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MARKET OUTLOOK



By Ralph Weil,
CFA

We cannot give you our market outlook without first commenting on the last fifteen months. The decline in the equity markets, and the short time frame in which it happened, is historically unprecedented except for the 1929-1932 decline nearly 80 years ago. At the beginning of 2008, we were mildly cautious on equities due to the collapse of the real estate markets and its anticipated effect on the banking system. No one with any legitimacy could have forecast how deep the problem would run, or its substantial impact on the

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“WHAT CAN WE EXPECT FROM A New Stimulus Package?”



By Carolyn Barber,
CFA, CIPM

The U.S. economy is officially in a recession and has been since December 2007. The National Bureau of Economic Research (NBER) is the body that makes this call. The NBER defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators.”

Last spring, Congress and the President enacted a tax rebate stimulus package in an attempt to support consumer spending, the largest component of our economy. While the stimulus checks helped cushion the downturn somewhat, they didn’t provide a big enough boost to counteract all the downward pressures on growth. By last fall, it became apparent that not only the U.S., but the entire world, was experiencing an economic slowdown. In October, the global credit crisis hit in full force. A loss of confidence in the world’s financial system caused banks to stop lending to one another, even overnight. Investors reacted with fear and panic. Congress authorized the Treasury to step in with a \$700 billion

rescue package aimed at preventing a collapse of the U.S. financial system. The Federal Reserve also took extraordinary measures to support the credit markets.

Without the actions of the Treasury and the Federal Reserve to support our financial institutions and to get credit flowing again, our economy would be in much worse shape than it is today. However, they can only do so much, and their efforts alone won’t get us back on the path to recovery. With the consumer tapped out, and businesses cautious, the only major source of stimulus available is the U.S. Government.

What are the pros and cons of massive Federal infrastructure spending as a form of economic stimulus?

To this end, President Obama wants Congress to prepare an economic stimulus package, to be signed into law as soon as he is inaugurated. His economic team is said to be working closely with Congressional leaders on the proposal, which is expected to emphasize infrastructure spending. He has outlined his spending priorities, as follows:

- Upgrading Federal buildings to improve energy efficiency, saving billions of

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MESSAGE FROM THE PRESIDENT



By Peter Boyle, CFA, CIC

Four times a year I draft a message to our clients and other readers of this newsletter. While elsewhere we will cover our thoughts on the market, I can't help but reflect on what will, hopefully, be the most challenging year of my career.

It is easy to list 2008's negatives: the biggest stock market downturn in a generation; the ending of a long period of economic prosperity; the bursting of a real estate bubble which is currently crippling one of the bedrocks of the American ideal; the disappearance of dozens of long-time American financial institutions. Most recently, the Madoff scandal serves as the exclamation point on a year rife with risk and greed.

For most of the last couple years, less and less value was placed on risk. Credit was cheap; everybody was creditworthy; hedge funds, stacked with really smart people, always outperformed the general market; all was good with the world. All seemingly true until the day, or in this case the year, when suddenly it was no longer. Add the rapidity of today's worldwide financial market, and the dream unwound stunningly fast.

So, what are the lessons? As has been written (and we have written) countless times, it is not different this time. It seldom ever is. Bubbles do burst - just ask kids who blow them, dot.com investors or housing speculators - and we seldom, if ever, see it coming. While it seems

unchecked greed will always exist in capitalism, it is equally true that those who take undue risk often learn the downside of that risk. Unfortunately, the resulting price is paid not only by the direct investors in these risky ventures, but also by other investors caught in the shockwave. As these "other investors," what, if anything, can we learn from this experience?

First, and foremost, we need to be informed investors. In the case of Madoff, it is easy to point at the SEC, but in reality, no regulator can or will completely protect us. As a result, we owe it to ourselves to invest where we are confident in the security of our holdings and have a general understanding of the investment process. Know where your investments are custodied. In a perfect world, that would be at an individual bank or brokerage firm. At a minimum, seek audited financial statements from a reputable source.

Next, understand the investment process. Without becoming a professional money manager yourself, you should know when your portfolio is expected to make money and, conversely, what would cause you to lose money. If it sounds too good to be true, it probably is. Indeed, it was this concern which led us to advise one client to sell his shares in Madoff's enterprise before it was too late. Remember

that generally risk and return are positively correlated. While we would have loved to show positive returns this year, I would have expected our clients to have been skeptical had we done so.

Lastly, try to understand the culture of the firm with whom you are investing. Culture begins at the top, and if management is looking for outsized returns, they may push the envelope to achieve them.

As I consider 2009, I want to leave

**First, and foremost,
we need to be informed investors.**

you with a couple of more optimistic observations. Last November's election was historic, not only because of the election of our first African-American President, but also because of the energy fostered in the next generation of Americans. At this point looking forward, stocks are cheap, President Obama's programs will provide short-term stimulus, and the continued engagement of this next generation may plant the seeds for our longer-term prosperity.

Happy New Year! ♦

CHARITABLE TRUST “QUALIFICATION” TESTS AND Charitable Lead Trusts



By Ken Dike,
Esq., CPA

In the *Planned Giving News* section of our second quarter 2008 newsletter, we discussed the effect of changes in the *IRS discount rate* on the present value calculations used to determine the charitable deduction for gifts to split interest charitable trusts. Every split-interest trust has two interests: the income interest, which is the right to receive periodic payments from the trust; and the remainder interest, which is the right to receive whatever remains in the trust upon its termination. The present value of the income interest is the charitable deduction for *charitable lead trusts*, and the present value of the remainder interest is the charitable deduction for *charitable remainder trusts*. The market value of any addition to the trust will equal the sum of the two present values as of the date of the addition. As the present value of the remainder interest increases due to increases in the discount rate, the present value of the income interest will decline by an equal amount.

We learned that changes in the *IRS discount rate*, which is the assumed future return on trust investments, have little effect on the present value calculations for unitrusts since the periodic payments from a unitrust are based on the periodic market value of the trust assets. In this way, the income interest and remainder interest “share” in the unitrust’s investment income. We also learned that changes in the *IRS discount rate* have a

relatively significant effect on the present value calculations for annuity trusts since the periodic payments from an annuity trust are fixed. Unlike a unitrust, the annuity trust periodic payments do not change due to changes in the trust’s market value and, therefore, the annuity trust income interest and remainder interest do not “share” in the annuity trust’s investment income.

Charitable Qualification Tests for Remainder Trusts

In order to qualify as a *charitable remainder trust*, the IRS requires that the present value of the remainder interest for a gift to either a charitable remainder unitrust or annuity trust must be at least 10% of the gift’s market value. In addition, there must be no more than a 5% chance that a charitable remainder annuity trust will use all its assets for the periodic payments leaving nothing for the charity upon its termination. Both of these tests are based, in part, on the *IRS discount rate*.

The maximum payout rate that can be offered where both tests are satisfied can be determined given a range of *IRS discount rates* while holding the life beneficiary age constant. The schedule below shows the maximum payout rates, as a percentage of the trust’s market value, at

two *IRS discount rates* assuming a life beneficiary age 70.

A change in the *IRS discount rate* has little effect on the IRS “qualification” tests for unitrusts as compared to annuity trusts, and unitrusts are allowed a much

For these reasons, charitable lead trusts become a viable alternative to charitable remainder trusts during times of relatively low *IRS discount rates*.

higher payout rate than annuity trusts at any *IRS discount rate*. This is because, as mentioned with respect to the effect of changes in the *IRS discount rate* on the present value calculations, unitrusts share in the investment returns while annuity trusts do not. Additionally, since the minimum payout rate for charitable remainder trusts is 5%, a life beneficiary age 70 cannot be the measuring life for a charitable remainder annuity trust when the *IRS discount rate* is less than 2.4%.

We can also look at the change in the maximum payout rate for both a charitable remainder unitrust and annuity trust given a change in the expected duration

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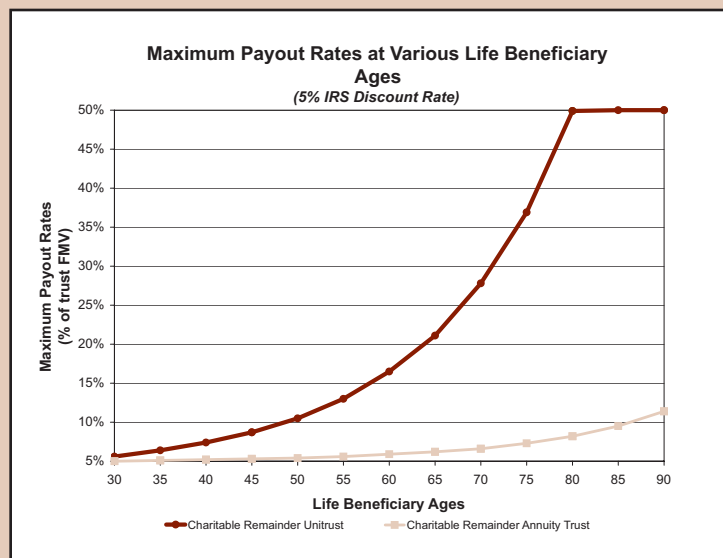
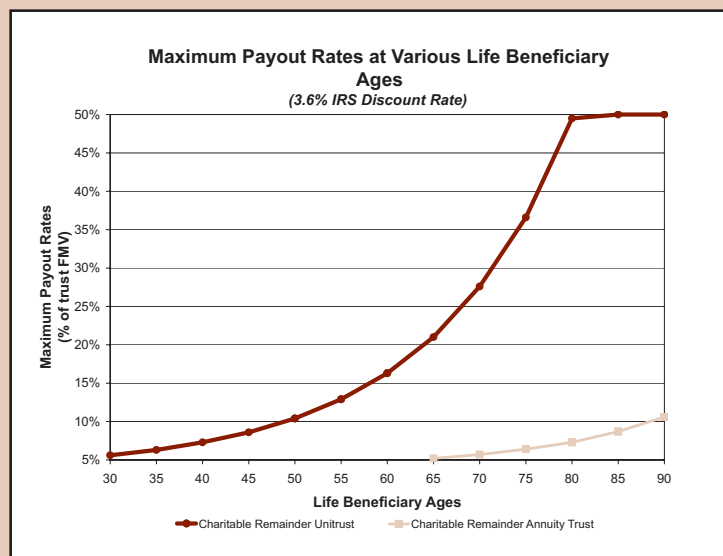
Maximum Payout Rates (% of trust market value, life beneficiary age 70)

	<u>2.4% discount rate</u>	<u>10% discount rate</u>
Charitable Remainder Unitrust	27.4%	28.7%
Charitable Remainder Annuity Trust	5.0	10.4

PLANNED GIVING NEWS

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(life beneficiary age) at a range of IRS discount rates. The following two graphs show the maximum payout rate, expressed as a percentage of the trust's market value, assuming various life beneficiary ages and IRS discount rates of 3.6% and 5%.



As is shown by these graphs, the maximum payout rate allowed for charitable remainder unitrusts at both the 3.6% and 5% IRS discount rates rises dramatically as does the age of the life beneficiary. Although there is a much smaller change in the maximum allowable annuity trust payout rate from a change in the age of the life beneficiary, a change in the IRS

discount rate has a significant effect on the minimum allowable age for a charitable remainder annuity trust life beneficiary.

Payout rates for charitable remainder trusts must be no less than 5% and no more than 50%. Given the requirements

of the “10% minimum remainder value” and “5% probability of corpus exhaustion” tests, the minimum age for an annuity trust is 65 when the IRS discount rate is 3.6% and age 30 when the IRS discount rate is 5%. Because current IRS discount rates approximate the 3.6% level, the minimum age of permissible annuity trust life beneficiaries is significantly reduced as compared with those usually allowed given historically higher discount rates.

Charitable Qualification Tests for Lead Trusts

The IRS “qualification” tests that apply to charitable remainder trusts are not required for

charitable lead trusts. In a charitable lead trust, the charity gets paid first and there is little chance that the charity will receive nothing from the trust. Also, unlike a charitable remainder trust and the 5% minimum payout, there is no minimum payout requirement of charitable lead trusts. For these reasons, charitable lead trusts become a viable alternative

to charitable remainder trusts during times of relatively low IRS discount rates.

Charitable Lead Trust - Overview

In a charitable lead trust, the periodic beneficiary distributions (income interest) are made to a charity and whatever remains in the trust upon its termination (remainder interest) goes to a noncharitable beneficiary such as the donor, the donor's family, or a noncharitable trust. This is a mirror image of the charitable remainder trust where a noncharitable beneficiary holds the income interest and a charity holds the remainder interest. The lead trust income beneficiary payments to charity can be fixed in amount, as in a charitable lead annuity trust, or vary each year based on the trust's market value, as in a charitable lead unitrust.

In a grantor charitable lead trust, the donor (grantor) receives whatever remains in the trust when it terminates. In a non-grantor charitable lead trust, a noncharitable beneficiary other than the donor receives whatever remains in the trust when it terminates. The remaining assets are often given to a member of the donor's family, which is why the term “Family Lead Trust” is sometimes used to describe a non-grantor lead trust paying members of the grantor's family upon termination.

Charitable Lead Trust - Income Tax Charitable Deduction

In a grantor charitable lead trust, the donor receives an income tax deduction for the present value of the income interest given to charity when assets are transferred to the trust. This deduction is subject to the 30% limitation of AGI or 20% limitation if appreciated capital gain property is transferred. If the donor dies during the term of the trust, the donor must recapture (recognize as income) a portion of the prior charitable deduction taken. In a non-grantor charitable lead trust, the donor receives no income tax deduction when assets are transferred to the trust.

Charitable Lead Trust - Gift & Estate (Transfer) Tax

Gifts to *grantor* and *non-grantor charitable lead trusts* are reportable on the donor's gift tax return at their full value. The donor then claims a gift tax charitable deduction for the present value of the charitable income interest resulting in potential gift tax due on the remainder interest portion of the gift. These gifts of the remainder interest do not qualify for the annual exclusion because they are not gifts of present interests.

The reversionary interest in a *grantor charitable lead* trust existing at the death of the donor can be included in the donor's estate. The closer the donor's death is to the end of the trust term, the greater the amount of the reversionary interest. If the charitable income interest continues after the donor's death, the donor's estate will get a charitable deduction for the present value of the remaining payments to charity. Also, the donor will probably have to recapture a portion of the charitable deduction he took when the trust was established since he did not outlive the term of the trust.

Any assets held in a *non-grantor charitable lead* trust created by the decedent are not included in the donor's estate. As mentioned above, the donor will pay gift tax on only the present value of the remainder interest calculated at the time assets were transferred to the *non-grantor charitable lead* trust. Any post-transfer appreciation in the trust assets that eventually pass to the noncharitable beneficiaries escapes transfer tax.

Lastly, there is a form of a charitable lead trust known as a "Supergrantor Trust", which is beyond the scope of this article, that will be treated for income tax purposes as a *grantor charitable lead* trust but be treated for estate tax purposes as a *non-grantor charitable lead* trust meaning that (1) the donor gets a charitable tax deduction when the assets are transferred to the trust, (2) the donor is taxed on the trust's income, and (3) any assets remaining in trust at the donor's death are not included in the donor's estate.

Charitable Lead Trust - Taxability of Trust Income

In a *grantor charitable lead* trust, the income earned by the trust, including gains on sales of trust investments, **is taxed to the donor** and the donor receives no tax deduction for the periodic payments to the charitable beneficiaries since the donor already received a tax deduction for the income interest given to the charity when the trust was created. In a *non-grantor charitable lead* trust the income earned by the trust **is taxed to the trust** and the trust gets an unlimited charitable deduction for its periodic distributions to charity.

Charitable Lead Trust - Conclusion

Charitable lead trusts are very complicated arrangements and should only be entered into after consulting with a tax law professional. This article is only meant to provide an introduction into the world of charitable lead trusts and is not to be considered an exhaustive explanation of the tax rules and traps that may be encountered in this area. ♦

MARKET OUTLOOK

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entire financial system. There is no need to rehash all of the major events that surfaced in the year from the collapse of Bear Stearns to the closing of Lehman Brothers. But we are reminded of our earlier comments last year at this time when we stated that the markets hate uncertainty. So, until we can see the light at the end of tunnel, and we are sure that it is not a train coming at us, the markets will stay in this volatile state.

To shed light in this "dark tunnel," what we have witnessed since mid-2008 is a massive infusion of liquidity into the banking system and the world-wide economy to meet massive global deleveraging. Most countries have recognized the problems facing all national economies and have stepped up to the plate to address them. This, in and of itself, is a good thing, but to date, it has not resulted in a turn-around or even a marked improvement in consumer confidence. The next step here in the U.S. will be providing additional liquidity plus massive stimulative spending on the part of the Federal Government to increase economic activity and confidence. The new Obama administration and the new Congress starting this month have pledged to do just about anything they can to get the economy going again.

When all of this liquidity and stimulus will have its critical impact on the economy is the \$64,000 question. Our best estimate, at this time, is that we expect the first two quarters of 2009 to have negative growth in real GDP and a flat to mild recovery to begin in the second half of the year. Historically, equity markets turn up three to six months prior to a turn in the economy, much the same as the markets turned down before we had the start of the current downturn in economic activity.

There are sectors in the economy that offer interesting investment opportunities, which we discuss elsewhere in this newsletter. Specifically, infrastructure and alternative energy deserve deeper exploration and monitoring. Additionally, we are starting to see very compelling stock prices, even on deeply discounted fundamentals, in today's stock market. When we look out twelve to eighteen months, we believe that we will see higher market values due to the government stimulus spending and liquidity infusion programs. Based on this, we anticipate putting cash reserves to work as we go through the first half of the new year. ♦

dollars a year now spent on heating, cooling and lighting.

- Making the “single largest new investment in our national infrastructure since the creation of the Federal highway system in the 1950s.” This includes construction of roads, bridges, water systems and public transportation.
- Upgrading school buildings for energy efficiency, and putting computers in classrooms.
- Expanding access to broadband to all Americans. Connecting libraries, schools and hospitals to the internet. Modernizing our health care system through the use of electronic medical records.

In his campaign, President Obama emphasized that new infrastructure spending must include a large component dedicated to “green” technology. The plan to improve building efficiency is part of this, but there are also likely to be government grants or tax incentives for solar, wind and other alternative-energy infrastructure projects.

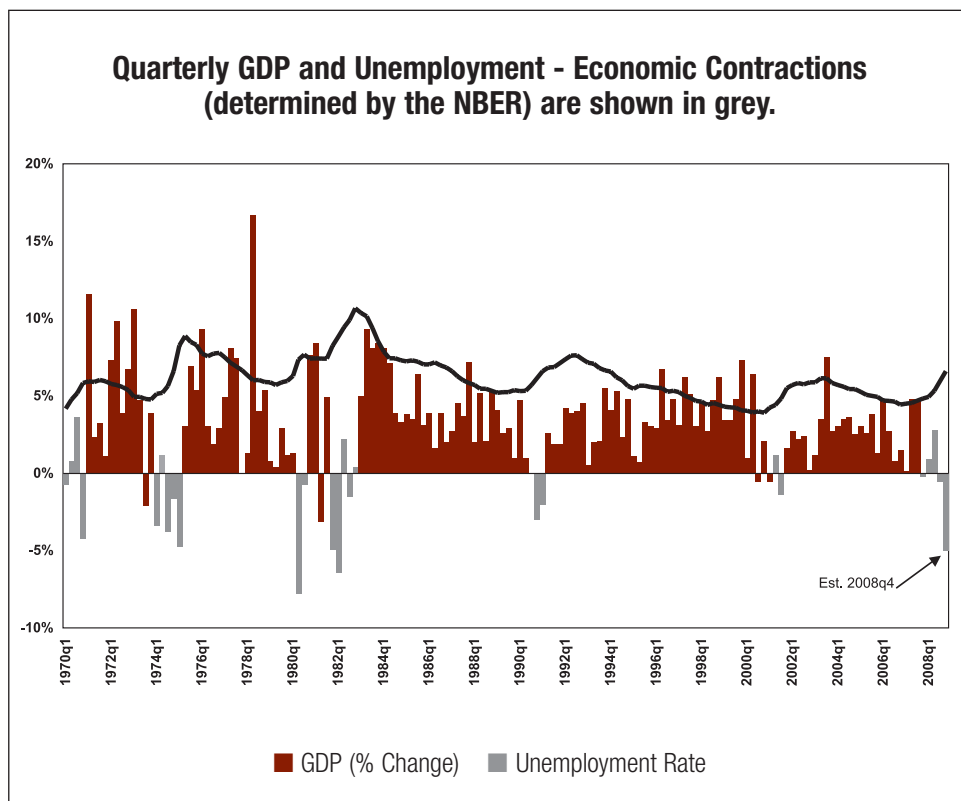
What are the pros and cons of massive Federal infrastructure spending as a form of economic stimulus?

Pros:

- It can be viewed as a long-term investment in U.S. assets that will pay off for generations.
- It will create well-paying jobs for skilled American workers.
- It is politically popular, and benefits all the States. Governors have their wish lists prepared with projects they say are “shovel ready.”

Cons:

- Some economists argue that it would take too long for infrastructure spending to reach the economy, even for “shovel ready” projects. They argue that we need something more immediate, such as extended unemployment benefits and an expanded food stamp program.
- If the infrastructure spending is loaded



with “pork” instead of truly needed projects, then taxpayers won’t get a good return on their investment.

- If the spending is not closely monitored, it will be subject to mismanagement or fraud.
- This type of spending creates mostly shorter-term jobs, rather than more permanent private sector employment.

Another concern is the long-term financial effect of all this government spending and borrowing. The Treasury and the Federal Reserve have already pumped hundreds of billions of dollars into the financial system, in order to avert a catastrophic failure. Now, Congress and the new President are likely to spend hundreds of billions more. Our national deficit reached a record \$164 billion in November. With the Fed printing money and the Treasury hitting the Federal debt ceiling, won’t all of this spending be inflationary?

Unfortunately, there is a much greater threat of deflation than inflation at present. Global economic growth has come to a screeching halt. The collapse in oil prices, from \$140 to \$40 a barrel, is a sign of just how weak global demand has become. An economic stimulus is vitally necessary in order to avoid a downward deflationary spiral. Deflation is a sus-

Monetary policy is a better tool for fighting inflation than for fighting deflation.

tained decrease in prices, the opposite of inflation. In a deflationary spiral, consumers are reluctant to spend and businesses slow to invest, because they expect to be able to pay lower prices for goods and services if they wait. The lack of spending and investment lowers total demand in the economy, driving down

Alternative Energy

prices even further. Businesses have lower revenues, so they lay off workers; higher unemployment exacerbates the downward spiral.

Japan struggled for a decade in the 1990s to overcome deflation. U.S. policy makers want to boost the economy now, and hasten a recovery sooner rather than later. It is possible that the Federal Reserve will have to fight inflation a few years down the road, but an inflationary outcome is not inevitable. Monetary policy is a better tool for fighting inflation than for fighting deflation. The Fed can keep raising rates until inflation is quashed, but they can only lower rates to zero in their attempts to prevent deflation.

A long-term concern about the stimulus package is how healthy or unhealthy it might be for government spending to become such a large part of our Gross Domestic Product (GDP). Federal spending is now nearly 20% of our economy. That's partly because other spending has dried up. Businesses have pulled back and consumer spending has declined dramatically. A high level of Federal spending is necessary now to fill the void. The long-term concern is to contain this spending after a recovery as a reasonable percentage of our GDP and to avoid the possible negative effects of government spending crowding out private investment.

The aim of the Federal stimulus package should be to tide us over through the economic contraction until the private sector has recovered, confidence has been restored, and the U.S. economy has returned to a steady footing. If the stimulus is managed well, it should be able to accomplish this goal. In addition, President Obama would like to steer our nation's productive resources toward a new paradigm involving energy savings, clean technologies, improved health care services and high-tech educational resources. This is an ambitious agenda, and if it succeeds, we all will be reaping the benefits for years to come. ♦



By Max Pray, CFA

It seems that the same people who predicted oil prices would go over \$200 per barrel back in July (when oil peaked at almost \$150), now are saying that \$10 oil is on the horizon, just five months later. Maybe your neighbor's two-year-old Prius is not carrying the premium used car price tag it was back in the summer, or you're thinking of cancelling that order for installing solar panels on your roof. Despite the media focus on the slower economy, as long-term investors it is still important for us to understand alternative energy solutions.

When considering the energy issue, we note that transportation and power generation comprise the main applications for energy in the industrialized world. The U.S. is the world's largest consumer of energy, and we produce about 70% of what we consume. The primary sources of energy consumed in the U.S. are derived from petroleum (40%), coal (23%), natural gas (22%), nuclear (8%) and renewables (7%). By comparison, the U.S. production of energy is mostly from coal (33%) and natural gas (30%) with the balance coming from petroleum (15%), nuclear (12%) and renewables (10%).

Along with this gap between what we consume and what we produce, there is a growing recognition of the need to shift our dependence on fossil fuels to other sources, primarily because of a finite supply, energy security and environmental considerations. Ultimately, the goal of the U.S. and other countries is to diversify our

energy sources and change the way we power our communities and maintain our mobility. While the magnitude of our dependency on oil can be reduced by improved energy efficiency (e.g. the hybrid car which still is a primary user of oil-based products, but with better mileage), the focus of this article will be on alternative solutions. The primary sources of alternative energy currently available are nuclear, hydropower, wind and solar, while secondary alternatives include biofuels, biomass, fuel cells, and geothermal.

As long-term investors, we look for opportunities to invest today in companies that will meet our return expectations over the next three to five years. Unfortunately, we see limited current opportunity in the capacity-constrained

When considering investment time horizons, it is essential to recognize that the supply chain and distribution system can be as important as the energy source.

nuclear and hydropower energy fields. There are over one hundred nuclear power reactors in the U.S. which produce about 20% of our electricity. No new reactor has been approved for construction in the U.S. in 30 years. Other than improving the existing nuclear reactor system, there is no immediate investable option in this industry in North America (though we do acknowledge that nuclear power development is more prevalent in France and Japan and there is some progress by the governments in Britain and China). Similarly, hydropower makes up about 40% of renewable energy, but is limited by

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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®
Kathleen M. Habegger, CFP®
Edward P. Ogle, Jr., CSA
Maxwell R. Pray, CFA
Terrell H. Price
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 80473
720.746.1244 Phone
720.294.9896 Fax
www.cliffordswan.com

the available capacity at dam sites of which the U.S. already uses about 75%.

When considering investment time horizons, it is essential to recognize that the supply chain and distribution system can be as important as the energy source. For example, the two likely alternatives to the gas engine are hydrogen-powered vehicles and biomass (such as ethanol) which would require an entire new infrastructure with a supply chain subject to its own complexity and costs. Electric vehicles are also an option, but current technology only allows 50-100 miles of driving before a recharge is needed. There are also political influences that must be factored into the investment equation in the form of government subsidies and regulations.

Today, the two most common areas discussed in the alternative energy space are wind and solar. Primarily, this is because both sources have unlimited supply and are environmentally friendly. However, wind and solar are intermittent sources which add a level of complexity to the system requiring another source of energy when the sun is not shining or the wind is not blowing. Storage of energy is expensive and cost-efficient solutions will need to be developed as the percent of intermittent energy sources increases. Though it gets lots of press, solar energy is still cost prohibitive compared to coal, natural gas, wind and nuclear. The cost per kilowatt-hour for solar is about 400% greater than that of the other four sources. The total revenues in the solar market last year for the entire world were \$21 billion and solar contributes less than 0.5% of the world's overall energy supply. It is a relatively new industry which does not have established business models that generate profits.

Where, then, do we participate in what we believe will be a growing space for profitable investment? Some investors' portfolios already have exposure to alternative energy through well-established large companies such as General Electric (GE) and British Petroleum (BP). GE is involved in almost every area of energy sourcing, including the alternatives of solar and

wind. GE is one of the world's leading producers of wind turbines through the GE Energy division. The company sells about \$1-2 billion per quarter in wind turbines and has over 8,000 installed across the globe. BP has invested hundreds of millions of dollars over the last two years in the solar and wind markets and will continue to invest in low-carbon technology, which is the fastest growing sector of the global energy market.

There are a number of investment options in alternative energy with smaller companies that seek to find non-carbon solutions in addition to enhancing existing fossil fuel technology. Most of these "pure play" companies are involved in the emerging technologies of fuel-cells, biomass, wind and solar, but many have limited revenues and no earnings. Though the attraction of a fast-growing market may spark interest, most of these companies have higher risk business models and, in some ways, remind us of the dot.com excitement and hype. There are a handful of companies that are somewhat more successful, such as First Solar (FSLR), but these companies trade at expensive valuations and are still very "new" without proven business models.

Another investment option is to diversify through an alternative energy mutual fund or ETF (exchange traded fund). However, due to the limited number of companies in this sector, these funds are small and concentrated, with many companies that have limited earnings and generally present a riskier profile than we would recommend.

Recognizing that the goal of the U.S. and other countries across the globe over the next few decades is to find ways to diversify the energy resources available to us, as investors we are cognizant of this changing landscape and will continue to look for opportunities in alternative energy as we go forward. In the near term, we expect these opportunities to come from well-established firms, but we continue to explore the more robust up-and-coming companies with sound business models. ♦