HOWE & RUSLING

INVESTMENT STRATEGY NEWS

SUMMER 2010

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AT A GLANCE

Retreat of the Bull

The second quarter was notable primarily for the news headlines--most of them bad. Taken singularly each event should have been fairly isolated to an individual or, at most, a handful of companies with not nearly the impact on the broader market. When investors looked at the events collectively, however, fear that the economic recovery is sputtering spread to the broader market and drove most stocks down for the first six months of 2010.

Conflict raged during the quarter between the outlook for individual companies and the outlook for the economy as a whole. This conflict was reflected in the violent stock market moves up and down throughout the quarter. The stock market peaked on April 23rd and was followed by the worst performance for the stock market in the month of May since 1940 and a further move down in June. By the end of the quarter fear overwhelmed what were, in general, good company earnings in the quarter and good expected future earnings for most companies.

The headlines really started in mid-April with a stock that we own for many clients, when the Securities & Exchange Commission filed fraud charges against Goldman Sachs and one of the firm's employees for "defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages as the U.S. housing market was beginning to falter."

Alas: More Government Regs & Spending

Next up was the horrific oil spill in the Gulf and the lack of a coherent government response other than calling for a six-month drilling ban and more future government regulations. (As an aside, we are not sure we need more regulators or regulations - maybe more effective regulations?). There are 16,000 fulltime government employees with an additional 93,094 government contractors working for the Department of Energy, which has an annual budget of $24.1 billion and $38.3 billion in stimulus funds to spend over the next two years.

The most disconcerting headlines for investors concerned the worry of Greece defaulting on their sovereign debt and the "Greek contagion" possibly spreading to other countries and the impact on European banks. Greece sovereign debt is only 2% of the total of the European Union Debt, but the Greece issue focused investors on "the large and growing problem with debt worldwide including in the United States and the fact that the way out is neither easy nor politically popular. Looking at the world as a whole, or the United States in particular, neither cutting spending nor raising taxes will continue to stimulate growth in the short-term.

A Change in the Political Winds

While obviously concerned and paying close attention, especially with the potential government response to the debt issue (namely higher taxes with no spending discipline), we do not have a dire outlook. Pressures are coming to bear from the electorate that make it more difficult (unfortunately not impossible) and less politically palatable to spend money as we have in the recent past. This is a necessity because, as Governor Chris Christie of New Jersey said in a speech given on May 25th, you can't continue to spend taxpayer money like we have in the past because "at some point the people's ability to pay runs out."

We know it is a distressing time for many investors and while we do not necessarily advocate changing long-term objectives, if you have concerns about your objectives, your asset allocation or general market conditions, we encourage you to call your Portfolio Manager.

Trimming the Sails

Coming off a very good year for H&R stocks and heading into 2010, we believed that economic growth was not going to be as robust as the consensus GDP estimates indicated. Slower growth than expected would also make it tougher for the stock market than in 2009.

We prepared in the first quarter by lightening up on our allocation to stocks somewhat and buying or maintaining holdings in large companies that have stable cash flows, moderate valuations and expected future earnings growth. This hurt our stock portfolios while the stock market was rising fairly dramatically through the end of April and GDP estimates were being revised upward. Oddly enough, the companies that performed the best through April were the most expensive from a valuation standpoint and with the worst average Earnings Per Share gains for the year ending 12/31/2009.

Morningstar ranks companies on the strength of their "moats" or barriers to entry for other competing companies and the data were similar. Companies with the worst combination of valuations and barriers to entry performed the best. The stock market through April was clearly anticipating a stronger economic recovery than consensus estimates. As Howe & Rusling's strategy is to seek out companies with strong competitive advantage as well as relative undervaluation to market, our performance came up a bit short during this market's upward move, but good valuations will win out. We continue to have faith in our process and outlook.

As fear is in the driver's seat, and the economic figures, namely unemployment and housing, have continued to be uninspiring, consensus GDP estimates have fallen with the stock market. And now, there are whispers about a dreaded double dip recession. Nearly all stocks have been hurt in the past few months, but stocks with a lower price to earnings multiples relative to their earnings growth rates that have a realistic outlook for earnings growth have been the better performers.

While there are reasons to be concerned about the long-term sustainability of a recovery given some of the headwinds, it is far from clear that the S&P 500 should have continued to drop like it did in May and June.

Just as we thought the market was overdone on the upside through April, we believe the current market downturn is getting close to being overdone as well. We do not believe the outlook is as grim as the current stock market downturn leads many to believe just like we did not believe the outlook was as good as the performance of the stock market through the first four months. The reality is that it is far from clear the shape and extent of the economic recovery, but the economy will continue to slowly recover. In the meantime, we will attempt to take advantage of the opportunities that this market affords.

Our time proven valuation disciplines remain in place. As of March 31, our major database, which tracks earnings estimates for the stocks in the S&P 500 Index as well as our own choices (most of which are in the Index) showed that our companies were expected to produce earnings growth at about the same level as that of the S&P 500 stocks as a group, but H&R stocks were selling at a significantly lower multiple of the expected earnings. What this means is that our stocks (those in your portfolio) should perform better in the marketplace than the index, as time passes. Net net: we are buying the earnings growth at a discount. This is intelligent investing.

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2nd Quarter – Bond Market Overview

In light of the current quarter's equity market "correction," the bond market continues to outperform. High quality investment grade bond portfolios have demonstrated good positive returns quarter to date. However, it would appear that there has been a trend reversal in market sector performance. U.S. Treasury securities (both Nominal and Inflation Protected) have outperformed the corporate bond sector. Is this the beginning of another risk aversion cycle or merely the market's reaction to continued concerns over a "softening" of economic prospects in the U.S. and Europe? Bad economic news usually means bond values appreciate – at least those of higher quality.

Start Date: 3/31/2010 End Date: 6/25/2010

Index	Return for Period
Intermediate U.S. Government / Credit	2.51%
U.S Treasury: Intermediate	3.07%
U.S. MBS Agency Fixed Rate MBS	2.89%
U.S. Agency: Intermediate	1.91%
Intermediate: Corporate	1.99%
Invest. Grade: Utility	2.71%
Invest. Grade: Industrial - Intermediate	2.56%
Invest. Grade: Financial Institutions - Intermediate	1.12%
U.S Treasury: Intermediate	5.18%
Municipal Bond: 1-10 Yr Blend (1-12)	1.46%

There is no question that recent data have given the capital markets reason to question the sustainability of the current economic recovery. Additionally, as we wrote last quarter, concerns over sovereign debt solvency in Europe (namely: Portugal, Ireland, Italy, Greece, and Spain) have weighed on our own capital markets. The uncertainty surrounding the negative effects of a possible sovereign default or debt "restructuring" have our markets questioning whether our economic stability may be at risk as well.

Leading Economic Indicators

Bond performance and the direction of interest rates depend greatly on how the economy develops. Because we try to anticipate the direction of interest rates, monitoring and evaluating economic conditions is of great concern.

Measurements of economic growth expectations over the last two months have shown decelerating growth. LEI (Leading Economic Indicators) for April, and May were 0.0% and 0.4% respectively. The six month annual change for the LEI was a positive 7.9% in May compared to 11.6% at the end of 2009. While still positive, the slowing trend is what the markets are focused on.

Is this trend forecasting a "double-dip" recession? We are concerned about the possibility of another recession because bond performance would most likely be affected. Bond performance could be affected both positively and negatively, depending on the type of bonds in our client portfolios. Recessionary periods normally have a greater positive effect on longer U.S. Treasury bonds, while they tend to have a slightly more negative effect on corporate bonds. As a result, we are keenly aware of these potential effects on your portfolio and we do from time to time re-allocate our target weighting between the various bond market sectors.

While the National Bureau of Economic Research (NBER) is the "official" arbiter of when economic cycles begin and end, its signals lag the actual beginning/ending of a cycle by a considerable amount of time. Another index provider that has gotten a lot of attention recently is the Economic Cycle Research Institute (ECRI). The ECRI's proprietary U.S. Long Leading Index (USLLI), which goes back to 1919, is signaling a slowdown.

June 25 (Reuters) - *- A measure of future U.S. economic growth rose slightly in the latest week, but its annualized growth rate continued to fall, indicating the economy is about to slow, a research group said on Friday.*

The Economic Cycle Research Institute, a New York-based independent forecasting group, said its Weekly Leading Index rose to 122.9 in the week ended June 18, up from 122.4 the prior week, originally reported as 122.5. The index's annualized growth rate fell to minus 6.9 percent from a revised minus 5.8 percent, originally reported as minus 5.7 percent. That was its lowest level since May 22, 2009, when it stood at minus 8.7 percent.

"After falling for six weeks, the uptick in the level of the Weekly Leading Index suggests some tentative stabilization, but the continuing decline in its growth rate to a 56-week low underscores the inevitability of the slowdown," said Lakshman Achuthan, managing director of ECRI.

Interestingly however, analysts at ECRI are not forecasting a "double-dip" recession. The negative trend is consistent with either a recession or slower economic growth. The index mentioned above would have to be consistently negative for a longer period of time before signaling a recession.

We share the opinion expressed by this analysis. Perhaps one of the most important contributors (in our opinion) of a leading economic indicator is initial jobless claims. How many newly unemployed are there week after week?

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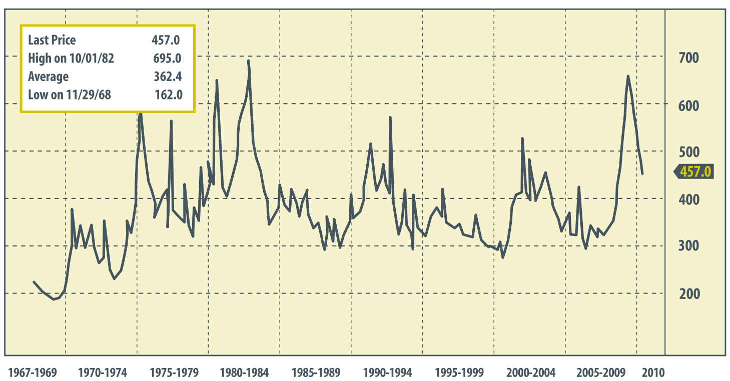
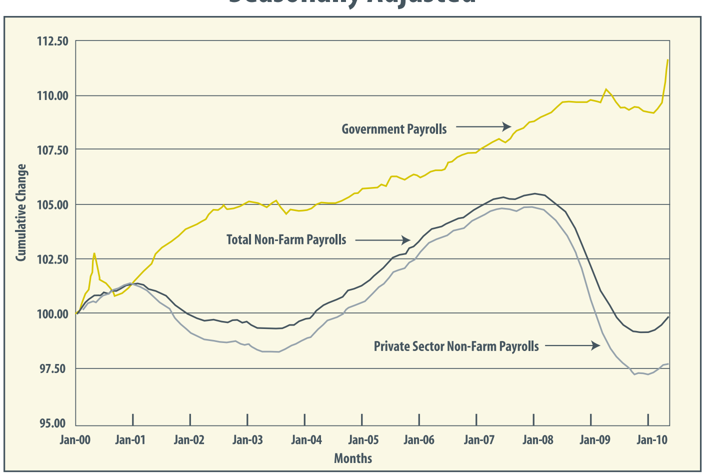
It is easy to see why this economic recovery is still considered "weak," and why bonds have outperformed equities. With initial jobless claims continuing to exceed 450 thousand, it still feels like a recession, even if we are (technically) not in one at the moment. While there is always going to be a "natural" rate of unemployment and people losing jobs on a weekly basis, our economy's potential will not approach normal until we see fewer lost jobs. Once fewer jobs are lost, our economy can benefit from the appropriate government policies to help stimulate new private sector jobs.

US Initial Jobless Claims



Source: Bloomberg, 2010

Growth of Non-Farm Payrolls Seasonally Adjusted



Source: Bureau of Labor Statistics

Private sector jobs are important for any economic recovery. These jobs are the "engine" of growth in our economic system. They create wealth and prosperity and provide the tax revenues that support the government sector. As we can see from the chart above, over the last 10 years, private sector payrolls (jobs) have declined approximately 2.5%, while government payrolls have grown more than 10%.[1] While we're beginning to see a slight upward trend in private sector jobs, much more is needed.

Government policies do matter. We currently have appropriate monetary policy that is designed to stimulate the economy. However, we now need the fiscal policies that would create the appropriate incentives for job and wealth creation. Those policies are not necessarily aligned with spending more, but rather taxing less. Unfortunately, taxing less requires spending much less in order to balance fiscal budgets. This is unfortunate because it would mean spending less on government jobs and programs in a difficult economic environment. The alternative would be to continue to increase our economy's debt burden. With the total public debt having "skyrocketed" over that last 18 months, and our employment outlook still very weak, it may be necessary and prudent to change the approach.

We cannot affect policy decisions. However, we are ever vigilant as to their effects on our client's fixed income investments. Over the last 18 months we have overweighted many of our client portfolios with corporate bonds and remain overweight to our benchmark index. We continue to feel confident in the degree of high quality corporate bonds we own. The decision to overweight corporate bonds during this period of time was based on our belief that we would be rewarded with higher price appreciation as our economy improved. That has indeed been the case. Even though we have highlighted in this writing some evidence of a slowing economy, we feel that corporate balance sheets in general are healthy enough to withstand slower economic growth, should it materialize. Our opinion is corroborated by recent data provided by the U.S. credit rating agencies where corporate credit upgrades for the quarter have exceeded the number of downgrades for the first time since the second quarter of 2007.[2]

Corporate profits in the U.S. rose at the fastest pace since 1984 in the first three months of this year. Cash levels at investment-grade borrowers have surged 15 percent from a year earlier while debt has fallen 2 percent, according to JPMorgan Chase & Co., suggesting corporations are healthy enough to weather a slowing economy.[3]

As mentioned earlier in our writing, we do evaluate the various bond sectors appropriate for our client portfolios, and we will from time to time use our discretion to adjust sector weightings in an effort to best match risk with reward.

[1] U.S. Department of Labor Statistics

[2] Bloomberg, LLC – "Bond Upgrades Top Cuts for First Time Since '07: Credit Markets" - By John Glover and Sapna Maheshwari

[3] Ibid