Bread & Circuses

February 2010

Investment Management & Trust Services

Tower Private Advisors

Bread & Circuses

- Roman poet Juvenal around 100 AD
- Roman politicians devised a plan to win the votes of the poor by giving out cheap food and entertainment.
- Politicians decided that this policy "bread and circuses" would be the most effective way to rise to power.
- To many it connotes the decadence and hedonism that defined the Roman Empire prior to its decline.
- Spanish intellectuals between the 19th and 20th centuries complained about similar "bread and bullfights".

Tim Frey

Vice President

Portfolio Manager

Investment Management & Trust Services

Tower Private Advisors

Market Outlook 2010

- Economy is recovering
  - Global economies are healing
  - Strength of recovery varies, by country and industry sector
  - Rally has been technical in nature - coming off lows in march-and Gov't stimulated
  - Focus now will be more on fundamentals - forward earnings
- Key question is sustainability
  - Normally (historically) need about 5 preconditions for a sustained recovery
  - Massive monetary & fiscal policy response, inventory replacement, financial stability, stabilization and improvement in consumer sentiment, and job growth

Recent clouds over markets to abate

- China slowing lending and increasing reserve requirements
- Sovereign debt crisis – PIGS
- Eurozone vs Dollar

<u>The real problem is staring us in the face (USA)</u>

- Vast majority of states running deficits
- 40% are being fed currently by stimulus $$$
- Unfunded pension liabilities - $2 trillion
- Another $1 trillion shortfall for health / retirement / plan assets
- The elections in 2010 won't focus much on this – 37 governor seats up for grabs!
- More tax increases will be coming!

Other Negatives

- Banks aren't lending or we aren't borrowing- banks have $1 trillion in excess reserves (15x normal)
- Mortgages will be a problem for at least 10-12 months. Applications at a 12 yr low - housing starts are flat
- Foreclosures may rise (as many as 3 million) as resets and loan modification programs fail

Positives

- Earnings picking up, companies more productive
- Industrial production was stronger in Jan, inventories slowly rising
- Capital spending is on the rise (3.5% in 2010-mostly on IT)
- Hiring should pick up in 2010 – 62% of S&P 500 say yes!
- More stimulus coming

What does all this mean in a secular bear market?

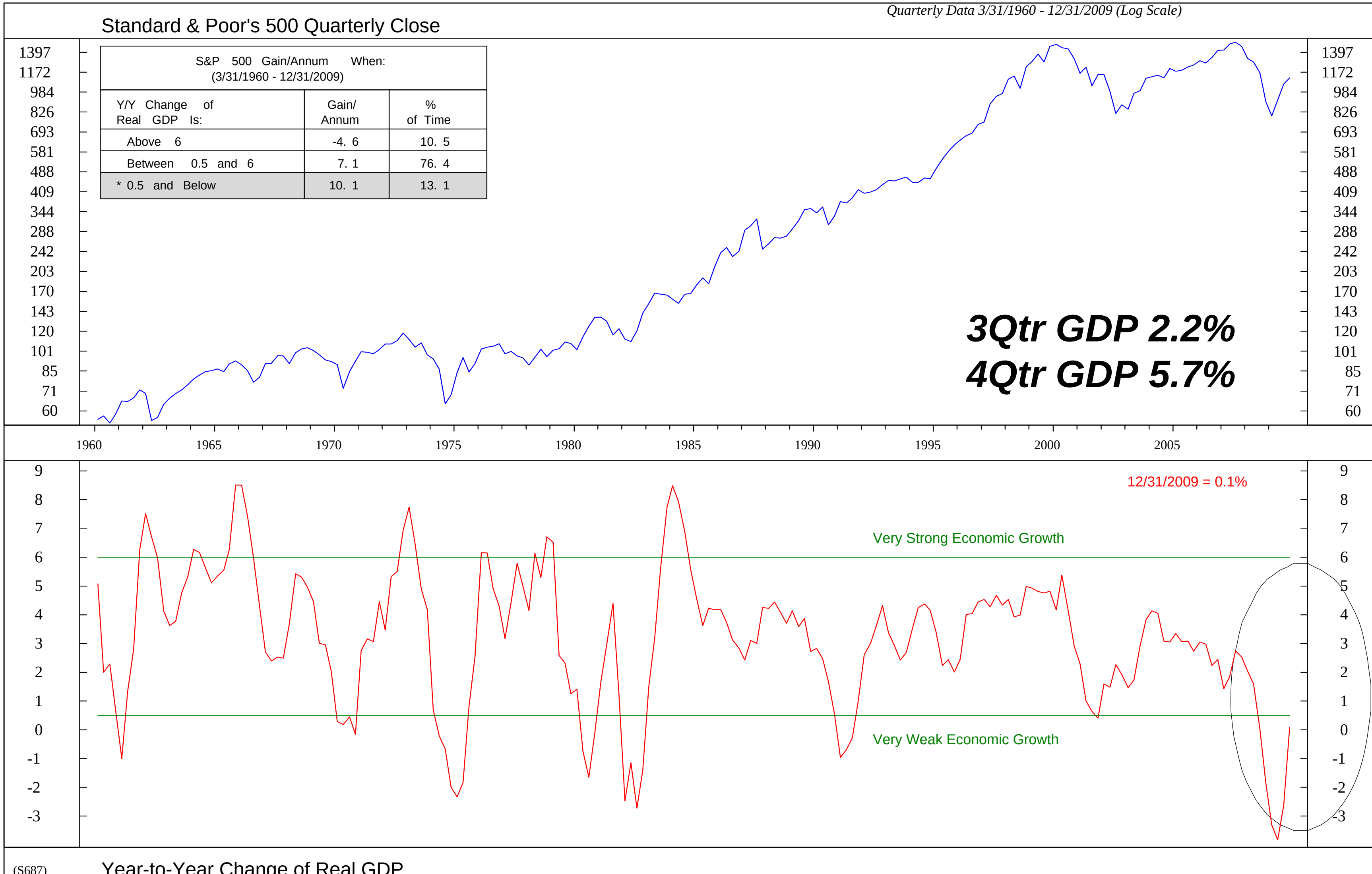
Cyclical Bulls - Secular Bear Markets (1900-2009)

- 18 cases historically with an average 64% gain over a mean length of 508 days
- Current cyclical rally since March 09-up 49% and has lasted 350 days
- There may be more left in 2010!

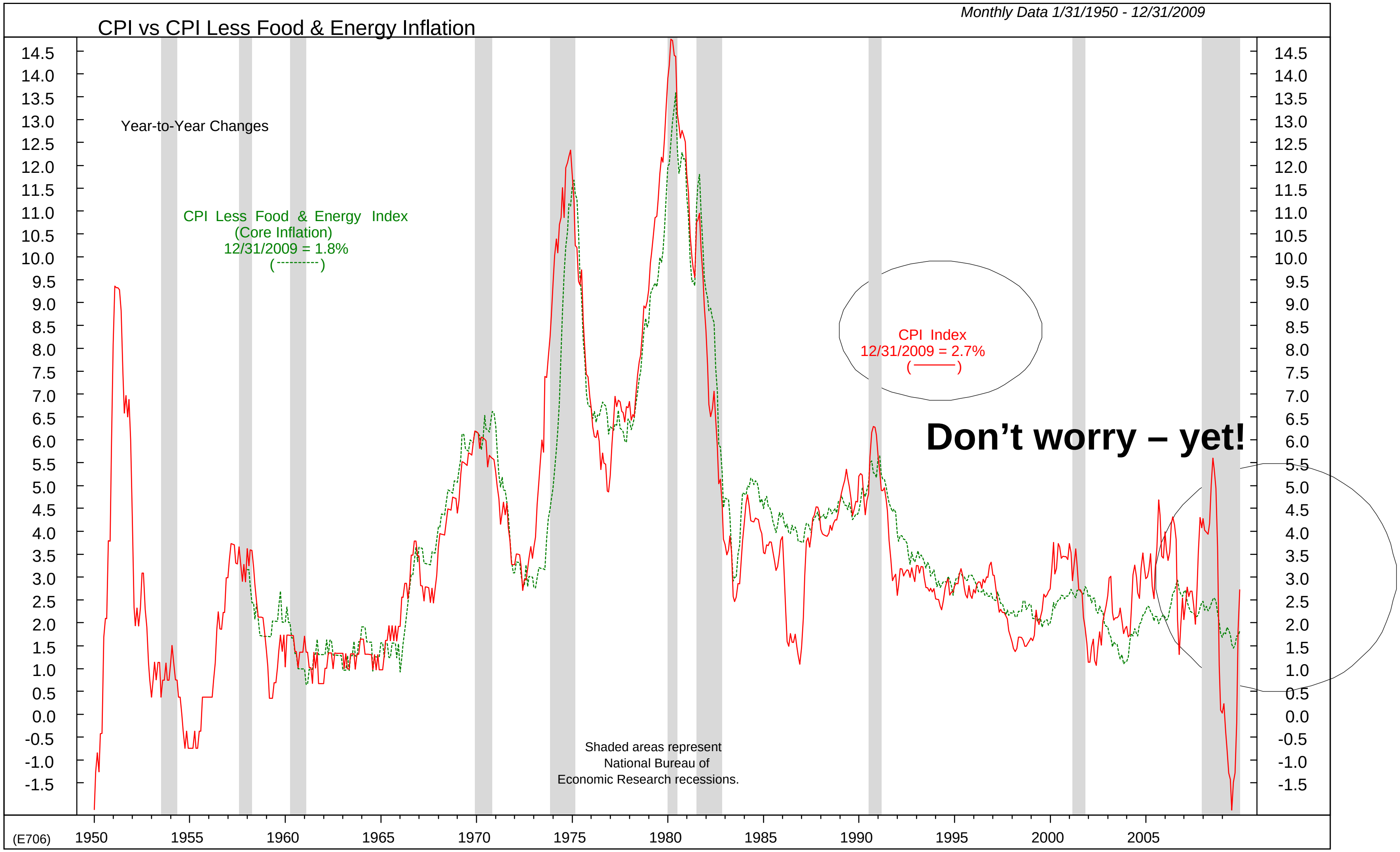
Note: Secular Bear - flat or declining stock prices over a long time --- have averaged about 15 years from 1900 - 1999

Cyclical Bull - 30% rise in 50 days or 13% after 155 days

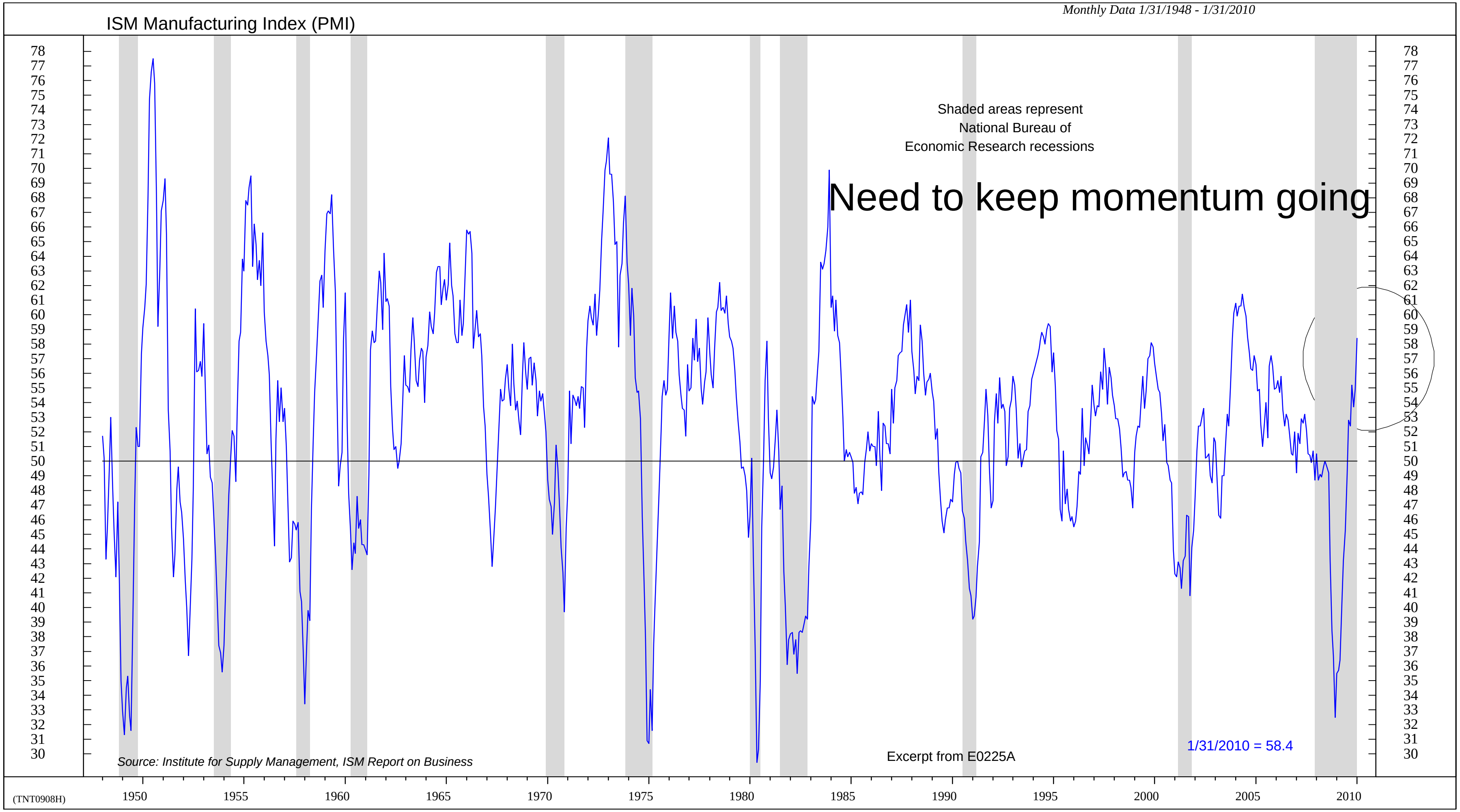
GDP- Can we get to and sustain 3-4% growth?



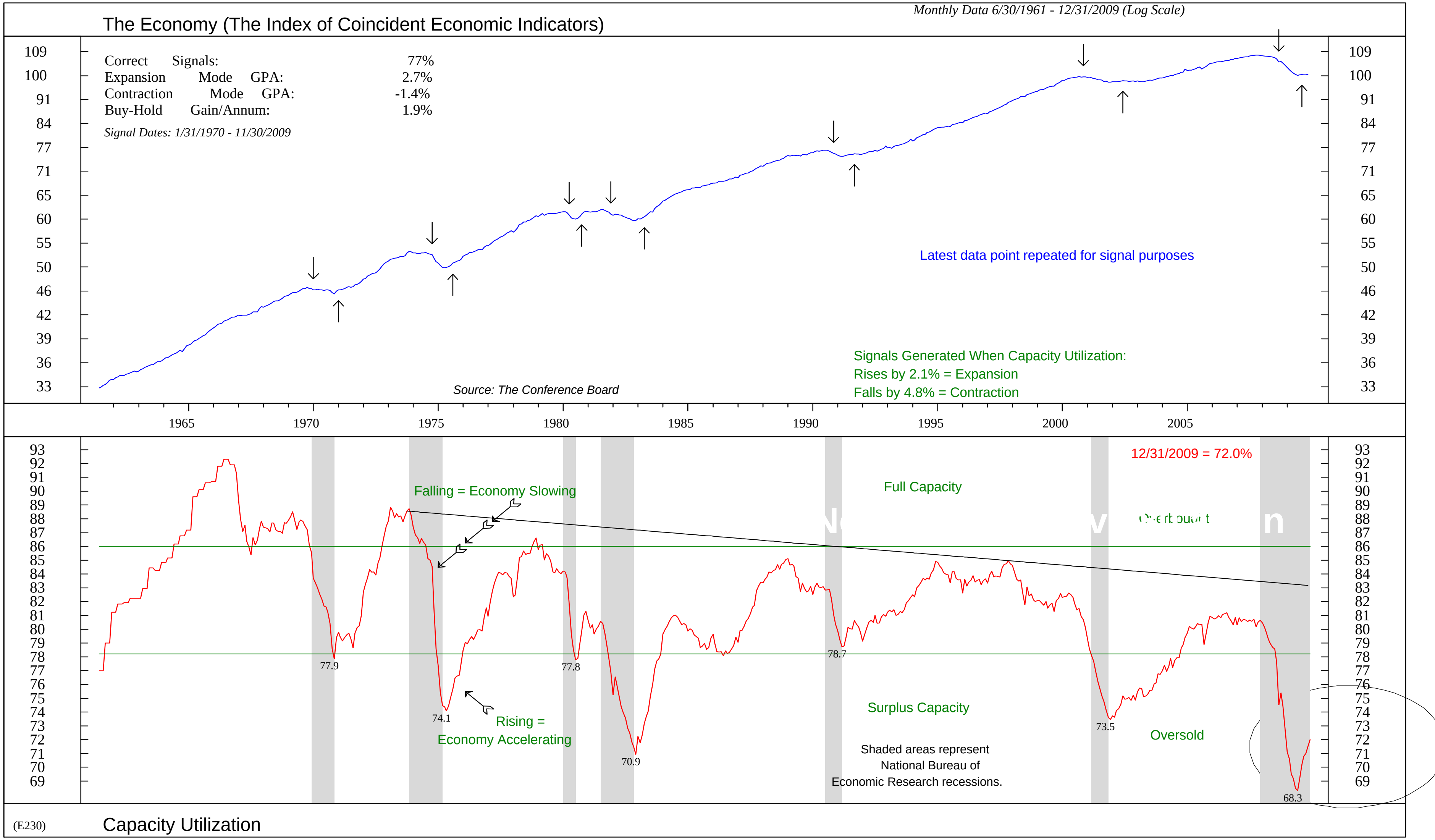
Inflation is in check for now



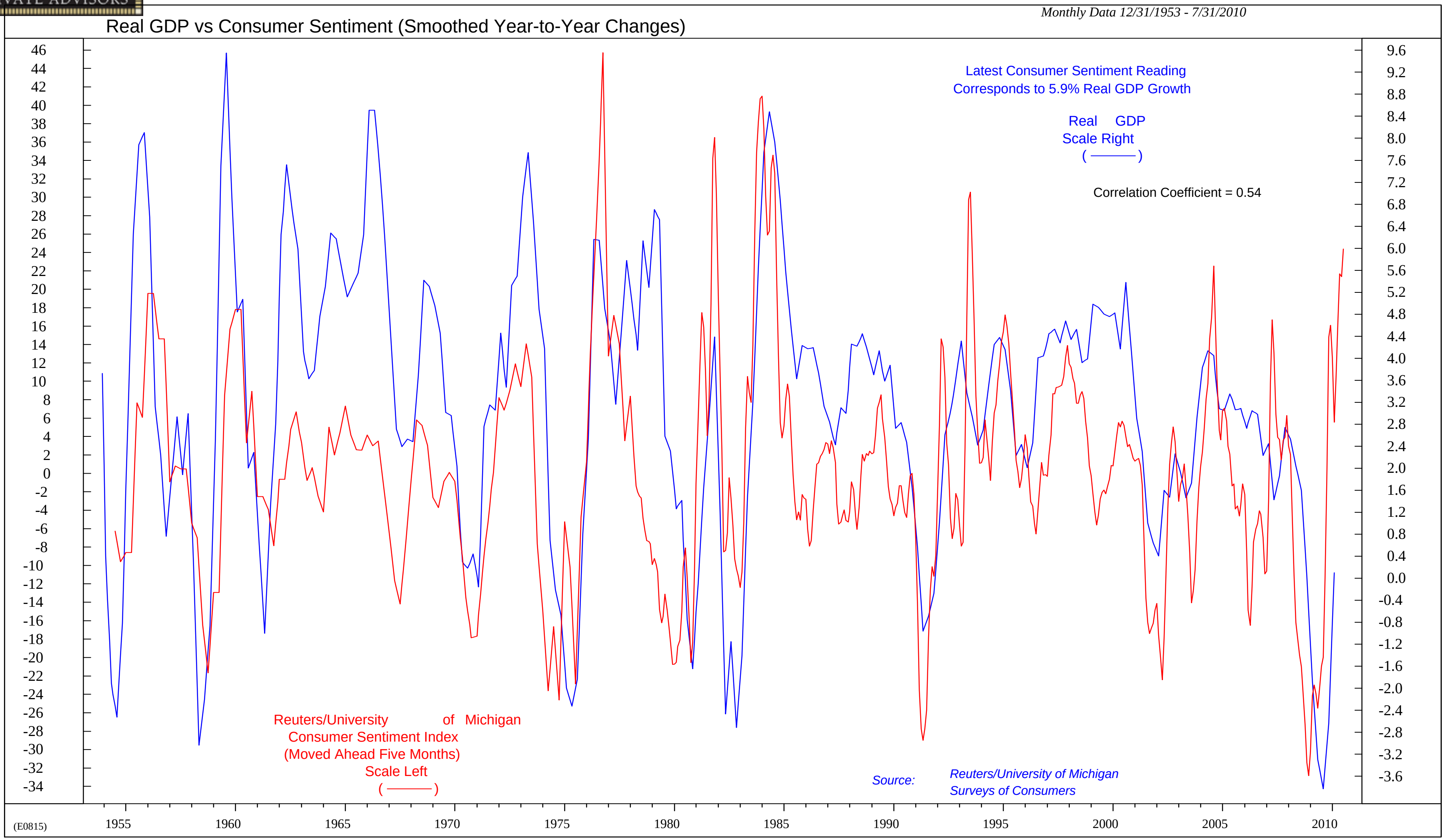
We are rebuilding inventories



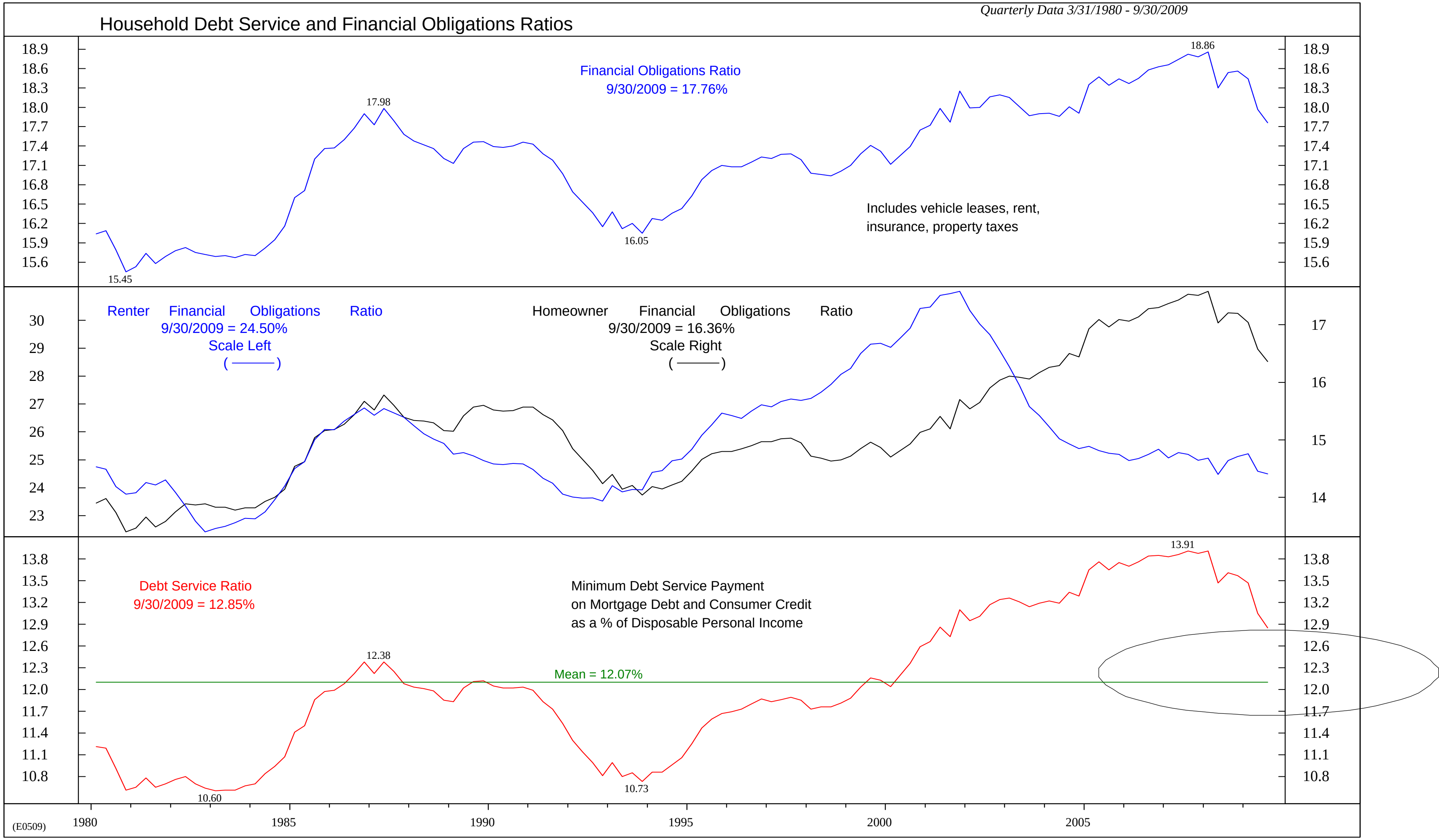
There is plenty of room to grow



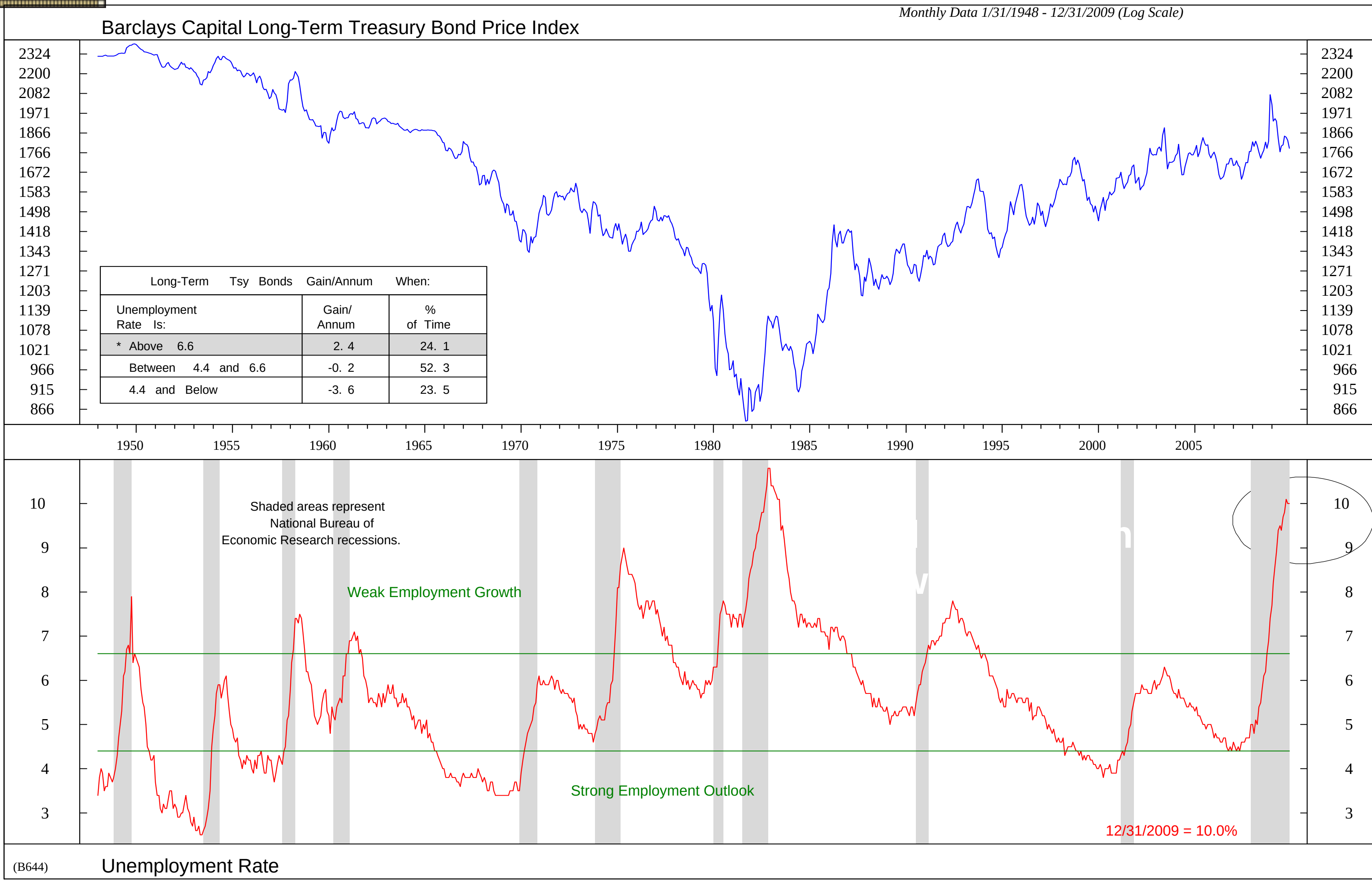
Consumer sentiment has improved



Consumer has retrenched



Need to create jobs! Unemployment is too high!



Long-Term Tsy Bonds Gain/Annum When:		
Unemployment Rate Is:	Gain/ Annum	% of Time
* Above 6.6	2. 4	24. 1
Between 4.4 and 6.6	-0. 2	52. 3
4.4 and Below	-3. 6	23. 5

Did you know?

- During previous expansion from 2001-2007 we created about 100,000 jobs/month to keep unemployment rate under 6% (considered full employment)
- Today it would take <u>150,000 new jobs /month for ten years</u> to absorb the 15-17 million unemployed and keep up with population trends
- If we create <u>200,000 jobs/month it would take 6 years</u> to get to 6% unemployment
- Our Government is going to try and create about 100,000/month from here forward— just to get the 8 million that lost jobs the past 2 years back to work

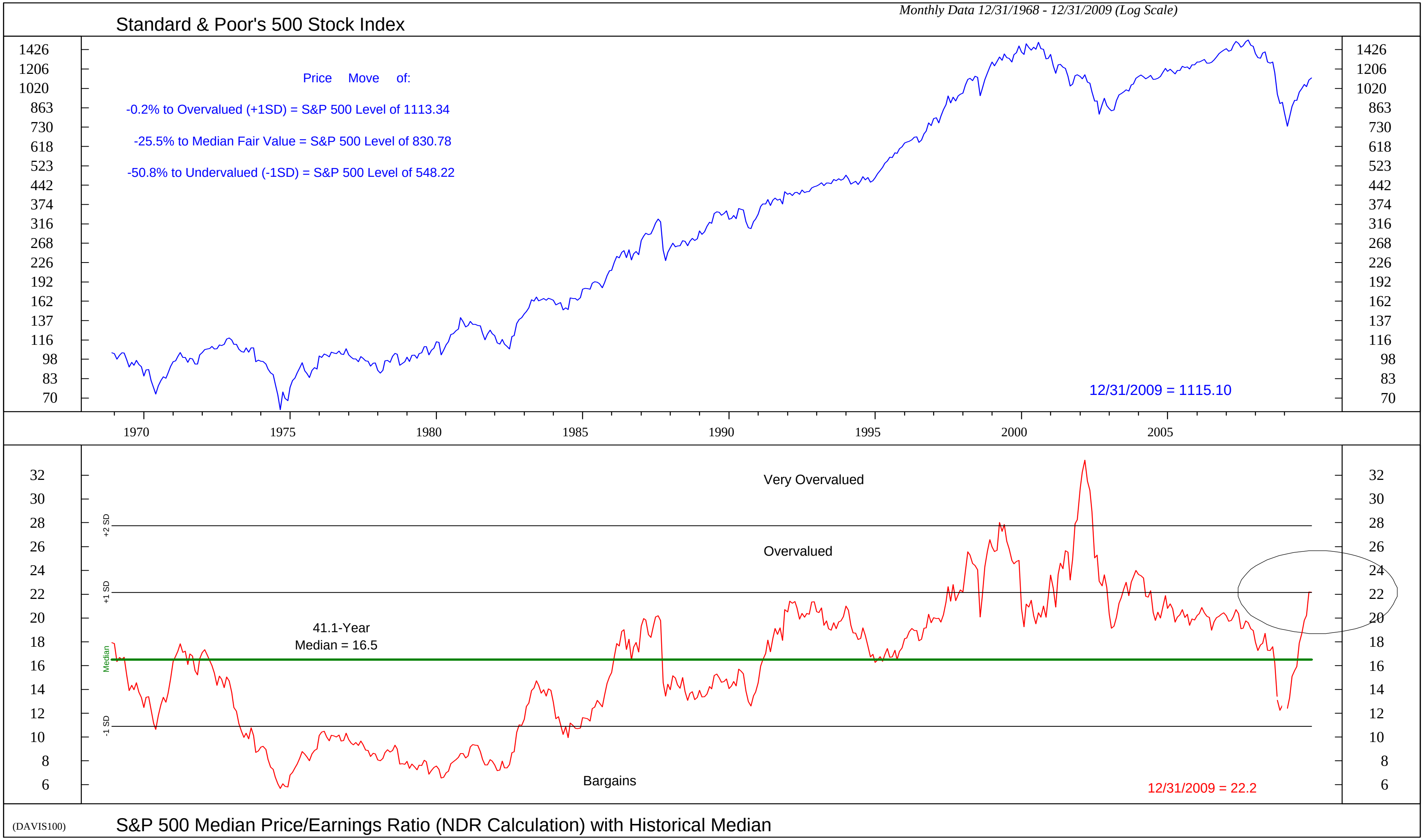
Global recovery is still accelerating

- Australia leading index up for a 7th straight month
- Germany's Purchase Manager Index surged in Feb
- Japan grew at 4.6% in 4qtr after a flat 3qtr
- Canada manufacturing sales rose a 4th straight month

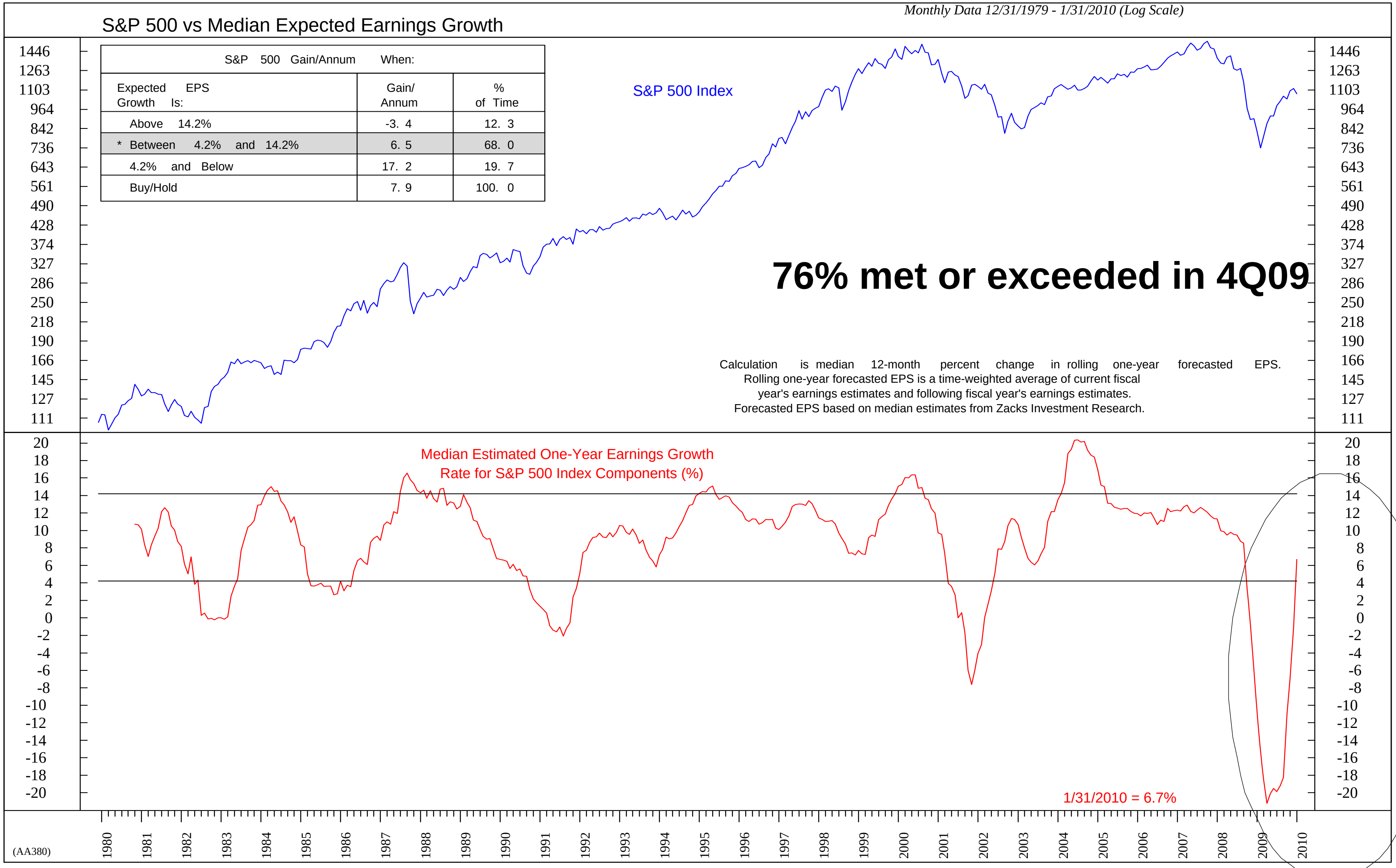
Emerging Markets are still a good place to be

- Valuations have corrected some
- Deficits are in better shape than most of the rest of the world
- Recent commodity sell-off due to sentiment not lack of growth
- Earnings are still strong – have provided great returns the past ten years

Domestic valuations were getting stretched!



Earnings should be strong for a few quarters



Expected EPS Growth Is:	S&P 500 Gain/Annum When: Gain/ Annum	% of Time
Above 14.2%	-3.4	12.3
* Between 4.2% and 14.2%	6.5	68.0
4.2% and Below	17.2	19.7
Buy/Hold	7.9	100.0

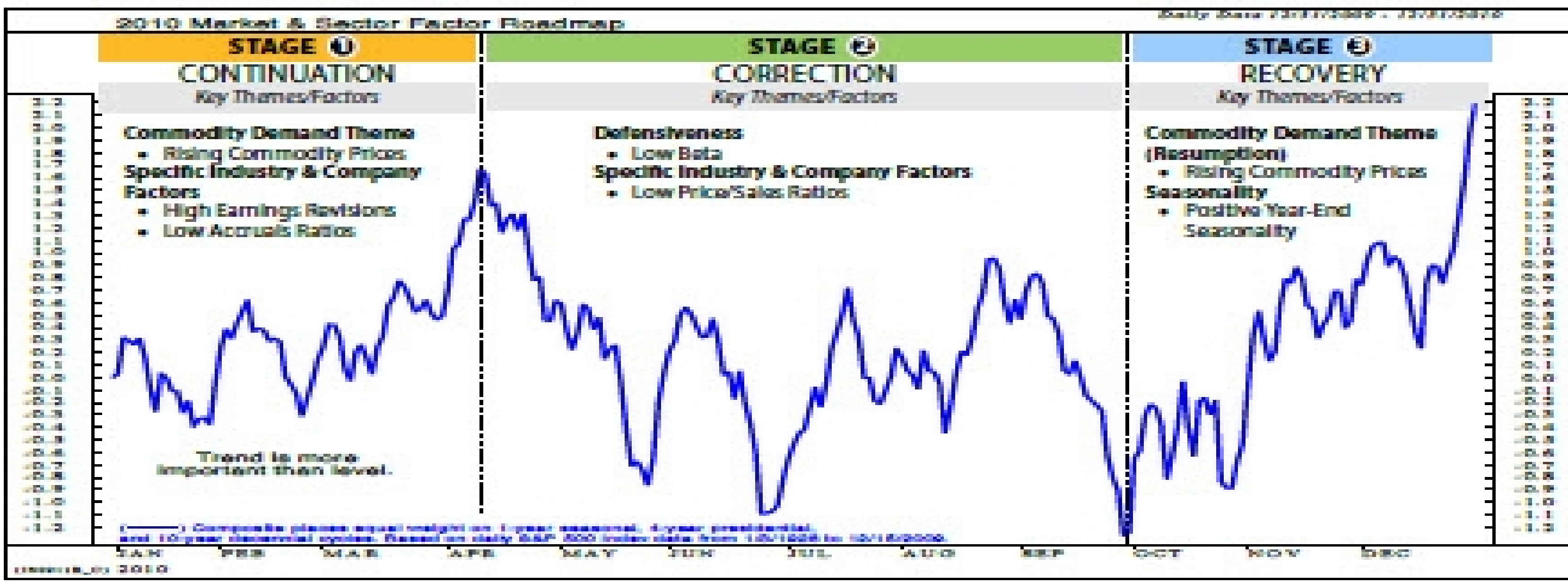
Economic roadmap

2010 S&P 500 SECTOR EXPECTATIONS BY STAGE

STAGE 1 CONTINUATION	STAGE 2 CORRECTION	STAGE 3 RECOVERY	
Materials Information Technology Energy	Utilities Telecommunication Services Health Care Consumer Staples	Materials Information Technology Energy	OVERWEIGHT
Financials Industrials Consumer Discretionary Telecommunication Services	Consumer Discretionary Industrials Financials	Financials Industrials Consumer Discretionary Telecommunication Services	
Utilities Consumer Staples Health Care	Information Technology Materials Energy	Utilities Consumer Staples Health Care	UNDERWEIGHT

Sector expectations are based on our sector expectational model for 2010....a summed rank ordering of the following factors:
Stages 1 & 3: Rising commodity prices, improving earnings growth expectations, earnings quality.
Stage 2: Low beta, low price to sales.

Ned Davis Research, Inc. *T_IS0911.2*



Bonds less exciting in 2010

- Yield curve to remain steep for most of year
- Short end to rise later in year as Fed removes stimulus
- Fed has stated rates to stay low for an "extended period of time"
- Need to show a sustained recovery for a few quarters

Summary

- ***Equity Markets will depend on***
  - Earnings, valuations, sustainability
  - Watching macro indicators
  - Returns should still outperform bonds, cash
  - Focus on multinationals with strong balance sheets, consistent earnings, and strong dividend payouts
  - Maintain some international exposure (emerging markets)- cheaper dollar play
  - Total return possible (8-12%)

- ***Bond Markets***
  - Rates to rise slowly later in year
  - Spread product to do well (Corps) & high yield
  - Focus on quality
  - Returns to be lower (3-7%)

- ***Asset allocation (assumes a balanced account model)***
  - ***Overweight stocks***
  - ***Underweight bonds and cash***

Note: <u>This is subject to change daily!</u>

Graig Stettner, CFA, CMT

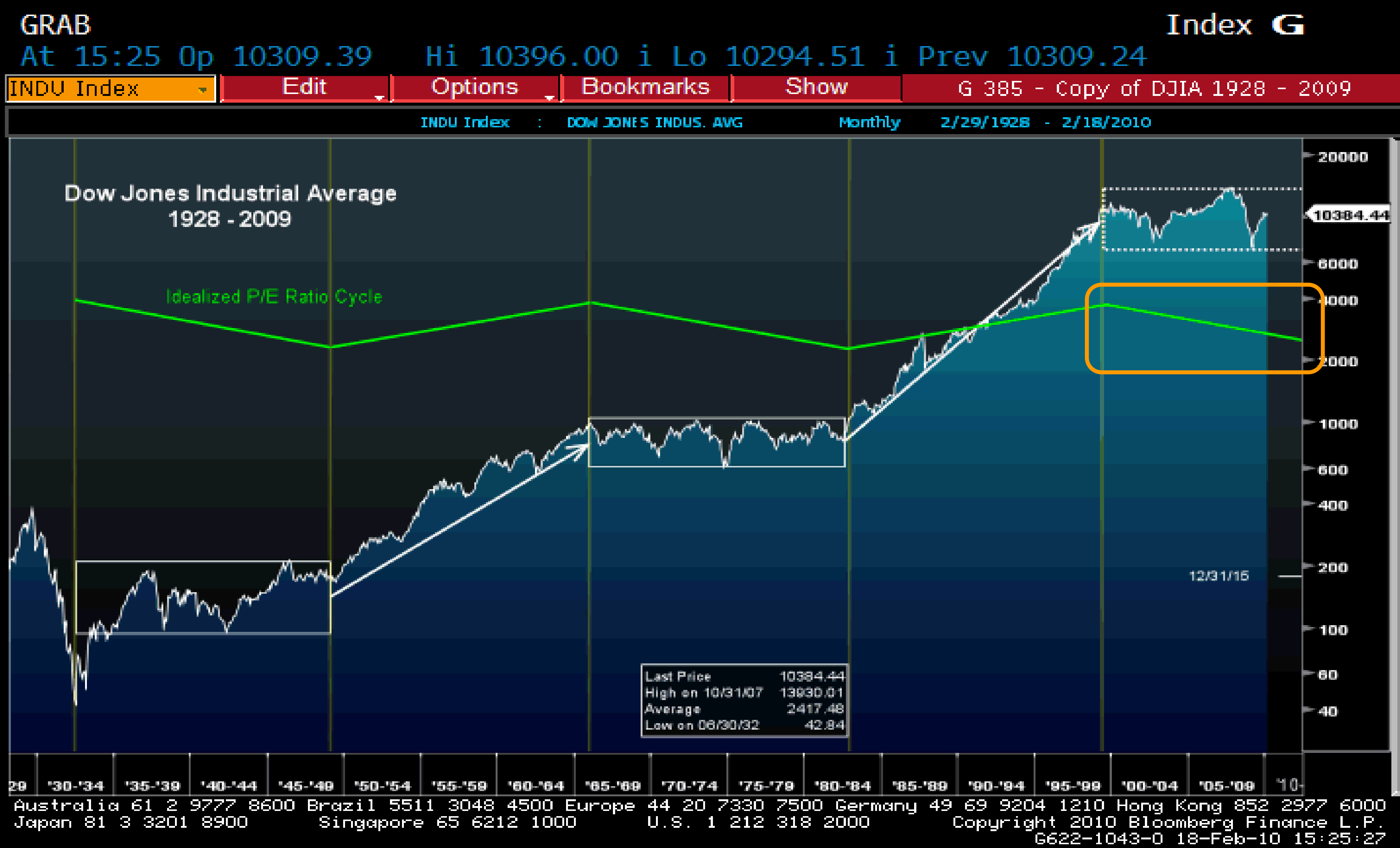
Vice President

Portfolio Manager

Investment Management & Trust Services

Tower Private Advisors

Secular Bear Market Follow-up

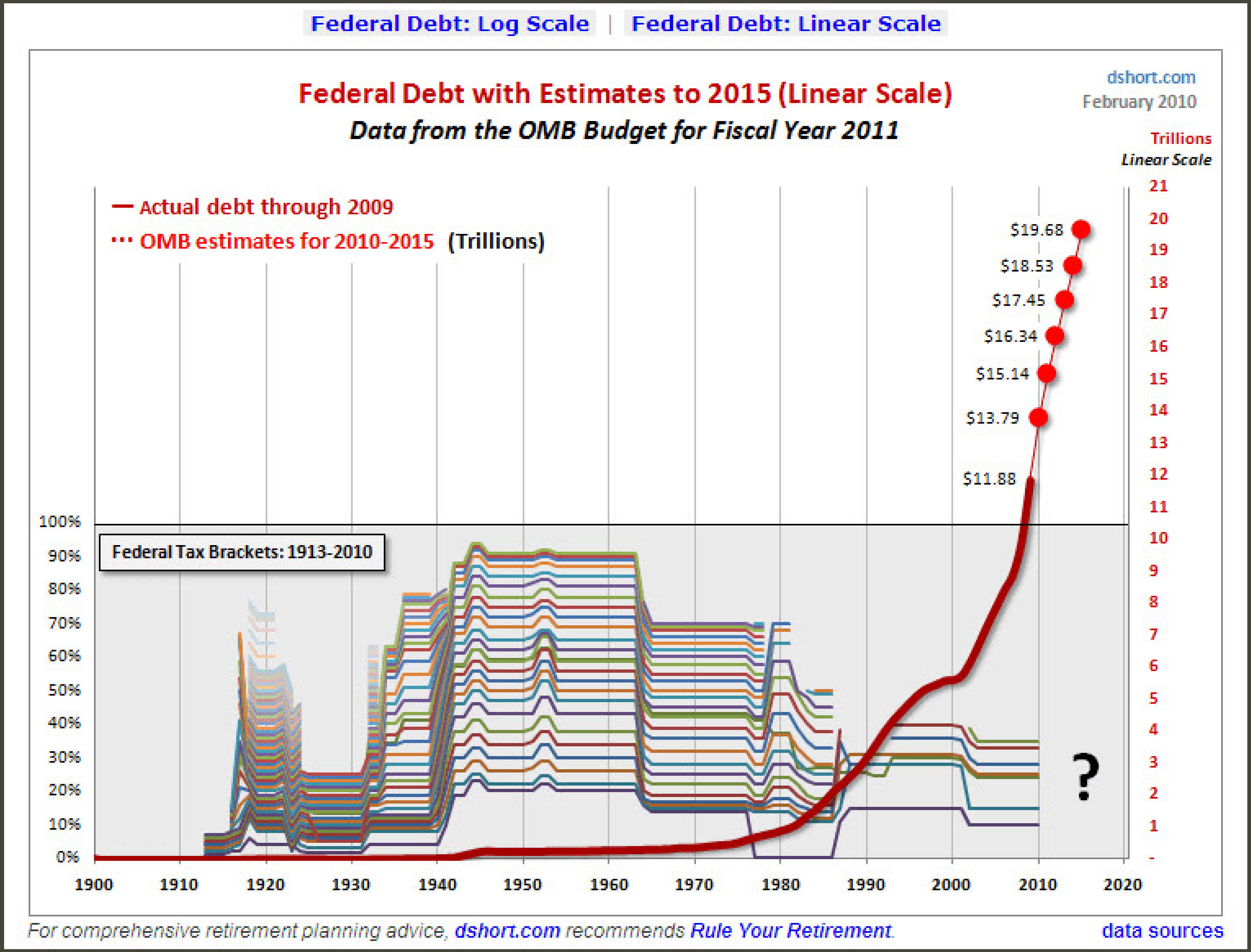


Let's zoom in on the future…

…and consider what issues we'll have to deal with in the next few years.

- Virtually inevitable inflation – when, not if (i.e. the "printing money" thing)
- Persistently high unemployment – need to add ~180,000 jobs per month just to keep up with population and workforce growth
- $1 trillion deficits as far as the eye can see
- Tax hikes and bond issuance needed to fill gaps at state and Federal levels
- Demographics

Debt and Taxes



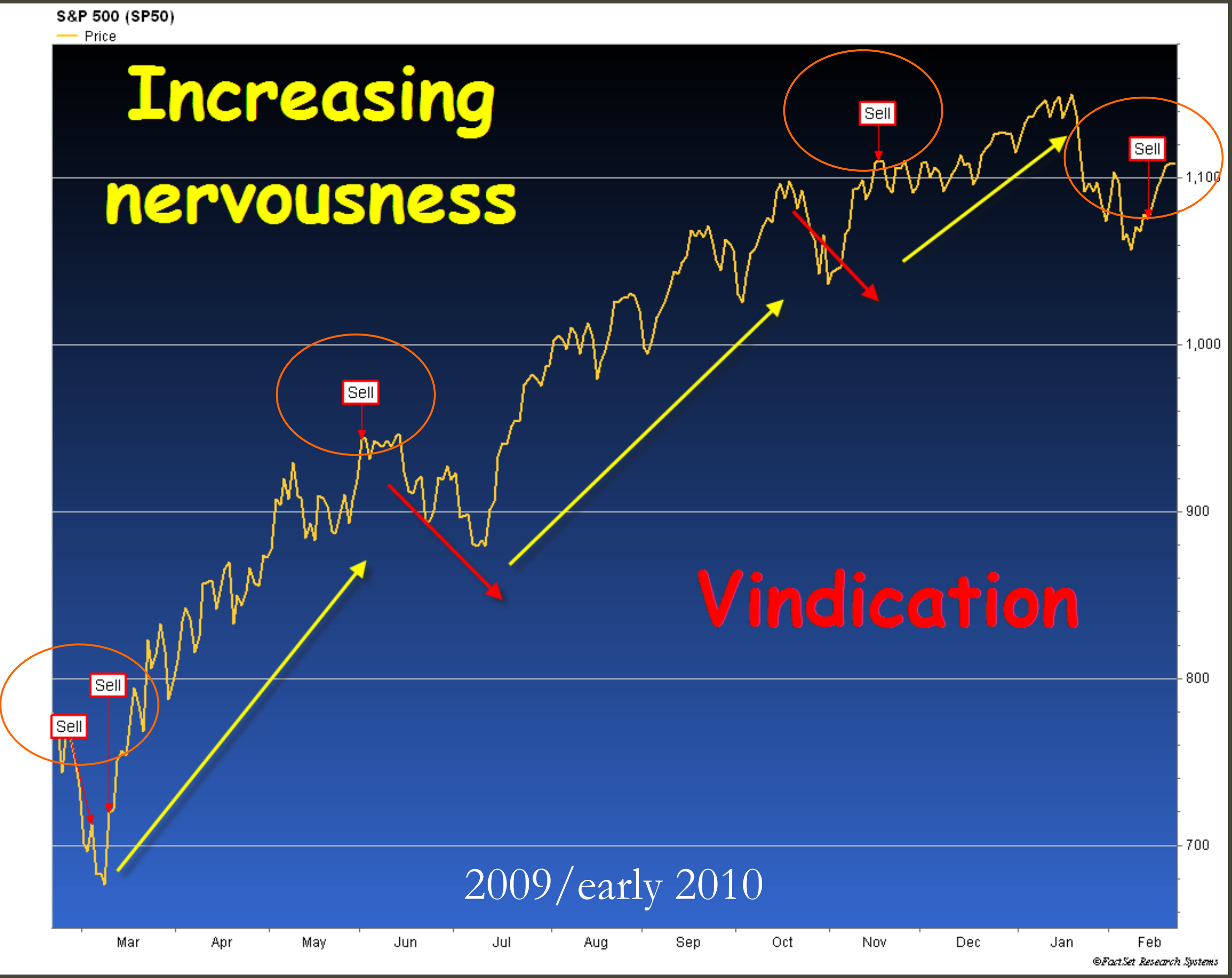
…and certain things start to make sense

Typical investor behavior

Sentiment goes with the market. Market goes up, investors more bullish; goes down, investors more bearish.

…like clients who sell as stocks *rise*

Not this time



Now sentiment goes opposite the market. Market goes up, clients more bearish (i.e. nervous); goes down, clients vindicated.

Unfortunately, they're running to the perceived safety of bonds. (More on this shortly from Zach.)

…which fits with post-bubble behavior

Stage

1. Birth of a bubble	1. Unique profit opportunity
2. Nurturing of a bubble	2. Cheap credit facilitates
3. Euphoria	3. Gotta-get-in mentality
4. Critical stage	4. Smart folks sell to dumb
5. Revulsion	5. Asset/class is shunned

This material from a GMO white paper, available at:

http://www.scribd.com/doc/27068417/10-Lessons-Not-Learned-Montier-GMO-Feb-2010

Smart people on the secular bear notion

Morgan Stanley – 8/10/09

Study of 19 secular bear markets. If the past is prologue, secular bear should end around mid-2016.

Simon Hunt, London economist – 2/10

"The world is unlikely to begin a new period of sustainable growth until 2018 at the earliest."

Jeremy Grantham, GMO – May 2009

" . . . to limp back to even a normal 50% ratio of debt to collateral. Seven years [i.e. 2016] just might do it."

Bank Credit Analyst Research – 2/15/10

" . . . the [global] economy will gradually return to equilibrium over the next 3-4 years."

Fidelity – 2009

" . . . the secular bear market may not end for another three to five years. . . . any recovery here could be merely a cyclical bull within a secular bear."

Stifel Nicolaus – 2/13/09

" . . . we see a multi-year trading range [to 2014.] We still believe that this is a long-term, or 'secular' bear market, the 4th in the past century. Such markets are typically range-bound for 13+ years."

Ned Davis Research – 1/27/10

"It will take at least six years to return to full employment."

Covered Call Writing as a Timely Investment Tactic

Option Basics

- Call option is one of two option types; the other is a put.
- Call option gives the buyer a purchase option. If exercised, that <u>right</u> becomes an <u>obligation</u> to the seller.
- A put option gives the buyer a *sale* option.
- Buyers of both puts and calls pay for the option in the form of an option premium.

Call Option Price Determinants

- Time to expiry longer = higher
- Volatility higher = higher
- Dividends higher = lower

Terminology

Premium – the option price

Expiry – expiration

Strike price – the price at which the underlying security can be bought or sold

The Thought Process

- Writing covered calls considered when:
  – We're concerned about security or market's future. Retain some upside and cushion downside.
  – We have a nice profit in a security. Wondering how much upside's left.
  – The option, itself, offers an attractive return.

Math Behind Option Attractiveness

1. Add option premium to the stock's upside.
2. Determine % return
3. Annualize the return

Example	
Alpha Natural Resources (ANR)	$48.15
February $50 call option premium	$1.85
Upside to strike price*	$1.85
Total return if assigned	$3.70
	7.7%
Annualized (360/31 x return)	89.4%

Results

1. Greater than 100%? do it
2. Between 50 – 100%? think hard
3. Less than 50%? pass

Benefits to Clients

- Additional source of return . . . by hook or by crook
- Fee offset
- Adds discipline to exit strategy

Actual Example

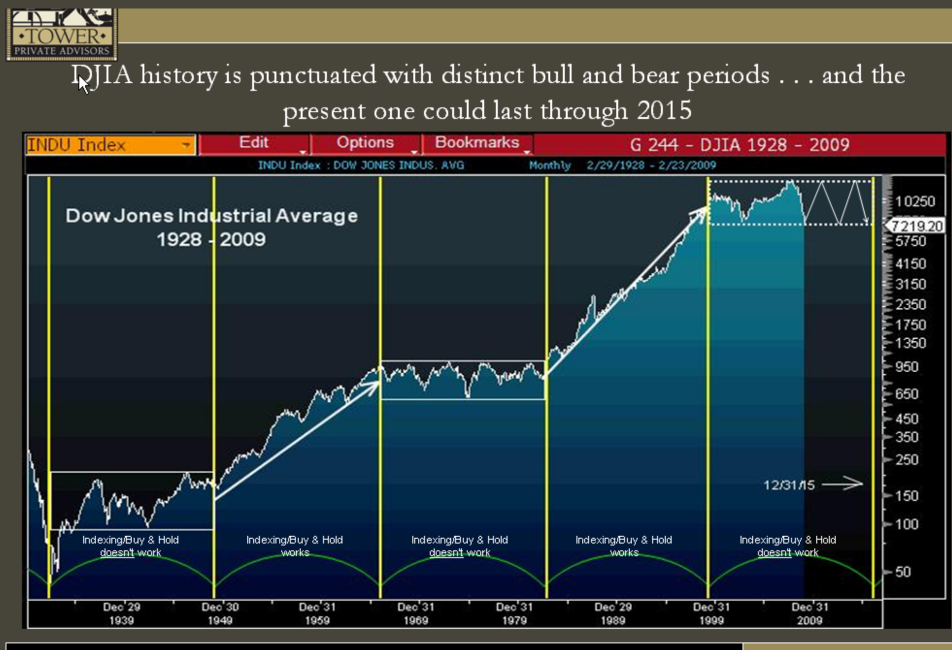
Bought Office Depot on September 23 for $6.44.

Stock's at $6.65. Return has been just $0.21, or 3.26%.

Wrote covered calls twice and received total option premiums totaling $0.96, or 14.84% of the stock's purchase price.

Converted a modest 3.26% return into an 18.11% return.

Works Well With Our Longer Term Outlook



It is again this writer's opinion that volatility will remain high in the market . . . as long as investors are nervous about their stock holdings. That could be for a considerable length of time, or for several more years, at least. If we experience a series of bull and bear markets in the future, prices are likely to remain volatile.

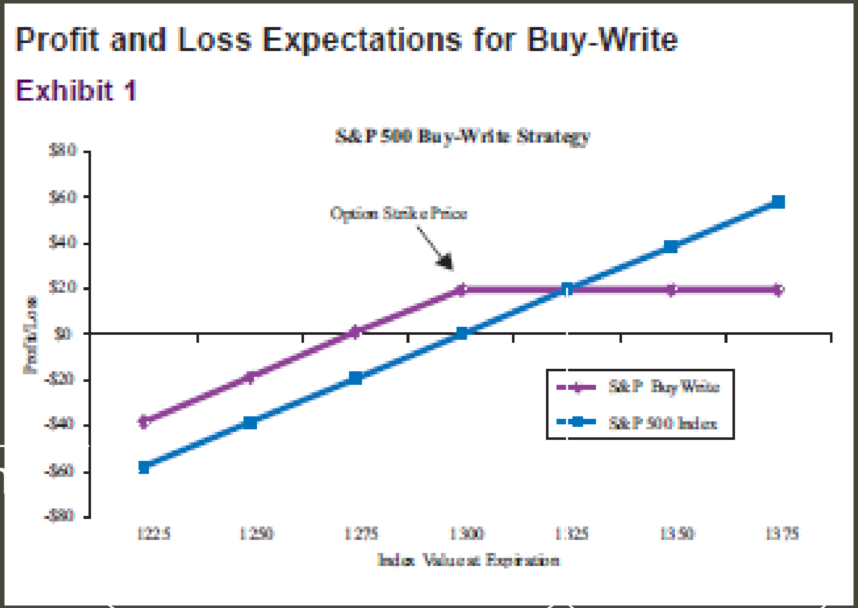
Looking at the historical record, in the period between 1966 and 1974, three dismal bear markets and two booming bull markets occurred, and each was considerable in magnitude. In other words, prices were volatile.

Between 1974 and 1982, prices were less volatile, with the market trading in a narrower range over those years. As has been noted, history never exactly repeats itself, yet it seems likely that we will undergo several years of volatile prices, as the last excesses of the huge bull market of the 1980s and 1990s are expunged, and then perhaps a period of tranquility as a base is built before the next great bull market takes place. Covered call writing will be an ideal strategy for many during that time period.

New Insights on Covered Call Writing, Richard Lehman and Lawrence G. McMillan

A Call Option, graphically

option
premium



option strategy
helps

option strategy
hurts

Zach Higgins
Portfolio Manager

Investment Management & Trust Services

Tower Private Advisors

Pay Attention to Dividends

- Why are dividends important now
  - Recession ended in June, so many dividend cuts are behind us
  - Historically dividend payers perform well after recessions end
  - Dividend payers are at an advantage with interest rates at zero
  - Dividend payers tend to be large-cap stocks, which will likely outperform during the correction phase (Q2 & Q3 2010)
  - Historically at this point in a cyclical bull, high quality stocks begin to outperform low quality stocks

- If you insist on lower turnover – an investment approach that focuses on dividend growth is compelling
- Focus on dividend growth; not dividend yield

Pay Attention to Dividends

TOWER PRIVATE ADVISORS

S&P 500 Stocks by Dividend Policy 1972 - 2010

- Dividend Growers & Initiators: 9.2%
- Dividend Payers w/ no Change in Dividends: 7.0%
- S&P 500: 6.8%
- Non-Dividend Paying Stock: 1.2%
- Dividend Cutters or Eliminators: -1.3%

*The above returns are annualized

Pay Attention to Dividends

- Dividend Aristocrats
  - Includes companies that have increased dividends for over 25 years in a row. Equally weighted and rebalanced once a year
  - Over the past 3, 5, and 7 years the dividend aristocrats have managed to outperform the S&P 500 by 5%, 3.7%, and 4.4% respectively
  - Be careful, the list included 67 stocks in 2001, it now contains 43
  - Look for low payout ratios, high ROE, high free cash flow to equity, and reasonable debt levels

Pay Attention to Dividends

A few names worth considering

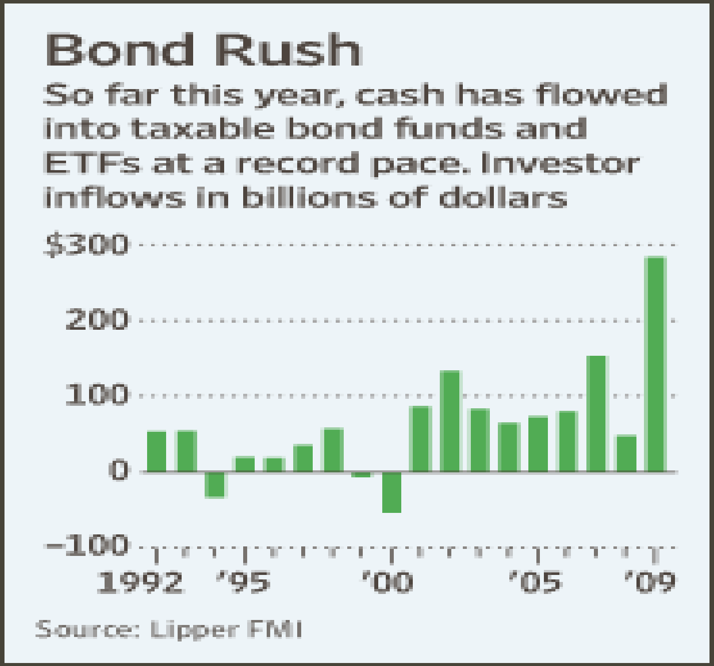
- Wal-Mart (WMT)
- Procter & Gamble (PG)
- AT&T (T)
- McDonalds (MCD)
- Pepsi (PEP)
- Family Dollar (FDO)
- Becton Dickinson (BDX)
- Air Products (APD)
- Abbott Labs(ABT)
- Cincinnati Financial (CINF)

Williams Inference Center

- **Inferential Scanning**
- The Williams approach of inferential scanning focuses attention on those areas of the outside world where change impacts the business environment - be it economic, political, social, cultural, technological or regulatory.

- Williams Inference maintains a staff of readers who monitor a broad spectrum of global information and select the anomalies.

Bond Bubble



Key Anomaly:

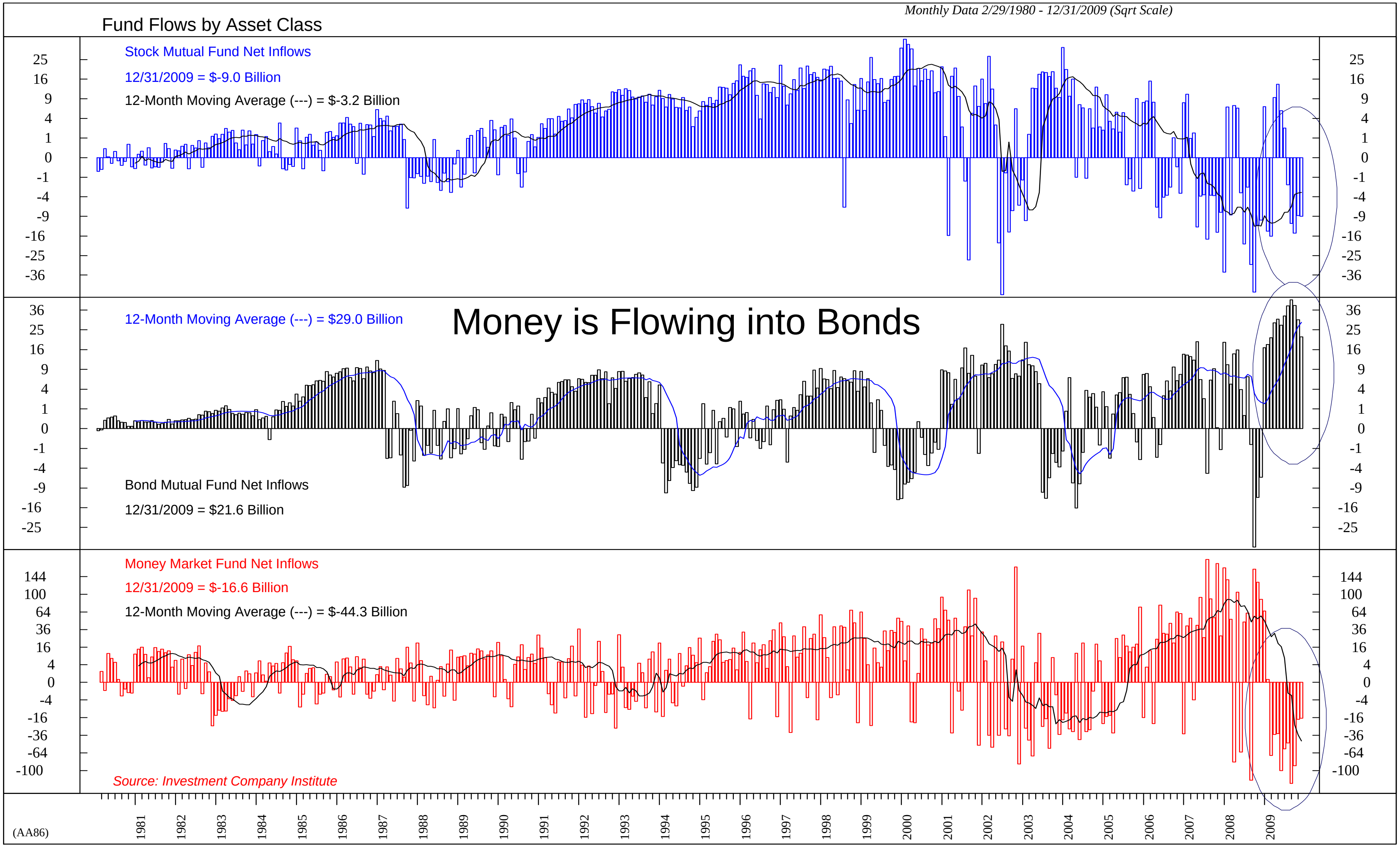
Investors have deposited a record $280 billion into taxable bond funds & ETFs this year.

The key to the bond activity is the movement of money from one bubble to another. When the Internet bubble collapsed, money found its way to real estate. Now that the real estate bubble has burst, money is finding its way into bonds. Should interest rates soar because of debt levels, this could all end very badly.

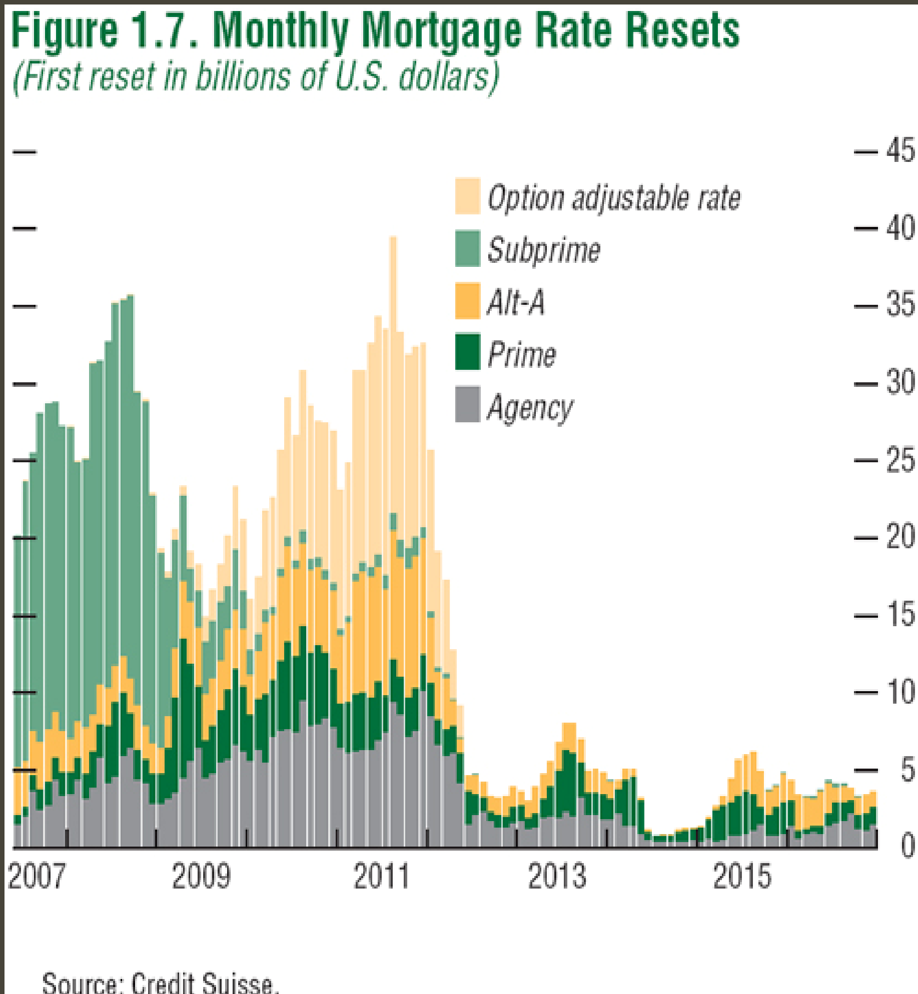
Red Hot Bond Market Masks Classic Investor Debacle - Reuters

Money is still pouring into U.S. bond mutual funds after last year's record-setting $376.6 billion, a classic sign that the fixed-income market – and the forlorn small investor is ripe for bruising

Bond Bubble


Fund Flows by Asset Class
Monthly Data 2/29/1980 - 12/31/2009 (Sqrt Scale)
Stock Mutual Fund Net Inflows
12/31/2009 = $-9.0 Billion
12-Month Moving Average (---) = $-3.2 Billion
25 16 9 4 1 0 -1 -4 -9 -16 -25 -36
12-Month Moving Average (---) = $29.0 Billion
Money is Flowing into Bonds
Bond Mutual Fund Net Inflows
12/31/2009 = $21.6 Billion
36 25 16 9 4 1 0 -1 -4 -9 -16 -25
Money Market Fund Net Inflows
12/31/2009 = $-16.6 Billion
12-Month Moving Average (---) = $-44.3 Billion
144 100 64 36 16 4 0 -4 -16 -36 -64 -100
Source: Investment Company Institute
(AA86)
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

Delayed Financial Problems

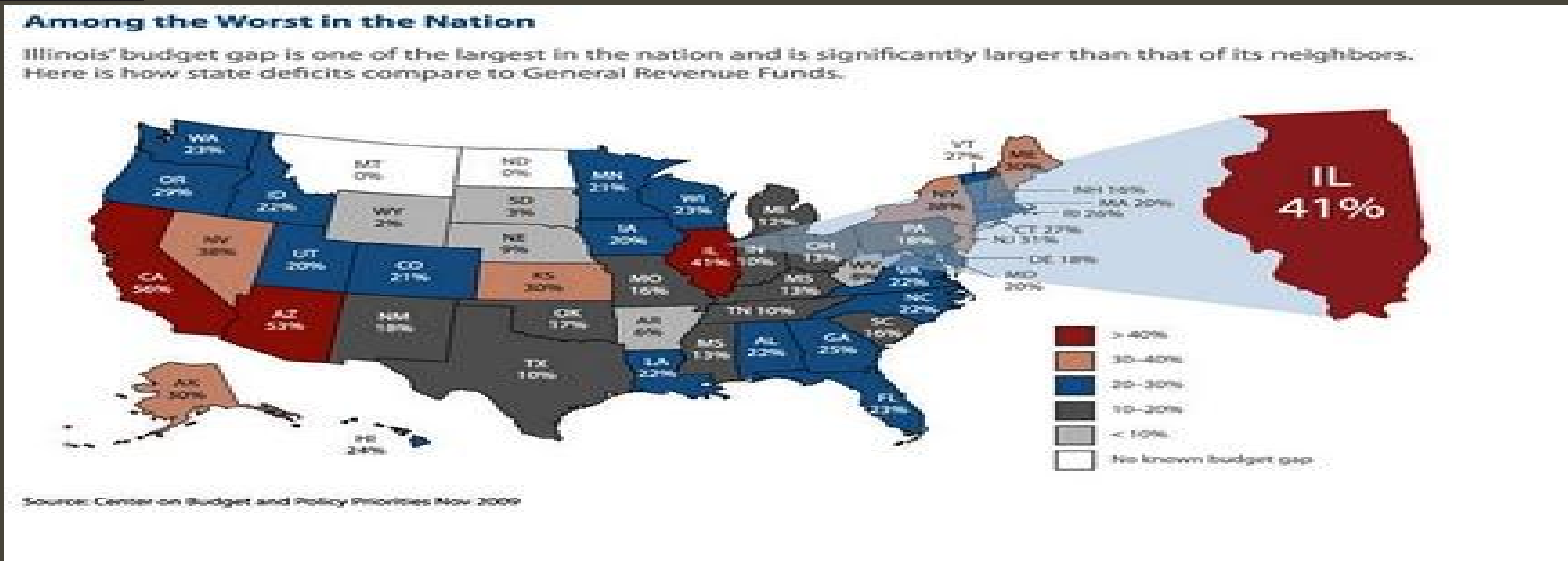


Key Anomaly:

Mortgage interest only monthly payments can jump as much as 75%.

- According to First American CoreLogic there are $2.8 million active interest only home loans worth a combined total of $908 billion
- The interest only periods, which put off the principal payments for five, seven or ten years are now beginning to expire
  - $71 billion in next 12 months
  - $100 billion the following year
  - $400 billion after mid/late 2011

Delayed Financial Problems



- Pension costs for counties in NY could triple over the next 3-5 years
- 91% of Illinois total debt is due to pensions and retiree health care
- Illinois retiree-related debt including pensions and health care is now $25,000 per household
- California's pension costs are up 2,000% over the last ten years, while revenues have only increased 24%

Cloud Computing

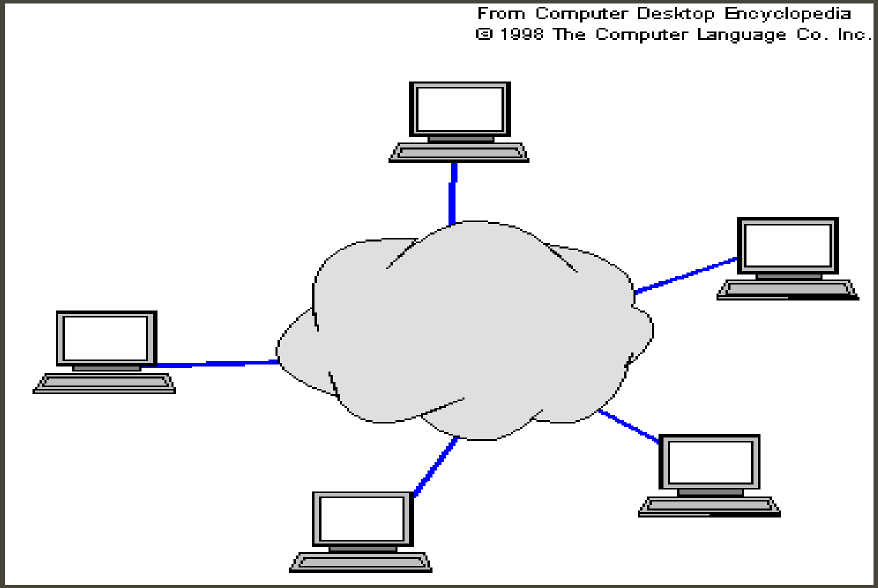
Key Anomaly:

For some a move to the cloud might cut computer costs in half (Newsweek).

- The key is cost savings
- Dropping your cable TV or satellite connection in favor of watching television via the web
- Medical community is tapping into patient data previously inaccessible

Cloud Computing

Shifts to the cloud are expected to remake technology as thoroughly as the Internet has. The move will produce winners and losers (Barrons).



Our potential winners list includes:

- **VMware (VMW)**
- Salesforce.com (CRM)
- **AT&T (T)**
- Hewlett Packard (HPQ)
- IBM (IBM)
- **Google (GOOG)**
- **Cisco (CSCO)**
- Amazon (AMZN)
- Allscripts (MDRX)

Summary

- Stock prices move higher (8-12%) total return
  - Correction during Q2 & Q3
  - Dividend and high quality names outperform
  - Take advantage of volatility with covered calls
  - Slight bias towards large caps (global exposure)
  - Favor growth for now; we anticipate a shift to value later in the year
  - Favor emerging markets within foreign allocation
- Neutral on commodities & Gold in the short term; although they remain in a secular bull
- Underweight Bonds

The New Roth Opportunity for 2010 and Beyond

Bob Nicholas, CFP
Investment Services
Tower Private Advisors

Important Information

Securities offered through **PrimeVest Financial Services**, member SIPC.

You should consider the investment objectives, risk, and charges and expenses of the investment options carefully before investing.

Consult your legal or tax counsel for advice and information concerning your particular circumstances. Neither PrimeVest nor any of its representatives may give legal or tax advice.

The Opportunity

- Tax law changes effective in 2010 allow access to a tax-advantaged retirement and estate planning vehicle, i.e. the Roth IRA, that was previously not available to certain people

TOWER PRIVATE ADVISORS

Tax-deferred vs. Tax-free

	Taxes	Distribution	RMD
Tax-deferred Accounts Traditional IRAs, 401(k), 403(b), 457(b), SEP & SIMPLE IRAs	•Tax deduction •Taxes paid when funds come out	Taxable	Yes
Tax-free Accounts Roth IRA, Roth 401(k), Roth 403(b)	•No tax deduction •Taxes paid when funds go in	Potentially Tax-free	No

Roth Conversion Eligibility

- **2009**
  - Single & married joint filers with modified adjusted gross income (MAGI) < $100,000
  - No conversion if married filing separately

- **2010 & beyond!**
  - **Anyone can convert regardless of income or filing status!**
  - **No MAGI restrictions!**

Tax Consequences

- Previously untaxed amounts converted included in income
- 2010 conversions only: tax liability may be spread ratably in 2011 & 2012
- Best Practice: outside funds to pay tax liability
- Low-cost conversion if convert before full market recovery

Why Convert?

- Roth IRA benefits:
  - Tax-free growth
  - No annual required minimum distribution (RMD), unlike traditional IRA
  - Tax-free legacy to heirs
  - No RMD to include in income to cause taxation of Social Security benefits
  - Contributions beyond 70 ½ if still working

Conversion May be Beneficial if:

1. You are a high-income earner
2. Expect to be in a higher income tax bracket at retirement
3. Do not anticipate needing a Roth IRA for retirement income
4. Want to leave a tax-free legacy to heirs
5. Anticipate income tax rates will increase in the future

Current and Future Tax Rates

	2009	2011 *(Anticipated)*
Highest	35%	39.6%
5th Bracket	33%	36%
4th Bracket	28%	31%
3rd Bracket	25%	28%
2nd Bracket	15%	15%
Lowest Bracket	10%	15%

Qualified Roth Distributions

- Are tax-free and penalty-free (including earnings) if:
  - account open for 5 years, AND
  - one of the following:
    - Attainment of age 59 ½
    - Death
    - Disability
    - First-time home purchase

Retirement Plan Rollovers

- Qualified plan assets may roll to a Roth IRA if you are eligible for a distribution
- Are you a *participant* eligible for a distribution?
  - Have you separated from service?
  - Have you reached retirement age?
  - Can you take an in-service distribution?

Consult Your Tax Advisor

- Taxation of Social Security benefits in year of conversion may be affected
- Options for paying the tax liability
  – Other assets
  – Withholding at source
  – Estimated tax payments
    - Adjust estimated tax payments to avoid penalty?

Consult a Financial Professional

- Knowledge of technical rules & issues
  - Distribution rules
  - Recharacterization (exit strategy)
- Evaluate your particular situation
  - Full or partial conversion? Over multiple years?
  - Estimated tax impact?
  - What sources should you use to pay the tax?
  - Establish separate Roth accounts to hedge against possible underperformance?

Bread & Circuses Today

- In modern usage it is used as a metaphor for handouts and petty amusements that politicians us to gain popular support instead of gaining it through sound public policy.
- **Any of these sound familiar**:
  - Healthcare overhaul
  - Cash for clunkers
  - New home tax credit
  - Political spectrum of the House of Reps and Congress

Questions?

Visit our investment blog at blog.towerbank.net