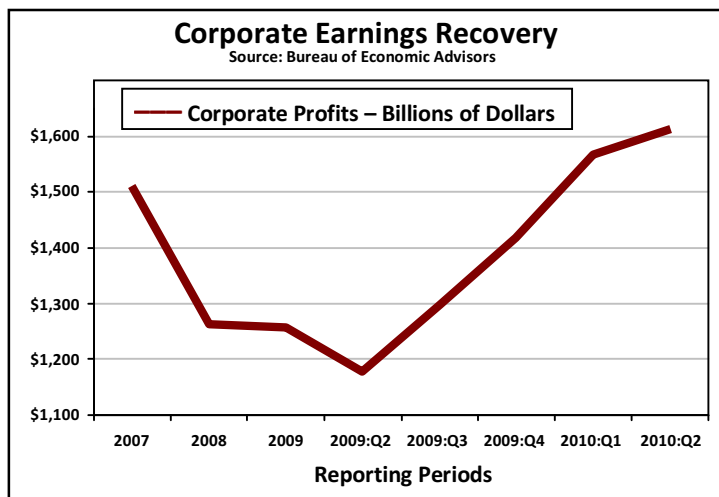


Should You “Elect” to Buy Stocks Now?

The stock market rebounded nicely to post solid double-digit gains in the third quarter. All capitalization sizes did well in the quarter but there was a clear preference for growth stocks over value stocks and most international indices performed better than domestic shares. The S&P 500 charged ahead by 11.29%. We are very pleased with our returns which were slightly below the index. Much has been written about how volatile the stock market has been this year yet has posted only modest year-to-date gains. As is our goal, our portfolios have experienced much less volatility and are near or above benchmark returns for the year. From the peak to trough the S&P 500 declined by 17% while our average portfolio only declined by around 10%. Our clients have experienced a gentler ride in 2010, a practice we hope to continue.

In last quarter’s letter we highlighted our more optimistic outlook. Due to the combination of extreme negativity (typically a bullish condition) and attractive prices it appeared downside risk was limited despite significant headwinds for the economy. Important research by Carmen Reinhart and Kenneth Rogoff suggest anemic growth with sustained high unemployment is par for the course in post financial crisis recoveries. We expect both conditions to exist in the U.S. economy. The housing bust still casts a shadow. Bank credit is scarce. Households are saving to work off excess debts, and businesses are cautious about investing. However, equities can do well in this hostile environment, if prices remain attractive and earnings don’t stumble. Stocks typically look beyond the current activity in the economy so sustainable earnings are key going forward.

The silver lining to the economy is the impressive rebound in corporate profits. **According to Federal Reserve data, earnings both in absolute terms and as a proportion of GDP are back within a whisker of the all-time highs achieved before the downturn in late 2008 (below).**

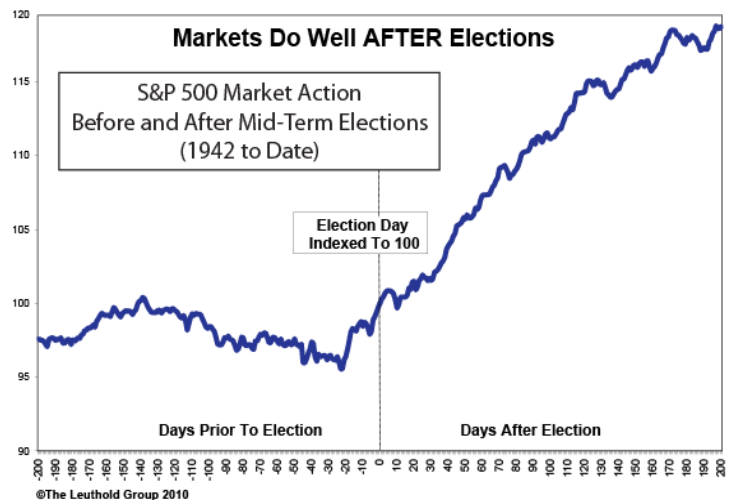


This strong performance reflects the substantial amount of business that is done overseas and the relative strength of foreign economies. Global industrial production is at record high levels, according to the Dutch Statistics Bureau.

International Monetary Fund raised its 2010 global growth estimate to 4.6%. Emerging markets – China, India, Latin America, and even Africa – look strong. The euro-zone economy grew at its fastest pace in four years in the second quarter, driven by an unexpectedly strong surge in Germany. Sweden, Norway, Australia and Canada add to the list of healthy economies. High cash levels in corporate America and a marked uptick in mergers and acquisitions add to reasons to be positive.

Best of all, prices for Blue Chip stocks remain at bargain levels. The average investor is still running to the safety of Treasuries, most likely yet another case of performance chasing which almost always ends in tears. Roughly 70% of our holdings yield more than the 10 year Treasury and offer significantly more appreciation potential over the long term.

Investors have been worried about the mid-term elections even though history is on the side of the bulls. **In the 17 midterm elections since 1942, the stock market over the next 200 days has gone up 100% of the time, with an average gain of 18.3% (see chart below).** Best of all, there is little difference in performance when midterm elections result in change in the Congressional majority rather than preserving the status quo.



Overall, we are maintaining our strategy of emphasizing steady-growth businesses, with strong balance sheets, healthy dividends and exposure to emerging economies. Volatility will likely still be an issue for investors, and we will continue to manage the portfolios to minimize as much of it as we can. While the long-term issues discussed above concern us, Blue Chips stocks are attractively priced and should overcome any macro headwinds. The imbalance in yields favoring blue chip stocks should eventually lure the investor out of low yielding fixed income.

Steve Wenstrup, Jim Tillar, CFA

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