Lowe, Brockenbrough & Co., Inc.

INVESTMENT COUNSEL

Managing Investments for Individuals & Institutions Since 1970

2009 Fourth Quarter Commentary

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The Financial Markets

- Following a seventeen month bear market that bottomed in March of 2009, equity markets rebounded strongly the remainder of the year, retracing half of the previous decline. For the year, the S&P 500 returned 26.5%, including a 6.0% return in the fourth quarter. Recovery gains were led by cyclical and riskier stocks that had been pummeled in 2008 and the first quarter of 2009. Fundamental earnings growth and valuation strategies, which have worked well over the longer term, were over-run by the risk trade. Towards the end of the year, the equity rally began to slowly broaden, with better quality companies, as defined by those with more stable earnings patterns, showing greater participation.

- For the quarter, the Technology and Consumer Discretionary sectors provided the strongest returns, followed by the Healthcare sector, which received a boost once the prospects for a government-controlled healthcare option faded. The Financial sector generated the only negative return during the quarter. For the entire year, the Technology and Consumer Discretionary sectors were joined by the Materials sector as the best performers, while the more defensive Telecom, Utility, Consumer Staples and Energy sectors lagged the most.

- International markets experienced their strongest recovery in a decade as worldwide government stimulus programs injected liquidity into the system. For the year, the MSCI EAFE Index returned 32.2% and the MSCI Emerging Market Index was up 78.3%. This followed declines for the EAFE and the Emerging Market Index in 2008 of 43.1% and 53.5%, respectively. Returns for the fourth quarter were positive as well, with the EAFE Index up 2.3%, and the Emerging Market Index rising 8.6%.

- The Federal Reserve reiterated its pledge to keep short rates low for an extended period, though bond investors continued to focus on when the central bank will start removing the massive monetary stimulus that stabilized the financial system.

- Treasury bond yields moved higher at quarter-end, and the yield curve steepened as it became more evident that the economy has entered a recovery. The yield on the 2-year Treasury Note rose to 1.13%, while the 10-year yield climbed over a half of one per cent to 3.84%. Following the flight to the safety in 2008 that caused yields to plunge, U.S. Treasuries produced negative returns in 2009, particularly in the longer maturities.

- Corporate bonds capped an extraordinary year with further narrowing of yield spreads in the fourth quarter. Investment grade corporate bonds produced outsized returns in 2009, as the Merrill Lynch Corporate Bond Index saw yield spreads tighten by more than 4.00% during the year. High yield bonds also benefited from renewed enthusiasm for riskier assets, with the Merrill Lynch High Yield Index spread tightening by nearly 12.00%.

- The municipal bond market generally saw yields move higher in the fourth quarter from the stretched valuations that existed at the end of September. The short end of the market quickly recovered from the October sell-off, attracting money from yield-starved money market investors. Long maturities benefited from the issuance of taxable Build America Bonds that diminishes supply of long tax-exempt paper. Lower quality credits and long maturities enjoyed the greatest price gains in 2009, a reversal of the risk avoidance that characterized 2008.

The Economy

- The economic recovery has begun with the economy expanding at 2.2% in the third quarter of 2009. Economists are looking for an increase of 3.0% or more for the fourth quarter. Leading indicators in November surprised on the positive side, and have now risen for eight consecutive months. Exports grew for the sixth consecutive month, helped by the drop in the value of the dollar. Retail sales rose 2.8% in December, a slight improvement over the 2008 holiday season that was the worst in 40 years. Federal and state governments continue to struggle with lower tax revenues, higher demand for services, new Federal programs and an explosion in outstanding debt.

- Record unemployment persists, though some companies have indicated they would be re-hiring workers in 2010 assuming new orders continue to materialize. In the last week of December, initial jobless claims fell 22,000 from the previous week, the lowest level since July, 2008. This was followed the first week of January by the December employment report, which showed an unexpected loss of 85,000 jobs. These readings are notoriously volatile, but the persistence of caution in hiring sets the stage for muted jobs growth moving forward.

- Factory orders jumped twice as much as expected in November, with increases in a broad array of products led by electronics, computers, capital goods (ex-aircraft and defense) and durable goods. Inventories rose slightly but still showed the lowest inventory/sales ratio since September of 2008. The December ISM factory index rose to 55.9, indicating the fastest expansion since April, 2006.

- The ISM Index for the service industries grew slightly in December. Consumers have changed their spending habits and are now more conservative. Household borrowing, which has grown steadily for many years, is now contracting.

- Sales of existing homes in November rose to a 6.54 million annual rate, the best level in almost three years. Many of the home sales are at the lower end, helped by the first time home buyer tax credit. Home prices continue to languish due to unemployment fears, foreclosures, and lack of credit availability. The overall market remains lethargic, but signs of stabilization are beginning to appear in some regions.

- Worldwide strength has been evident in most major markets except Japan, which is still struggling with deflation. Chinese industrial production was up almost 20% in November, with Indian production ramping to over 10% growth. Over the last two years, China has surpassed both the U.S and Germany to become the world's largest merchandise exporter. Chinese domestic consumption was up over 16% last month, though The Peoples Bank of China has recently moved to increase a key interest rate, saying "growth is no longer its only goal." European manufacturing grew last month at the fastest rate in 21 months, driven by global stimulus. Export economies such as Germany and Sweden that were hit hard during the downturn are seeing big rebounds entering 2010. Spain and Ireland, the hardest hit by the financial crisis and plummeting property values, are recovering at a slower pace. Asia Pacific, Brazil and Canada are now recovering quicker than other major Western economies.

Future Prospects and Portfolio Strategy

- The economic recovery will likely remain sluggish, with high unemployment persisting throughout 2010. Inventory rebuilding should be positive overall, offset by the likelihood the Federal Reserve will begin withdrawing liquidity from the system. Consumer spending is expected to be modest.

- Earnings growth estimates for 2010 show a strong bounce back from 2009. Currently, consensus S&P 500 estimates on earnings per share from continuing operations for 2010 are at $74.24, a 27.0% increase from the $58.57 mean estimate for 2009. Revision trends for 2010 earnings have moved strongly upward in the last few months, primarily due to greater optimism compared to "gloom and doom" forecasts made earlier in 2009. These upward trends in revisions have been a driver of stocks prices and sentiment.

- We expect the focus to return to fundamentals and valuation from the cyclical strategies and the higher beta stocks that have driven the market recovery since March. As the cycle matures, investors typically gravitate toward stocks with more consistent earnings and dividend growth and with higher quality balance sheets. These types of stocks have lagged during the rally, and now sell at attractive relative valuations. In this slower growth, low inflation atmosphere, stocks with more consistent growth should achieve higher relative valuations and perform well.

- As financial markets have stabilized, all eyes are on central banks for signals of reversing the extraordinary degree of monetary stimulus. Historically, the Federal Reserve has not started to raise rates until the unemployment rate begins to fall. Heavy borrowing by the federal government could also cause longer term rates to move higher in order to continue to attract buyers, including foreign central banks that have become sizable holders of U.S. debt. Inflation is not expected to be a near-term threat due to considerable slack in resource utilization, which should keep a lid on rising prices. At this point in the interest rate cycle, caution on interest rate risk is warranted. Corporate bonds should outperform Treasuries, but credit spreads have already normalized for many segments of the corporate market.

- The Federal Reserve is nearing completion of its program to purchase $1.25 trillion of mortgage-backed securities which has supported prices and narrowed yield spreads to record lows. There is concern that mortgage loan rates could turn higher when the Fed stops buying. If the economic recovery falters, the Fed may respond by resuming its asset purchases.

- Low absolute yields and deteriorating state budgets could dim the prospects for municipal bonds, especially following the strong returns of 2009. Investors should consider taxable instruments such as CDs or corporate bonds in the shortest maturities while extending to longer maturities in high grade tax-exempt bonds where relative value is more attractive. When short rates eventually start to rise, look for the yield curve to flatten, with resilient demand for long maturities. Municipal credit quality will lag the economic recovery as state and local governments face another year of painful revenue shortfalls.

In a remarkable turn of events, markets today are focused on charting the shape of the global recovery, when just 12 months ago concerns were fixated on stopping the second Great Depression. Massive global fiscal and monetary stimulus measures appear to have achieved their objective of an economic recovery. There remain many potential growth impediments, including extraordinary budget deficits and the eventual removal of monetary stimulus. Still, it appears the cyclical forces already in motion will sustain economic growth in 2010, particularly during the first half of the year. While we believe there is too much economic slack globally to create meaningful inflationary pressures, we do expect interest rates to migrate higher over the course of the year. In this environment, equities will likely outperform fixed income. However, we expect more volatility than equities have experienced since the March lows, with more muted returns going forward than equity markets delivered in 2009. At current levels, we believe equity prices are now near the middle of a broader trading range in which they will remain for the balance of the year. Given the higher valuation levels of riskier assets, we do not see a repeat in 2010 of the phenomenal outperformance that they delivered last year.

Recent data trends suggest decent economic growth for the last quarter of 2009, with continued growth likely during the first half of 2010. Inventory levels relative to sales are back near the low levels set before the recession hit. Early in the year, production will need to be ramped up to rebuild these depleted inventories and meet final demand. Deferred capital spending is also likely to lead to an increase in enterprise spending. How these trends affect hiring and final demand will determine whether or not this becomes a more self-sustaining economic recovery. Even so, excluding the possibility of rising commodity prices, inflation is likely to be contained in 2010 as unemployment declines slowly and the economic output gap between actual growth and potential growth remains elevated.

One of the biggest surprises throughout the downturn is how well domestic corporate earnings have held up. Unprecedented cuts in SG&A costs (down 9% year over year through the third quarter) have enabled profit margins to hold up better than in other recent downturns, despite severe economic conditions (charts 1 & 2 below).

Chart 1

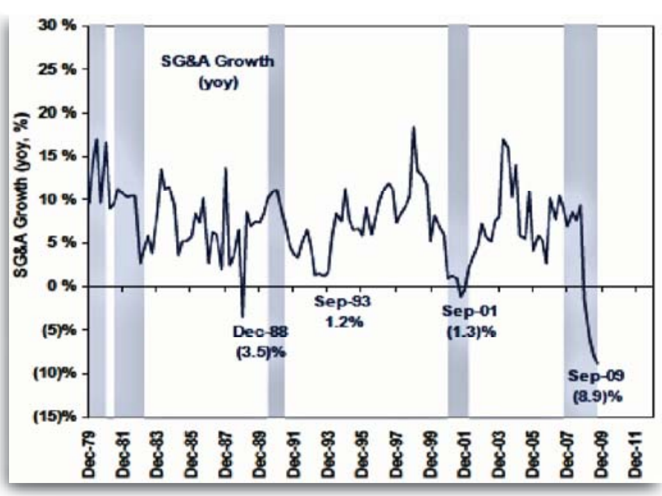
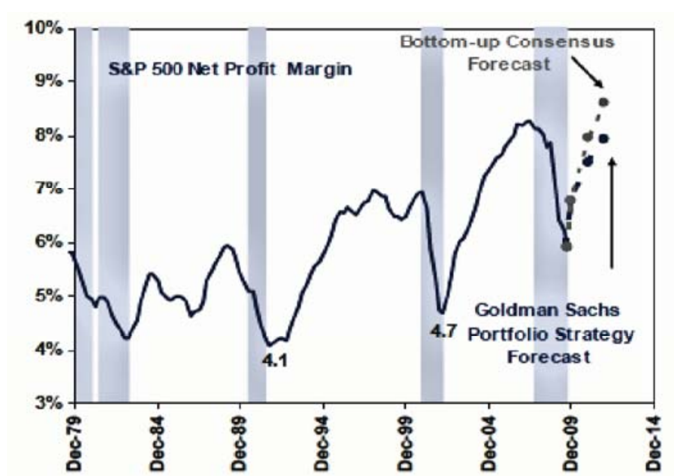
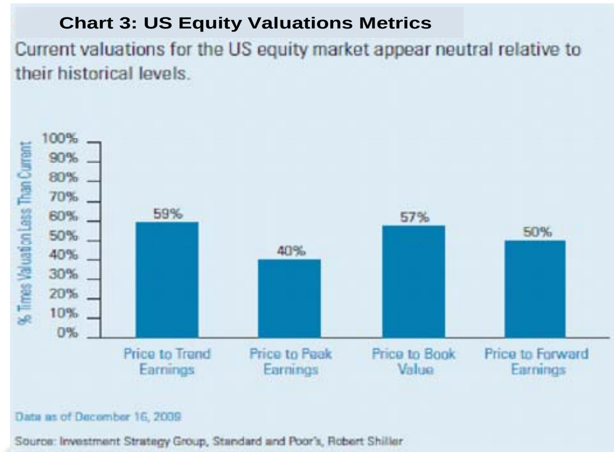


Chart 2



Source: Compustat, FirstCall, I/B/E/S and Goldman Sachs Global ECS Research

As a result, small revenue increases are likely to foster meaningful earnings growth over the next year. Earnings growth will likely be a critical component of equity returns going forward, as valuations for US stocks reside around the middle of their historic postwar ranges (chart 3 right).

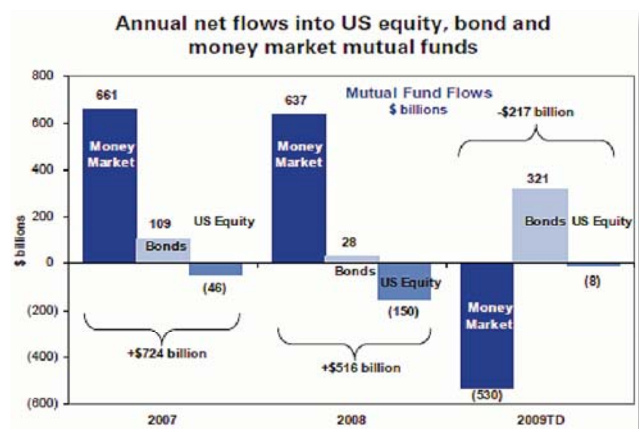


European stocks still trade at a modest discount to more recent averages. Emerging markets, on the other hand, trade at a premium to developed markets compared to the more traditional discount as investors reward the faster economic growth in emerging economies. We still believe diversified exposure across developed and emerging markets is warranted in today's environment.

Unless interest rates rise more than we anticipate, equities should be able to tolerate somewhat higher rates. Free cash flow yields on equities trade on par with yields on corporate bonds, traditionally a level that favors stronger equity performance. Our rate outlook also warrants continued exposure to spread-oriented fixed income instruments (i.e., investment grade corporate bonds) and shorter durations.

We do have some shorter term concerns about investors' recent optimistic view of the equity markets. The percentage of investors that are bullish has moved back to levels not seen since 2007. However, from an intermediate to longer term perspective, sentiment does not seem overly optimistic.

One of the more striking features of this rally has been the notable lack of participation by individual investors. Despite the equity market move in 2009, there were net outflows from US-oriented mutual funds and ETFs (chart 4 right). Ownership of equities by various constituencies is also below long term averages. Typically, levels of significant equity market risk are marked by greater equity ownership and significant inflows into mutual funds.



Source: Haver Analytics, Bloomberg and Goldman Sachs ECS Global Research

Last year, we learned that low rates and generous liquidity are, if anything, more powerful than we thought. That said, the majority of the valuation expansion phase for equities is likely over, and further price appreciation will be dependent on earnings growth. Historically, the largest price gains and the majority of market multiple expansions take place in the year that a recession ends. However, prices tend to increase at a more modest pace the year after a recession ends, despite the fact that this second year usually supports the largest increase in earnings. Earnings are on track to deliver a "V" shaped recovery (although the economy is not), which should support further moderate gains for global equities in what is likely to be a more volatile environment.

ROTH IRA CONVERSIONS

At the beginning of this year, the $100,000 modified adjusted gross income (MAGI) limit was dropped for converting traditional IRAs to Roth IRAs. A primary benefit of the Roth is that since it is funded with after-tax money, it can grow tax-free like traditional IRAs and future discretionary withdrawals are also tax-free. This has created the opportunity to assess if a full or partial conversion makes sense for you.

If your traditional IRA has dropped in value and you expect to be subject to higher federal income tax rates in future years, now is a good time to evaluate converting all or part of your traditional IRA into a Roth IRA. Here's why. If you convert, it will trigger a current tax hit on the amount you convert. But with your traditional IRA balance at a potentially lower value due to the recent market decline (and possibly your overall income too), the tax hit will be less. After the conversion, your new Roth IRA balance can grow free of federal and state income taxes. Eventually you can take tax-free withdrawals after age 59½, with no required minimum distributions at age 70½, when your marginal tax rate may be higher (perhaps much higher) than it is right now.

Roth Conversion Basics

Prior to 2010, a $100,000 MAGI limit prevented conversions. For 2010, the $100,000 restriction has been eliminated, which will allow all individuals to take advantage of the Roth conversion strategy no matter how high their income.

A Roth conversion is treated as a taxable distribution from your traditional IRA because you are deemed to have received a taxable payout from your traditional IRA, with the money then going into the new Roth account. So, a conversion will generally trigger a current federal income tax bill (and maybe a state income tax bill, too). But the following positive factors may outweigh the current tax hit:

- The conversion tax hit today may be reduced if the value of your traditional IRA is not back to its peak market value.

- While 2010 is the actual year that you will be able to convert, the income may be deferred until 2011 and 2012. Expecting a vast majority of converters to take advantage of this, the IRS has set up a special provision on how the tax will be paid. The IRS is granting the option to claim the conversion amount ratably over tax years 2011 and 2012. Keep in mind this is only for 2010 Roth IRA conversions. Also keep in mind, if you elect to pay the tax over the two year period, the tax rate is determined for that year only. For example, in 2011 you will pay the tax based on your tax bracket just for that year. If your income were to increase significantly in 2012, then you will be paying more in taxes that year for the conversion. Therefore, when planning the conversion, remember that a conversion to a Roth IRA could bump you up into a higher tax bracket since the conversion amount is taxable. In these cases, a partial conversion may be a better option.

- Today's tax rates might be the lowest you'll see for the rest of your life. If so, converting would allow you to completely avoid any higher future federal income tax rates on the entire post-conversion increase in the value of your Roth account.

You Can Reverse an Ill-Advised Roth Conversion

Another positive aspect about the Roth conversion strategy is you can change your mind well after the fact. Believe it or not, you have until October 15 of the year following the conversion year to recharacterize (unwind) your converted account (or accounts). For example, say you convert two traditional IRAs into Roth accounts in early 2010. Later the next year, the values of the converted accounts drop due to market conditions. In this scenario, you would pay 2010 income tax on value that later disappeared. Bad idea! Thankfully, however, you have until October 15, 2011 to recharacterize the two converted accounts back to traditional IRA status. It's as if the ill-advised conversions never happened. Therefore, you would not owe any 2010 income tax on the unwound conversions.

Other Benefits of a Roth IRA

- There are no RMDs (required minimum distributions) from Roth IRAs starting at age 70½, unlike traditional IRAs. Thus, retirees have complete flexibility to manage their cash flows, and in some cases, taxes. If RMDs are sizeable, these forced IRA distributions can potentially bump an individual up into the next marginal tax bracket.
- Contributions to a Roth IRA can be made after the participant reaches age 70½. Therefore, a Roth IRA can allow a worker extending his/her career to continue to build tax-favored retirement savings.
- For taxable estates, Roth IRAs can be more attractive vehicles than traditional IRAs for heirs. While future estate tax laws are being debated, Roth IRA assets generally are included in an estate under current post-2010 estate tax rules. However, heirs may not owe income taxes on withdrawals from the inherited Roth IRA account.

Precautions

- If Congress changes tax rules in the future, Roth IRAs may lose some of their tax benefits.
- An amount distributed from a traditional IRA to meet RMD rules does not qualify for conversion into a Roth IRA.
- One important question to answer is "How to pay for the taxes?" In order to not deplete the retirement account, it is generally advisable to pay the tax with money outside of your IRA.
- If you are currently not paying income taxes on 85% of your social security benefits due to your income level, keep in mind that the conversion would increase your taxable income and potentially cause a higher percentage of your social security benefits to be taxable in the conversion years.
- Contributions to Roth IRAs phase out when the participant reaches certain adjusted gross income levels.
- If you convert a Roth IRA under 59½, the account must be open 5 years before withdrawals can be made or you face withdrawal penalties. Regardless of when you convert a Roth IRA, once you reach the age of 59½, you may make penalty-free withdrawals. Each Roth IRA that is opened has its own 5 year time frame.
- Medicare Part B participants need to be aware of potentially higher premiums from a Roth Conversion. Premiums for Part B are tied to income and converting a Roth IRA would increase the income over a certain time period.

Conclusion

If you believe that you have low current tax cost for converting, plus the chance to avoid higher future tax rates on income and gains that will accumulate in your Roth account as the economy recovers, then evaluating a Roth conversion would be prudent. As always, you should consult your tax advisor regarding the tax implications of a Roth IRA conversion.

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