

# *J.W. Burns & Company*

## *Investment Counsel*

*Quarterly Update - October 2010*

### *Sea Of Liquidity*

*or*

### *Healthy Gridlock*

*“Equity money is dynamic, debt money is static.”*  
-Edmund Burke

**D**ear Clients and Friends,

Despite widespread fear of a double-dip recession, stocks performed well in the 3<sup>rd</sup> quarter of 2010 with the S&P 500 Index up 11.30%. Your portfolio(s) participated very smartly in the late summer rally has well below-average risk compared to the market as a whole. Although we acknowledge that the global economic recovery remains fragile, the combination of low equity valuations and staggering levels of cash sitting on the sidelines have made for a very attractive backdrop for superior stock market performance. We continue to believe that our clients will be pleasantly surprised by the strong returns generated by your high-quality, durable growth equities.

During the summer months, we sent out various client communications that highlighted our firm-wide belief



**“In our view, the contrarian and common sense message is clear - *stick with stocks.*”**

that stocks offer a robust investment opportunity, especially compared to bonds and other fixed income securities. The fact remains that while retail investors are pouring money into bonds and bond funds at record levels, the high-quality stocks that you own are paying an almost equivalent dividend yield - that will likely increase over the years, unlike fixed income securities - and offer significant growth from these levels. Put another way, the earnings yield on stocks in the S&P 500 Index (the earnings yield is different from the dividend yield; the earnings yield is not income, but simply the combined earnings per share of all the companies in the S&P 500 Index, divided by the overall price of the index) is now almost at 7%, a 20-year high,

while the income yield on medium-term bonds is less than 3%! This is the exact opposite of the way things were back in 2000, when bonds were yielding 6-7% and the earnings yield on equities was approximately 2½%. Of course, bonds went on to have a strong decade while stocks fared poorly. And, of course, no one wanted to buy bonds back in

2000, only stocks. Now, no one wants to buy stocks when they may represent great value, only bonds! The clear explanation is that many unsophisticated retail investors are simply chasing performance. In our view, the contrarian and common sense message is clear – ***stick with stocks.***

Not surprisingly, as sentiment is improving, so are the money flows into stocks and equity mutual funds. Further-

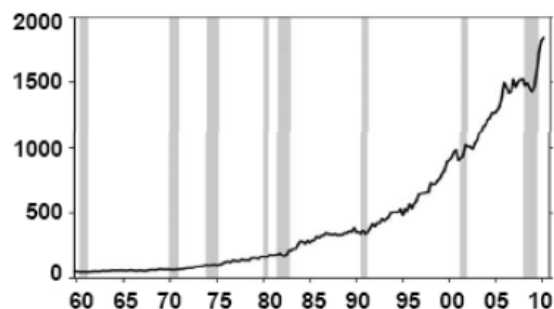
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more, there remains a staggering level of money not only in bonds, but also in CDs and money market funds, earning next to nothing. This heightened liquidity provides both a cushion under the market as well as pent up demand and buying power for equities; that is, with a relatively minor shift of these cash assets, stocks could rise powerfully.

Finally, another reason we remain bullish heading into the end of the year and into 2011 is the political environment. As we manage portfolios for both conservative and liberal organizations and individuals, let me say up front that this is not about my political leanings but about market realities.

In a speech I gave in Rochester back in August, I stated the main factor holding equities back was general lack of confidence. This could be seen by the intense hoarding of cash by both individuals and corporations. As you can see, corporate cash levels are almost off the charts!

Figure 2. U.S. Nonfinancial Corporate Liquid Assets (\$ Bn)



Source: ISI Group

With two major pieces of legislation passed in 2010, the healthcare and financial reform bills (whose implications are largely unknown), and a serious debate remaining on tax policy, many businesses are lacking the clarity necessary to make long-term investment decisions, be it hiring new employees, mergers and acquisitions, stock buy backs, dividend increases, etc. Given the poor returns on cash, we believe that equity investors will be very encouraged by two likely results from

the mid-term elections: more political gridlock and less hostility towards business. Keep in mind, after the 1994 mid-term elections, with a Democrat as President and Republicans holding the House and Senate, stocks soared for the next 5 years!

Indeed, I believe that some of the market's recent strength can be attributed to the anticipation of the Republican takeover of Congress and in the leveling out of the Senate's balance of power.

We acknowledge a troublesome macro economic environment, including subpar economic growth, high unemployment, and serious deficit

and debt issues. Another worry of ours is a protracted battle over tax policy between the two political parties, which could lead to erosion of confidence. As always, we will continue to manage your portfolio prudently and make adjustments as necessary. The fact is, however, the markets "climb a wall of worry" or, as Warren Buffet likes to say, "You

pay a high price for a cheery consensus." ***Our strategy with your portfolio is to continue to build and monitor a global portfolio with durable earnings and dividend streams, as well as solid representation in the fast growing emerging market economies.*** We are also actively researching companies who may benefit from greater Republican control, through less onerous regulation. Overall, the underlying earnings power of your portfolio is very strong and almost all of your companies get a significant portion of their revenues from international markets. We are confident that your portfolio is positioned for an above-average return with well below - average risk.

**"I believe that some of the market's recent strength can be attributed to the anticipation of the Republican takeover of Congress."**

Now on to your questions.

**Q. Do you believe dividend-paying companies can continue to lead the market higher as they did in the second quarter?**

A. I surely do! I think this goes back to the question of investing in bonds versus stocks. With such low interest rates, fixed income securities offer paltry yields. Many of the stocks in your portfolio pay as high or higher than a 10-year Treasury Bond, or even medium/long-term corporate notes. ***And, in a poor economic environment, many investors are seeking higher income over time, which high-quality companies provide by consistently receiving their dividend payouts.*** So yes, I believe dividend-paying stocks can and will lead the market higher.

Dividends are a major marker of quality in our investing approach. Probably 90% or more of the stocks in your portfolio pay dividends and most of them have a successful track record increasing their dividend payouts year in and year out. That does not mean, however, that we will not occasionally buy an emerging growth stock or turnaround situation where the company does not pay a dividend. An important part of our job is to constantly seek out companies with a powerful upside, and these may at times include non-dividend paying stocks. Overall, however, we are big fans of strong dividend-paying companies. And your portfolio clearly reflects that.

**Q. I've heard through the media about the Federal Reserve's "QE2 Plan." What the devil is QE2, and how will it affect my portfolio?**

A. QE2 stands for Quantitative Easing, and the 2 is added because the first round took place in the turmoil of the market meltdown of 2008. The Fed's plan is to

buy U.S. Treasury Bonds, thus increasing the money supply, and hopefully spurring economic growth. The amount of bonds currently being discussed is between \$500 billion and \$2 trillion. If the Federal Reserve were to buy \$2 trillion of bonds, the effect on GDP would be an increase of somewhere between .5 and 1%, according to various economists. It is unclear to most, however, how long this increase would be sustained, and by how much. The \$1.3 trillion of "QE1" had a desirable but not very long-lived effect as revealed by the current economic softness (although some argue the positive affects are still on-going). And QE1 took place when the economy was in a crisis, producing a much more dramatic effect than QE2 would now, as the economy is in a more stable condition.

As the Federal Reserve expands its balance sheet more, effectively printing more dollars, the value of the U.S. dollar will likely decline.

**"Overall we are big fans of strong dividend paying companies. And your portfolio clearly reflects that."**

This can be a positive for stocks in the short and medium term, as we have seen equities rally on a weaker dollar. This can also be stimulative for the U.S. economy, as our goods and services become cheaper to international consumers. However, over the longer term, I am not a believer in a "weak dollar" policy. Our concern is the real possibility for a significant increase in inflation over time that erodes the purchasing power of the U.S. consumer.

How then should one invest if the Federal Reserve wants to inflate its way out of our debt issues? Not to beat a dead horse but, again, you want to own assets that can appreciate (such as stocks, good real estate and commodities) and generally be wary of "fixed income" positions

that become less valuable as inflation rises. At J.W. Burns & Company, we have constructed a superb portfolio for you of global businesses who will in fact benefit from a falling dollar and higher inflation. ***While nothing is certain, we are very confident that the companies you own have the growth characteristics to prosper as the economy reflates, if you will.***

In short, we remain bullish on your stocks heading into the final quarter of 2010. We continue to structure your portfolio with high-quality global powerhouses with rising earnings and dividend streams. With robust liquidity levels throughout the economy, and less likely government interventions in the market place, the likelihood of a healthy yearend rally is good. We are also constructive on stocks going into 2011, as the third year of the presidential election cycle has historically been far and away the best one for equities. More on that in January.

In the meantime, as always, if you have any questions or concerns, please call us.

Thank you for your continued confidence.

Best wishes,



James C. Burns, CFA  
President

P.S. - As “Healthy Gridlock” is part of our title this quarter, I thought this excerpt was appropriate:

*“Similar to other economic recoveries, there is a great deal of anxiety and frustration with the pace of economic growth. This is especially true given the severity of the recent recession and the highest level of unemployment witnessed in many years. Although investors yearn for better times ahead, this is not an easy task given the incessant drumbeat of negative news that is now perva-*

*sive across all the 24-hours-per-day news networks.*

*In this environment, we believe it is essential that investors maintain a longer-term perspective, filtering out much of the negative noise. A closer look reveals many good things occurring, including strong and growing corporate earnings, solid balance sheets, and many catalysts on the horizon – the November elections, to name just one – that could well bring about much more constructive investor sentiment and higher stock prices.”*

*-Haverford Outlook, Autumn 2010*

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**J.W. BURNS & COMPANY, INC.**  
INVESTMENT COUNSEL

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