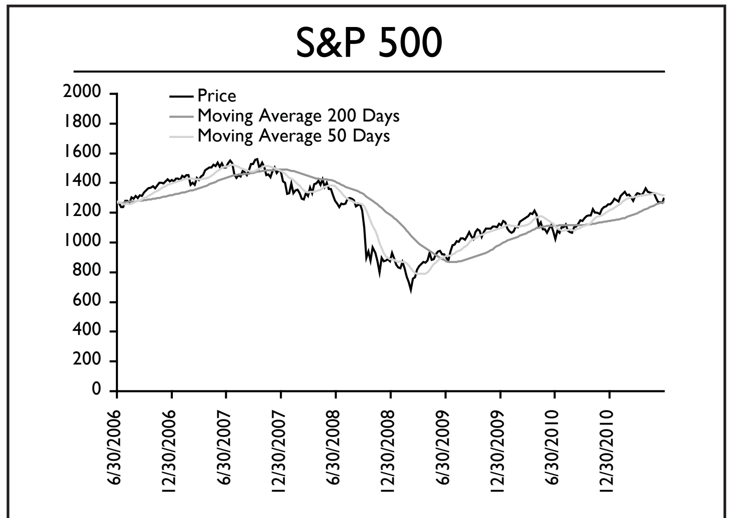
Technical Analysis: What the Market Is Telling You

by Timothy D. Carkin, CAIA, CMT
Senior Equity Trader

Carkin is a Chartered Market Technician (CMT). This specialized certification is administered by the Market Technicians Association and denotes proficiency in technical analysis of the financial markets.

At its heart, *technical analysis* is the study of the stock, *not* the underlying company. Simply put, a stock's value is the price at which someone is willing to buy it and another is willing to sell it. This differs from fundamental analysis where many factors such as cash flow, earnings and dividend discount models are employed in an attempt to calculate the "fair market value" of a security.

Technical analysts, on the other hand, look at various measures of price action (see chart) to discern a stock's value. Some indicators employed are the relative strength of a stock, velocity and moving averages. These measures can be applied not only to individual securities, but also to market and sectors.



Source: FactSet

Looking at this last market cycle, it is easy to see how stocks can trade vastly different from what their fundamentals might suggest. The folly investment managers may run into is relying solely on the fundamentals and buying so-called "value traps." These are stocks that appear cheap fundamentally but ultimately fall further in price. At Ferguson Wellman, we are not hesitant to employ technical analysis in order to provide more robust information regarding the timeliness of our trades. This has proven to be a valuable "overlay" to our fundamental analysis.

Technically Speaking …

Where We've Been (S&P 500)

- Most technicians believe that most of the last decade was a downtrend in the market
- Toward the end of 2007, stocks were showing signs of exhaustion. During the first few months of 2008, most technical indicators showed weakness
- As illustration, watching the moving averages (50 and 200 day shown in the chart above), one would be negative through most of 2008 and turn positive early to mid-2009. In this case, we could look to technical indicators to validate our thesis when many fundamental-based investors were still gun shy

Looking Ahead

- Equity markets are still in an uptrend, with a year-end technical target of 1335 to 1365
- Energy, healthcare and staples are technically the most attractive domestic sectors
- We will probably stay in the same trading ranges (1260 to 1370) through summer
- Signs of weakness usually show up on the new highs list. Watch for "leading stocks" to sell off

Investment Services Spotlight

Best Practices for Serving Institutional Clients

by Donald L. Rainer
Institutional Services Committee Chair

Two years ago, a group of Ferguson Wellman professionals started meeting on a monthly basis to discuss investment and financial questions asked by individual and family clients. From these meetings came the creation of our *Wealth Management Framework*—our best thinking on how to meet clients' investment needs and identify financial milestones they may face in the years ahead. Last year, another group formed at the firm, this time focused on our institutional clients.

53% of our new client assets in 2011 are from institutions. (as of 6/30/11)

The institutional services committee started with reviewing how we serve clients when we are first hired and identified ways to make the transition as swift and as convenient as possible for them. For existing clients, we've standardized the review process of their investment policy and are updating new board member and trustee information annually. In our 2011 client survey, we found that nearly three-fourths of institutions expressed interest in investment education. We will continue to evaluate opportunities to serve institutions—for their investment management and beyond.

Communication and Education

Women and Wealth Management

by Helena B. Lankton
Wealth Management Committee Chair

There has been considerable national data in recent years about the changing landscape of women and wealth. Our latest client survey showed our women and men clients share similar characteristics and views, with a few distinctions. For example, more than half of our women clients are below the age of retirement, compared to more than half of our men clients being 65 and older. Half of women respondents came to Ferguson Wellman through a family member or friend, whereas men tend to have heard about our firm from more sources.

When asked what issues were important beyond investment management, a greater percentage of women clients than men clients mentioned wealth transition to family members over retirement. Also, 86 percent of women said their investment style is moderate to conservative compared to 75 percent of men.

We found that the majority of our women clients are interested in receiving more information about investing and economic news from our firm. We were also pleased to learn that, similar to men, 98 percent of women found their quarterly reports organized and easy to navigate, and 81 percent read and value our *Market Letter*. Our survey data helps create the foundation for our planning of events, publications and services that meet the needs of all of our clients.

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.