CUTLER INVESTMENT GROUP LLC

Economic Update: A Buying Opportunity?

1st Quarter 2010

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The arrival of 2009 investment statements brought relief to many investors. While still well off the 2007 market highs, investment portfolios had returned to more comfortable levels. With regular contributions, 401k balances had nearly returned to their highs. Housing prices had stabilized, with real estate values appearing to have (nearly) bottomed. All of this added up to a great big sigh of relief for investors after a tumultuous previous year.

Yet, while the markets have recovered, concerns remain. What happens when the Fed begins raising rates? Where is the growth coming from with unemployment over 10%? Will inflation slowly erode the American standard of living? Some investors see these concerns as an opportunity. Warren Buffett recently proclaimed, after making his biggest investment ever in the purchase of Burlington Northern Santa Fe Railway (a modest $34 billion), that this investment amounted to an "all in bet on the economic future of the US." Why now?

> ***Warren Buffet recently made an all in bet on the U.S. economy.***
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> ***Why Now?***

At Cutler, we also see this market as a buying opportunity. The problems facing the equity markets are no longer an anomaly. The market has battled inflation and unemployment in the past. It has faced regulatory uncertainty. US companies have battled more imposing tax regimes, and faced daunting foreign competition. Today, the problems facing the market are not dissimilar to the early 1980's, where inflation and taxation were high, and Japanese companies were out-producing many domestic stalwarts. That time period also happened to be the precipice for the greatest bull market of the 20th century.

One may argue that the US is moving toward an onerous regulatory framework today, rather than away from one at the onset of the last bull market. This may be true, but the lessons of the past have not been abandoned. America today remains one of the best places to do business in the world. The Heritage Foundation annually ranks countries for their economic freedom, and while the US has slipped in its ranking (city-states dominate the top of the list), it still ranks 8th overall. America's 21st century rival, China, ranks 140th (Brazil a more respectable 44th), and the 20th century's rival Russia at 143rd (Japan 19th). Today, American companies clearly have a strategic advantage over the competition. Open and free economies are good for business.

Given more freedom, an investor would expect a premium for US equities over more "risky" economies. This ultimately is where opportunities for investors remain. The drop in value of equity prices reflected the cratering economy, and was appropriate given the earnings losses in 2008. Today, growth has returned to the market and equity prices have accordingly recovered. However, prices have not returned to previous highs, primarily because earnings have not. Some companies may never fully recover, but Cutler's focus on high quality dividend payers increases confidence that the portfolio investment's have sound business models. As earnings continue to climb higher, valuations should follow. Patient investors should be rewarded, as the recovery moves forward.

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*"When you earn a dollar, it has gained your respect.
When you invest that dollar, the investment should reflect your respect."*

- Kenneth R. Cutler

"Paying Dividends"

Asset Allocation Decisions

Erich Patten
Portfolio Manager

In this quarter's 'Paying Dividends' article, I would like to address the importance of asset allocation decisions on an investors' portfolio.

Asset allocation is perhaps the most difficult decision investors are forced to make. It can be argued that it is also the most important decision for investors. Past studies have demonstrated that a portfolio's mix of investments (such as the percentage of stocks versus the percentage of bonds) can determine over 90% of investment returns. The balance of the return is determined by the particulars of the investments; such as the quality of the investments selected, the timing of cash flows, and fees. An investor's appropriate asset allocation decision is a function of their age, desired risk, and available resources. As a portfolio manager, however, these decisions also require an assessment of the relative risk for each asset class. Today's fixed income markets are an exceptional example. With the Federal Funds rate at a historically low 0% since October 2008, it is evident that this benchmark rate has nowhere to go but up. Rising interest rates are a negative for bonds, so there is greater risk in bond prices than in a normal interest rate environment. This risk can be managed by owning shorter maturity bonds, but investors are also sacrificing short-term returns through dismal interest rates.

> ***"Studies show that over 90% of your investment returns will be determined by your asset allocation"***

Clearly, this is not the easiest environment for fixed income portfolio managers! Companies' earnings, however, are less directly affected by inflation as they can generally pass on higher costs to their customers through higher prices. While equity risks remain substantial, our analysis favors stocks over bonds in a balanced portfolio.

The question then for an investor is, how does one balance these views? There is value to owning bonds, even with 0% interest rates due to their uncorrelated nature with stocks. Ultimately, asset allocation changes should be made "on the margins" of the portfolio. Perhaps if you have a 70/30 (equities/bonds) portfolio you would slightly increase the equities stake in an environment such as today's. It is imperative to remember, however, that individual circumstances are the overriding variable in determining the appropriate asset allocation. If you have questions on your asset allocation, please feel free to contact our office and we will help you determine what is most appropriate for your situation.

"Paying Dividends" is a regular contribution to Cutler's Quarterly Newsletter and features rotating authorship by members of the Cutler team, presenting on topical subject matter. Look for Keegan Denn's article in our 2nd Quarter-2010 newsletter.

Global Market Update

Global Recovery: China Leads The Way

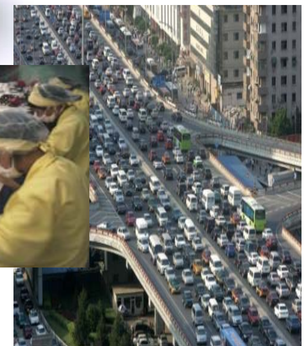
For the year of 2009, almost all international sectors and countries posted positive performance returns. In general, sectors and countries (including currencies) that tend to be more leveraged to the economy showed impressive results. The best performing MSCI (Morgan Stanley Capital International index) sectors for the year were basic materials, financials, and industrials, while sectors considered relatively more defensive and having slower growth characteristics, such as utilities and telecommunication services, had much milder annual returns. As for the US equity markets, small-cap companies performed better than those defined as mid-cap, and mid-cap outperformed large-cap.

All emerging market countries had strong annual returns. For the year, heavy commodity-linked currencies such as the Brazilian real, Australian dollar, South African rand, Russian ruble, New Zealand kiwi, Canadian dollar, and Norwegian krone had significant gains relative to the U.S. dollar at 33.8%, 29.0%, 25.6%, 10.6%, 24.5%, 17.8%, and 21.2%, respectively. The currency movements are consistent with the view that global risk-taking has returned, putting relative pressure on the U.S. dollar. It also explains why the Japanese yen, having also benefitted from an unwinding of risk at the height of the crisis, lost 2.6% against the greenback for the year. The Japanese yen was the only developed market currency to depreciate relative to the dollar.

The global recovery has been driven by growth in China. Chinese government stimulus measures enacted at the height of the crisis have had a sizable impact on China's economic growth. China has now surpassed Germany as the number one exporter in the world, and is considered the largest automobile market in the world. And, due to currency movements relative to the U.S. dollar, China is more competitive versus other Asian currencies. In our opinion, too much weight is currently being placed on its growth story. At this point, the Chinese government is moving to curtail lending, and a reduction in Chinese demand is a considerable risk to global equity markets.

A significant international theme in 2010 will be central bankers' willingness to reduce liquidity. With China taking steps to reduce bank lending and European bankers expressing concerns about inflation pressures (Norway recently raised rates to 1.5%), the US Federal Reserve appears to be behind the international banking community's inflation bears.

The global recovery has been driven by growth in China, as it surpasses Germany as the number one exporter in the world!



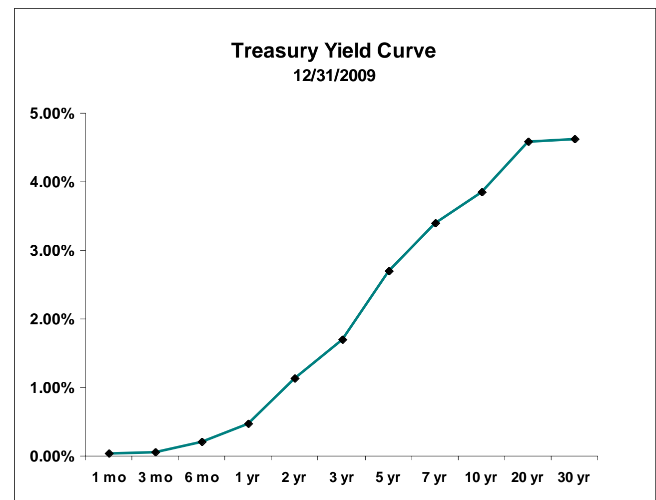
Fixed Income Update

Fixed Income: Credit Sector Leads The Way

The Fourth Quarter of 2009 followed the same path as the previous two quarters, as the credit sector continued to post better returns versus the government sector. The Barclays Capital Aggregate Index produced a total return of 0.20%. Both the Treasury and Agency sectors produced negative returns of -1.30% and -.03%, respectively. Except for the 3-month US Treasury Bill, whose yield dropped 5 basis points, the remainder of the yield curve rates increased. The result was an increasingly steeper yield curve. The yield spread differential between the 3-month Treasury Bill and the 30-year Treasury Bond increased from 3.95% to 4.6%.

Interest rates have become more attractive in the belly of the yield curve (5-10 year maturities), which may pose a short-term opportunity. On the other spectrum, a sustained rally in Treasuries remains a low probability considering the enormous supply that is coming to market monthly, and the ever-looming fear of inflation. Caution on the direction of interest rates continues to be the best strategy for fixed income. The steeper yield curve may create an opportunity of extending maturities strategically to take advantage of roll-down opportunities. However, with so much lingering uncertainty regarding the economy and potential inflation, it remains prudent not to deviate too far from the benchmark's term structure.

The largest risk to portfolios is the loss of yield in a very low interest environment, but that low interest environment also does not provide much cushion in a credit-widening event, or rise in interest rates. As the year 2010 unfolds, neutrality versus the benchmark may reveal itself the best strategy.



June Lee Joins our Team

Cutler is pleased to announce the addition of June Lee as Vice President of Marketing. June is a Southern Oregon native, and a graduate of the University of Oregon with a Bachelors Degree in Economics. She is active in local not for profits, and the Medford Rogue Rotary Club.

Ms. Lee's passion is working with companies to develop an effective 401k plan for their employees. In an ever changing business environment, having employees who are actively engaged in planning for their retirement adds an incredible amount of value to a company, both for recruitment and retention. When an employee recognizes the true value of their retirement plan, the company maximizes their investment in this invaluable benefit.

June's has a tremendous amount of enthusiasm for working with plan sponsors and as such, we look forward to introducing her to you in the near future.

June Lee
Vice President - Marketing

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