

1st Quarter 2011 Review

Several potential disasters affected the global financial markets in the first three months of 2011. After a year in which we experienced three distinct movements of growth and decline, the first quarter of the new year could have been a nice time for investors to take a breath. The reality was just the opposite.

If one were to fall asleep on January 1st and wake up on March 31st their reaction regarding the returns experienced by their investments during that period would have been surprising joy. The large company dominated S&P 500 gained 5.9%, and the small cap driven Russell 2000 rose 7.94%. Those gains are acceptable for an annual return, let alone for one quarter, and indicate the January through March period was a success.

However the experience of Q1 2011 was far more interesting and anxiety filled than our sleeping investor perceived. From February 18 to March 16 the S&P 500 fell 6.1%. Surrounding this time we were stunned by the events of the tsunami in Japan that led to the Fukushima Daiichi nuclear plant meltdown, civil revolt in Egypt, civil war in Libya, and a European debt crisis that bubbled up again. There was plenty of reason to become downtrodden and sell into the turmoil and compound the losses.

From September through mid-February, the indexes for small, medium, and large companies in the U.S. were all up over 20%. That return was staggering considering a headache still existed from the 2008-2009 recession. Markets tend to take a breath after extended runs and typically sell off, or “correct”, and retreat to a trend line for average growth that is more realistic. Investors, both institutional and individual, were waiting for a decline but as is often the case they did not foresee the events that would trigger the correction. It is fairly common to have a geo-political or surprise event spook investors, and begin the momentum for a sustained sell-off. When profit taking ensues, fear can become panic.

During the first quarter of 2011, even with significant headlines, the market did not severely correct, and was quite resilient. The volatility allowed some investors to take advantage of the dip, and buy into the market at slightly lower prices than the previous month. Investors mostly had a positive experience for the quarter and felt pleased regardless if they were trying to time the ups and downs, or if they were simply holding positions from start to finish.

The Russell 3000 Value index slightly outperformed the Russell 3000 Growth index for the quarter. Among sectors, Energy, Industrial, and Health Care stocks outperformed all others, while Consumer Staples, Technology, and Utility companies lagged. As for international equities, the developed markets edged out the return of emerging markets.

Figure 1.1 is a matrix of the returns experienced in Large, Mid, and Small cap indexes across Growth, Blend, and Value styles for the first quarter of 2011, and the full year of 2010.

Fig 1.1¹

	Q1 2011			2010		
	Value	Blend	Growth	Value	Blend	Growth
Large	6.5%	5.9%	6.0%	15.5%	15.1%	16.7%
Mid	7.4%	7.6%	7.9%	24.8%	25.5%	26.4%
Small	6.6%	7.9%	9.2%	24.5%	26.9%	29.1%

Fixed income securities performed modestly during the quarter as a result of interest rates inching higher. The Barclays Capital Aggregate Bond Index², which measures the performance of the taxable bond market, generated a 0.4% return, and the BarCap Municipal Bond Index rose 0.5%. The yield on the benchmark 10-year Treasury bond rose from 3.30% to 3.45% during the quarter. Most observers believe the Federal Reserve’s purchase of Treasury securities as part of its current quantitative easing program has resulted in maintaining a low interest rate environment. This was the intention of the Fed and came to fruition.

Building a Base

Over time, we have seen the market reach new heights, then retreat, only to make higher highs in the future. The challenge is defining when that new high will occur. Aside from outright default, investor fear is more closely associated with time than it is to the current investing environment. The inability of an investment to produce enough money when you need it, whether it is 10 years from now or tomorrow, is an essential concern.

The perception that an investment will not fall below a base value is incredibly important to the psyche of an investor.

This can be measured in terms of the book value of an investment. Once a base level is solidified, investors are more comfortable placing their savings into the market and no longer withhold capital in fear of significant investment loss.

The case we make today is that the market has achieved a base level and downside equity risks seem contained given various sources. The downside potential may be reduced by resources from governmental intervention, individual investor cash savings, and a change from conservative corporate capital spending habits. These factors provide an opportunity for reinvestment that will support current market levels, and drive growth in 2011.

We can note several sources from which investment capital may flow. (1) Pension funds are evaluating their overweighting to bonds, and will likely shift their asset allocation models from bonds to stocks in an effort to keep pace with actuarial assumptions. (2) Corporate cash holdings are historically high³ and seem poised to be redeployed for either capital expenditures or acquisitions. (3) Mutual fund flows have turned toward equity funds, and away from money market and bonds⁴. Lastly, (4) dividend increases have become more fashionable as corporations are in a better position to pass along this benefit to shareholders. This is significant as we have seen that dividend paying companies have out performed non-dividend payers by 7% per year over the past 40 years⁵.

In our opinion, the combination of dividend increases, pension funds, foreign and U.S. corporate investing, along with the change in sentiment among long-term retirement oriented investors in defined contribution plans, provides a floor to the value of the stock market today. However – here is the hedge – the backdrop of government budget challenges and the potential slowing of recent economic momentum can impact upside returns.

Our conclusion is the market has reached a level of stability based on notable factors, but has some restrictions holding it back from a complete breakout to the upside. This confirms to long-term investors that they should feel comfortable placing capital into growth oriented investments, and favor stocks over bonds. It is challenging to be bearish at this time, and there are more fundamental reasons to believe equities will outperform over the last three quarters of the year.

Past performance is no guarantee of future results. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly. Investing in sectors may involve a greater degree of risk than investments with broader diversification. International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks. The information contained herein is obtained from sources believed to be reliable, but its accuracy or completeness is not guaranteed. This report is for informational purposes only and is not a solicitation or a recommendation that any particular investor should purchase or sell any particular security. All expressions of opinions are subject to change without notice.

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¹ Fig 1.1 Style Returns: Style box returns based on Russell Indexes with the exception of the Large-Cap Blend box, which reflects the S&P 500 Index. All values are cumulative total return for stated period including the reinvestment of dividends. The Index used from L to R, top to bottom are: S&P 500 Index (Index represents the 500 Large Cap portion of the stock market, and is comprised of 500 stocks as selected by the S&P Index Committee), Russell 1000 Value Index (Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values), Russell 1000 Growth Index (Measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values), Russell Mid Cap Value Index (Measures the performance of those Russell Mid Cap companies with lower price-to-book ratios and lower forecasted growth values), Russell Mid Cap Index (The Russell Midcap Index includes the smallest 800 securities in the Russell 1000), Russell Mid Cap Growth Index (Measures the performance of those Russell Mid Cap companies with higher price-to-book ratios and higher forecasted growth values), Russell 2000 Value Index (Measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values), Russell 2000 Index (The Russell 2000 includes the smallest 2000 securities in the Russell 3000) Russell2000 Growth Index (Measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values).

Market Returns: All data represents total return including the reinvestment of dividends for stated period. Index: MSCI – EAFE; provided by: MSCI – gross official pricing. Index: UK; provided by: MSCI – gross official pricing. Index: Europe ex-UK; provided by: MSCI – gross official pricing. Index: Japan; provided by: MSCI – gross official pricing. Index: Asia ex-Japan; provided by: MSCI – gross official pricing. Index: S&P 500 Index; provided by: IDC.

² Barclays Capital Aggregate Bond Index: a market-capitalization weighted index of which the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Barclays Capital Municipal Bond Index: A broad-based, total return index. The Index is comprised of 8,000 actual bonds. The bonds are all municipal issued investment-grade, fixed-rate, long-term maturities (greater than two years) and are selected from issues larger than \$50 million dated since January 1984. Bonds are added to the Index and weighted and updated monthly, with a one-month lag.

³ Source: Ned Davis Research

⁴ Source: Morningstar, as of 2/1/2011

⁵ Source: Ned Davis Research