SLOCUM, GORDON & CO. LLP
INVESTMENT MANAGEMENT AND COUNSEL

VIEWPOINTS

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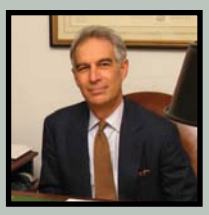
This Economic Commentary is designed to present the Firm's current views on timely topics that we feel may be of interest to our clients. *Viewpoints* is also available electronically on our website:slocumgordon.com.

JOHN J. SLOCUM JR.



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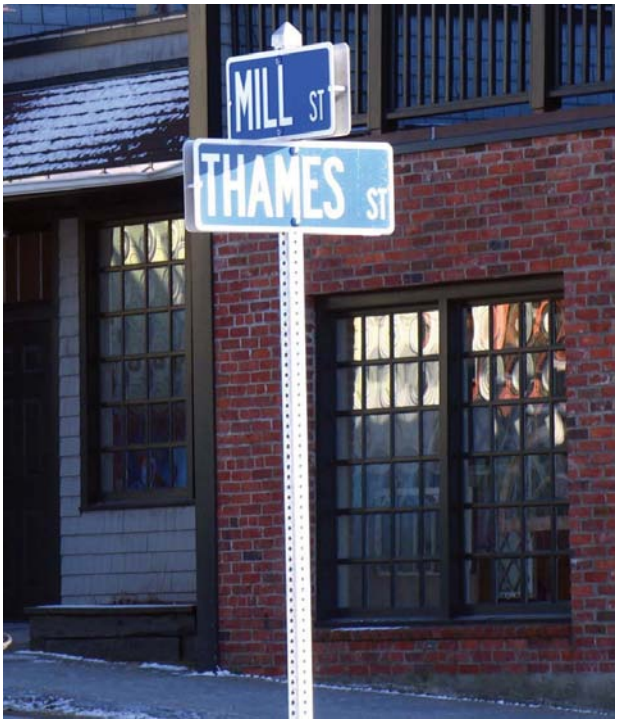
Just when it appeared that the global economic picture was slowly clawing its way back to some semblance of normalcy in this otherwise chaotic world, a bolt out of the blue strikes to humble even the most optimistic forecaster. A natural disaster the likes of which we have seen unfold in Japan is almost too much to comprehend on the television screen. Clearly, the human suffering and economic cost seem overwhelming at this moment. Furthermore, when there is such a paucity of good information as was the case with the damaged Fukushima Dai-Ichi nuclear power plant, global markets react very quickly. "Black swan" events like this, by their very definition, are only meant to occur extremely rarely, but it would appear that their frequency has increased lately.

Compounding this tragic event, of course, is the on-going problem of the Middle East. Concurrent unsettling news stories from Libya, Egypt, Bahrain, and fears of unrest in the major oil-producing Saudi Arabia, have served to add further disruption to the already tight commodity markets. And, as if this were not enough, continuing issues of countries, states, and municipalities dealing with potential bankruptcy might ordinarily send the sternest of us packing for shelter.

So why is the stock market basically still holding its own, and why are we continuing to position our clients' portfolios with a balanced exposure to equities? Over the past few months, evidence has begun to build, however slowly, that a modest recovery in earnings is taking shape, that companies are flush with cash and are increasing dividends, and that the healing

in the financial system is moving forward. The stock market has had a great run over the last year or more and a correction was certainly not unexpected. In fact, that process had already begun long before the current disturbing events in Japan occurred; the market volatility was simply magnified by the news. Nascent indicators of positive economic growth are obscured by the headline information about persistent unemployment, rising oil prices, tenuous real estate stability, and the financial chaos of government finances at all levels. However, the motivation for investors must be the future, not the present, and certainly not the past.

Once the emotional reaction evolves into a more practical analysis of the necessary steps its recovery, the devastation in Japan will present a very powerful natural stimulus to global economic activity. Japan will need to rebuild on a large scale, which implies a major increase in demand for resources. Unemployment is high enough in Japan that increased hiring should help Japanese growth. Japan will need to increase imports for raw materials, like steel and concrete, to rebuild their infrastructure. Where indigenous manufacturing of necessary equipment, like cranes and bulldozers, is delayed by their own production bottlenecks, U.S. suppliers should benefit from increased exports to Japan. U.S. firms may also experience increased sales of LNG to Japan to replace lost nuclear-based output. The picture will take time to come together, but it is certain that Japan will rebuild with an intensity not likely seen in other parts of the world.



Perhaps the single largest effect in the United States right now may be the psychological impact on consumer spending. While this is a natural reaction to global uncertainties, it typically has a short-term lifespan until clarity reinforces confidence that job prospects and income will not be disturbed. Consequently, slower growth in the U.S. in the next few months would not be unexpected.

As to our investment strategy, we continue to focus our attention on companies that have a strong history of dividend payments as part of their corporate mission. Evidence is mounting that managements are again committing to sharing profits with stockholders in line with more historic norms. As the table below indicates, dividends have accounted for over 40% of total return since 1930.

S&P 500 Total Return: Price and Dividend Contribution

	Total Return	Price Appreciation	Income Return	As a Share of Total Return: Price App.	As a Share of Total Return: Div. Income
1930's	0.1%	(5.3%)	5.7%	na	na
1940's	8.9%	3.0%	5.7%	33.6%	64.5%
1950's	18.9%	13.6%	4.7%	72.0%	24.7%
1960's	7.7%	4.4%	3.1%	57.2%	41.0%
1970's	5.8%	1.6%	4.1%	27.8%	71.1%
1980's	17.2%	12.6%	4.1%	73.2%	23.8%
1990's	18.0%	15.3%	2.3%	85.1%	12.9%
2000's	(0.9%)	(2.7%)	1.8%	na	na
2010	11.8%	10.3%	1.3%	87.7%	11.1%
2003-2010	6.3%	4.3%	1.9%	68.1%	30.6%
1930-2010	9.2%	5.1%	3.9%	55.5%	42.3%

Source: Ibbotson, Robert Shiller, Factset, Morgan Stanley Research

Therefore, assuming a certain amount of risk is both necessary and unavoidable in a balanced investment portfolio, the key is to manage the level of risk in a prudent manner. Traditional investment theory suggests that a properly balanced portfolio is one that is designed to protect both principal and purchasing power. With current bond interest rates so low, holding low yielding bonds to maturity may protect nominal principle, but not purchasing power.

In our opinion, high-quality, large capitalization, dividend paying companies represent an asset class that has been widely overlooked for years and appears to provide extraordinary value right now.

We have always encouraged our clients to maintain realistic expectations of how invested assets could and should perform over time. A meeting of the minds of personal requirements,

relative comfort with various forms of risk, and an understanding of historic trends of returns, all factor into a coherent investment strategy. When it appears that valuation of certain assets is particularly attractive, it can defy the suggestion that higher returns can only be achieved by taking higher risk. In fact, a relatively low valuation (implying lower risk) actually can increase future return potential. That strategy would support our singular goal to achieve a higher return with a lower risk profile over time. We believe that opportunities can appear in this market environment as long as patience is added as a necessary element of investment success.

The investment roadblocks are not insubstantial. We have enumerated them in past commentaries, and certainly current events in Japan and the Middle East compound an already difficult environment for investors. With such a traumatic financial shock as the world has recently encountered, it will simply take time to work through all the excesses and the problems they created on a global scale. So, as is our fiduciary responsibility, we continue to take cautious steps in the management of our clients' portfolios.