

# CLIFFORD SWAN

## THE INVESTMENT COUNSELOR

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THIRD QUARTER 2010

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## From Idea to Investment: OUR RESEARCH PROCESS AT WORK



By Roger L.  
Gewecke, Jr., CFA

Clients often wonder how investment firms analyze and attempt to make sense of all the conflicting news and information regarding the economy and the investment markets. We thought it might be enjoyable and interesting to take you through a typical week in our research and investment meetings and show you how our thinking goes into your portfolios—where “the rubber meets the road.”

Every Monday morning, our nine-member research team meets. The first order of business is to discuss items of note regarding the general economic climate and the investment markets. These discussion points come from a variety of sources including Wall Street, independent research reports and the financial press. Information is more plentiful than ever before, and the internet has really leveled the playing field between the individual investor and large Wall Street firms. We try hard to include articles on both sides of the economic story, so that all angles are considered. Sometimes it is difficult to find an opinion that is contrary to the consensus; it is here where a committee really helps, since a member who plays “devil’s advocate” might be able to point out opportunities that the consensus is missing and from which our clients might profit!

In a “top-down” approach, a firm’s economic forecast is paramount in managing a portfolio, driving significant changes to asset allocation and individual investments. Clifford Swan has always had a “bottom-up” investing approach, meaning that portfolios are built one investment at a time, while considering proper diversification. As our written investment philosophy states, “we believe fundamental research can

“Companies with these characteristics tend to have lower business risk which may lead to lower turnover in a portfolio—a potentially significant tax advantage for our clients.”

identify leading companies with increasing internal rates of return on invested capital. By managing diversified portfolios invested in such companies, the patient investor will be rewarded with superior inflation-adjusted returns.” In contrast, we believe that a

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### MARKET OUTLOOK



By Ralph E. Weil, CFA

As we look back at the last three quarters, we see what a volatile market looks like. The year started out with the market, as measured by the Standard & Poor’s 500, down about 5% after a very strong recovery in the last three quarters of 2009. This was followed in the spring by a 10% gain and then a move back to a loss during the summer. The market’s latest upward move has netted a gain of about 4% for the first three quarters of 2010. This volatility is caused largely by investors who were expecting a more

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# Educating the Next Generation



By Linda Davis Taylor

For many of us, September always brings thoughts of “back to school” and the sense of excitement and energy that new learning opportunities represent. This year, Clifford Swan embraced its own brand of education by introducing the “Young Stewards Program” to teach teens wealth stewardship and financial skills. The program, held at The Huntington Library, Art Collections and Botanical Gardens, was geared to youth ages 15-19, and was an interactive workshop designed to encourage a deeper understanding of family history, shared values, community involvement, and legacy. Many families have told us that they worry whether the next generation will be wise and competent stewards of their financial resources. This half-day session was designed to respond to the need for educating teens about important key financial skills: saving, investing, spending wisely, entrepreneurship, and philanthropy.

As I often find when working with “next gens,” these young people exceeded my expectations. They were positive, collaborative, curious, and yes, appropriately competitive! During a portion of the afternoon workshop, the teens played a money-game which asked them to make decisions about investing, saving, spending, entrepreneurship and giving.

While shouts of laughter were heard from the teens, parents were in a separate session receiving tips about two challenging



topics: how to talk with teens about money and how to navigate the college admission process. This program reflects our commitment to helping prepare the next generation for their roles as educated and responsible family leaders, and we look forward to making it an annual event.

The feedback was positive; as one parent wrote, “I can’t tell you enough how much we enjoyed your program and the fantastic conversations it has generated in our family.”

## Commitment to Philanthropy

Another new initiative that underscores Clifford Swan’s belief in the importance of careful financial stewardship and “giving back” is our participation in a Pasadena-based philanthropic program, the Pasadena Independent Schools Foundation

(PISF). This innovative program teaches philanthropic skills by providing hands-on grant-making experience to Pasadena middle and high school students. On November 9, PISF is being recognized at National Philanthropy Day as one of the top three private foundations in Los Angeles. With the program’s educational goals and commitment to local non-profit organizations who receive the grants, it is an ideal partnership for the firm.

As we all look toward our year-end planning and think about what 2010 has brought, the Clifford Swan team is grateful for the support and confidence of our clients and friends. Please let us know how we can serve you better. ♦

# Leadership through Good Governance

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By Linda Davis Taylor

## Why Governance Matters

**A**spiring writers are often given the advice, “write about what you know.” In thinking about how to best use this opportunity to share some ideas and thoughts with you, I paused to consider whether there is any common thread in the myriad of activities that I am privileged to enjoy as a business executive, board chairman, non-profit director, foundation trustee, and family leader. I would suggest that each of these roles offers the opportunity and responsibility to serve by encouraging effective governance. Often the term “governance” conjures thoughts of remote corporate practices that seem beyond the scope of our control, except for the proxy votes accompanying our stock ownership. However, every entity which aspires to long term success, from family group to non-profit organization, can improve by focusing on its culture of decision-making.

Consider this Wikipedia description of governance:

*“The moral and natural purpose of governance consists of assuring, on behalf of those governed, a worthy pattern of good while avoiding an undesirable pattern of bad circumstances, by making decisions that define expectations, grant power, and verify performance” (Wikipedia.com).*

With this view in mind, I would like to share some thoughts on how we can improve culture and decision-making for our families and non-profit organizations by leading through good governance.

## Strong Governance Strengthens Families

Why should families, not only the famous dynasties such as Rockefeller or Vanderbilt, address their governance practices? Governance, as defined above, guides the process of decision-making, and effective decisions impact long-term family success. Sound family governance should include a careful approach to defining the family’s core values, forming the basis of its mission and overarching purpose. Governance should also address transition and succession, such as incorporating educational activities designed to teach the next generation or other family members not well versed

in family business or other financial matters. This builds their capacity for stewardship and, ultimately, their financial independence. Consider involving family members in charitable activities in order to not only instill a sense of responsibility for giving back to the community, but to encourage collaborative decision-making within the family through grant making.

Those of you who have been part of any organization, whether as a company leader, employee, or volunteer, are familiar with mission and vision statements, retreats, and annual meetings. Families, too, are using some of these strategies to engage their families in the discussion of “what does it mean to be us?” Just as an engaged group of employees, that has had the opportunity to share their views and contribute to the corporate vision, builds a positive and productive corporate culture, the family whose members are linked by commitment to elements of a common purpose has a greater likelihood of success across multiple generations. Similar to the concept that corporate leaders should not leave the future of the company to chance is the belief that families should invest time and effort on defining their bigger purpose and vision.

Discuss and define your family values, develop a mission, and start activities that educate and involve the younger generation in the rewards of connection with the collective family wealth.

*“Our mission is to strengthen our family and the communities in which we live through commitment to entrepreneurship, adventure, and community outreach.”*

—Example of a family mission statement

## Effective Governance and Non-Profit Organizations

I have had the privilege of being associated with more than a dozen non-profit organizations over the past 35 years—as staff member, corporate officer, and trustee. Recent economic realities have impacted the financial conditions of nearly all our country’s non-profit organizations—entities whose missions greatly improve the quality of life throughout our communities. These challenges create problems that make their way to the governing boards, thereby driving committee agendas and taxing decision-making practices. It is more important than ever that non-profit leaders remain attuned to thoughtful governance practices when making decisions during turbulent times.

Effective non-profit boards contribute significantly to the organization’s ability to thrive and fulfill its mission. According to

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# FROM IDEA TO INVESTMENT: OUR RESEARCH PROCESS AT WORK

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“top-down” approach is difficult to consistently employ and profit from, particularly for taxable investors.

How does a new company become approved for investment at Clifford Swan? Let’s take a closer look at our research process.

The initial idea for a prospective investment might come from something a member of our research team has read in the financial press, an outside research report, a regular “screen” we run for new ideas, or a suggestion from one of our clients with expertise in a certain area.

Sectors in the Standard & Poor’s indices are assigned to specific analysts at Clifford Swan. A company under consideration for investment is given to the analyst responsible for its sector. In order to determine the company’s suitability for investment, the analyst reads available public documents, and utilizes Wall Street and other research sources for information on the company and industry. An old advertising slogan once said, “Quality is job one,” and the same applies to prospective portfolio investments at Clifford Swan. We focus on companies with strong returns in both good and bad economic times, with stable balance sheets, and that are competitively positioned for a promising future. Companies with these characteristics tend to have lower business risk, which may lead to lower turnover in a portfolio—a potentially significant tax advantage for our clients.

If a company passes our quality test, then the assigned analyst does more detailed valuation work, taking into account future sales and margin projections. We believe an important competitive advantage is our ability to look at companies with a three-to-five year time frame, since most institutional investors look at prospects for only the next quarter or two. A recent example served our clients especially well: in the bear market of 2008-2009, we found that many of our portfolio companies were undervalued under a

**“Our investment counselors then decide whether the stock is suitable for their individual client portfolios based on a number of personalized criteria unique to each client.”**

“stress test” incorporating a very long and dire economic scenario (worse than the one that actually ensued), giving us confidence in our companies that a short-term orientation wouldn’t have allowed.

If a company makes it this far in our research process, it is brought before the full research committee—the investment equivalent of bringing someone home to Mom and Dad. The assigned analyst is questioned about many fundamental factors regarding the company, including its customers and competitors, and valuation work is examined in order to ensure that it incorporates a range of potential outcomes. Oftentimes, the committee brings up other issues that are important to understand before endorsing a stock for client portfolios, requiring further, but essential, legwork from the analyst.

After all the research has been completed, if the company qualifies as a “Clifford Swan stock,” and shows sufficient upside to our estimate of its worth, it is approved to be added to client portfolios. Our investment counselors then decide whether the stock is suitable for their individual client portfolios based on a number of personalized criteria unique to each client. The stock continues to be followed by the sector analyst, who regularly updates the stock valuation and disseminates any newsworthy information or changes in his investment opinion to our counselors.

Significant price moves are a regular

topic for discussion amongst our analysts. Stocks with recent strong gains are examined to see if there is remaining upside potential for future growth. Stocks suffering recent declines are examined to see whether the fundamentals underlying these companies justify additional investment at lower prices, or whether the investment should be eliminated. As you might imagine, stocks that bother you also bother us, and much time is spent examining stocks from the perspective of minimizing downside risk.

On Tuesday afternoon, our entire investment team meets, and the research committee shares its findings with the larger investment group. The main ideas of the week are discussed and disseminated, with plenty of time for questions from investment counselors which often arise out of discussions with our clients. Successful management of your portfolios is an ongoing process. Investment counselors often meet individually throughout the week with our analysts to discuss specific company or investment issues.

Successful portfolio management is also an individual matter since each individual’s goals and circumstances are different. Through your relationship with your investment counselor, critical understanding is gained about your objectives, your values, your concerns and your hopes surrounding your financial life. Income requirements, tolerance for portfolio volatility, and tax-sensitive issues, such as low basis stock, are also key components of your investment profile. These very personal criteria influence the decisions your counselor makes regarding which of our approved stocks actually enter your portfolio. We believe that your portfolio should be a reflection of you, not represent a collection of products you’ve been sold.

We hope this article sheds some light on our research and investment processes. The investment seas are often choppy, but it is gratifying work helping you to navigate the waters and reach your investment goals! ♦

# LEADERSHIP THROUGH GOOD GOVERNANCE

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BoardSource, a leading non-profit board consulting firm, “Effective boards should adopt practices that carry out four fundamental responsibilities: 1) Set direction, 2) Ensure resources, 3) Provide oversight, 4) Manage board processes and operations.”

## Set Direction: Shared Mission and Vision

As in successful families and companies, effective governance for non-profit organizations begins with the articulation of a clear mission and vision. Best practices should include a mission statement, vision statement, code of ethics, and complete strategic plan—all written and adopted by the full board. All constituencies should participate in the planning process to answer the following questions: what is our purpose, where are we going, and how are we going to get there?

## Ensure Resources: Human, Financial and Social Capital

In order to carry out its mission, any organization requires resources. This “capital” includes the employees (human capital), the budgets and endowments needed to fund the operations (financial capital), and the sufficient goodwill and public image (social capital) needed to compete effectively in the broader community. The board must ensure that ample resources are provided to recruit and retain the leaders and staff needed to manage the organization and fulfill its purpose. The board is the ultimate steward of the financial resources and must seek appropriate funds to adequately fund operations and ensure long-term financial sustainability. Board members must serve as advocates for the organization in the community and assist in attracting others as supporters and volunteers.

## Provide Oversight

While oversight includes programmatic as well as financial matters, I will comment only on governance practices as related to financial oversight.

Basic financial governance for the board

includes, at a minimum, approval of the annual budget and oversight of the annual audit process. If an organization has an endowment, the board members who oversee the endowment as investment committee members should inform the full board of the investment strategy and integrate investment decisions with the organization’s full financial structure. Because the investment committee is often made up of investment professionals, board members who are not as skilled in this area often see the investment portfolio as “a separate business.” The investment policy that describes overall asset allocation strategy should be shared, and adopted, by the full board. Joint meetings should be held with the budget committee (overseeing operations) and the investment committee (overseeing the endowment). Professional investment advisors employed by the organization should make presentations to the full board, annually. All of the key financial drivers that impact the financial health of the organization should be tied together through a five year financial plan that incorporates spending needs, cash flow, and requirements for capital projects. Bond covenants and lines of credit should be understood broadly.

Other important oversight practices include an annual distribution of the Form 990 to the full board, and adoption and distribution of appropriate policies: conflict of interest policy, whistleblower policy, document retention and destruction policy, and officers and directors liability insurance.

## Manage Board Processes and Operations

Successful governing boards manage their own processes and have appropriate checks and balances to evaluate the leadership of the board and of the organization. These include conducting a formal board orientation, which can be useful not only for new members but to bring continuing members up to date on board practices and processes. Board terms should be defined, and number of

**“It is more important than ever that non-profit leaders remain attuned to thoughtful governance practices when making decisions during turbulent times.”**

consecutive years of board service should be determined. Healthy boards evaluate themselves formally at certain intervals, such as to coincide with transition in board leadership. With the help of professional consultants skilled in compiling and analyzing assessment tools, the evaluation gives each board member the opportunity to offer its opinion and ideas about how the board is functioning and ways to become more effective.

A fundamental responsibility of the governing board is to recruit, retain, and supervise the CEO of the organization. The CEO should be evaluated annually by the board through a formal process. The board determines compensation for the CEO, and should review compensation at comparable organizations to ensure fair and competitive standards.

## Board Culture

As for any entity, the culture of the governing board has a great impact on the success of the whole organization. Careful attention to effective governance processes as described above can contribute to a culture that encourages open and candid engagement. Few activities are more inspiring than having the privilege of working with a group of committed trustees and organizational leaders to guide and shape the work of an important institution and contribute to society through fulfilling its mission. ♦

# Retirement Account from Your Spouse



By S. David Andrew

When individuals lose a spouse, they often inherit the assets from their spouse's retirement plan. Although the knowledge of this inheritance often comes at a difficult time, it is important that the surviving spouse quickly evaluate the available options, determine his or her own financial needs, understand the tax implications, and consider the inheritance of future beneficiaries. Since some of these choices are irrevocable, it is extremely important that they be carefully considered. In order to preserve all available options, beneficiaries must make certain decisions within nine months of the date of death of the original account holder.

In general, inherited Individual Retirement Accounts (IRAs) are specifically designed to benefit the beneficiaries. They offer an opportunity to continue tax-deferred growth, with distributions based on the beneficiary's own life expectancy. However, there is still widespread misunderstanding of the basic IRA withdrawal rules for Inherited IRAs. This confusion oftentimes reduces the tax deferral benefit for IRA beneficiaries. Knowing the capacity in which the beneficiary has inherited the plan will help simplify the options. This information can be determined from an account statement or by phoning the institution where the account is held. *Since the rules are more complicated when the beneficiary is a trust, this article will only focus on individual spousal beneficiaries. We strongly suggest consulting a qualified tax professional or attorney to determine the best course of action for your particular situation.*

For the spousal beneficiary of an IRA, there are four courses of action, of which one may be chosen.

### Option 1: Transfer Assets to Surviving Spouse's IRA

The *first* option allows the surviving spouse to transfer the inherited retirement plan's assets to his or her own retirement account. A new IRA account can be

**“Inherited IRAs offer an opportunity to continue tax-deferred growth, with distributions based on the beneficiary's own life expectancy.”**

opened if one does not already exist. This option is available only if the surviving spouse is the sole beneficiary. The transferred assets are then available for withdrawal, although there may be penalties if the withdrawals are made without having a penalty exemption, i.e. unreimbursed medical expenses. The account holder can access the funds at any time; however, the account will be regulated by the same distribution rules as if the IRA had originally been their own. The benefit of this option is that both the amount and the timing of required distributions will be based on the

beneficiary's age—a significant tax-deferral advantage depending upon the age of the surviving spouse.

### Option 2: Open an Inherited IRA

The *second* option for the beneficiary is to open an account called an Inherited IRA or a Beneficiary IRA. The surviving spouse simply transfers the assets from the plan that was inherited to the new IRA account. The new account will be re-titled, “Sam Smith, Deceased IRA, for the benefit of Mary Smith, beneficiary.” The transferred assets will then continue growing tax-deferred or even tax-free in some cases. Once the Inherited IRA is opened, the account holder can usually begin withdrawing money immediately without penalty. This is because the 10 percent early withdrawal penalty is waived, regardless of the beneficiary's age. Depending upon the surviving spouse's need to access this money, this waiver can be a significant advantage in choosing this option.

The beneficiary can choose to withdraw money from the account each year as a Required Minimum Distribution (RMD) or elect to withdraw the balance of the account completely by the end of the fifth year after the original account holder's death. Regardless, the amount withdrawn will be taxed on each distribution.

If the original IRA account holder was *under 70-1/2*, then the beneficiary must start taking an annual RMD by the later of these two dates: December 31 following the year in which the original account holder died, or December 31 of the

“Since the government allows retirement money to exist in tax-deferred status for a lifetime, it is important that the account holder name the right beneficiary for their retirement plans.”

year in which the original account holder would have reached age 70-1/2.

If the original account holder was *over* age 70-1/2, the beneficiary must begin taking a RMD over his or her own life expectancy, beginning no later than December 31 following the original account holder's death.

### **Option 3: Lump Sum Distribution**

The *third* option is to take the assets as a lump-sum distribution. After all of the assets are sold, the money in the inherited IRA is then distributed. Caution should be utilized when considering this option as taxes will be due on the entire distribution, and this may move the account holder into a higher tax bracket.

### **Option 4: Disclaiming Assets**

The *fourth* option is to disclaim ownership of the IRA assets, either in part or in full. The assets refused will then pass to any remaining primary beneficiaries or, if none exist, to any secondary beneficiaries. The decision to disclaim assets is an irrevocable election with special rules.

### **Inherited Roth IRA**

In general, Roth IRAs are more likely to be advantageous if you expect higher taxes in retirement, and you can pay the taxes with money outside of the IRA being converted to the Roth IRA. Roth IRAs are especially attractive to people who plan to leave their IRAs largely untouched as an inheritance for their children and grandchildren. Since Roth IRAs are funded with after-tax dol-

lars, they are increasingly being viewed as inheritance vehicles. This strategy may influence the decision a surviving spouse makes when inheriting a Roth IRA.

If the beneficiary of a decedent's Roth IRA is a spouse, there are three options. The *first* option is to open an Inherited Roth IRA in the beneficiary's own name. With this option, the surviving spouse, unlike the original owner of the account, must take annual distributions that are spread out over his or her single-life expectancy. If the five-year holding period has passed, then the distributions will be tax-free. Otherwise, only earnings will be taxed. If the surviving spouse is the sole beneficiary, then he or she has the option to postpone distributions until the later of two dates: 1) December 31 following the year the original account holder died, or 2) when the original account holder would have reached 70-1/2.

The *second* option is to take the assets as a lump-sum distribution. This option is available when the beneficiary is a spouse or non-spouse. If the five-year holding period has been met at the time of the account holder's death, earnings are not taxed.

The *third* option is for the spousal beneficiary (must be sole beneficiary) to transfer the assets into their own existing or new Roth IRA. The funds are available at any time and the account will be regulated by the same distribution rules as if the IRA was in the beneficiary's name originally. Normal early withdrawal penalties may still apply. Earnings will generally be taxable until the account holder reaches 59-1/2 and the five-year holding

period has been met. This option has the additional advantage of no required distributions from the Roth, allowing the surviving spouse to more fully consider the next generation of beneficiaries as part of an estate plan.

### **Retirement Plans and Estate Planning**

One of the smartest provisions of the tax code is to allow individuals to defer tax on their retirement account contributions and earnings. This is an especially powerful tool for high-net-worth individuals and their families. Since the government allows retirement money to exist in tax-deferred status for a lifetime, it is important that the account holder name the right beneficiary for their retirement plans. If handled properly, these “Stretch IRA” accounts can continue to grow tax-free for decades into a sizable nest-egg.

The “Stretch IRA” approach avoids large lump-sum distributions to the IRA owner and his or her beneficiaries, and spreads out the distribution of IRA assets to one or two later beneficiaries. As we have mentioned, Roth IRAs can be used in a similar fashion.

### **Conclusion**

The time, effort and cost involved in establishing the best plan for an individual and their family can have lasting benefits. It is important that these complex matters be considered before the situation becomes too overwhelming. Consequently, it is recommended that you consult with an advisor to discuss the impact any decision may have on your financial situation. ♦

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## MARKET OUTLOOK

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stable recovery and have been surprised by the unpredictable economic environment we've experienced. Another contributing factor to recent market volatility is the fear of deflation, though we do not currently give high probability to the likelihood of this occurring due to the tremendous volume of money in the system. Rather, we continue to anticipate slow progress and have been cautious in our approach to both the equity and bond markets.

Our current outlook for the economy predicts more of the same into the foreseeable future. Slow growth in real Gross Domestic Product (GDP) is expected to hover around 1%-2% for the third and fourth quarters of 2010. Job growth will remain anemic, allowing for no meaningful reduction in the unemployment rate until well into next year. Consumers will continue to hold back spending because of feeble job growth, increasing anxiety over job security, and the resulting desire to pay down accumulated debt. Manufacturing, as it relates to exports, however, is one of few bright spots in the U.S. economy, and we expect the sector to continue its winning ways into 2011.

The positive side of slow economic growth is that inflation should be held in check at least until the end of next year. Right now, we are at the point of asking the proverbial question about the chicken and the egg. Or, put in economic terms, if economic activity needs to turn more positive for consumers to increase spending on goods and services, but the economy can't improve until consumer spending does, which comes first? This question is faced at the beginning of every economic up-turn, and is especially challenging now given the fact that interest rates have been held at low levels and all the stimulus money has been spent—both efforts having relatively modest impacts to date.

As investors in this environment, how, then, do we approach the bond and equity markets? Fixed income, at this time, seems to be priced very aggressively. When we consider the money that has flowed out of

common stocks and into bonds for perceived safety, and the corresponding low interest rates, there is not much room in anticipated yields to cushion the risk-reward relationship. We are not forecasting that we are in the middle of a bond bubble, but suggest that the prudent thing to do at this time is to make any new commitments to fixed income in shorter maturities (inside of 10, preferably inside of 5, years). By using shorter maturities, we will get lower interest income, but have less risk of losing market value as interest rates rise in the future.

In addition, we continue to minimize the potential risks associated with today's fixed income market through our research into, and focus on, very high quality bond issuers.

Due to slow economic growth, we anticipate that equity investment will continue to be extremely selective through 2010 and for a good part of 2011. While the National Bureau of Economic Research officially dated the end of the recession at June of 2009, many people feel that we are still in a recessionary period because of the sluggish recovery, especially in the job and housing markets. On the other hand, when we look at overall corporate health, it is not all that bad. Witness the strong recovery in earnings over the last year as businesses that downsized rapidly have maintained tight operating structures, helping to bring costs down faster than revenues slowed. Going forward, our research group will focus less on companies that are reducing costs and more on those who are increasing revenues. We will take this same focus to the global environment, with a particular interest in those U.S. companies involved in exporting and those with exposure to growing international countries, including participation in the emerging markets of the world.

In summary, our fixed income investments will be high quality and in the 3 to 7-year maturity range, while equity investments will focus on companies exhibiting revenue growth and strong management for maintaining cost control. We will continue to make investment decisions with the approach that companies with more international exposure will do better than those only doing business here in the U.S. ♦