



TEALWOOD

ASSET MANAGEMENT

Strategy Update: Two Years into the Recovery — The Best of Times and the Most Important Factors

By Tealwood's Strategy Group

Two years into the recovery, we have an investment update from a notable correspondent. Here is his report on how investors have fared over the last two years:

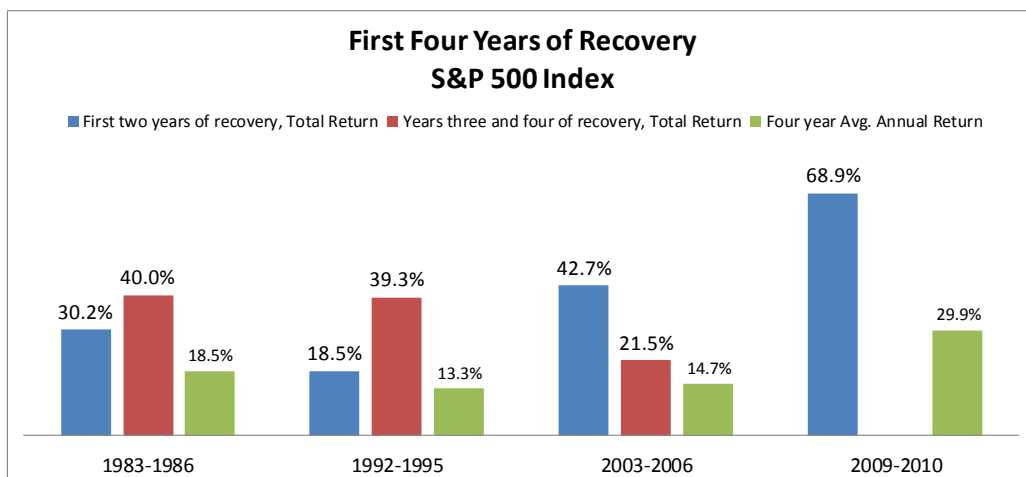
It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, ...--in short, the period was so far like the present period... Dickens, Tale of Two Cities

For the two years ended March 31, 2011, the S&P 500 Index returned 72.6%. Our equity portfolios outperformed that result. (Contact us for details.) Have we ever been through a period of such positive results simultaneous with such a negative reception? Let us exercise our gift for the obvious with a few summary observations:

- This is a BULL market! (Just because no one else will state the obvious does not diminish the obvious);
- Investors' perspective is SO dominated by the hangover from the crash, it is difficult to grasp the obvious;
- The real injury from the crash has been most acute for those who allocated out of equities after enduring recessionary losses and have stayed out in this recovery. Those with the forbearance to endure in equities have seen values restored and have participated in a first-class comeback.

A Historical Perspective: This recovery is not remarkable, it is typical, and assuming it continues to be typical, the period ahead will be VERY productive.

The period of the first four years of economic expansion after a contraction are the most predictably productive episodes of the economic cycle for equity investors. Over the last four recoveries, the first two years of recovery have seen an average return from the S&P 500 Index of just over 40%. The second two-year period of the first four years has averaged 33%, and the four-year period total annualized return has averaged just over 19%. Having strong results coming out of an economic contraction is not remarkable, it is typical. We assume we are going to continue in recovery mode and we expect that typical results for years three and four of a recovery are probable. (Continued on page 3)



Past three recoveries—a productive first two years followed by two more productive years.



Michele Hanson, Vice President Institutional Relationships

The Answers to Timing the Market

By Michele Hanson, Vice President Institutional Relationships

Have you ever had your vacation sabotaged by involuntary thoughts about business? Even after emphatically insisting to yourself that “I AM ON VACATION!”, that little voice goes on... trumping even the breathtaking view over the Pacific.

So it was when in Mexico in March, that my mind stubbornly dwelt upon two interconnected thoughts. The first: the ugly results many investors have derived out of emotionally-driven behavior that takes them in and out of equities at inopportune times. The second: Tealwood’s *Strategy for the Economic Cycle* thesis. Working through questions about market timing and behavioral finance, harmonizing them was, then, my dilemma. I want to share the harmonizing thoughts that got me back to the task of relaxing on vacation.

Emotions and Investing

As an investor, it’s not easy to know what the right thing to do is and when to do it. At times our emotions get the better of us and we do not make the best decisions. There is a resource that helps illustrate this dilemma: *Dalbar’s 2010 Quantitative Analysis of Investor Behavior* examines the returns investors actually realize and the behaviors that produce those returns. The results for the 20-year period ended December 31, 2009: S&P 500 Index return = 8%, average equity investor return = 3%; Barclays Aggregate Bond Index = 7%, average bond investor return = 1%.

Investment results are more dependent on investor behavior than on asset class performance. Many an investor falls into an unproductive cycle that goes something like this: the market shows several years of nice returns and funds then get committed to stocks. After a couple of years of favorable results, stocks reverse course and painful losses are incurred. Eventually it’s too much to bear, the investor sells, and swears off risk and its attendant pains. Then the cycle is repeated. And repeated. It is unproductive and exhausting.

The Economic Cycle

The economy goes through regular patterns of expansion and contraction. Not surprisingly, equities do well during expansions, and fare poorly during contractions. Over the last 50 years, the average expansion has lasted six years and seen the S&P 500 Index rise by 112%. The average contraction has lasted one and a half years and posted a decline of 32%. The characters in this cyclical drama are forever changing, but it’s still the cycle. We have had 11 recessions since WWII, and nearly every one has been reached with a kind of naïve denial that the party could ever end.

Tealwood’s Strategy for the Cycle

- **We prepare for the window of opportunity** that opens once a cycle at the back end of the economic contraction, when fear and frustration have the run of the market and the best businesses trade at trough prices and valuations.
- **The first four years of the expansion** following the contraction are the most predictably positive periods for equity investors. Investors wanting to allocate to offense must be in the game during this episode of expansion.
- **Around year five and later**, investors need to be alert to the potential change of seasons as expansion matures and contraction looms. We do not have a formula to offer for precise timing. We think the idea that there can be precise market timing is counterproductive. You do not have to know what day it’s going to snow to know winter is coming.
- **In the contraction**, our strategy is to emphasize defense. Reducing some equity exposure and allocating to safer asset classes to reduce risk and volatility.
- **Repeat.**

So here is the harmonization. Managing risk through the economic cycle does not make you a market timer. A historically informed strategy serves as an antidote to emotion, and we look forward to improved offense and defense.

Strategy Update (continued from page 1)

The Information Torrent

We live in an information age where investors are subject to a deluge of data. Investment value is not found in simply being informed, it is in having the judgment and expertise to know what is the most important data. For a strategic investor with a multi-year timeframe, we believe the most important variables are: 1) Where are we in the economic cycle, 2) What is the valuation, and 3) What is happening with profits?

At this point in time, each of these variables is in a favorable posture for equity investors:

Strategy for the Cycle: Our assessment is that we are in the third year of the recovery; we are now in the sweet spot of the “growing season,” within the first four years of expansion.

Valuation: The S&P 500 Index closed the first quarter at 1,328. Consensus earnings estimates for the Index are now \$96 for 2011. While we are forever skeptics about both forecasts and consensus, using this estimate as a ballpark number pegs the market’s forward multiple at 13.8X. In 2010, we spent the year in a multiple range of 13X-15X forward estimates. We can see a “common sense” valuation of 15X trailing results, projecting to an upside of 8%+ for the rest of this year, on top of the 6% already realized year-to-date through March 31. Market valuation is reasonable, and more importantly to us, our

portfolios are trading at a meaningful valuation discount to the market.

Profits: It is highly probable that 2011 will see all-time record profits for the S&P 500 Index. Repeat: It is highly probable that 2011 will see all-time record profits for the S&P 500 Index! Is there any evidence of this bullish news in your news flow? We guess there is not. A period of margin expansion and productivity gains is also a very typical feature of the early period of recovery in the economic cycle. The news on profits is nearly uniformly positive.

From our perspective, when you have the most important variables in favorable alignment, the probability of lesser variables (political moods, scandals du jour, natural disasters and other usual suspects) causing a derailment are modest. We do not pretend that “the fix is in.” All of the above are subject to change with little notice and we are vigilant in staying alert to a change in direction. We do believe the recovery will progress and good things will happen for investors who are focused on the opportunities. So remember the lessons of the past two years:

- This is a BULL market;
- Investors’ perspective on the recovery is SO dominated by the hangover from the crash, that it is difficult to grasp the obvious; and
- We believe that those with the forbearance to allocate to equities will continue to be rewarded.



Charlie Mahar, Chief Executive Officer and Chief Investment Officer

A Special Thanks...

The last two years have revealed to us the most essential ingredient in the making of a great investment firm. It is you! Without a close second, having great clients is *the* essential ingredient.

The reason Tealwood has enjoyed such strong results since the crash of '08 is because you kept a strategic perspective through the crises and stayed in the game. The restoration of value we have seen came first and foremost from your vote of confidence and we are very, very grateful for that. On behalf of everyone at Tealwood, *thank you.*

Tealwood Events

Special Events

Tealwood's Special Events offer our clients and friends unique experiences that can be fun, educational and inspiring. Please be sure to register/reserve your place with us in advance.

Thursday, May 26, 12:00 — 1:00p at the Minneapolis Club

Economic Club of Minnesota Luncheon featuring **R. Glenn Hubbard**, Dean, Columbia Business School

SAVE THE DATE! Tuesday, May 31, 4:00—6:00p, downtown Minneapolis location to be announced.

Internet Capital Group's (ICGE) Co-founder and Chief Executive Officer, Walter Buckley, will be Tealwood's featured guest and presenter at this private event. ICGE, a technology, software and internet marketing firm, is a position in Tealwood's *Value Growth Portfolio*.

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

Delve into portfolio specifics in an informative and lively format. Held throughout the year, upcoming luncheon dates:

Thursday, April 21 · Thursday, June 2 · Thursday, July 7

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

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

Thursday, May 12 · Thursday, June 30

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

Dave Kansas Event

Dave Kansas, Chief Markets Commentator of *The Wall Street Journal*, spoke to a group of over 100 Tealwood clients and friends at the Golden Valley Country Club in February. "Having Dave, who was raised in Minnesota, come home to share his insights with this group was a special treat", said Charlie Mahar, Tealwood's CEO.

Among the highlights of Mr. Kansas's comments were his "10 Surprises" for 2011. Charlie Mahar also shared Tealwood's constructive 2010 results for all strategies.

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



Bruce Langer, Tealwood, with guest Patty Smith enjoy the reception following the evening's presentation.

Tealwood Asset Management

1225 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402 612.340.0181 www.tealwood.com