ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

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Economic Conditions & Market Outlook

While doing research for a New Year's story on economic trends for the upcoming year, a financial reporter recently asked me if 2011 would be the year in which 'recession' would finally be eclipsed by 'recovery' as the predominant term used by the media to describe the current economy. His query was on target and rather simply sums up the subtle but steady transition from negative to positive attitude observed since mid-2010.

As a whole, the economy will likely continue to demonstrate this incremental but fundamental improvement. While recovery from the recent recession has been anything but rapid, and certainly not robust an increasing number of economic indicators continue to move in the right direction. Key measures in manufacturing and consumer spending were trending positive as last year closed out; with even some of the stubbornly resistant labor market indicators appearing to be on the cusp of progress as the four-week moving average of initial unemployment claims fell in mid-December for the sixth consecutive week. This somewhat muted but nevertheless improving economic recovery is likely to be the norm for much of 2011.

The paced nature of this forward economic progress, as well as the lasting imprint of the malaise being left behind, will undoubtedly prompt lingering fears of a recessionary relapse whenever econometric measures appear less than conclusive. This 'push me, pull you' effect will likely tug at investor sentiment throughout the months ahead. In this environment, it is important to focus on macro movements in key measures as opposed to headline data bites that may or may not give a clear picture of the broader trends.

Case in point, the January 10th issue of Barron's contained the ominous sounding, bold-type title that *'Retail Sales Disappoint'*, with accompanying text lamenting that December's retail sales numbers rose at a 'lower-than-expected rate'. Yet, in the very same section of the previous week's Barron's was the highlighted title of *'Santatastic Sales'*, with the subsequent paragraph stating that year end U.S. retail sales had 'the best showing since 2005' for the period measured. And in the Barron's issue before that, authors of a column titled *'Revenge of the Consumer'* patted themselves on the back for predicting the surprising surge in retail sales that had outpaced more moderate estimates, forcing the National Retail Federation to up its holiday sales forecast.

So which set of apparently conflicting facts about year end U.S. retail sales are accurate? Essentially all are. Each makes use of a different comparative reference point. But each could also lead observers to draw varied and, very likely, erroneous conclusions if viewed in a vacuum. Such is always the case when evaluating financial information but it is even more important to critically focus on the 'sum' and not the 'parts' during periods of significant economic transition, a time when various data metrics are likely to be mixed and opinions flow freely as to whether the glass is half-empty or half-full.

Similarly, much is often made about the impact of 'market psychology' in moving security prices up or down based on the prevailing mindset of the investing masses. However, aside from a few high-profile sentiment indicators, there is comparably little regular discussion about the impact of what might be categorized as 'economic psychology'. There is indeed overlap between these two terms, and some might argue we are splitting hairs; but economic measures and information are often incorrectly imbued with the same sense of objectivity and gravitas typically reserved for scientific data. Such is not the case and we see the current propensity of assessing economic news in a somewhat more positive light being just as important a driver in propelling this recovery forward as the measure itself. While subtle, this shift in attitude is significant.

Some of this modification in mindset has occurred because several uncertainties which had negatively impacted business and market psyche throughout much of last year have been resolved. November's election results provided some clarity as to the political and policy landscape for 2011. Additionally, the U.S. Congress' last minute resolution of federal tax legislation finally clarified for individual taxpayers who will be owing what to whom…at least for now.

Additionally, Federal Reserve monetary policy continues to be accommodative to economic growth, if not downright stimulative in nature. And while higher interest rates and inflationary pressure may potentially be the result down the road when growth finally gets rolling, these issues are not likely to be problematic in the immediate future. Rightly or wrongly, the Federal Reserve has clearly sent the message that it is committed to do whatever is necessary for as long as it is necessary to kindle the embers of this nascent recovery.

'Nascent' may seem like an inappropriate word to use when describing a recovery that officially began in September 2009, when U.S. gross domestic product (GDP) again turned positive with 1.6% quarterly growth after languishing in negative numbers for quite some time. Since then, the U.S. economy has had four additional quarters of solid upward movement in GDP, with growth for fourth quarter 2010 forecast to range near 3.3% when the first estimate is released by the U.S. Dept. of Commerce's Bureau of Economic Analysis later in January. However, as many economists and social commentators have repeatedly observed, until recently it sure didn't 'feel' like things were getting better. That corner may finally have been turned.

Lest we be accused of having our perspective skewed like *The Doors* lyric that we've *'been down so long that it looks like up to me';* things are far from rosy in every part of the economy. Housing numbers continue to be weak and will remain so until the glut of inventory in key geographic areas is eventually sopped up. Net unemployment will also persist at stubbornly high levels for quite some time. Yet while analysts debate the cause behind this effect and monthly payroll number revisions are revised again, the fact remains that an ever-increasing number of new jobs are being added to the equation…some in places that may come as a surprise.

For example, data just released on January 19th shows that U.S. manufacturing jobs grew by 1.2%, or 136,000, in 2010. This is the first net growth in U.S. manufacturing sector jobs since 1997 and economists project this sector's jobs growth will likely increase again in 2011. With new jobs being created and less jobs being lost, the trend is clearly moving in the right direction. Our overall economic perspective can adequately be summed up by once again channeling Jim Morrison and suggesting that this is, *'no time to wallow in the mire.'* Baby.

The stock market has also been the beneficiary of an improving fundamental outlook for the economy and aided by the return of a greater level of risk acceptance. For 2010, the Dow Jones Industrial Average, Standard & Poor's 500, and NASDAQ indices had price gains of 11.02%, 12.78% and16.91% respectively, much of which came in the last quarter of the year. This momentum has continued into 2011, with major indices logging price appreciation of 1.81%, 2.83% and 3.86% respectively for the first two weeks of January. This upward trend in prices will not continue unabated, and a price correction will inevitably occur, but the ride continues for now.

Some of the equity price movement has been due to the increasingly attractive relative return offered by high-yielding, low PE (price to earnings ratio) stocks when compared to bonds or cash. Recognizing this, for the past several months our firm has been increasing overall portfolio equity exposure while correspondingly reducing fixed income portfolio weightings. A critical component of assessing relative return is weighing comparable risk. While we do not envision an imploding 'bubble' in bond prices that some have feared, it is very likely that any bond price premiums previously caused by investors fleeing risk will continue to erode from current levels. Fixed income mutual fund holders be forewarned; while bonds are indeed academically 'safer' than stocks, deflating bond prices will negatively impact bond fund values just the same. Bond funds do not offer investors the assurance of a bond's value being returned at maturity the way individual issues do.

As noted in the previous *Investment Update*, many companies reported both steadily improving bottom line earnings and top line growth throughout the last few quarters of 2010. This has been another impetus driving stock prices higher and will likely continue to be so. However, it will become increasingly difficult for companies to post significant upside earnings surprises as the prior quarters to which new profits are compared return to more normal, post-recession levels. New reports of corporate earnings for year end 2010 have just begun to be released and early indications are this earnings improvement trend will continue.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding upside value to client portfolios while also controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and ongoing evaluation of portfolio return relative to various risk measures.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used across most portfolio managed are outlined below:

• The overall ***target level*** for managed portfolio allocations is currently at ***one-step below maximum equity*** based on each client's individual investment policy range. After letting the previous targeted allocation level appreciate upward from ***mid point*** for several months, the formal move to the current target level occurred in December 2010. As noted in the commentary, the ***relative risk/return*** potential in equities is presently ***more attractive*** than either bonds or cash.

Some of this is due to the ***higher dividend yields*** available in many quality equities relative to very low money market and modest intermediate-term bond interest rates. Higher relative ***appreciation potential*** in equities is also a significant motivator in the change in target asset allocation. The firm's bias is to next move the target allocation again upward to ***maximum*** equity due to these positive factors, as well as the lackluster opportunities that are currently available in the fixed income asset space. ***Portfolio rebalancing*** methodologies continue to be used to add both short and long term portfolio value.

• Portfolio composition has been consistently modified to ***capture opportunity and reduce risk***. ***Profits were taken*** in several equity and fund holdings toward the end of 2010 and early January due to ***notable appreciation.*** Positions were ***rebalanced to target*** if additional appreciation was suspected but eliminated if full appreciation was attained or risk versus return potential had deteriorated. Continual vetting of all holdings is part of the firm's ongoing management and portfolio review process.

As always, overall portfolio ***diversification is a priority*** but unique opportunities in specific sectors continue to be utilized to ***capture near term appreciation.*** Equity exposure currently remains close to benchmark weightings for most balanced and growth portfolios but a slight ***overconcentration*** continues in the ***Industrial/Materials and Energy*** sectors. Sector weightings in ***Telecom*** have been ***raised*** and ***Utilities*** sector exposure has been ***reduced***. Select holdings in the ***Financials*** sector that were average to poor performers in 2010 may offer attractive opportunities in 2011 and are positioned accordingly.

The firm's higher-than-typical ***mid-cap equity exposure*** enhanced returns in latter 2010 and currently remains ***above norm.*** Dedicated ***foreign equity*** exposure is ***underweighted,*** with the firm's participation in international markets coming primarily via our concentration in select ***large, multi-national companies*** that offer superior comparative returns relative to purely foreign alternatives.

• Ultra-short-term fixed income investments continue to be maintained at ***significantly below target levels*** due to the very low yields available. The ***average duration*** of bond portfolios remains relatively ***short to intermediate,*** with slightly ***longer maturities*** used for select individual issues if both ***yield and quality*** appeal.

In late 2010, several bond positions that had ***extraordinary price appreciation*** were sold to lock in ***notable gains*** as opposed to letting them drift back to face value as they mature. Other than those unique opportunities, the firm's fixed income emphasis remains on enhancing portfolio cash flow and net yield.

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