

Volatility Returns: Emerson's Strategy for Dealing with New Global Challenges

*Timely thoughts from Emerson's Investment Strategy Committee
July 2010*

This year began with steady gains in stock prices along with an improving global economic picture. But during the second quarter, volatility returned to the market as investor confidence in the sustainability of the recovery waned. The quarter finished on a tumultuous note with most global stock indices down from their April post-recovery highs.

The recent weakness in the world markets can be attributed to a number of factors from the European debt crisis to disappointing U.S. economic data, such as private sector job creation. Some now fear that our global economic recovery is at risk, which could lead to another bear market. At Emerson, we believe we are still in a self-sustaining economic recovery, as the powerful combination of low interest rates and low inflation fuel growth. Economic indicators are often "choppy" during a recovery, but we are not dissuaded from our view that our economy should improve from here.

The 2010 market correction was the first one since 2009's stunning recovery. Corrections such as this are normal as markets rarely go straight up or down. Corrections are also relatively unpredictable and prices can temporarily fall to irrationally low levels. Technically the market looks weak, but many of its component stocks are fundamentally strong. With improving corporate earnings and strong balance sheets, we do not believe we are looking at another bear market for global stocks. This thesis helps drive our asset allocation in balanced accounts which currently favors stocks versus bonds, is neutral on real estate and underweight commodities.

DURING THE SECOND QUARTER:

Within Emerson's international strategy, we reduced exposure to European equities and took advantage of opportunities in China and Japan. We expect China's stock market to rebound from recent weakness as the market focuses attention on its strong internal growth prospects. Japanese exports should benefit from both a weaker yen and increasing demand from China.

Financial Market Returns as of 6/30/10		
	Quarter End	Year to Date
Domestic Markets		
S&P 500	-11.44%	-6.66%
Russell 1000 Growth	-11.74%	-7.65%
Russell 1000 Value	-11.15%	-5.12%
Smallcap (Russell 2000)	-9.92%	-1.94%
International Markets		
Developed Markets	-13.69%	-12.84%
Emerging Markets	-8.28%	-6.13%
All World Ex US	-12.45%	-11.06%
Alternatives		
NAREIT (REITs)	-3.66%	5.45%
DJ UBS (Commodity)	-4.85%	-9.66%
Domestic Fixed Income		
Barclays Aggregate	3.49%	5.33%
Barclays Credit	3.27%	5.62%
Barclays High Yield	-0.11%	4.51%

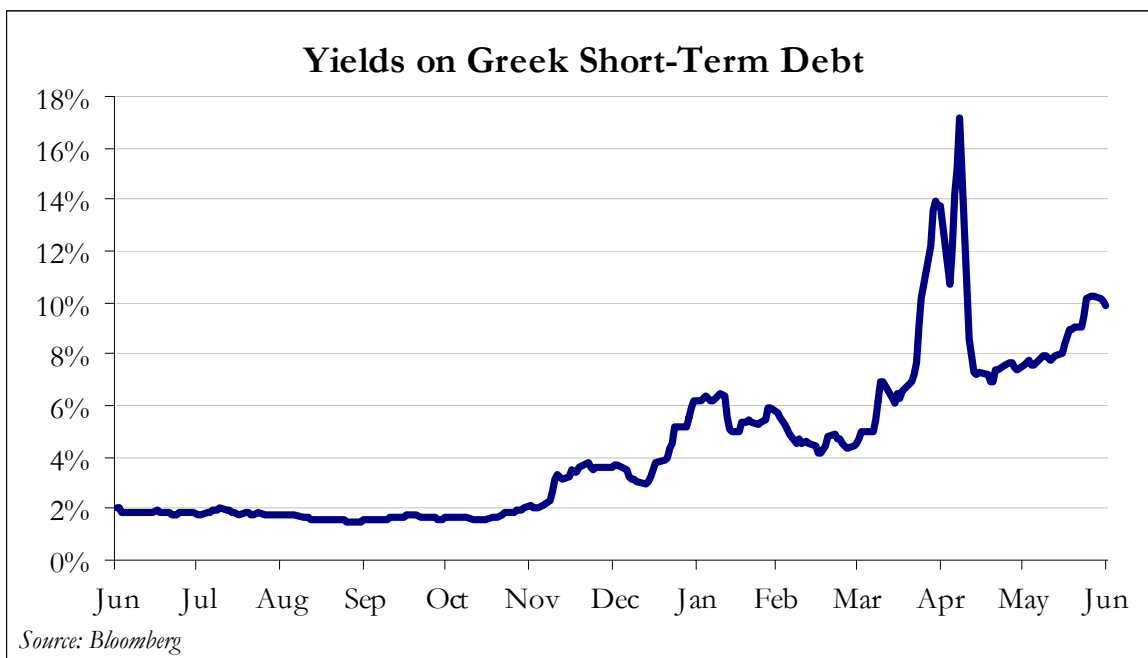
Despite the timely sale of some of our European investments, Emerson’s overall equity performance lagged the S&P 500. The relatively weak performance of the non-U.S. markets and the strength of the U.S. dollar made investments outside of the U.S. a drag on second quarter performance.

Commodities declined again this quarter in the wake of slowing Chinese demand, while real estate investment trusts (REITs) continued to show strength versus other asset classes. Fixed income proved to be a stable place to hide in a volatile market, and our balanced portfolio performance benefited from exposure to fixed income.

THE GLOBAL ECONOMIC CHALLENGE: HOW TO REBUILD PROSPERITY?

The 2009 global economic recovery was ignited by simultaneous bold initiatives of developed countries around the globe. Interest rates were lowered to historically low levels and government spending was raised to unsustainable levels, creating huge deficits funded by the issuance of debt. Initially these initiatives were very successful as economic growth recovered and the worldwide stock markets staged one of their strongest rallies ever.

The 2009 rally continued into early 2010 until Greece acknowledged that its level of deficit spending was far higher than previously reported. Fears soon emerged that other European nations such as Portugal, Italy and Spain would also have difficulty meeting future debt obligations. Interest rates on Greek government bonds soared (see Bloomberg chart below) as both the euro and the British pound lost value compared to the U.S. dollar, and soon thereafter stock markets around the world began to fall.



The capital markets clearly announced that profligate fiscal policies would no longer be tolerated. Rising interest rates and falling currency values are warnings that investors fear European governments will not take

the necessary steps to balance their budgets and reduce debt. At the same time, the strengthening of the U.S. dollar may provide Europeans with time to make their adjustments before the U.S. addresses its own spending problems.

Heeding the market's warnings, there are signs that European governments have begun the difficult task of balancing government spending with government receipts. Germany plans to halve its deficit between 2011 and 2014. France expects to reduce its deficit to less than 3% of gross domestic product (GDP) in 2013 and is raising the minimum retirement age from 60 to age 62. Spain's government is pursuing labor-market, financial and pension reforms. Hungary has cut spending and is also cutting taxes in hopes of stimulating growth. New leadership in the U.K. has targeted spending cuts and tax increases totaling approximately 8% of GDP.

It is too early to gauge the effectiveness of Europe's economic remedies, but it appears that the market's message to Europe is also being heard in the U.S. For example, on June 16th the Senate rejected a spending bill to extend jobless benefits for the long-term unemployed due to concerns over the federal deficit.

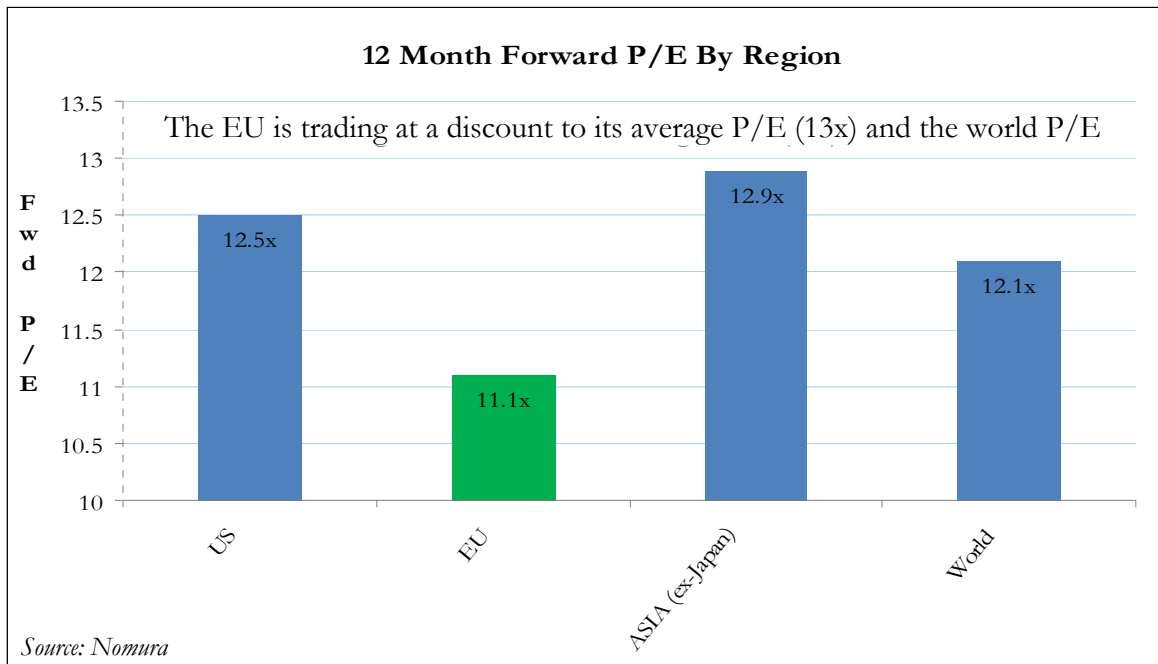
Public reaction to tougher fiscal policies and budget cuts has been surprisingly favorable. A recent survey of voters in Britain (*The Economist*, July 3, 2010) shows support for a variety of tough spending cuts. And here in the United States there is growing popular outrage over our projected deficits and growing support for politicians with the will to address them.

Europe's initial steps to reign in deficits are positive developments. If continued, the stage will be set for the U.S. to take similar steps leading to the eventual resumption of stable and sustainable economic growth within the developed countries of the world.

INVESTMENT STRATEGY

Emerson expects the economic recovery now underway to continue, albeit at a slower growth rate and with a higher level of unemployment than in previous recoveries. Risk assets such as stocks, high yield bonds and commodities should recover from recent weakness, but volatility levels may remain elevated as Europe sorts through its problems. The prospect of interest rates eventually rising from their historically low levels warrants a continued cautious outlook and calls for underweighting fixed income assets within balanced portfolios. We are underweight commodities due to low expected levels of inflation and volatility concerns. Emerson portfolios continue to produce safe and dependable income from fixed income and dividends on stocks (and equity exchange traded funds). Portfolio income is a major part of Emerson's total return strategy, as clients can count on the income despite volatility in asset prices. In the past quarter, we were pleased to note that 38% of the S&P 500 dividend paying companies increased their dividends – an indication of management's confidence in a sustained economic recovery.

We continue to favor equities over other asset classes for the near term. European stocks have priced in much of the bad news with price/earnings (P/E) ratios of 11 times versus their historical average of 13 times and the forward P/E of 12.5 times for the U.S. (See P/E Graph on the following page).



The euro's recent decline may have only just begun. At recent levels it is trading close to its long-term average of \$1.19 and well above its early decade lows of \$0.85. On a purchasing power parity basis (adjusting for price differences between the U.S. and Europe) the euro is 10%-15% overvalued at its current levels. The combination of a devalued euro and low P/Es on European stocks will eventually create an opportunity to reallocate funds from more fully valued assets back into European equities.

TWENTY FIVE YEARS OF INVESTING – FOUR IMPORTANT TENETS

During the past quarter many clients attended Emerson's Annual Investment Summit as we celebrated our twenty fifth year as an independent advisory firm. (A webcast summary of Summit is available at www.emersonim.com in the "Knowledge Center: Education Exchange"). We concluded the Summit with a summary of our Tenet's of Long-Term Investing. With the return of volatility in the markets, we wanted to emphasize these tenets once again:

- *Thoughtful and prudent diversification limits risk*
- *Time in the markets (NOT market timing) optimizes returns*
- *Identifying value through disciplined research is critical*
- *Emphasizing safe & dependable income (from interest and growing dividends) anchors a portfolio*

These important tenets limit risk in volatile markets, provide positive returns in good markets and assure safe income in all markets.

