DEIGHAN
ASSOCIATES

INVESTMENT QUARTERLY

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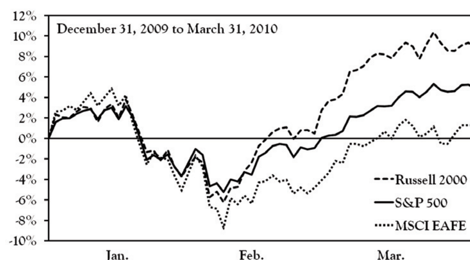
We don't expect the broad economy to recover as rapidly.

Market Commentary

On March 20th, the temperature in Bangor hit a record of 68 degrees. That's higher than June 20th of last year! Typically, come March we cheer when the mercury hits the high 40's. Perhaps it is fitting then that the market has also felt a bit like an anomaly. Since March 2009, the S&P 500 has increased by over 70%, a stunning recovery by any measure. However, relief is far from widespread. Unemployment sits near 10%, and those who have jobs face stagnant wage growth. The average American is wondering, perhaps rightly, why stocks have done so well when there is still so much uncertainty and hurt going around.

We'd like to say the answer is simple, that the stock market is a leading indicator and the economy will follow-suit. This may be true, to a point, but continued signs of weakness make us pause. We don't expect the broad economy to recover as rapidly as the stock market. In March, the Consumer Confidence Index (CCI) rose to 52.5, its biggest gain in seven months. Many commentators see this as proof of a full-fledged recovery. Yet keep in mind that, over the past 30 years, the CCI has averaged 94.4 with a high of 144.7. It's nice to see the CCI above the 'breakeven' of 50.0, but consumers are essentially right on the line between pessimism and optimism. Plans to buy an automobile have fallen to lows last reached in November 2008, and plans to purchase a major appliance have worsened as well.



Plans to buy a home have improved, but these figures likely reflect last-minute shoppers hoping to cash in on the homebuyer tax credit before it expires. Existing home prices are roughly 4% above their lows, but they remain 30% below their peak. In addition to the tax credit, home purchases have been stimulated by artificially low mortgage rates. Rates could begin to rise, however, because on March 31st the Federal Reserve ended its program to purchase mortgage-backed securities.

The Fed has voiced a commitment to slowly disengage its numerous stimulative measures as the economy improves, and we are starting to see that now. In February, the Fed raised the discount rate—the rate it charges banks for short-term loans—to 0.75%. As a result, bank use of the discount window has fallen significantly. However, the Fed is also prepared to leave the federal funds rate, the country's target short-term rate, at or near zero for the foreseeable future.

Unfortunately for Chairman Bernanke and company, the Fed must now walk a tightrope. While inflation is currently on the backburner, it could reignite if rates are left too low for too long. Also, as the U.S. looks to fund its massive deficit spending, the foreign countries financing our debt may begin to require higher interest rates. Two weeks ago there were three Treasury bond sales, one short-term and two long-term. The short-term issue sold quickly, but China, Japan, and Korea were completely absent from the long-term sales. This sent the benchmark 10-year U.S. Treasury yield to its highest level since June 2009. Throughout the Greek debt crisis, demand for the dollar was strong. However, now that the European Union has developed a patchwork bailout package, negative dollar sentiment has returned. A weak dollar could force the Fed's hand too soon, because it typically means higher commodity prices and less demand for U.S. debt. Were the Fed to find itself in a position where it needed to raise rates in order to attract foreign buyers of U.S. debt, this could put the brakes on the domestic recovery and tip the country back into recession.

Meanwhile, stocks have rallied in part because U.S. companies have delivered strong earnings thanks to necessary cost cutting. Those same companies have also started to accumulate excess cash that could be used for product development or mergers and acquisitions. Such positive factors are expected to provide the market

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MARKET COMMENTARY *continued from page 1*

with some buoyancy. Yet, in aggregate, stocks seem either fairly valued or slightly over-valued. Nearly 90% of stocks in the S&P 500 are trading above their 10-week moving averages. This is not to say there aren't pockets of value to be had, but there is a strong potential for a short-term pullback. At the very least, we expect stocks to grind for awhile, as they have over the past quarter. The first quarter of 2010 turned out to be a good one for stocks, with the S&P 500 rising 5.39%. But there were no large upward jumps. The war was won with little daily victories that added up incrementally. For stocks to continue their uphill march, investors are going to start requiring that earnings be driven by long-term fundamentals. Cost cutting can only be implemented and relied upon for so long.

The bond market offers scarce investment alternative. Yields remain unattractively low across much of the curve, and the spread between U.S. Treasuries and investment grade corporate debt has narrowed to the point where there is only modest reward for the added risk of default. Unfortunately, investors have little choice but to make do with what's available, while also understanding that interest rates will eventually be rising. As a result, we've chosen to remain short on the fixed income side of client portfolios, not going much beyond 2011 or 2012. We are willing to accept lower yields in the near term, rather than extend too long and subject clients to potentially significant interest rate risk down the road. In order to augment low yields, we have increased allocations to well-managed high yield and international bond funds. High yield bonds remain somewhat attractively priced, and their higher coupons provide them with a buffer to help absorb the shock of rising rates. International bonds help to diversify currency risk in client portfolios, and they allow clients to gain exposure to fixed income markets where interest rates aren't necessarily set to increase.

Yields remain unattractively low.

Our use of high yield and international bonds is actually part of a broader strategy we implemented in mid-March. At the onset of the financial crisis, we cut back stock exposure in client portfolios by about 10%. Throughout 2009, these positions self-healed, but come March 2010 we were still a little heavy in cash and fixed income. With cash earning nothing and stocks looking expensive, we decided that the marketable alternatives asset class looks the most attractive for current investment. Keep in mind, the term 'marketable alternatives' is a type of catch-all for a wide variety of different investments. While each plays a separate role within client portfolios, they all serve one common purpose. That is, they generally do not correlate with either stocks or domestic bonds, the two major asset classes that have grown a bit ripe.

We include the following investments within the marketable alternatives asset class, many of which have been in client portfolios for some time: high yield bonds, international bonds, commodities, global real estate, and equity hedging strategies (long-short, market neutral, equity arbitrage, etc.). We added incremental, but effective, amounts to each of these areas, with the exception of global real estate which continues to host specific risks. High yield and international bonds were upped for reasons outlined above. We increased commodity holdings by adding a hard asset fund, Van Eck Global Hard Asset, to the two funds we already hold. The Fed might not see inflation as a current concern, but we see it as a future concern. In order to make money, investors need to act in advance. Commodities provide a good hedge against a falling dollar and rising prices. In recent days, speculation has driven the price of oil up to over $86 per barrel. If prices can rise during times of ample supply, then imagine what the price might do during times of scarcity.

Within most client portfolios, we now hold three funds whose job it is to 'hedge' the movement of traditional stocks. We put the word hedge in quotations to make a point. These are not 'hedge funds' like you might read about in the news. Hedge funds are secretive pools of money outside the purview of traditional regulatory channels that require investors to lock-in their money for a number of years. The managers of those funds often charge a base fee plus a performance fee, which could be up to 20% of portfolio returns. No. We use open-ended, transparent, regulated mutual funds that simply employ strategies that serve to benefit in the event stocks become volatile or turn downward. Up to this point, we have held a long-short fund and a covered call writing fund. We have now added a fund that seeks to capitalize on inefficiencies arising from corporate mergers and acquisitions. Together, these funds, in their own distinct ways, provide a degree of downside protection for client portfolios. In the event that we do see a pullback in the near-term, these funds should gain.

We did not just add to the marketable alternatives asset class and call it a day. We also made structural changes within our exist-

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ing domestic and foreign stock holdings. On the domestic side, we reduced small and mid-cap holdings in favor of larger companies. The sustainability of the recovery is still in question, and small businesses continue to have difficulty gaining access to credit. Therefore, we would rather have a tilt toward larger businesses that can generate cash flow and financing on their own, and that have broader access to economies outside the U.S.

On the foreign side, we reduced developed economies, such as Europe, in favor of emerging economies. Yes, emerging markets stocks have been on a tear, and our clients have participated and benefited. There is some question as to how long the emerging markets story might run. But short-term prospects for Europe and Japan, which make up the bulk of most developed international holdings, are weak. Given that we want a certain level of foreign exposure in client portfolios, we see the emerging markets as being the better alternative. These are areas of the world where there is a drive to grow and succeed, where the potential of a working middle class has yet to be adequately explored.

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When More Becomes Less

Years ago while visiting my husband's grandmother, I was awed by her collection of salt and pepper shakers. From dancing ceramic lobsters to the obligatory black and white cats, they stood in pairs everywhere covering countertops and window sills alike. Seeing my expression, my grandmother-in-law agreed, "Yes, I certainly have a lot of them. It was fun in the beginning, but I am starting to lose track of them. Now I can't find some of my favorite ones!" Unfortunately, many investors feel the same way about their investment accounts. The busier we get and the more accounts we amass, the more overwhelming it all becomes. The end result is poor oversight and missed opportunities.

Some investors purposefully establish multiple account relationships in search of diversity, thinking that holding assets at different institutions will lower their risk level. While this notion might make sense in the context of large cash deposits, owning a number of accounts is usually inefficient, and it can expose an investor to unnecessary risk.

For example, the more one's assets are spread across multiple vendors, the more chance there is for investment overlap and overconcentration. Trading fees might also be higher in aggregate, because accounts aren't always large enough on their own to purchase a desired quantity in one fell swoop. Or, a given vendor might award lower trading costs to clients who custody more assets with them. A similar size problem might arise when it comes to investment minimums. An investor could be excluded from an investment opportunity, because their asset base at a given vendor is too small. And there is always the difficulty of juggling several statements each quarter, putting them into an allocation model, and placing trades at different websites just to rebalance. The end result? Investments don't always get rebalanced, and this negatively impacts long-term returns.

If that's not enough, just when everyone is ready for a touch of spring, investors with multiple accounts find themselves laboring beneath a blizzard of 1099's that must be reconciled and reported. It is far more difficult to manage tax liabilities and strategically offset gains when assets are strewn far and wide. Wash sale rule violations are also much more likely to occur.

For all of these reasons, we strongly recommend consolidating under one responsible custodian whenever possible. Responsible custodians include Charles Schwab, Fidelity, and TD Ameritrade, among others. And, not to sound too biased, but a competent financial advisor can help investors determine which accounts are necessary, and which are not; which can be consolidated, and which must stand alone for legal purposes. A financial advisor can also help to select and monitor investments, implement tax strategies, assist in planning, set up distributions, and provide trusted advice.

Don't be an overwhelmed collector of investment accounts. You wouldn't plant half your vegetables on one side of your house and the other half on the other side, would you? To do so would require more work for no immediate gain. Take advantage of the spring cleaning mentality! Prioritize and consolidate your investment accounts sooner, rather than later.

Soundbytes

In February, Blaine Meehan passed the Series 65 Uniform Investment Advisor Law Examination. The exam is designed to qualify candidates as investment adviser representatives, covering topics that are necessary in order to provide investment advice to clients. Congratulations, Blaine!

In March, Jenifer Wilson flew to Phoenix, Arizona to attend training for Tamarac, our new trading and rebalancing platform.

Last year we had such a wonderful time at our Seasons of Maine Art reception and sale that we decided to repeat it. We plan to have the event on Thursday afternoon, June 10, 2010. Stay tuned for more info!

Market Commentary *continued from page 3*

As you can see, we have been diligent in our efforts to squeeze value out of client portfolios during a time of market uncertainty. Our ultimate goal has been, and will continue to be, finding a rational mix of investments that work together to strike a balance between risk management and investment reward. We hope you agree with our thesis, and we encourage any comments or questions you might have. Don't let a rising market lull you into complacency. Our nation is still working through difficult times, and a unique set of challenges will face us in the future, even if a recovery is imminent. Our job is to position your portfolio such that it can handle anomalies as they arise. Until next time, enjoy the early spring!

Portfolio Changes

Van Eck Global Hard Asset Fund (GHAAX) – Added – Van Eck Global Hard Asset is one of the longest tenured funds in the commodities space. It has outperformed a majority of its peers in 8 of the last 10 calendar years, and it has one of the broadest portfolios in its category. The fund owns energy, base and precious metals, agriculture, and other commodities. It primarily invests in the stocks of commodity companies, but it can also directly hold commodities. Van Eck's hard asset team is comprised of 10 professionals, including one geologist, each with an average of 16 years experience. GHAAX won the 2009 Lipper Fund Award in the Global Natural Resources category, and it currently holds a 5-Star Morningstar rating. Its broad mandate and skilled team make it a nice complement to our other commodity fund holdings.

Artio Global High Income Fund (BJBHX) – Added – We've long been a fan of the research team at Artio Global Investors (formerly Julius Baer). Client accounts currently hold one of two Artio International stock funds (BJBIX or JETAX). We actually held the Global High Income fund until September 2008, at which point the financial crisis started to gain traction. We exited all high yield funds at that time, even though we still liked the management of this particular fund. Now that world economies have started to stabilize and high yield bonds still represent opportunity, we have decided to again invest in Artio Global High Income. The fund has a broad, global focus with a seasoned manager at the helm in Greg Hopper. Hopper is supported by a team of five portfolio managers and analysts. The fund currently holds a 5-Star Morningstar rating.

Arbitrage Fund (ARBFX) – Added – Don't let the name fool you. The Arbitrage Fund is neither as risky nor as exotic as it sounds. In fact, its mandate causes it to closely resemble the performance and volatility of short-term Treasury bonds, while employing an equity-based strategy and simultaneously offering an interest rate hedge. The fund engages in merger arbitrage, meaning it invests in a portfolio of stocks involved in merger situations. It profits by earning the difference, or spread, between the pre- and post-merger prices of target companies. The fund is well managed with over 75 years of combined experience and an emphasis on capital preservation and risk management. Lipper has awarded the fund a 5 out of 5 for Total Return, Consistent Return, and Preservation. It named the Arbitrage Fund the Best Equity Market Neutral Fund over the five year period ending December 31, 2008.

Verizon Communications, Inc. (VZ) – Added – In those client accounts where we purchase individual stocks, we recently re-entered the telecom sector with our purchase of Verizon Communications, Inc. Verizon offers wireline, wireless, and broadband services to customers in the United States. Through its joint venture with Vodaphone, Verizon is the nation's largest wireless carrier with over 91 million wireless customers. The company continues to divest unprofitable rural wireline businesses while it focuses on the build-out of its 4G wireless network. We believe Verizon's aggressive, simple smartphone pricing plans should enable the company to compete effectively for customers. Strong free cash flow helps to secure the 5% dividend and support debt reduction. Shares are attractively priced given the company's growth prospects in wireless and enterprise operations.

Disclaimer: Past performance is no guarantee of future results.The information contained herein is obtained from sources believed to be reliable, but its accuracy or completeness is not guaranteed. This commentary is for informational purposes only and is not a solicitation, or a recommendation, that any particular investor should purchase or sell any particular security. All expressions of opinions are subject to change without notice.

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