

INVESTMENT REVIEW AND OUTLOOK

“Offense Sells Tickets, Defense Wins Championships”

We can't remember who coined this phrase relating to athletic teams, but it seems an apt metaphor for the current investment environment. The rewards of the conservative, stable return strategy that Moody, Lynn & Co. pursues have been demonstrated over several market cycles. The ability to protect client portfolios in bear markets has been a feature of our portfolios for twenty years. However the benefits of a defensive strategy are less obvious after big rallies in risk assets, particularly recovery rallies off bear market lows like the one registered in 2009. Indeed, such a strategy is virtually guaranteed to lag in powerful rallies. This is an attribute, not a weakness. The strength of this approach lies in its ability to preserve capital in down markets. *The idea is to lose less in order to make more over the long term.* Returning to the sports game plan analogy, the fans can sometimes become frustrated with a conservative strategy, calling for a change at just the wrong time. *The S&P 500 has gained an astonishing 86% since its low in March 2009.* According to Ned Davis Research, this is the best performance over a comparable time period since 1955. Yet in a broader context, we are likely in the latter stages of a cyclical bull market within the secular bear market that began in 2000. If so, this could be an inauspicious time to change the emphasis from defense to offense. Market sentiment has swung quickly to the bullish side, a cautionary indicator. Our recommendation is to stay the course.

2010 Recap

Almost all asset classes produced solid returns in 2010 and Moody, Lynn & Co. portfolios showed good appreciation year over year. *Yet a record number of mutual funds and investment managers underperformed their respective benchmarks for the year.* One reason for this is that the markets were obsessed with macro events, lurching between risk-on and risk-off modes. Systemic concerns overwhelmed individual company fundamentals as investor sentiment seesawed between fear and hope. Stocks plunged in the spring based on intense fears of a double dip recession, only to rally sharply as those fears receded in the wake of the Fed's QE2 announcement in August. (The 16% correction in stocks that took place between April and July seems a distant memory.) Month to month volatility was extreme, making it impossible to fully participate in rallies while striving to protect client assets. The hedge fund community had an especially difficult time coping with these choppy conditions. A monthly breakdown of

percentage returns from January through December 2010 is illustrative: (3.6), 3.1, 6.0, 1.6, (8.0), (5.2), 7.0, (4.5), 8.9, 3.8, 0.0, and 6.7.

One big surprise last year was the wide margin by which small and mid cap stocks beat large cap stocks. The Russell 2000 index returned an impressive 26.9% in 2010. In contrast, the large cap S&P Global 100 gained only 5.96%. This latter index is comprised of such bellwethers as Exxon Mobil, Microsoft, GE, IBM, Proctor and Gamble and Johnson and Johnson. Commodities were also big winners in 2010 as was gold. From a sector perspective, consumer discretionary and industrial stocks were the leaders while consumer staple, healthcare, utility and, surprisingly, technology shares lagged.

Outlook

Advocating for a prudent overall strategy does not mean we are bearish on equities. Economic fundamentals are clearly improving, albeit from very depressed levels. The trends in manufacturing orders, consumer spending and business investment spending are all moving in the right direction. Even the employment data appears to be getting better, at least at the margin. And whatever one thinks about the November elections and the December tax compromise agreement, they were clearly “market friendly” events in the short term. Policy uncertainties had haunted the markets and this cloud lifted somewhat in the November-December timeframe. In our prior two letters we indicated that we strongly favored stocks relative to most other asset classes and we still do. Valuations, particularly for the beleaguered large cap sector look reasonable against a backdrop of paltry short term yields and a 3.3% 10 year government bond rate. ***The combination of accommodative fiscal and monetary policy and improving economic growth is positive for stocks but neutral to negative for bonds.*** All of this should allow stocks some further room to run in 2011, although growth comparisons will become more difficult in the second half of the year. As we transition from a “lean and mean” recovery to a more mature phase of the expansion, negative surprises on the profit margin front become more of a risk. Sharply rising commodity prices are particularly worrisome in this regard. Investors would also do well to remember that faster economic growth doesn’t necessarily correlate with better stock market performance. If it did, 2009 and 2010 would have produced weak, not strong returns. ***Equity markets tend to be driven more by changes in GDP growth expectations. On this basis, U.S. stocks look like one of the better bets for 2011.*** The resiliency of our business sector and, amazingly, our consumer sector is being demonstrated once again.

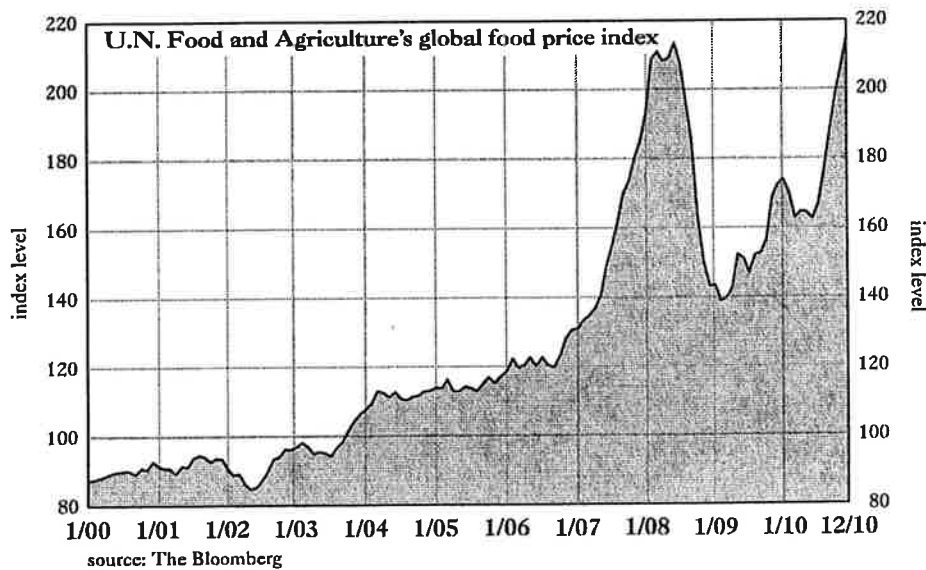
“I place economy among the first and most important virtues and public debt as the great danger to be feared. To preserve our independence, we must not let our leaders load us with perpetual debt. We must make our choice between economy and liberty or profusion and servitude.”

Thomas Jefferson

While economic momentum and valuation factors are supportive of equities, very big structural issues remain just under the surface. The major issues all relate to debt in one way or another, whether it is debt at the Federal, state and local or household/mortgage level. The intractable situation in Southern Europe continues to be a big macro risk as well. It is hard to see how a debt restructuring/banking crisis can be avoided in the European periphery. The bottom line is that there are still plenty of things to keep an investor up at night. As we said in our last communiqué, this is not a time to be chasing benchmarks or jumping from one strategy to another. The sharp rise in risk assets over past year has already discounted an improvement in business conditions. A sustained rally in stocks *from these levels* will require that none of the big structural risks break the wrong way. To assume an aggressive investment posture at this juncture one must believe, among other things, that:

- The Eurozone Muddles Through
- A State and Municipal Fiscal Crisis is Avoided
- Bond Markets Don't Rebel Against Excessive U.S. Debt
- Asian Growth Continues Apace
- Food and Energy Price Increases Moderate

This strikes us as a Pollyannaish scenario. The food and energy crisis is quickly taking center stage, as the following chart illustrates. With the consumer representing 70% of the U.S economy, the rising cost of food and energy represents a serious threat to the recovery.



In summary, the economy is improving and the valuation backdrop, particularly for large cap U.S. stocks, is favorable. However, the macro risks remain large and the valuation case for stocks assumes no significant erosion in profit margins in the year ahead as a result of higher input costs. It is an encouraging but fragile situation that we intend to monitor closely.

As always, we welcome your questions and comments.