April 1, 2011

Name
Address
City

Dear Client,

Call it the Teflon market of 2011 - no amount of bad news seemed to make a mess that couldn't be quickly wiped away. Stocks in the first quarter advanced in spite of numerous, normally market disrupting, events. Severe unrest in the Middle East led to a spike up in oil prices, adding to already rapidly advancing commodity prices and inflation. Expanding major problems in Europe's more economically challenged countries also repeatedly made the headlines. Finally, the 9.0 magnitude earthquake and tsunami, which unleashed the possibility of a nuclear meltdown in close proximity to Tokyo, disrupted the supply chains of many global manufactures. This market resilience can be attributed to a slowly improving U.S. economy and the rotation by investors out of bonds and into stocks. That said, bonds also held up pretty well, probably the result of the Federal Reserve's zero percent interest rate policy and its ongoing purchases of U.S. Government bonds.

The accounts I manage advanced in the quarter, but not to the degree of the equity indices mainly due to the fact that these accounts are not fully invested in stocks and the two sectors that provided the strongest performance in the period are areas that I have intentionally underweighted in my portfolios out of concern for economic cycle risk. Enclosed please find the article titled “Two Sectors Provide 60% of the S&P's Gains” about this topic.

I have been letting the bonds that I purchased for clients in late 2008 and early 2009 run off (have not reinvested the proceeds of maturing bonds back into new bonds) which has led to a fairly large buildup of cash in some accounts. This is a bit painful, as these balances are earning nothing, but I would rather suffer a little pain from lack of earnings now than a lot of pain later when expected interest rate increases cause a big decline in bond prices. I have enclosed a chart labeled “Two Hundred Years of U.S. Government Bond Yields” as evidence that interest rates have been higher, sometimes much higher, about 90% of the time as compared to now. This suggests that there will be far better opportunities to reinvest this cash in the future. On the other hand, should the opportunity present itself, I reserve the right to park funds in short-term Government bonds.

With the stock market continuing its relentless ascent, the question begs to be asked, why not put more of the above mentioned cash into stocks? I have been selectively adding to existing and new company holdings from time to time and will continue to do so in the future. However, the market as a whole is not inexpensive after having doubled over the last two years and, as can be seen in the enclosed chart titled “Market Capitalization as a % of Nominal GDP”, is not cheap compared to the country's economic output. While at lower levels now as compared to the market tops of 2000 and 2007, the sharp declines following those peaks warns an investor not to be the last one in. In addition, one of the most damaging things an investment manager can do to a portfolio is to dramatically expand the asset allocation to a sector that has substantially increased recently. This is the epitome of buying high, which is something I try to avoid at all costs.

On a personal note, over the last year I have sent my youngest off to college, while my eldest graduated from college, helped family members plan for senior living and became a grandfather. All of which have provided me with in-depth personal experience regarding college saving and funding vehicles as well as with selecting and financing retirement living arrangements. If these are areas that you are concerned about for yourself or others, I would be happy to share my thoughts on the subject with you. Enclosed please find your most recent quarterly portfolio report. Feel free to contact me if you want to talk about this report or other items in greater detail.

Best regards,

Peter V. Hedberg