Tealwood Reports
October, 2011
Volume 24, Issue 4

Strategy Update: Muddle? Yes. Doomsday? No.

By Tealwood's Strategy Group

We believe the word DO is very important in this market. **DO** *proactively* execute to **<u>your</u>** strategy, as opposed to *reacting* to market volatility. **DO** decide what percentage of your assets you want focused on defense and offense. **DO** diversify internationally, **DO** emphasize: dividends, dollar hedges and defensive sectors. **DO** <u>NOT</u> be paralyzed and feel your investment strategy is irrelevant in times of uncertainty. Taking action to keep your assets aligned with your goals is what we want to help you **DO**.

Defense: Defensive Fixed Income and Strategic Income Portfolios

Here is our approach to defense in our *Defensive Fixed Income* portfolio. Invest in shorter maturity bonds (our average maturity is currently just over three years), use our core competence in security analysis to identify quality credits, and invest for competitive returns.

<u>Shorter Maturities:</u> We are concerned longer bond maturities will become significant risks when interest rates rise. We are investing for defense, not offense, in our bonds so we focus on keeping our maturities short. Getting 100 cents on the dollar at maturity is the defining characteristic of defense. We like the idea of getting our money back in three years and deciding then what the world looks like.

<u>Quality Credits:</u> We focus on two primary variables: a healthy balance sheet and a generous level of cash flow coverage of debt service. As a portfolio average, at quarter-end our portfolio composites were: net debt to capital of 26%, and cash flow coverage of debt service of 5X coverage.

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Offense: Large Cap Value and Value Growth (small and mid-cap equities) Portfolios

The headline of the *Wall Street Journal* (9/23/11) declares, "**Markets Swoon on Recession Fears**." And investors with nerves still raw from the trauma of the "Fall of 2008" cringe at the awful notion of impending collapse. **We at Tealwood see a different scenario.**

<u>The Economy: Continued Modest Recovery.</u> We expect the U.S. economy to move forward and upward in a continued modest recovery, with mild GDP growth over the next year of around 2% annually, accompanied by impressive earnings and profits. The good news about the bottom line will be offset with unsatisfactory news in the headlines. European finance will continue to be disruptive, political influences will cause frustration, housing and unemployment will stay stuck in neutral and stock market valuations will be modest by historical standards. This "tug-of-war" between positive results for profits and marketplace complexity is likely to result in a modest multiple (say a price-to-earnings ratio of 13X or so, whereas 15X would be more representative of historical averages) and produce an outcome of an S&P 500 Index around 1,300 over the next year. From 1,158 (where that index ended the quarter on September 30th), 1,300 on the S&P would represent an upside of more than 12%.

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Strategy Update

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Defense — continued

Competitive Returns: From today's valuations, we expect to invest for a current yield and a yield-to-maturity of well over 4% annually. We believe these returns represent a compelling advantage in shorter maturity bonds.

Offense — Continued

Equity Markets – A Muddle, Yes. Doomsday, No.
While this may not represent the most exciting forecast imaginable, importantly, it does not represent doomsday either. While sentiment has been very negative, the hard data of the marketplace has ranged from benign to positive. BUT, the voice in your head (and on your television) shouts, "things *could* turn much worse." It is difficult to prove a negative, but rational attention to business results compels us to see that we are not going off the cliff today. We expect next year to resemble the last two years, forging ahead through the muddle, two steps forward and one step back, ever feeling we are denied clarity and finding confidence lacking. For these prior two years ending September 30th, the S&P 500 Index returned 5.47% and bonds returned 3.43%.

Stocks are Cheap. Stocks we Buy are Cheaper.
While we do not believe a recession is imminent, it certainly seems that we have already paid for one in terms of equity valuations. The catalyst for the market will be a combination of solid profits and some expansion in valuations as we move beyond the fears of recession and settle back into just being frustrated with the slow pace of recovery.

Managing Risk with Security Selection. From the DO list noted above, international diversification, dividends, dollar hedge and defensive sectors have become more significant to our approach. Taking a static approach does not make sense in this dynamic environment.

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Deep Client Connections

Wendy K. Bennis — Chair, Client Care

Next year marks Tealwood's 25th anniversary as a company, and with warm nostalgia we are already sharing stories and reflecting on our past. We are also taking a fresh look at our processes as we head into the next 25 years. From a client care standpoint, we examined how we are delivering on our core value of creating and sustaining deep client connections. While we enjoy many close and longstanding relationships, we are driven to ask how we can be better.

Growing thriving relationships takes time. Yet the passage of time in and of itself is certainly not enough. ***We understand that our most meaningful relationships are a result of regular, scheduled contact.*** What carries the weight are robust dialogues and shared experiences. The number of connections can vary based on individual circumstances, but having intentional, scheduled contact is key.

Following is our framework for delivering on Tealwood's core value, Deep Client Connections:

Key initiative: Develop an appropriate customized communication plan with each client or their representative as part of a "My Strategy" document, a personalized investment strategy action plan.

Opportunities we want our clients and strategic partners to take advantage of:
- **Monthly Private Strategy Briefing luncheons** at our office (consider attending one or two a year);
- **Attend our educational and lifestyle events**, and Tealwood's Annual Investor Conference in September;
- **Obtain market and portfolio strategy updates** via our quarterly newsletters, E-Digests, and website.

Quarterly reporting: Provide quarterly performance reporting (see the new look of third quarter reports!).

We are passionate about fostering deep client connections and will continue to work to deliver on this core value. We look forward to another outstanding 25 years together.

Strategy Update *(continued from page 2)*

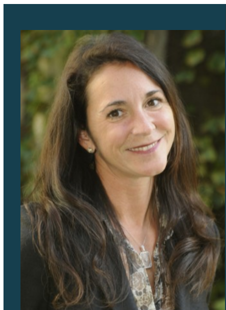
Offense — Continued

Equity Dividends. We believe dividends will continue to provide for a meaningful investment advantage. We have added a number of companies to our portfolios that offer reasonable valuations, top line growth and attractive dividend yields.

Deleveraging is Okay. Do not lose sight of the phenomena that the American consumer is getting healthier. We could have a recovery characterized by faster growth if we lapsed back into funding consumption with debt. However, we would not be more stable because of that "growth," we would be less stable because of the leverage. We took 25 years to get to "over-leveraged," it will take some more years from here for deleveraging to work through our economy. This is not bad, it is *healthy*.

Don't Expect Political Inspiration. Frustration over political ineffectiveness reached appalling heights through the debt ceiling debate in late July and early August. We believe this "political hangover" is the primary factor depressing valuations and investors. We see little reason to expect any kind of resolution prior to the 2012 elections, but for the sake of mental health, recognize that expecting political compromise to deliver inspiration has never worked as an investment strategy.

The Market Follows Where Earnings Lead. In 2008, earnings fell and the market fell. In 2009, earnings recovered and the market recovered. In 2010, earnings grew and the market grew. And in 2011, earnings will likely be up in the range of 15% or more. Over the last 30 years, there has been an 82% correlation between rising earnings and a rising market. This dynamic is the most important variable and we believe that in the year ahead earnings will continue to rise and the market will follow. Then offense will again be offense and no longer offensive.



Tealwood 2011 Investor Conference Recap

Michele Hanson — Vice President, Institutional Relationships

On September 27th we hosted our Annual Investor Conference. We are thrilled with this year's event and thank our speakers and the more than 150 guests for joining us.

The conference featured CFO Stefan Schulz and VP of Finance Jeff Jagerson from Minnesota-based Digital River, a company we own in our *Value Growth* portfolio. Messrs. Schulz and Jagerson detailed their product solutions and global reach. Digital River boasts a pristine balance sheet with $9 per share in cash, which equates to 44% of the current (9/30/11) share price of $20.57. We estimate free cash flow of over $2 per share in 2012 and $2.60 in 2013. With a free cash flow multiple of 13X, we anticipate the business value is dramatically higher than the current share price. Digital River fits our investment philosophy of great valuations, high quality and necessary catalyst to obtain growth targets.

Tealwood team members with Messrs. Schulz and Jagerson

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Tealwood Events

Tealwood 2011 Investor Conference Recap

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Doug Lennick, President and Co-Founder of Lennick-Aberman delivered a delightful and thoughtful discussion on human beings as investors. Specifically, Mr. Lennick humorously called out that we are emotional beings, and where decisions concerning our finances are concerned, our emotions play a significant and often detrimental role. Mr. Lennick encouraged that in addition to our IQ (Intelligence Quotient), we identify our EQ (Emotional Quotient), and recognize how we react to an outside event with our emotions, thoughts and ultimately, our behaviors. He raised our awareness about thought patterns and supported the need to reflect on long-term strategies—not letting emotions and current short-term events affect long-term goals and investment decisions. The graphic at left illustrates Mr. Lennick's point that our emotions can— often incorrectly — filter how we process outside stimulus.

Finally, Charlie Mahar, Tealwood's CEO and Chief Investment Officer, pulled it all together, summarizing Tealwood's vision and point of view on the markets, which is articulated in this newsletter with the article beginning on Page 1. Thank you again to all of our guests. Join us next September as we celebrate our 25th Anniversary!

Upcoming Events…

Private Strategy Briefing Luncheons, 12:00-1:00p at Tealwood

Learn more about Tealwood, overviews of our methodologies, performance, market insights and research findings:

Wednesday, November 16

Portfolio Briefing Luncheons, 12:00-1:00p at Tealwood

Delve into portfolio specifics in an informative and lively format. Upcoming luncheon dates are:

Wednesday, October 19 · Thursday, December 8

Visit www.tealwood.com for details. To RSVP: cpeppin@tealwood.com or 612.340.0181.

Tealwood holds special events throughout the year. Visit our website often for schedules and updates.

Tealwood Asset Management

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