Clifford Swan
The Investment Counselor

SERVING CLIENTS SINCE 1915 FOURTH QUARTER 2009

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THINKING IT THROUGH:
Roth IRA Conversions

By Max Pray, CFA

We have addressed Roth IRAs in past newsletters, providing an in-depth review of the topic in 2007 with a piece entitled, "Should You Consider a Roth IRA Conversion in 2010?" (Please visit our website www.cliffordswan.com to access an archived copy of this article). Now that 2010 is upon us, we thought it timely to look into the details to help better understand the conversion option for investors. A brief review of the Roth IRA conversion process is warranted before we get into the numbers.

A Roth IRA conversion prior to 2010 was allowed only for taxpayers below the $100,000 modified adjusted gross income level. In 2010, this conversion limit is lifted, so everyone will be able to convert a traditional IRA to a Roth IRA.

While there are many factors which may influence a decision to convert, there are two key issues to first consider when discussing options with your advisors. One is fairly simple to understand, but difficult sometimes to predict. If your marginal income tax rates will be higher in the future than they are today, then a conversion likely makes sense. The second factor involves the timing of withdrawals from the IRA. Generally, the longer the period where money is not withdrawn from the IRA, the more it favors conversion to a Roth. In fact, one very real option is to plan on using a Roth IRA as that part of your estate which goes to beneficiaries. Leaving your Roth IRA to children or grandchildren allows the benefit of stretching out the tax-free growth benefits, while still maintaining the tax-free withdrawals. Both traditional IRAs and Roth IRAs are considered part of your taxable estate (unless the beneficiary is a charitable organization). This means that to maintain the financial benefits of the conversion, it would be best if estate taxes do not come out of the Roth IRA, but from other sources.

There are four other nuances that are important to remember with a conversion from a traditional IRA to a Roth IRA. First, if you convert in 2010 (or other years), you have until October 15 of the following year (6 months extension from your normal tax filing of April 15th) to do a recharacterization (reverse the conversion). You would consider this option if the value of the assets declined since the conversion was made. For example, if the value of the Roth IRA at conversion was $100,000 and you are in

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MARKET OUTLOOK

By Ralph E. Weil, CFA

It is that time of year again when the prognosticators polish off their crystal balls in an attempt to provide visionary forecasts about the coming year. While we recognize the limited productiveness of such

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MESSAGE FROM THE PRESIDENT

By Peter J. Boyle, CFA, CIC

At this time of the year, many of us are jotting down New Year's resolutions and hoping to keep more than not. At Clifford Swan, we have our own list of resolutions which, while not new, are certainly worth reaffirming on a regular basis. We urge not only our clients, but the investing public to consider the same.

- Understand the *risk* in every investment. While there is not a risk-free way to make money in the long-term, it is equally true that you can't make money without some level of risk. We want to make sure you are being properly compensated for any risk taken.
- *Leverage* is your friend in bull markets, but your worst enemy during a crisis. We would caution our clients against buying any investment on margin. Buying an investment that contains leverage within its structure is little different.
- Performing objective, in-depth *due-diligence* is critical rather than relying on rating agencies. The for-profit rating agencies are, at best, conflicted between their bottom lines and their ratings outlook.
- Investment vehicle *complexity* may sound enchanting, but it is not riskless. The advances in technology which allow for the creation of these complex investments have nothing to do with analyzing their risks. *Caveat emptor*.
- Keep enough *liquidity* to weather a storm. Companies and individuals who had liquidity available weathered this storm better than those who needed to sell investments at depressed levels.

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While Ralph Weil covers our investment outlook in his article, 2010 ought to be an interesting year for other reasons as well.

- President Bush's tax cuts will expire at the end of the year. While there will undoubtedly be a push to shield the "middle class" from the additional burden, doing so will not be without cost. What this could mean is a rollback of the 15% tax on dividends and a return to 20% taxes on long-term capital gains. Given the size of the budget deficit, I wouldn't bet against either of these events occurring.
- Effective January 1st, estate taxes were eliminated, but for only 2010. They spring back in 2011 at much lower limits and with higher rates. Most people, however, expect Congress to approve stop-gap legislation sometime this year that would extend the basic structure of last year's law at least until the end of 2010. In 2009, the first $3.5 million of an estate typically was free from the federal estate tax, and the top tax rate was 45%.
- 2009's IRA Required Minimum Distribution holiday was not extended, so for those already or turning 70-1/2, we will be calculating these distributions.
- The Build America Bond program, which was part of the stimulus program authorizing state and local governments to issue taxable bonds, continues into 2010. The federal government will subsidize a portion of the borrowing cost. What this means for investors is the possible purchase of these bonds in otherwise tax-exempt portfolios.
- Roth IRA conversion limits are removed for 2010 allowing every IRA owner the opportunity to convert to a Roth. Whether this is a good opportunity or not requires a crystal ball, an issue Max Pray addresses elsewhere in this newsletter.

Lastly, I am happy to announce that Linda Davis Taylor, our Chairman, relocated back to the Clifford Swan offices in early January. Linda has spent much of the last two years successfully developing new wealth advisory services in family governance, education, and philanthropy, and will be introducing these resources to you in the coming months. The two of us look forward to working together with the entire team to continue to serve our clients in the year ahead.

Happy New Year! ◆

COMMUTED PAYMENT GIFT ANNUITY

College Tuition Annuity

By Ken Dike, Esq., CPA

It is possible for an individual to receive a charitable tax deduction today and avoid taxation on a portion of appreciated assets currently held while providing future financial assistance to both a charity and heir of their choice. A grandparent holding appreciated stock can donate the stock to a charity in exchange for a *Commuted Payment Gift Annuity* that pays the grandchild a fixed amount for four years beginning when the grandchild reaches the age of eighteen and is likely to begin his/her college experience. In addition to a current charitable tax deduction and avoidance of capital gain taxes, the grandparent moves some accumulated assets out of the estate thereby avoiding possible estate tax on the assets transferred. Also, since the donated assets are held by a nonprofit charitable organization that is not subject to income tax, the investment income earned by the donated assets escapes taxation.

Through several Private Letter Rulings, the IRS has allowed charities to issue *Commuted Payment Gift Annuities*. The *Commuted Payment Gift Annuity*, also known as a *Commuted Payment Deferred Charitable Gift Annuity*, *Deferred Gift Annuity Tuition Plan*, *Tuition Assistance Plan*, *Tuition Annuity Plan*, and *College Annuity*, is a wrinkle on the traditional *Deferred Gift Annuity*. Under a *Deferred Gift Annuity*, an annuitant receives annuity payments that begin at some point in the future and continue for the remaining life of the annuitant. In a *Commuted Payment Gift Annuity*, the annuitant has the right to receive the future payments for a fixed number of years instead of his/her remaining life. When used to assist with college tuition, these payments usually begin when the annuitant reaches the age of 18 and continue for four or five years.

Amount of Annuity

A *Commuted Payment Gift Annuity* gives the annuitant the option of receiving payments for life or in a fixed number of installments. The decision to *commute* the lifetime payments to a fixed term, which must be made at least one year prior to when the payments begin, affects the amount of the annual payments to the annuitant. Since the present value of the future annuity payments must be the same whether they are paid for the remaining life of the annuitant or for a fixed number of years, the amount of the annual annuity increases as the duration of the annuity payments decrease.

Below is a comparison of the annual annuity amount, per the *American Council on Gift Annuities* suggested payout rates, assuming it is paid out over various time periods. These amounts are based on (1) a gift of $10,000 made eighteen years before the payments begin, (2) a present value discount rate of 3.4%, and (3) an annuitant age of eighteen when the payments begin:

Duration of Payments	Annual Annuity
Four-Year Fixed Term	**$4,115**
Five-Year Fixed Term	3,347
Ten-Year Fixed Term	1,817
Remaining Life of Annuitant Age 18	610

As the deferral period (years between the gift and when the payments begin) decreases, so does the amount of the annuity. This is reflected by the following table of annual annuity amounts paid for four years assuming various deferral periods (all other variables are the same as in the prior table):

Deferral Period	Annual Annuity (4 Years)
Eighteen Years	**$4,115**
Fifteen Years	3,642
Ten Years	2,968
Five Years	2,361

The discount rate used to determine the present value also affects the amount paid to the annuitant. The greater the discount rate, the smaller the annual annuity payment. This discount rate is determined by the IRS and is updated monthly. These rates are at historical lows ranging from about 3.4% currently to a high of 8% in the past decade. The following table shows the annual annuity amount paid for four years after an eighteen-year deferral period given various present value discount rates (all

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Divide and Conquer

By *Mike Davis*, CFA, CIC

Dividends: What Are They?

Every business, if it is successful, reaches a point where it is profitable. The owners of the business then have one of the most fundamental financial decisions to make: how much of the profit to reinvest in the enterprise in order to grow future revenues, and how much, if any, of the profits to share with the owners of the business (through dividends and/or share buybacks). The direct distributions of the owners' share of the profits are called dividends, a word derived from the Latin *dividendum*, meaning "thing to be divided."

To Pay or Not to Pay

The answer to the reinvest versus distribute question is a function of several variables including the following:

- What is the expected growth rate of the business and how is it to be financed?
- What is the ideal capital structure for the firm? Should cash from profits be used to pay down debt and/or buy shares of stock?
- What is the constituency of the firm's shareholders? Are they mainly small investors who may be dependent upon generous dividend payments, or is the shareholder group dominated by a few wealthy investors or institutions who do not need the cash flow from dividends?

The Company Lifecycle and Dividend Policy

For the majority of companies, the most important factor affecting dividend policy is the appetite the business has for cash in order to remain healthy. Companies tend to have a natural life cycle, not unlike humans. They experience their most rapid growth in their youth. This growth requires a lot of capital (read food for humans) which can be supplied by reinvesting profits instead of paying dividends. An image of my teenage daughters who eat twice as much as I can without putting on weight comes to mind. These young companies tend to make minimal, or no, dividend payments. Without commenting on their suitability for inclusion in our portfolios, examples of these companies include Oracle in the technology industry and Amgen in healthcare.

As companies move from the rapid growth of youth to the more moderate expansion of middle age, the need for reinvestment of profits back into the business diminishes, often allowing for the initiation of dividends, and their gradual increase in relation to reinvestment. Examples include IBM in technology, Abbott Labs or Johnson & Johnson in healthcare, and Colgate-Palmolive in consumer goods.

Eventually, almost every business, unless it can expand into new products or services or into new geographic areas, reaches maturity as the market becomes saturated with its goods and services. Profitability may remain high, but the need to reinvest in the business is much reduced, allowing for a relatively high percentage of profits to distribute as dividends. This is equivalent to our old age. Examples of these include Altria in consumer goods (cigarettes), Verizon and AT&T in telecom, and most electric utility companies.

Dividend Metrics

Investment analysts use a percentage called the Dividend Payout Ratio (DPR) to capture a company's policy regarding dividend payments. The DPR is simply the annual dividend payment divided by the annual earnings per share. For example, if a company has $4.00 of earnings per share and pays $1.00 in dividends, the DPO is $1.00/$4.00, or 25%. As a rough rule of thumb, DPRs typically range from 0–25% for young, high growth businesses, 30–55% for moderate growth companies and 60%+ for mature, slow growth companies.

Another important ratio in analyzing dividend payments is the Dividend Yield which is the return, stated as a percent, investors receive on the stock's dividend. It is calculated by dividing the annual dividend payment by the current stock price. Therefore, a company paying a $1.00 dividend and whose stock trades at $50 per share has a 2% dividend yield ($1.00/$50). Similarly, a different company paying the same $1.00 annual dividend, but whose stock trades at $16.60 per share has a 6% dividend yield.

Dividends and Total Return

In the above example, what accounts for the disparity in annual dividend return (yield)? The answer lies in the difference in growth rates investors expect each company to achieve. Over the long term, we believe investors in stocks should have a reasonable expectation of earning roughly an 8% annual return from the combination of dividend yield and the growth of the dividend. Therefore, investors buying a stock which yields 6% probably view it as a slow growth business which might increase the dividend only 2% per year, thereby achieving the (8%) annual return objective. Conversely, investors in a stock yielding 2% must believe the dividend can grow at least 6% per year, so as to achieve the 8% objective. In reality, those investors willing to accept

For the majority of companies, the most important factor affecting dividend policy is the appetite the business has for cash in order to remain healthy.

only 2% in current dividend yield must expect to achieve even faster growth than 6% in order to be compensated for not receiving as much return up front as the high-yielding stock purchases are getting. This discussion highlights that stock investors should consider the total expected return on their investment, not just the current dividend yield. Growth in the dividend is the second important factor in the total return calculation. Ironically, the growth component of the dividend results from the profits that have been reinvested in order to expand the business. Since 1926 (as far back as we have good data), for the stocks in the Standard & Poors 500 Index, about 44% of the average annual total return has come from dividends and 56% from price appreciation.

Dividends vs. Bond Interest Payments

Often, clients will ask us to defend our rationale for buying the common stock of a particular company versus the bond issued by the same company. For example, as of this writing, one could buy a 10 year maturity bond of AT&T which would yield 4.90% per year with reasonable confidence, instead of the common stock which has a current, less predicable, dividend yield of 6.00%. Is it worth it to take the additional risk for only 1.10 percentage points in additional yield? The answer may well be "yes" when one looks at the total return (dividend yield plus growth) potential of AT&T stock and the tax advantage the dividends currently receive. In a taxable account, the 4.90% bond yield will be subject to ordinary income taxes of as high as 40% for a California resident in the top Federal and State tax brackets. Therefore, only 60% of the 4.90% yield is retained, resulting in only a 2.94% net, after-tax return. Most ordinary common stock dividends receive favorable tax treatment at the 20% level for California investors in the highest tax brackets. This means 80% of the 6.00% dividend yield on AT&T is retained after taxes, resulting in a 4.80% net yield. We believe that is a fairly compelling argument for owning the stock of AT&T instead of the bond, for income-oriented investors.

Investment Ramifications: Dividend Tilt

Given today's stock market environment, what types of stocks offer the best prospects for total return: growth-oriented stocks with no or low dividends, or stocks with higher dividend yields but less growth potential? We believe a well diversified portfolio should incorporate an array of growth versus yield-oriented stocks. However, the current market may favor a modest tilt toward current yield instead of growth. This is because the market rally of the past nine months has resulted in stock prices advancing close to 65%, on average, compared with an average stock dividend yield of about 2–3%. Clearly this market has favored the growth side of the total return equation.

The rise in stock prices has far outstripped the modest recovery in the economy, and it is reasonable to expect the stock market to advance more gradually while the economy catches up. In a slower growth environment, the dividend component of the total return equation could start to look a lot more attractive. With a dividend tilt, investors will "be paid to wait" and this logic seems compelling to us. ◆

MARKET OUTLOOK

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an exercise, we thought it might be interesting to look back at last year's outlook for 2009 and see how we did in predicting what might happen during the year.

Last year's article began with our belief that the market would remain volatile until some clarity came to the economic outlook. That clarity began to surface with the passage and implementation of the bank bailout package and similar programs by other foreign governments, which pulled the world's financial system back from the precipice. These steps and others, such as the stimulus package Congress passed early in the year, brought some encouragement that governments worldwide were going to throw everything they could at the same economic problems. As expected, it took until early summer to see positive movement in the economy from these actions.

We stated a year ago that it was our best estimate that the economy would show negative growth in the first two quarters and then a mild recovery starting in the second half of the year. So far, that is the way it has worked out. It could be argued that the second-half recovery is mild with only 2.2% growth in third quarter real GDP and a forecast of 2.5% to 3.5% for the fourth quarter. Our concern with the recovery so far is that it is not broadly based. The major areas of economic growth have been the beneficiaries of either tax breaks or special bonuses such as the tax incentives for buyers of new houses and the Cash for Clunkers program.

As far as the equity markets are concerned, we stated that historically markets turn up three to six months before a turn in the economy. The year 2009 followed this general rule. Equity markets started

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the 25% income tax bracket, you would pay $25,000 in taxes. If the value fell to $75,000 in the ensuing months, you may want to recharacterize the Roth IRA. If the IRA remains at the $75,000 level after recharacterization, and you do another conversion on the reduced amount, you would pay $18,750 in taxes, saving yourself over $6,000 in taxes. There is another interesting method to use to take advantage of recharacterization, if you feel creative. Let's say you have a regular IRA worth $200,000 and you want to convert $50,000 to a Roth. You could convert all $200,000 into four separate accounts with four different assets, then evaluate the four accounts the following year to see which one performed the best, and recharacterize the other three. By doing this, you are getting a good start on maximizing your tax-free Roth IRA account.

The second nuance for conversions completed in 2010 is the option to pay the taxes over a two year period in 2011 and 2012. Speaking of taxes, it usually makes more sense to convert to a Roth IRA if you can pay the income taxes out of a non-IRA account, thereby allowing the full IRA amount to grow tax-free in the Roth IRA. Thirdly, by paying income taxes at the time of conversion, this payment amount is removed from your estate, thus avoiding future estate taxes which are typically higher than income taxes. Finally, another facet to remember is that the Roth IRA has a "5-year rule" which requires you to wait five years before taking a distribution, or you may be subject to penalties.

Let's consider our base case scenario which involves a 65 year old man who has a $2,000,000 IRA which he is considering converting to a Roth. He is married, has other income which puts him in the 28% federal bracket, and pays no state income tax. In addition, we assume 6% returns for all accounts, and that future income tax rates will be the same as they are in the conversion year. He converts his regular IRA to a Roth IRA which moves him into higher tax brackets, pays the $670,000 in income tax for the conversion, and lives for 10 years. During those 10 years he does not take any withdrawals, and upon his death the Roth IRA goes to his wife who is 70 at that time (the Roth IRA would be worth about $3,580,000 at that time under our assumptions). She lives another 10 years and does not take any distributions. On her death, the Roth IRA goes to their then 50-year old daughter who stretches the distribution amounts over her lifetime of 30 years (value at this point is $6,400,000). At the point the daughter inherits the Roth IRA, she is required to take distributions, but the advantage in this scenario is that the account has preserved its tax-free earnings power and tax-free distribution power for a very long period of time. The math would work out to about a $250,000 annual distribution for the daughter. The husband and his wife, in practical terms, set up a long term tax-free annuity for their daughter which "costs" less than if they tried to accomplish a similar transition of wealth while using a regular IRA.

This example is fairly straight forward and could save multiple generations of families hundreds of thousands of dollars in taxes if handled properly. The breakeven point for conversion in this case is about 15 years before distributions begin, but recognize that every circumstance will be slightly different. In addition to all the criteria we have discussed, there are other risks that need to be considered. First, the tax laws for Roth IRA rules must remain as they are now; the two main features - distributions not being taxed, and no forced distributions - must remain in place. Second, the owner of the Roth IRA must keep the balance intact for a number of years before distributions are taken.

There are so many factors to consider in answering the question of whether to convert, that we encourage you to consult with both your tax and estate planning professionals, in addition to your investment adviser. ◆

PLANNED GIVING

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other variables are the same as in the prior tables):

IRS Discount Rate	Annual Annuity (4 Years)
3.4%	**$4,115**
4.0%	3,711
5.0%	3,184
6.0%	2,788

The amount of the fixed-term payments that an annuitant receives under a *Commuted Payment Gift Annuity* is based on the IRS discount rate and mortality assumptions in effect for the month in which the annuitant elects the fixed-term *commuted* payments instead of the lifetime payments. This election must be made after the gift annuity is established but before the first payment is made to the annuitant. Since the IRS discount rate changes monthly, the actual amount of the *commuted* payments cannot be determined until some time in the future, often several years after the gift annuity is established. During this time, the IRS discount rate and mortality assumptions could change significantly from those in effect when the *Commuted Payment Gift Annuity* was established.

Income Tax Considerations

As with a *Deferred Gift Annuity*, a *Commuted Payment Gift Annuity* is a type of bargain sale transaction where the donor gives assets to a charity in exchange for the charity's promise to make a series of fixed payments to an annuitant selected by the donor. Both types of charitable gift annuities (1) require the donor to recognize, for tax purposes, a portion of any gain inherent in the gifted assets; (2) exclude a portion of the annuity payments from taxation to the annuitant; and (3) entitle the donor to a charitable tax deduction when the gift annuity is established.

As with a *Deferred Gift Annuity*, the donor to a *Commuted Payment Gift Annuity* must recognize, for income tax purposes, a portion of any capital gain

held in the assets donated. The total gain, which is the difference between the market value of the security when it is donated and the donor's cost, is apportioned between the present value of the remainder interest (charitable deduction) and the *investment in contract* (present value of annuity payments). This *investment in contract ratio* is applied to the total gain to determine the amount that must be recognized as capital gain income on the donor's tax return. Under a *Deferred Gift Annuity*, this gain is recognized over the duration of the annuity payments when the donor is the annuitant. However, in a *Commuted Payment Gift Annuity*, the gain is always recognized in the year that the gift annuity is established.

Also, as with a *Deferred Gift Annuity*, a portion of the annuity payments from a *Commuted Payment Gift Annuity* is exempt from taxation to the annuitant. This tax exempt portion is the *investment in contract* prorated by the number of payments. For example, an $8,292 *investment in contract* that is paid out in quarterly installments over four years will exclude $518.25 ($8,292 ÷ 16) of each payment from income taxation to the annuitant.

The charitable deduction is based on (1) the IRS present value discount rate, (2) length of the deferral period (time between the gift and when the payments begin), and (3) the amount paid to the annuitant. Assuming the amount paid to the annuitant remains unchanged, a decline in the deferral period or an increase in the IRS discount rate results in an increase to the charitable deduction.

The following table shows the charitable deduction and *investment in contract* of a $10,000 gift establishing a *Commuted Payment Gift Annuity* under various deferral periods with a 3.4% IRS present value discount rate and quarterly payments to an annuitant age eighteen when the payments begin:

Deferral Period	Charitable Deduction	Investment In Contract Amount	Investment In Contract Ratio
Eighteen Years	**$1,708**	**$8,292**	**82.9%**
Fifteen Years	1,822	8,178	81.8%
Ten Years	2,116	7,884	78.8%
Five Years	2,582	7,418	74.2%

The following table shows the charitable deduction and *investment in contract* under various IRS discount rates assuming an eighteen-year deferral period (all other variables are the same as in the prior table):

Discount Rate	Charitable Deduction	Investment In Contract Amount	Investment In Contract Ratio
3.4%	**$1,708**	**$8,292**	**82.9%**
4.0%	3,342	6,658	66.6%
5.0%	5,285	4,715	47.2%
6.0%	6,586	3,414	34.1%

Generation-Skipping-Transfer Tax

Generation skipping transfer taxes may apply when the annuitant is two or more generations below the donor (grandchild, great-grandchild). This is true for both *Deferred Gift Annuities* and *Commuted Payment Gift Annuities*. The amount of the gift to the grandchild is equal to the *investment in contract*.

10% IRC §72(q) Penalty Tax

A significant difference between a *Deferred Gift Annuity* and *Commuted Payment Gift Annuity* is the 10% IRC Sec §72(q) penalty tax. This tax is assessed on any fixed-term annuity payment from a *Commuted Payment Gift Annuity* to an annuitant who is younger than age 59½. This tax does not apply to *Deferred Gift Annuities* that provide for lifetime payments.

Benefits Provided

First and foremost, a *Commuted Payment Gift Annuity* benefits the charity. It enables donors to provide funding for the charity of their choice. It enables charities to continue their work addressing a variety of societal needs.

A *Commuted Payment Gift Annuity* gives the donor an immediate charitable tax deduction and excludes from taxation any investment return earned by the gifted assets since they are held by a nonprofit charitable organization.

A *Commuted Payment Gift Annuity* provides a stream of income, some of which is not taxable to the recipient, to an annuitant of the donor's choice. This income stream can coincide with the annuitant's college years and help with their educational expenses.

There is no reason why the *Commuted Payment Gift Annuity* must be used for educational expenses. The payments may be used by the annuitant for anything and, in some cases, have been used to supplement the donor's income during the initial years of retirement.

How Can Clifford Swan Help?

For both donors and the charities they support, we can provide all the calculations necessary to establish a *Commuted Payment Gift Annuity* under a variety of scenarios. These calculations include the charitable deduction, *investment in contract*, payout amount, and taxability of the payments to the annuitant.

We can advise donors on the selection of a charity that (1) is capable of entering into and administering a *Commuted Payment Gift Annuity* arrangement and (2) supports the donor's charitable interests.

Lastly, Clifford Swan has a proven track record in providing all the related administrative and investment management functions for charities that accept gift annuities of any type, including *Commuted Payment Gift Annuities*. ◆

CLIFFORD SWAN
INVESTMENT COUNSEL

PROFESSIONALS

Maye Albanez, CFA, CIC
S. David Andrew
Carolyn S. Barber, CFA, CIPM
Peter J. Boyle, CFA, CIC
James R. Brown
Michael G. Davis, CFA, CIC
Kenneth H. Dike, Esq., CPA
James D. Gamb, CFA
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
Edward P. Ogle, Jr., CSA
Maxwell R. Pray, CFA
Terrell H. Price
Linda Davis Taylor
Ralph E. Weil, CFA
Bruce C. White
Randall L. Zaharia, CFA

OFFICES

Pasadena
200 South Los Robles, Suite 320
Pasadena, CA 91101
626.792.2228 Phone
626.792.2670 Fax

Huntington Beach
16902 Bolsa Chica Street, Suite 204
Huntington Beach, CA 92649
714.846.2851 Phone
714.840.5212 Fax

Evergreen
P.O. Box 2945
Evergreen, CO 80437
720.746.1244 Phone
720.294.9896 Fax
www.cliffordswan.com

MARKET OUTLOOK

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acting better at the beginning of March and have been moving up ever since. As we believed, the result is a higher equity market at the end of the year.

Our outlook for the U.S. economy in 2010 is positive, with one large caveat. The recovery depends upon the folks in Washington not passing legislation that could put too much of an additional burden on businesses. With that said, we believe we will see growth for the year in the range of 2.75% to 3.25%. Most of the growth will come during the first half of the year, followed by a moderate slowing in the second half. We believe Washington has held some of the stimulus monies back, in reserve, to spend prior to next year. This additional spending will help boost economic activity towards the end of 2010. Our expectation for the job market is that it will improve, probably starting in the spring, although the recovery will be slow. But once the unemployment rate stops increasing and starts to decline, people who are still working will feel better about their situations and will start loosening their purse strings. Consumer spending is still the main engine for economic growth and should make up for any slowing in government spending as the Treasury and the Federal Reserve start to fight potential inflation. However, the extent of the consumer spending rebound is the biggest wildcard. In addition, we believe the U.S. economy will see an improvement in its net exports which should add to economic growth for the year.

Our outlook for the fixed income markets and equity markets is mildly optimistic with the same caveat mentioned above. We think the Federal Reserve will artificially hold short-term interest rates low to encourage economic activity, at least well into the first half of the year. After that, short rates should start to rise as the Fed contracts the money supply and the Treasury tightens its expansionary programs. Long rates most likely will move somewhat higher in the first half of the year and then flatten out and maybe even decline a little as the fears of inflation subside.

Our outlook for the U.S. economy in 2010 is positive, with one large caveat.

Our outlook for equities suggests some back and forth movement during the first half of the year while the market waits for the economy to catch up to its expectations. Also, equity buyers are concerned about inflation and the steps that the Fed and Treasury will take to reduce that risk. The markets know that the Fed and the Treasury are walking a fine line when that inflection point is reached because tightening too early could abort the recovery. The second half of the year should show a resumption of growth in stock prices but at a moderate rate and not anything like we experienced over the last nine months. We think most sectors in the equity market will participate in the rise in prices with, perhaps, the exception of consumer non-discretionary companies such as food and other essential product industries. The healthcare area is an unknown at this time because of the legislation now in Congress. The other sectors should do reasonably well in the environment we see for 2010 with positive, single digit growth. ◆