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Recent Thoughts
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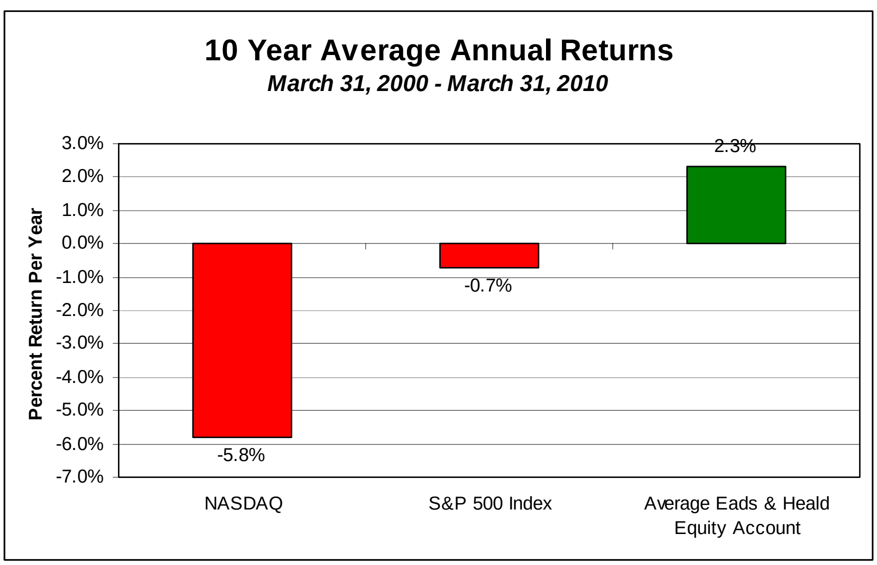
Since March 31, 2000, which represents the peak of the late nineties technology bubble, the NASDAQ has returned -44.9% (-5.8% per year), the S&P 500 has returned -6.5% (-0.7% per year) while the average Eads & Heald Investment Counsel equity account has returned 25.6% (2.3% per year). For almost seven years the previous sentence has provided a running comparison of our equity composite performance to that of the S&P 500 since March 31, 2000. We are occasionally asked why we include performance for what seems like an arbitrary period of time.

Quite simply, we wanted to illustrate how our investment strategy performed against our benchmark following the fallout of the dot-com bubble. Further, as it turns out, the ten years following the end of the dot-com bubble proved to be one of the most tumultuous decades in investment history, with two major market declines and two market rallies. So, with this letter we present a complete ten year snapshot of our performance relative to the market.

Over the last ten years, the compound average annual return for the Eads & Heald equity composite was 3% higher than the S&P 500 (2.3% per year for Eads & Heald Investment Counsel versus -0.7% per year for the S&P 500). We attribute this out-performance to several factors. First, as is now well-known in our history, we wisely did not allow our portfolios to become over-exposed to technology stocks during the dot-com bubble. Thus, when the tech mania ended and the rally came to a screaming halt, our clients were relatively well-protected. Second, we have maintained a consistent strategy throughout our 23 years in business. While we have made periodic strategic shifts in portfolios over time for a variety of reasons, Eads & Heald has remained committed to a constant strategy that we believe serves investors well.



The first quarter of 2010 marked the fourth consecutive quarter of positive returns for the S&P 500 and the best first quarter showing since 1998. March 9th marked the one year anniversary of the market reaching its low for the most recent downturn. The S&P 500 staged an impressive 73% rally from the low last spring to the end of the first quarter. Not all sectors of the market have participated equally during the rally of the past year. As we have noted over the last several quarters, sectors most leveraged to an economic recovery have outperformed more defensive sectors. Those stocks that suffered the most damage in the downturn have benefited the most from the recent upturn. The first quarter stayed true to form as Financial, Industrial and Consumer Discretionary stocks registered the best returns. Telecom Services, Utilities and Energy were the three worst performing sectors during the quarter.

Recent reports on retail sales, factory output and the service sector all confirm that the economic recovery has gained some traction. In addition, capacity utilization rates have improved for U.S. industries. Although still below the long-term trend of around 80%, utilization rates have increased by approximately 5% from the record low reached last year. And finally, after two years of horrific employment numbers, the economy is slowly starting to add jobs. The pace of job growth will have to increase dramatically to make up for the millions of jobs lost since the start of the recession, but the last few months are at least a move in the right direction. While many feel the recession likely ended in mid-2009, the National Bureau of Economic Research (NBER), the official arbiter of recession start and end dates, has yet to call an end to the downturn that started in December 2007.

For the past year, the Fed has stated its intention to keep interest rates near zero “for an extended period.” Despite tangible signs of an economic recovery, the Fed is expected to maintain its current interest rate policy for now. Low inflation, excess capacity and soft labor markets have allowed the Fed to justify keeping rates at extraordinarily low levels. Some fear that the use of the “extended period” phrase will limit the Fed’s flexibility to raise rates should economic conditions warrant such a move. By most accounts, the Fed will remove the “extended period” wording in the next few meetings before finally raising rates sometime late this year.

Opponents of the health care bill celebrated the election of Scott Brown to the U.S. Senate earlier this year as the vote that would likely derail the legislation. However, through a process known as reconciliation, the threat of a filibuster was effectively killed and the bill made its way to the President’s desk and was signed into law. The Congressional Budget Office (CBO) is on record stating that the law will reduce federal deficits over the coming decades. Others question the assumptions used in the CBO’s calculations and warn that the legislation will result in a fiscal disaster down the road. It will be another four years before the major components of the plan are fully enacted and many more years still before the true costs are known. The two parties don’t have the luxury of waiting until the final costs are known, as they will now have to return home and defend their support or opposition for the bill during the run-up to the mid-term elections this fall.

Eads & Heald maintains a proprietary Fair Value Channel for the S&P 500. The future direction of the channel is based on projections for earnings growth and inflation. After soaring through the upper boundary of the channel in the late nineties and plummeting through the lower boundary following the recent credit/housing bubble, the market currently resides near the low end of fair value, as defined by the model. This could bode well for stock returns over the next decade or so. This longer-term optimism should be tempered somewhat over the short-term by the fact that stocks have registered significant gains over a short period of time and could be due for a modest correction.