Special Report

An Annual Publication of Ferguson Wellman Capital Management

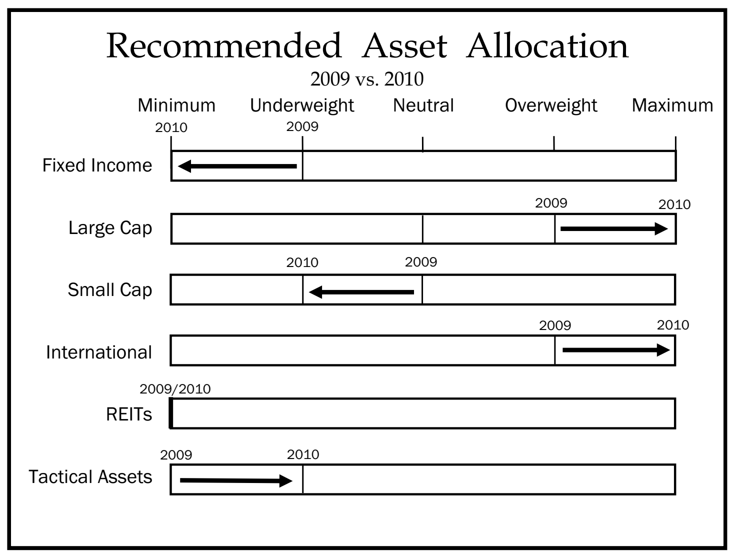
Outlook 2010

Sugar High?

by George Hosfield, CFA

What a difference a year makes. After one of the worst years in history for investors, 2009 brought above-average returns across all equity styles. Aided by unprecedented monetary and fiscal stimulus, credit markets thawed and investors' risk tolerance returned. Like the emergency room patient who doctors stabilize before nearly losing to anaphylactic shock, stocks rose from what felt like the dead in March, climbing a wall of worry to recoup roughly half of the damage done since the highs of 2007.

The Great Recession has ended. Despite high unemployment and continued job losses, the U.S. economy began growing again in the second half of 2009 and we expect continued expansion in 2010. In our *Outlook 2009*, we predicted that unemployment would peak near 10 percent sometime in 2010; that benchmark has now been reached but we believe that it will top out soon. To a significant extent, the equity returns of 2009 reflected diligent cost-cutting by corporations that boosted productivity through job cuts. Going forward, these companies will likely add workers to more fully participate in the unfolding emerging recovery. As people go back to work and consumer confidence improves, a more enduring rebound in consumer spending and economic growth should occur.



Though substantial earnings growth is likely in 2010, we expect more modest equity returns as investors begin to discount Fed tightening, reduced government stimulus, and probable tax increases to stem a ballooning budget deficit. A key debate continues to be how well the economy will perform when stimulus is removed. We will be closely monitoring credit markets to see how key interest rates respond to an improving economy and the Fed's anticipated exit from the agency mortgage-backed securities market.

Regarding asset allocation, with the Fed sidelined (for now) by high unemployment and excess productive capacity, the dollar is likely to remain weak. In an environment where China and other emerging economies are leading the world out of recession, we expect to further overweight international equities and increase exposure to U.S. large-cap companies whose global footprint positions them to benefit from overseas demand and currency translation. A weak dollar should also support commodity prices. We envision further reducing our allocation to bonds and small-cap equities while maintaining minimal exposure to REITs, which remain susceptible to ongoing challenges in commercial real estate.

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ASSET CLASS OVERVIEW AND EQUITY SECTOR STRATEGIES

Domestic Equity

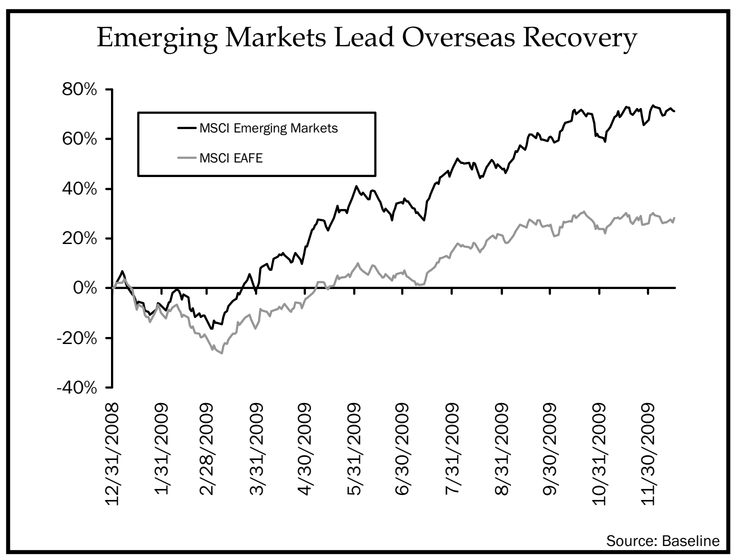
BY GEORGE HOSFIELD, CFA

Off the lows of March, U.S. equities rallied handsomely in 2009. While we do not foresee the same magnitude of gains in 2010, we hold a constructive view of domestic equities and are focusing on economically-sensitive issues in the technology, industrials, energy, and basic materials sectors. With the productive capacity of our workforce stretched by job cuts, companies are doing more with less by investing in labor-saving technology and capital goods. Overweighting late-cycle materials and energy reflects our positive outlook for global economic growth next year. Emerging market economies have become the marginal buyer of commodities, and inasmuch as the dollar remains weak, commodity-based companies should benefit from higher prices and volume gains. Tighter U.S. monetary policy is likely toward the end of 2010, and with tax increases on the legislative agenda, we will be vigilant for changes in leading economic indicators that could cause us to move to a more defensive posture.

International Equity

BY RALPH COLE, CFA

International equity returns are driven by capital gains, dividends and currency. Moving international equities underweight in 2008 was prompted by risk aversion and our sense that the dollar had temporarily bottomed. In 2009 we reversed those trades. After the global economy bottomed in 2009, we believed our clients would benefit from more global investments. International markets have some advantages over the U.S. market in coming years. European markets have a valuation advantage, while emerging markets will be driving much of global growth in 2010. We don't think emerging market growth is just in Southeast Asia; Brazil is also one of our favorite markets. Of the developed economies, both Australia and Canada are uniquely positioned as resource-rich economies that can benefit from growth around the world. We continue to believe that international equities will be a growing part of our portfolios over the next decade. When it comes to sectors in our international portfolios, we are overweight the cyclical trade. We favor technology and industrials, as well as energy and materials. Our challenge will be to identify the best companies to take advantage of the emerging consumer class in developing countries.



Real Estate Investment Trusts (REITs)

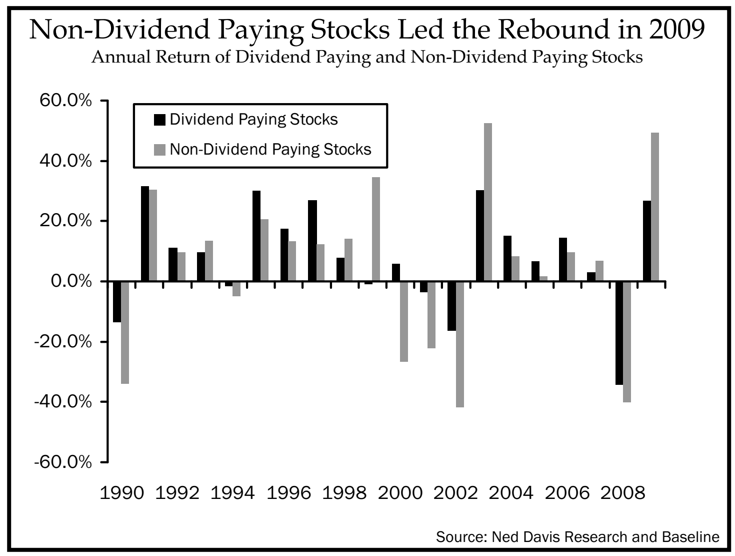
BY RALPH COLE, CFA

After being priced for virtual extinction in early 2009, real estate investment trusts (REITs) rallied from the brink in the second half of the year. The large, publicly traded real estate companies in which we invest have proven their ability to access the capital markets. This puts them at an advantage to private commercial real estate companies that can only source funds from the private markets and banks. We think this dislocation will lead to some investment opportunities for the higher quality REITs. When we dig into the fundamentals of real estate companies, we find cash flows that are bottoming, but not yet re-accelerating. We think the sector has already priced in a recovery that is still several years out for real estate. While earnings for the S&P 500 bottomed in the first quarter of 2009, REIT earnings will not bottom until sometime next year (depending on job growth). Despite continued bearishness toward most of the real estate market sector, we currently prefer hotels and specialty real estate companies that are likely to be early beneficiaries of the economic recovery.

Dividend Value

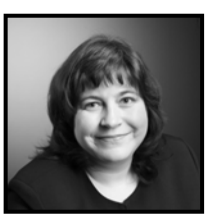
BY JASON NORRIS, CFA

What makes our *Dividend Value* discipline unique is its focus on companies with growing dividends and cash flows, not just "cheap" value stocks. The result is a more robust discipline than many pedestrian value/income approaches. However, this strategy lagged the broad market in 2009 due to underperformance driven by the financials and consumer discretionary sectors. Entering the third quarter, we were underweight both sectors and positioned defensively due to our concerns within those areas. However, as we saw in 2003, the lower quality, riskier names dramatically outperformed. Since the market bottom in March, low-quality stocks are up close to 120 percent versus 40 percent for high-quality stocks. This difference varies meaningfully from historic trends. On average, low quality stocks will out perform six months following a market bottom; however, the dispersion is usually 40 to 20 percent (double the performance, not triple as we saw in this most recent rebound). We believe that investors will rotate into higher quality stocks, which will benefit our strategy. As illustrated, dividend paying stocks have also lagged non-dividend paying stocks throughout this low-quality rally. In 2010, we expect dividend payers to exhibit strong relative performance, as they have in 14 of the last 20 years. We continue to invest in companies with strong cash flows and attractive valuations. Even though there will be short periods where dividend paying stocks lag the market, we believe this strategy should continue to generate strong returns.



Municipal Bonds

BY DEIDRA KRYS-RUSOFF

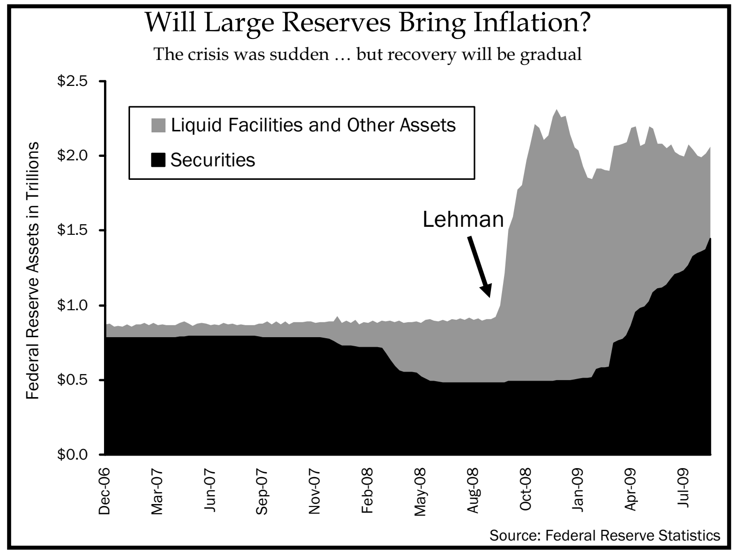


With the easing of the financial crisis, municipal bonds performed well, returning significantly above their coupon. In a reversal of 2008, lower quality and longer duration bonds drove most of the high returns realized by municipal indices in 2009. While the tremendous values of early 2009 are gone, good value still exists in municipal bonds, especially when comparing their taxable equivalent yields to Treasury yields. Municipal issuers have felt the effects of the economic downturn and most have been restructuring their budgets to avoid rating downgrades. Tax-exempt supply is likely to remain low through 2010, which should provide stability to municipal bond prices.

Fixed Income

BY MARC FOVINCI, CFA

Despite being mired in a state of high unemployment, the economy is now in the early stages of recovery. Financial institutions continue weaning themselves from Federal government "life support." Although unemployment rates are likely to remain high in 2010, employment growth should arrive early this year. Once employment growth moves into a sustainable pattern, the Federal Reserve will begin removing the large amount of reserves from the system, reversing current interest rate trends. In addition to bringing money market rates to zero, the bulge in reserves is depressing rates across the entire yield curve. The effects are most pronounced in shorter maturities and higher credit quality securities but are being felt everywhere in the credit markets. As employment growth turns positive, we expect the bond market will start discounting the tightening of credit, and interest rates will begin to march upward. The net result will be a return of interest rates to pre-financial crisis levels. We now favor corporate bonds to Treasury bonds, agency bonds, and mortgage-baked securities.



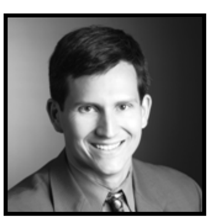
Financials

BY RALPH COLE, CFA

2008 and 2009 will not soon be forgotten in the annals of financial history. Obviously, no sector was more affected by the stomach-churning events than financial stocks. While we cannot forget the lessons learned in recent years, we must also be open to prudent risk-taking in profitable, well-run companies. We remain underweight the sector for fear of rising rates and stressed balance sheets. We have entered a brave new world for the financial community. Increased oversight, decreased leverage and new regulations make it challenging to evaluate potential profitability for the sector longer-term. We are focusing our efforts on companies that have addressed their issues with this new paradigm in mind. We remain underweight regional banks, but anticipate adding some quality names as 2010 progresses. Currently, we own companies with capital market exposure that are benefitting from the run-up in global stock markets. One area in which we are invested that might surprise many is credit card companies. We believe that job growth will turn positive sooner than many expect, which will lead to better payment metrics for the industry.

Telecommunications

BY SHAWN NARANCICH, CFA

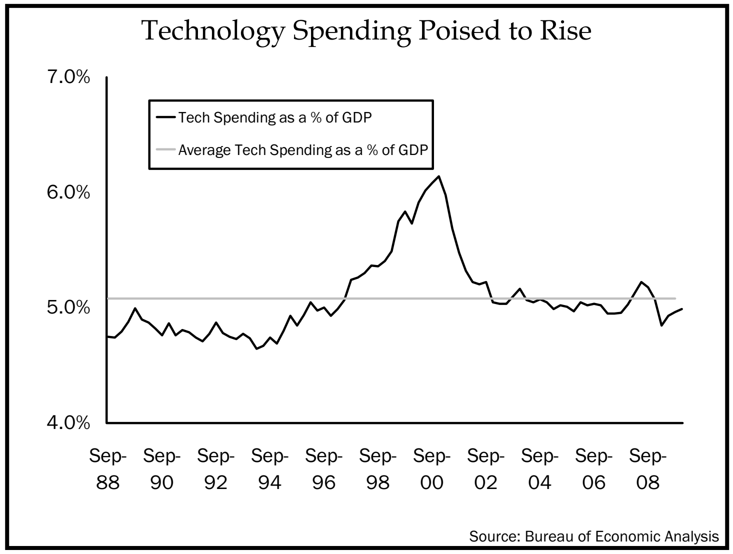


Telecom was the worst performing sector in 2009. Its defensive, income-oriented profile was shunned by investors favoring more economically sensitive plays. We expect this dynamic to continue in 2010 because of telecom's lackluster earnings outlook and expectations for substantial earnings growth elsewhere. The industry is challenged by fixed-line phone losses and a saturated mobile phone market that threatens to erode profitability. Despite attractive valuations and high dividend yields, secular and cyclical headwinds underpin our underweight of the sector. In this context, we favor large cap, integrated service providers.

Technology

BY JASON NORRIS, CFA

Technology stocks were one of the best performing sectors in 2009, more than doubling the return of the S&P 500. Due to the strength of most companies' balance sheets and operating models, most were able to remain profitable throughout the year.



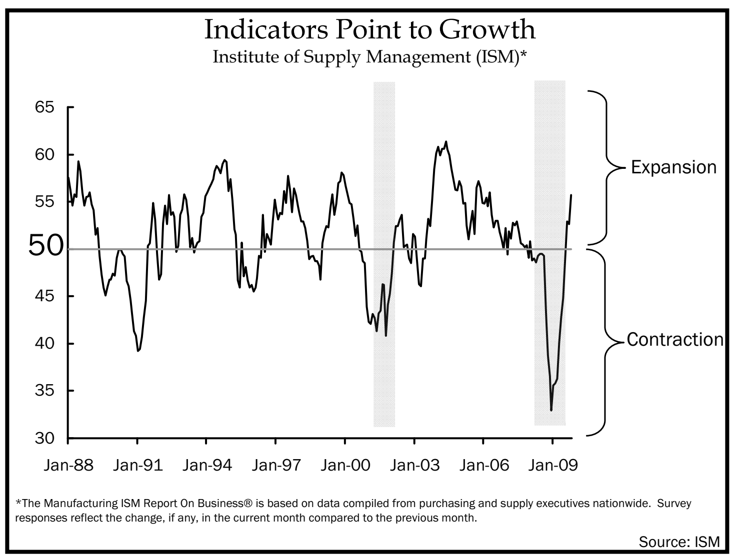
We continue to favor the sector in 2010 and our themes will remain broadband growth, security and storage. With the growth of wireless and wireline applications, network capacity and storage will receive an increasing amount of spending.

Technology spending dropped meaningfully as a percentage of GDP over the last several quarters. Even if spending reverts to its long-term average, we would expect 5 percent-plus growth in 2010. An area that we expect to see resumption of growth is the PC market. With Microsoft's new Windows release (Win7) and an aging PC inventory, we believe that from 2010 to 2012 we will see annual unit growth of over 10 percent. We will continue to focus on companies with strong cash flow generation that serve attractively growing markets.

Industrials

BY JIM RUDD AND RALPH COLE, CFA

Within industrials, we favor companies and industries with significant exposure to emerging economies, due to their rapidly growing consumer class and strong growth prospects.



While we believe the U.S. has exited the recession, we know that in 2008 consumer goods comprised 53 percent of industrial production. Consequently, we expect U.S. industrial production growth to be subdued in 2010 given our belief that consumer spending will not recover as rapidly as it has in prior recoveries.

Also, we believe that any material inventory re-stocking in the U.S. is likely several quarters away due to, again, constrained consumer spending and current low levels (67 percent) of capacity utilization acting as a re-stocking disincentive. We see infrastructure build (roads, dams, power generation, etc.), energy efficiency and agriculture machinery as the driving themes in 2010, and prefer commodity-exposed securities over those primarily dependent on industrial production.

Materials

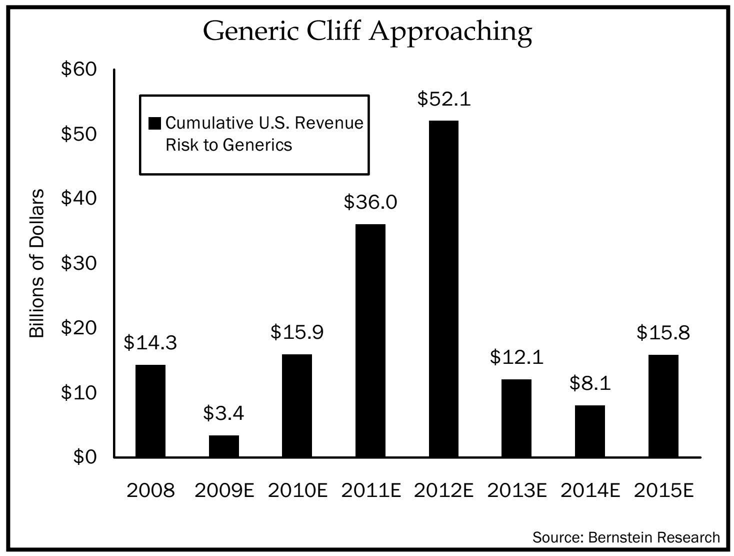
BY JIM RUDD AND JASON NORRIS, CFA

The "reflation trade" is once again our macro theme in 2010 for the materials sector. Nominal GDP estimates for emerging economies are for 10 percent-plus growth, much higher than the U.S. and other developed economies. The drivers of this relatively strong growth are global energy demand and the urbanization that is occurring in countries like China, Brazil and India. The continued growth in infrastructure spending will drive import prices for commodities such as copper, steel and aluminum. While much of the rise in commodity prices can be explained by supply-demand improvement, a significant portion is a direct result of the reflation trade. With the recent strength in overall commodity prices, any material increase in supply or inventories may lead to meaningful price declines.

Healthcare

BY DEAN DORDEVIC AND JASON NORRIS, CFA

2009 was a volatile year for the healthcare sector due to legislative proposals at the Federal level as well as investors reducing exposure to the defensive sectors and moving toward riskier names. While we believe that any healthcare reform will be watered down, there still will be headline risk in 2010. Also, several large drug patents are set to expire in the next several years, creating a mixed outlook for large-cap pharma. With our belief that a "public option" will not be included in any reform plan, we have increased our exposure to the HMOs. We also continue to favor medical technology companies believing that there is less substitution risk within the sector. Generic competition will continue to be an issue in 2010 and we have been analyzing companies that will benefit from this phenomenon.



Utilities

BY SHAWN NARANCICH, CFA

Credit markets thawed and the economy reversed course in 2009, leading investors away from regulated utilities. The group underperformed, but returns varied widely. Proposed carbon cap & trade legislation, low prices for natural gas (a key fuel for power production that helps set the marginal price of electricity), and weak electricity demand are key issues confronting the industry. In the context of an improving domestic economy, our utility investments tilt towards economically sensitive names that stand to gain from higher natural gas prices and regulated rate base growth enabled by healthier credit markets.

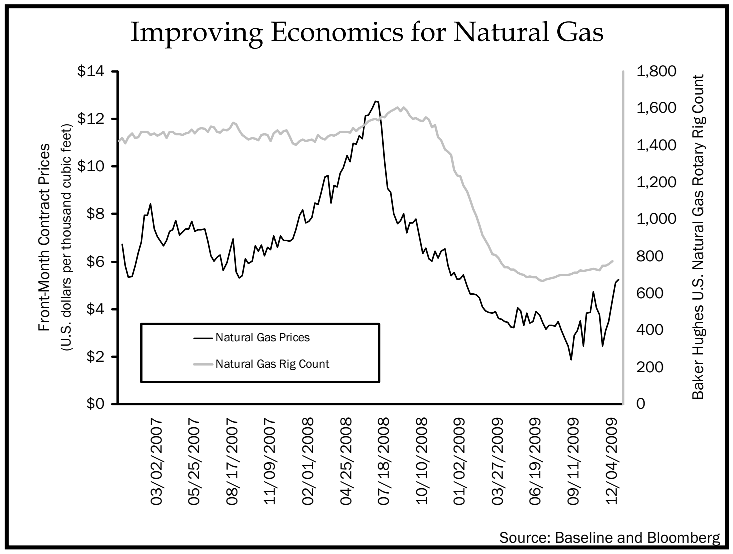
Consumer Discretionary

BY GEORGE HOSFIELD, CFA

With real estate and equity values plummeting, credit markets constrained and the highest unemployment rate in 27 years, last year at this time we felt it would soon be time to commit additional capital to this sector. Despite a pessimistic backdrop for the consumer, this proved to be the appropriate strategy as consumer discretionary stocks dramatically outperformed the market in 2009. The sector is typically a canary in the coal mine for economic activity. With equities now reaching a cyclical high, leading indicators pointing towards growth and house prices finding a floor, the news for the beleaguered U.S. consumer is getting better. As such, history suggests it is now time to underweight the sector. Not only do we envision reducing our sector weighting, but we also will change our emphasis from "early-cycle" industries, such as retail and autos, to "late-cycle" industries, such as media and entertainment.

Energy

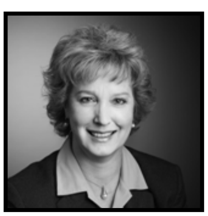
BY MARK KRALJ



The price of oil in 2009 was significantly more volatile than the stock market, as economic growth went from a panic slowdown to an apparent recovery. In 2010, global economic growth will once again be the dominant determining factor of oil prices. Economic growth in developed countries, but most importantly, China, puts a strain on the oil supply/demand equation as new oil reserves become more difficult and expensive to find. As the economy sank last year, companies slashed their drilling budgets. Lower rig counts limit the future supply of new oil and natural gas, thus helping support prices. Now that energy demand is growing once again, more rigs are being deployed to boost production, leading us to emphasize oil service stocks that will benefit from rising rig counts. We also favor exploration and production companies as a play on our bullish view of natural gas. A key factor that would disrupt the long-term thesis for higher energy prices would be another significant slowdown in the global economy.

Consumer Staples

BY LORI FLEXER, CFA AND SHAWN NARANCICH, CFA



The consumer staples sector typically outperforms during periods of market volatility. It is defensive and seen as a relative safe haven with more earnings stability and higher dividend yields. These same attributes make the sector less attractive during periods of economic and market recovery. 2009 was no exception as this sector substantially underperformed the S&P 500. We anticipate this underperformance extending into 2010 as the global economy expands. Partly because of slower expected earnings growth, consumer staples valuations have contracted for the first time in a number of years and now trade at a P/E discount to the broader market. As a result, we are underweight the sector and do not anticipate adding to it in the foreseeable future. Our stock selection strategy has been tilted to take advantage of the economic upturn, a weaker U.S. dollar and global growth.

WEALTH MANAGEMENT AND PORTFOLIO STRATEGIES

The New Year Brings Change and Opportunities

BY NATHAN AYOTTE

This year brings a new opportunity for high-income taxpayers to convert their existing IRA or 401k to a Roth IRA. Historically, conversions were limited to investors with a modified adjusted-gross income under $100,000. Beginning in 2010, conversion is available to all taxpayers without limitation. In 2009, clients over 70.5 years of age could defer their required minimum distributions for their retirement accounts. This year the withdrawal requirement will resume and we encourage those who deferred their distribution to review their account portfolios and withdrawal schedule.

Establishing, maintaining and revisiting your financial goals are important components of our wealth management process. Many clients have benefited from Ferguson Wellman's forecasting tool, *Horizon*™, which helps them look at their goals and answer important questions regarding retirement, gifting and lifestyle. Your portfolio manager can arrange a meeting to create or review your *Horizon*™ report in the new year.

Seeing the Big Picture throughout the Year

BY STEVE HOLWERDA, CFA AND HELENA LANKTON

One of the areas we continue to focus on as portfolio managers is taking a holistic approach to asset allocation; not only understanding the assets that we directly manage for our clients but also the assets outside of their Ferguson Wellman portfolio. These assets can include real estate, private equity in a business and the present value of the client's future earnings (also called human capital in our *Horizon*™ report). Getting a sense of the value of these assets is particularly important following the valuation adjustments that have occurred in the last two years. Real estate values have dropped considerably, equity valuations have adjusted, and earnings power has shifted downward.

A key role we fulfill for clients is to ensure that their portfolios are well diversified. For example, if we are aware that a client owns a significant amount of income-producing real estate, we would limit their portfolio exposure to REITs. This concept can also be illustrated through a tax-planning lens for clients who may own a large amount of low tax basis stock. By being aware of tax-loss carryforwards that a client may have, our portfolio managers can reduce portfolio risk by selling a portion of the stock. Gains on the sale are offset by a portion of the tax loss carryforward and proceeds are used to diversify the portfolio. Finally, if a client's human capital has been significantly reduced in the last two years, we would reevaluate their portfolio's asset allocation to account for the change in circumstances.

With these and other factors in mind, we are launching a new investment resource in 2010 called the *Client Balance Sheet*. Blending data from the portfolios we manage with data accumulated from our clients' other assets, we can provide a personal balance sheet report showing their total net worth. This report offers a complete picture of clients' assets and liabilities to better enable our portfolio managers and clients to identify any imbalances that should be addressed.