TW ADVISORS

Hold on to Quality

The true bright spot in this economic recovery has been extremely strong corporate profits, and the analyst community has high expectations for 2011 penciling in earnings of $95 for the S&P 500. If these earnings are accurate and sustainable, stocks are a bargain at only 12.6x earnings. Many commentators are arguing that earnings will steadily climb from these levels over the next few years, meaning we are in the early stages of a bull market.

However, we have our doubts that the stock market will provide such smooth sailing. At some point the massive fiscal and monetary stimulus will have to reverse. Our bet is this transition will not be smooth and the hoped for self-sustaining recovery will prove elusive. Moreover, longer-term valuation measures are not so comforting. Our favorite measure is the cyclically adjusted price-earnings ratio (CAPE) which was developed by Yale professor Richard Shiller. In short, this valuation tool looks at earnings over a complete economic cycle. The current reading of just under 24 is 40% above the long-term average. See the chart : http://www.econ.yale.edu/~shiller/data/ie_data.xls

But valuation is not a very good timing tool so its warning signal could be flashing for awhile. Given our long-term concerns with overall valuation and rising financial risks we normally would have more cash equivalents in the portfolio. However, many high-quality stocks are still attractively valued and momentum for the stock market is powerful. When a correction does occur our stocks should hold up relatively well, plus we have some cash to take advantage of lower prices. Nevertheless, as long as the market prefers risky stocks, quality may lag.

One sentiment measure that says the market is "near-term" overvalued is one that measures the number of stocks in the (S&P500) index that are near their 200 day price moving average. As you can see from the chart below the number of stocks, as a percentage of all stocks in the S&P500 index, presently that are above their 200 day moving average is very high and at the level the market normally corrects itself as it has in the past.

What Other Advisors Are Saying

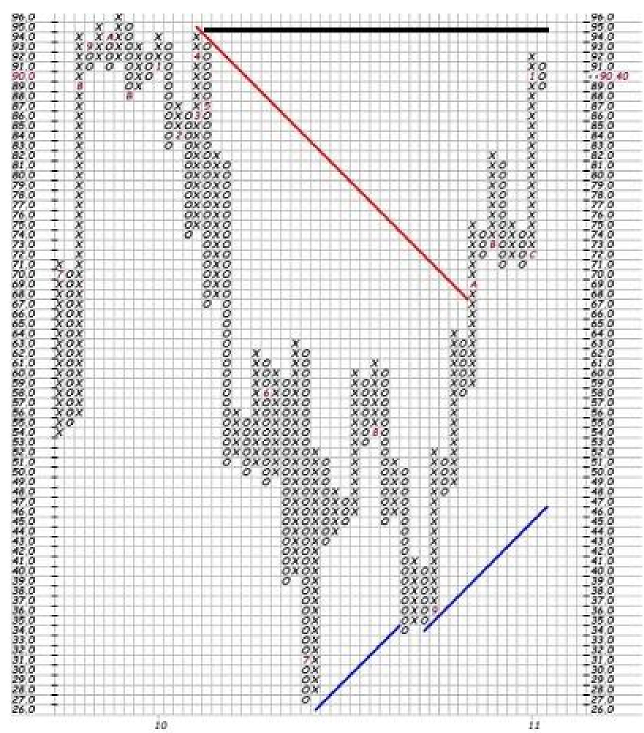
GMO Quarterly Letter January 2011 -Jeremy Grantham

- Be prepared for a strong market and continued outperformance of everything risky.
- But be aware that you are living on borrowed time as a bull; on our data, the market is worth about 910 on the S&P 500, substantially less than current levels, and most risky components are even more overpriced.
- The speed with which you should pull back from the market as it advances into dangerously overpriced territory this year is more of an art than a science, but by October 1 you should probably be thinking much more conservatively.
- As before, in our opinion, U.S. quality stocks are the least overpriced equities.

Market Climate January 31, 2011 -John P. Hussman, Ph.D. www.hussmanfunds.com

- As of last week, the Market Climate for stocks remained characterized by an overvalued, overbought, overbullish, rising-yields syndrome that has historically been quite hostile for stocks, but with what I've called "unpleasant skew" - a seemingly relentless series of slight, marginal new highs, typically followed by an abrupt vertical plunge that wipes out weeks or months of progress in a few sessions. Our long-term shareholders have seen this before, and have seen how it ends, but in the meantime - it is what it is. The present instance has been compounded by some "basis risk" in that the strongest stocks have been speculative, richly-valued, highly leveraged and cyclical companies that we tend to avoid in any event.

S&P 500 - Percent of Stocks Above 200 Day Moving Average



We appreciate your comments and would be glad to answer any questions you may have.

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