CAPITAL INVESTMENT *Advisors, Inc.*

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11 for 2011

The CIA Investment Committee

As we head into each New Year, the CIA Investment Committee takes time to identify the most useful piece of advice from the past 12 months. This year's winner comes in the form of a *reminder* from John Bogle, founder of The Vanguard mutual funds. Bogle points out that the stock market produces *nothing*. It is simply a reflection of how *businesses* in America perform over time. How have they performed over time? Well, earnings growth has averaged a very stable 6%, while dividends have averaged about 3%. Put the two together, and you arrive at a *long term* average rate of return in the 9% range.

Will this 100 year trend *change* in the coming decade? Have we established a "*new normal*" of dramatically lowered expectations and returns? **We don't think so.** We believe the cornerstones of America's long term economic success -- innovation, hard work and an entrepreneurial spirit – are still solidly in place. So we expect a continued growth rate in the US economy of at least 5% (slightly lower than the long term average) which will directly translate into corporate earnings. Couple that with a 2-3% dividend yield and we could see an overall 7-8 % average return for markets in the decade ahead. Yes, it's that simple.

But what about the near-term – 2011? Here are ***11 important themes*** that the CIA Investment Committee is watching in the coming year:

1. **The Stock Market** – Look for continued strength into the latter part of 2011, then the potential for a correction late in the year and into early 2012. We expect to see markets finish up in the high single digits for the year. But by the middle of 2011, the cyclical bull market that we are currently experiencing will be 9 quarters old. Of the 34 cyclical bull markets since 1900, only 10 have lasted longer than 9 quarters. Regardless of the timing, long term investors should *press on regardless*.

2. **Bonds and Interest Rates** – Interest rates could easily rise to a 4%+ yield on the 10 Year Treasury. This means bond holders and *income investors* should follow this strategy: ***Keep your bond maturities LOW and your stock dividends HIGH***. Floating rate bonds should continue to offer a hedge against rising rates. Also, despite the recent noise in the municipal bond market, most state and local governments are in

solid financial shape – hence, the municipal bond market should remain on solid footing.

3. **Inflation** – Commodity prices have been soaring. At the end of 2010, silver prices were up 78.6%, gold: 27.2%, palladium: 95.5%, copper: 31.3%, tin: 57.5%, aluminum alloy: 18.8%, nickel: 28.9%, lumber: 48%, corn: 48.6%, coffee: 73.8%, cotton: 88.9%, and oil just broke $90. This trend might translate into inflation during 2011.

4. **The Economy** – We are nearly two years into what has been a *moderate* economic recovery. GDP (total output for the US economy) has grown now for five and soon to be six consecutive quarters. With Washington finally making a decision to keep taxes low, and 9 out of 10 leading indicators (manufacturing, jobless claims, money supply, et cetera) pointed higher, we could see 4%+ real GDP growth for the US.

5. **Jobs –** Jobless claims continued to trend lower in 2010. While *more tha*n 15 million people are still unemployed in the US, we did add nearly *one million* jobs in 2010. As GDP grows in 2011, that trend will continue. Companies are now in very good financial shape and have squeezed nearly every ounce of productivity out of their current workforces. Eventually something has to give. Worker productivity can not *continue* to rise at a torrid pace forever; and business owners will soon have to start hiring in order to expand. Couple that with lower tax rates for small business owners and an increase in business confidence – and we should see the unemployment rate drop below 9%.

6. **Housing** – This sector will experience continued pain. Despite considerable fluctuations, we expect home prices to remain flat year-over-year. Mortgage rates will continue to tick up if the 10-year-Treasury yield hits 4%. But, the cost of borrowing will still remain at *relatively* low historical rates. This will help home builders and sellers; but it is hard to see prices rising given the continued high level of housing inventory.

7. **Sectors** – If our inflation and economic calls are correct… and Congress stays more *balanced…* the energy sector should have a strong year. From a dividend perspective, utilities could also do well as a Republican Congress squashes 'cap and trade'. Also, there are *95 million* baby boomers on the verge of retirement seeking the kind of yield available with utility stocks. If financials are able to continue raising dividends, this sector might also benefit from the hunt for yield.

8. **Small vs. Large** – In 2010 small and mid cap stocks had returns nearly double those of the very large companies that make up the Dow Jones Industrial Average. In 2011 that trend could reverse; and high quality, Large-Cap *dividend paying* stocks could out pace smaller, non-dividend paying stocks.

9. **Banks Raise Dividends –** Big banks and financial companies *used* to be a solid bet for retirees seeking dividend yield. The financial crisis changed that. We already see banks *starting* to restore their pre-crisis dividend yields, but they still have a long way to go. This dividend restoration should continue for the financial sector.

10. **Asset Allocation –** Spreading your investments across markets and investment types will continue to provide protection for your nest egg. At CIA, we call this the "bucket approach" to investing. Placing your money in a combination of Cash, Income, Growth, and Alternative Income *BUCKETS* can smooth out your overall portfolio volatility in those inevitable times of market stress.

11. **Income Investing** – This strategy will continue to play a huge role in total return. Income comes from three places: dividends from stocks, interest from bonds, and distributions from alternative investments like MLP stocks, Closed End Funds, and Energy Royalty Trusts. Put them all together, and they add up to your ***portfolio yield***. Unlike the *stock market,* your *portfolio yield* is highly predictable from year to year.

Much of the above makes sense even if interest rates *don't* go through the roof; **and** even if the economy doesn't perform as well as we think it will. Fundamentals like Asset Allocation, owning high quality dividend paying stocks, investing for income/yield, and hedging against inflation should always make it into the playbook for long term investors looking to capture the "simple" 5% growth and 2-3% dividend that we expect over time.

We look forward to a happy and healthy 2011, and wish you and your family the same.

-The CIA Investment Committee

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