June 24, 2010

THE OUTLOOK

In this issue of THE OUTLOOK. . .

We propose a series of policies that we believe are necessary to put the global economy on a more sustainable course of improvement

We review key sectors that are poised to benefit as well as portfolio implications

We continue to see standout investment opportunities in businesses well-positioned to benefit from the growing divergences between developed and developing economies

In a tug-of-war between the forces of deleveraging and the power of industrialization, maintaining perspective is paramount.

We would like to extend a special invitation for you to join in a conference call to discuss the Outlook.

Date: July 8, 2010; Time: 11:00 AM EST
Dial-in number: (877) 224 – 6689; Int'l (706) 643 – 1275
Conference ID: 84774179
A replay will be available for 30 days by calling:
Domestic (800) 642 – 1687; Int'l (706) 645 – 9291

Thoughts on the Global Policy Debate and Investment Implications

Since our March 31st Outlook, the environment has shifted to one best characterized by rising uncertainty and volatility. The European sovereign debt crisis and the austerity plans now being considered have created the greatest source of uncertainty, but there are several other factors unsettling the markets, such as the outlook for corporate earnings, global financial reform, ebbing government stimulus and upcoming tax increases. In the US and Europe, governments are struggling to contain record deficits while simultaneously addressing high levels of unemployment and trying to avoid a double-dip recession, which would be far more damaging, difficult and costly from which to recover.

There is significant disagreement as to which goals to prioritize and how best to accomplish them. Most recently, one camp is arguing for further fiscal stimulus and the other for fiscal austerity, with each believing their approach to be best for boosting the economy and addressing deficits. These disagreements in economic philosophy are further complicated by what are at times conflicting national interests. The burdens of debt deleveraging will be with the developed economies for the foreseeable future. At the same time, opportunities presented by secular growth resulting from industrialization and rising living standards in the developing economies remain intact. We are witnessing a tug-of-war between the forces of deleveraging and the power of industrialization that is playing out in the media and in the markets on a daily basis.

In such an environment, maintaining perspective is paramount. ARS remains focused on taking advantage of market volatility to opportunistically invest in undervalued businesses that are the beneficiaries of enduring market forces.

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While it is common for market participants to become paralyzed by uncertainty, history has proven that it is in such times that standout opportunities come to the fore. At present, we believe that the practical approach to portfolio management includes holding higher-than-normal cash positions from time to time in order to take advantage of opportunities as they present themselves. In this Outlook, ARS proposes a series of policies that we believe are necessary to put the global economy on a more sustainable course of improvement. We also review key sectors that are poised to benefit, as well as portfolio implications.

Structural Solutions Needed for Structural Problems

We need pragmatic long-term solutions to replace politicized and populist quick fixes.

In our view, the sustainability of global recovery is imperiled by governments and central banks using short term solutions to solve structural problems. We need pragmatic long-term solutions to replace politicized and populist quick fixes which are too often accompanied by serious unintended consequences. The recent performance of many policymakers casts doubt on their ability or willingness to come to consensus on a constructive solution. In our opinion, policy makers need to consider implementing policy to support the following ideas:

First, we believe that this is not the time for additional contractionary policies nor excessive focus on budget reduction for the US and Europe. History has shown that any savings from such policies have often been offset by declines in GDP and government receipts thereby making further cuts necessary in a reinforcing downward cycle. This is a time for initiatives favoring sustainable economic growth and job creation. While it is critical to address the intermediate and longer-term structural issues including legacy benefit programs, growth must be the top priority.

Second, global financial reform, a key topic at the G-20 Summit, must be transnational in its implementation to prevent country-to-country arbitrage. Reforms must be carefully crafted to change any inappropriate behaviors but without being excessively punitive such as to restrict the necessary lending to businesses and consumers.

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Third, the European Central Bank should arrange for long-term (5-10 year) debt facilities for the most at-risk countries in the European Union at rates set significantly below such countries' realistic growth rates. This would give them a cost of capital that would allow them to delever and the time needed to grow out of their debt burdens without the need to access the capital markets. This would have the added benefit of taking pressure off the euro.

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When a country is already heavily in debt, it is imperative that any incremental deficit spending be as productive as possible.

Fourth, when a country is already heavily in debt, it is imperative that any incremental deficit spending be as productive as possible with a high return on investment. As we have discussed in previous Outlooks, the American Society of Civil Engineers has graded the aging US roads, bridges, dams, and energy grid with a "D" and estimates that more than $2.2 trillion is required to restore the US infrastructure to acceptable levels. An infrastructure-intensive stimulus program would address these pressing needs while simultaneously creating jobs and making the country more productive and competitive.

The US urgently needs an intelligent energy policy that takes advantage of its existing resources in a safe, responsible and economic manner.

Fifth, the US urgently needs an intelligent energy policy that takes advantage of its existing resources, including oil, natural gas and coal in a safe, responsible and economic manner. This would lessen dependence on imported oil and improve the US trade imbalance. This will require the government working alongside the energy companies rather than against them, and also require the leadership to cut through narrowly-focused special interests. Decreasing US dependence on imported oil and gas is perhaps the clearest example of how the US can stimulate its economy without increasing its deficit.

Sixth, recent events in the financial and energy industries remind us that responsible regulation is critical. However, it is equally important that regulation be appropriate and balanced in order not to unduly suppress innovation, entrepreneurship and private sector growth. Government at the highest level must work side-by-side with private industry in a comprehensive review of existing regulations with an eye toward streamlining, modernizing and where appropriate, reducing excessive regulations.

Seventh, President Obama should appoint a bi-partisan committee of respected public and private sector leaders to study and make recommendations to ensure the future solvency of US entitlement programs. This is essential for restoring fiscal health and maintaining the ongoing confidence of the holders of US Treasuries.

Eighth, the US needs to develop an intelligent tax program that encourages savings, investment and productive growth. One solution is to lower corporate taxes and capital gains rates, replacing them with increasing taxes on select areas of consumption. In the absence of a new tax regime, we are facing the sunset of the Bush tax cuts in 2011, which will be contractionary for the economy at precisely the wrong time.

Growth and jobs must be the current focus. There is a time and a place for austerity, and there is certainly a need to eliminate wasteful programs. Governments cannot afford a double-dip recession, and any government that embarks on policies resulting in a double-dip recession would likely be voted out of power. The political troubles of Australia's Kevin Rudd present a

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cautionary tale for the world's political leaders as his country has been one of the stronger economies coming out of the recession, yet he was recently replaced as Prime Minister following his controversial mining industry tax proposal.

Updated Thoughts on China

In advance of the G-20 meeting this week in Toronto, the Chinese government took steps to reduce one area of concern by indicating that it would allow for a modest appreciation of its currency, thereby reducing the threat of protectionism and avoiding the "currency manipulator" designation by the United States. Treasury Secretary Timothy Geithner has been working to have China move more aggressively to revalue its currency, but understandably China is focused on its own best interests. A growing desire of factory workers for a higher standard of living has recently resulted in higher wages and increases in food and housing subsidies. The Chinese government has not entirely discouraged this movement since it knows that higher wages will spur domestic spending and reduce its dependence on exports. Over time, this will achieve the effect of having a more balanced economy. Moreover a gradual revaluation of its currency should allow for greater domestic spending while helping to contain inflation. Importantly, it should also lead to greater economic activity and job growth for other low-cost producing emerging economies that export to China. China has been and remains a major driver of global growth, and its effectiveness in transitioning its economy is key to avoiding a global downturn. China made the strategic decision to free its economic and not its political system 25 years ago, and thus far has effectively executed a command and control administration of its economy. China now stands as the second leading global economic power and the leading creditor nation in the world.

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Investments Poised to Benefit

Gold

We remain enthusiastic about opportunities in precious metals investments. When we first began investing in gold in mid-2002, the price of gold was under $325/oz. At that time, we believed that gold was going to become a new asset class promoted to institutional investors worldwide by the World Gold Council. In subsequent years, our conviction in gold increased due to concerns about growing budget deficits, the ongoing printing of money and the tendency of countries toward policies of competitive currency devaluations. Today it is striking that the forces underpinning higher gold prices are even more powerful than they were during the earlier period of the decade. This is due in major part to the increase in the quantities of reserve currencies and the fact that there is nothing backing these currencies other than the paper on which they are printed. Central banks are free to create whatever amounts they require. It is also worth noting that central banks have

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shifted from multi-year selling to buying, state-sanctioned quantitative easing (printing of money) has been moved from theory to practice and investing in physical gold, which used to be inconvenient requiring delivery, storage and insurance, is now available on the stock exchanges around the world through physical gold-backed investment securities that can now attract a greater number of institutional and individual investors. In addition, the marginal cost of new production continues to rise (now in excess of $600 per oz) while supply growth has been flat since the mid-1990's and has declined over the past 5 years.

While fundamentals continue to be supportive of higher gold prices in the years ahead, experience teaches us that gold can be subject to periodic pull-backs. We therefore limit our precious metal equity investments to miners whose valuations on a net asset value (or discounted cash flow) valuation could be supported even at considerably lower gold and silver prices. These opportunities offer us a margin of safety for pull-backs as well as significant appreciation potential in stronger metals markets.

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Energy

The recent oil spill in the Gulf of Mexico has proven to be a game-changing event for the US energy sector. As a result, we would expect the value of onshore and shallow-water drilling properties to be enhanced as the new regulations increase the cost of exploration and development for deep-water properties. Since share prices of oil and gas companies have declined in general in recent weeks, greater undervaluation has been created. At the same time, oil prices have begun to rise in recognition of the longer term impact on global supply as deep-water projects represented some of the greatest opportunities for reserve replacement and production growth for the industry.

The value of onshore and shallow-water drilling properties will be enhanced as the new regulations increase the cost of exploration and development for deep-water properties.

The inability of BP to stem the leaking oil well has had significant near-term regulatory, environmental and company-specific implications. President Obama has halted new drilling initiatives in the Gulf, and Congress has already held hearings. The role of the Gulf and offshore, deep-water drilling is under review. Norway has also suspended some deep-water projects in a sign that this is not just a US issue. We maintain a favorable long-term view of the energy sector for reasons we have discussed in previous Outlooks, including growing global demand, limited availability and high cost of exploration and production. In just a few short years, China's oil demand has grown from 10% of US consumption to 40% of US consumption and continues to grow as China develops its industrial and consumption base. In addition, the Middle East is also experiencing significant domestic energy demand growth.

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Health Care

Although health care has been one of the most out-of-favor areas in the markets in recent months, there is considerable value in many of the leading large-cap pharmaceutical and biotech franchises. Concerns over expiring patents and changing government regulations have driven pharmaceutical valuations to their lowest levels in decades, with P/E ratios under 10x, free-cash-flow yields of 10% or greater and dividend yields of 4-6%. Several companies have dividend yields that are substantially higher than the yield-to-maturity of their outstanding long-term debt (implying a negative long-term growth rate), despite the fact that many of these companies have committed to increasing their dividend payouts over the next several years. There are a number of catalysts that should cause the market to re-evaluate these businesses over the coming quarters. First, with bond yields at multi-decade lows, companies with safe, attractive and growing dividend yields are likely to attract capital for investors requiring income. Second, with the health care bill now having been passed and its consequences better understood, a major overhang has been lifted. Moreover, the costs of the bill to the pharmaceutical industry were front-loaded while the benefits are further down the road with more Americans entering the insured rolls in the years ahead. Third, expectations for the R&D pipelines are currently quite low, yet several of the companies we have added to portfolios have several more candidates for commercialization in the next few years than they have had in the recent past. Any positive news on new drug developments is likely to provide a surprise to the market and be well-received. Finally, these businesses are global, with rock-solid balance sheets and in many cases record cash balances. They are well-positioned to use their cash flows and balance sheets opportunistically, for raising dividends, making niche acquisitions, entering into marketing or distribution partnerships, executing share buybacks or some combination of the four. In short, we find the risk-reward of these investments to be very favorable.

Technology continues to play a vital role for companies seeking to maximize productivity and is also essential to the build-out and urbanization of developing nations.

Technology

Technology continues to play a vital role for companies seeking to maximize productivity and is also essential to the build-out and urbanization of developing nations. In the developed markets, companies have slashed cost structures since the financial crisis making them more dependent on productivity to support their operations and growth. In addition, a capital expenditure catch-up phase following a period of under-investment is still only in the earlier innings as is a meaningful product upgrade cycle. In the developing markets, technology is increasingly integral to the infrastructure needed for urbanization, such as energy distribution, traffic systems and security. In addition, portable computing, through smart phones and tablet devices, is rapidly becoming integrated into the lives of consumers. Global penetration rates remain low, particularly in developing markets, and we expect to see profitable growth in this segment for several years. The larger,

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multi-national technology companies are best suited to meet many of these demands. These companies offer the additional investment benefits of valuations at multi-decade lows, rising dividends and return of cash to investors and fortress balance sheets, often with tens of billions of dollars of net cash and minimal dependence on the capital markets for growth.

Portfolio Implications

Given the uncertainty and volatility we have highlighted throughout this Outlook, ARS remains focused on employing the investment process that has served our clients since 1971. Our experience over the past four decades reminds us that it is in times of great discomfort and uncertainty that standout opportunities are most often found. Companies that are best positioned to benefit from the diverging profiles between the developed and the developing nations should continue to be prime candidates for investment portfolios. This includes businesses that own, produce and distribute the materials needed for industrialization and infrastructure development as well as those whose products and services help to raise productivity and living standards globally. In addition, ARS remains focused on the preservation of purchasing power for client portfolios given the global need for competitive currency devaluation to maintain export competitiveness. We have had the view for some time now that rates need to stay low for a prolonged period. In light of the policies now in place and those being considered, we have further conviction of the need for rates to stay low into 2012.

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At present, the practical approach to portfolio management includes holding higher-than-normal cash positions from time to time in order to take advantage of opportunities as they present themselves. In the context of this environment, our portfolio implementation includes actively locking in outsized gains in successful investments as well as moving decisively to trim or eliminate positions when appropriate. This was particularly evident during the past quarter as we were quick to respond to the oil spill in the Gulf of Mexico in shifting or lowering exposure to select energy holdings, while locking in gains on select health care and materials holdings.

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For fixed income investments there are relative-value income opportunities in investment grade corporate securities in the 4 to 7 year range. With regard to credit selection, we favor select financials, energy, health care and industrial companies whose balance sheets are stable or strengthening. With the severe budget constraints facing states and municipalities, we are particularly cautious with regard to the municipal bond market. Given continuing economic and sovereign debt challenges, there is a high probability that demand for US Treasury debt will remain strong keeping the rate structure at low levels.

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While investors continue to express concerns about investing in the broad market, this is a time for opportunistic and thoughtful security selection from our perspective, as we expect to see separation and performance for those companies that are well-positioned to benefit from the global divergences and imbalances described above.

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