

# Sound Investments Inc.

Kenneth A. Gilpin CFP

Third Quarter 2010

## Summary

DJIA 10788.05

S&P 500 1141.20

NSDAQ 2388.05

Even though the economy continues to battle elevated unemployment and a sluggish housing market, a growth rate of 2 to 3% appears reasonable. (A poll of 46 economists in October estimated growth rate at 2.6%) our estimate of the 2010 S&P 500 companies earnings are reduced to \$78 and our 2011 estimate is 86. **Based on a historic price / earnings multiple of 15 to 15.5 multiplied by estimated earnings of 86, produces a range of 1290 to 1330 on the S&P 500 about a 10% increase from where we are now.** Of course, a lot depends on the sustainability of the recovery. Please see the two charts on the back of page 1, which show the S&P 500 chart for 20 years and the last 3 years. The chart shows we are in a trading range between 1000 to 1275 on the S&P 500 index. I think we can make some progress above 1200 but in order to breakout to 1400, we need continued strong earnings and a better economic environment. In addition, I believe that many investors will come to realize that the market is the best place for retirement and pension funds.

We believe the bull market, that started in Mar 2009, is still intact but are currently range bound between 1000 and 1275 on the S&P 500. There will be days and possible weeks of volatility but as long as there is an improvement in the economy, we anticipate further market progress into next year

*The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research.*

## September Surge

In my last newsletter, I remarked at how difficult it is to predict the market action, but I thought it would go higher. We had to wait through July and August, but September was worth it. All three averages were up between 8 and 13%, the best Sept in 71 years. The market had been alternating between euphoria and despair. It broke to the upside on relatively low volume, a sign many investors are still waiting on the sidelines.

The economic underpinnings are stabilizing as we move through the second half of the year. The GDP, or Gross National Product, is up by 3.7% and 1.6% in the first and second half quarters and 1.5 to 2 % in the last 3 months. Holding back stronger activity is the fact that fewer jobs are being created now than one would expect after four straight quarters of growth.

We expect growth to stabilize at modest levels over the next six months as uneven unemployment trends and listless home construction are offset by better trends in export orientated industrial production and a brighter look at the retail counter. The result is likely to be an economy that will continue to press ahead in small increments. We sense the odds of a double dip recession are now about one in three, with such setbacks not evolving, in our view, in the absence of higher interest rates or a reduction in house hold spending.

## What's Working

"Macro" investors, who study the big picture for clues of the market direction, are worried the economy is in a funk, especially, as noted above, Gross National Product growth rate has been declining. Yet investors who look at the fundamentals, who study corporate developments, point to well run companies with robust profits and improving balance sheets. Of particular note is the cash on those balance sheets, which now accounts for 11% of all the assets of the S&P 500 companies. This is an extraordinary number and hasn't happened since the Eisenhower era of the 1950's.

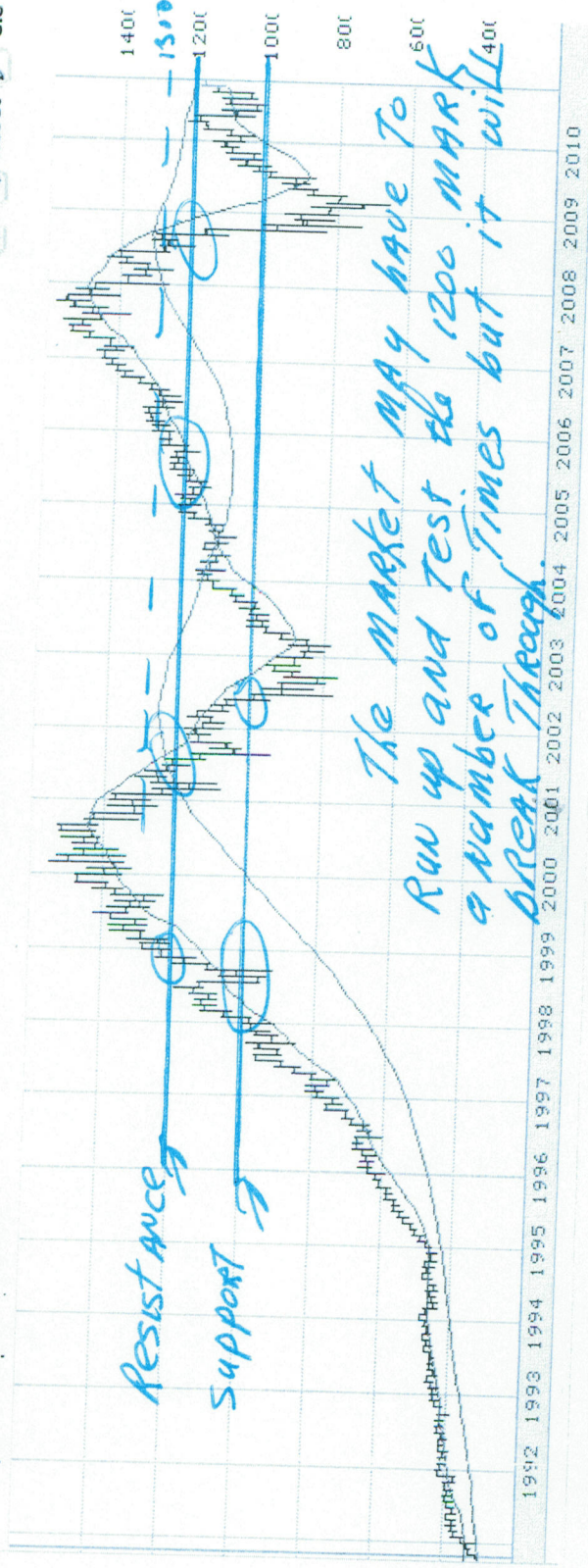
Manufacturing continues to stand tall in an otherwise flat landscape. Purchasing manages at a wide range of manufacturing companies continue to increase production and hiring. Business equipment spending remains strong with spending up over 15%. U.S. exports reached their best level in almost 2 years. Factory output, excluding



# S&P 500 Index

20 YEARS

Reset Clear

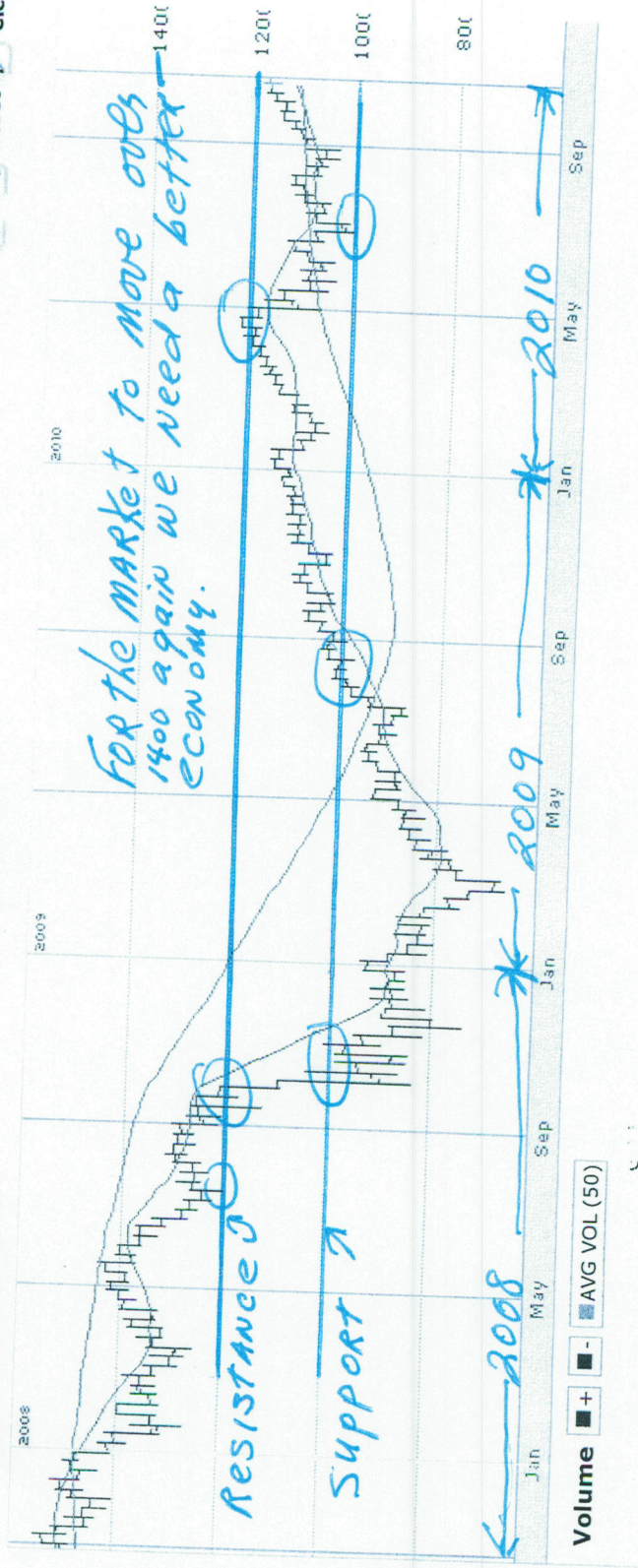


20 year  
chart.  
of  
S+P 500

# S&P 500 Index

3 YEARS

Reset Clear



3 year  
chart of  
S+P 500



autos, was up ½%, the best showing since May. Auto production was down 5% after jumping 9.5% in July due to factory retooling in August. The conference board of leading economic indicators increased .3% in August following a 0.1% increase in July and a 0.2% decline in June.

Even though the economy continues to battle elevated unemployment and a sluggish housing market, a growth rate of 2 to 3% appears reasonable. (A poll of 46 economist in October estimated growth rate at 2.6%) our estimate of the 2010 S&P 500 companies earnings are reduced to \$78 and our 2011 estimate is 86. **Based on a historic price / earnings multiple of 15 to 15.5 multiplied by estimated earnings of 86, produces a range of 1290 to 1330 on the S&P 500 about a 10% increase from where we are now.** Of course, a lot depends on the sustainability of the recovery. Please see the two charts on the back of page 1, which show the S&P 500 chart for 20 years and the last 3 years. The chart shows we are in a trading range between 1000 to 1275 on the S& P 500 index. I think we can make some progress above 1200 but in order to breakout to 1400, we need continued strong earnings and a better economic environment. In addition, I believe that many investors will come to realize that the market is the best place for retirement and pension funds.

### Emerging Markets

Emerging markets refer to less developed countries in Asia and South America. We are upgrading to funds that are investing in this area. The economies of the developed world like the USA. and Europe face high unemployment, slower consuming spending, aging demographics and high government debt. In the emerging world, it is almost the opposite. For instance, they enjoy relatively clean balance sheets, strong exports, favorable demographics and an emerging middle class. The stock market rewards growth and potential and is one of the reasons funds are flowing there. When you think about it; it makes sense since less developed countries can grow fast by copying our technology from cell phones to designs for cement and mini steel mills.

Petrobras, a large Brazilian oil company, just recently issued new shares raising over \$67 Billion dollars, the world's largest new issue which is another indicator these markets are not peripheral any more. However, these are volatile markets and we recommend a longer time horizon with a smaller asset allocation.

On the back of this page, there is a Morningstar report on Mathews Asia Growth and Income Fund. It is rated an analyst pick, with experienced managers, lower expenses and takes a conservative tack in a riskier category.

### What a Lower Dollar Means

The US Dollar has decline approximately 35% since 2002. Every time the dollar falls, it makes hard assets like stocks, gold oil, commodities more valuable as they are priced in Dollars; hence, they go up in price. It also makes our exports cheaper and is one of the reasons for the increase in manufacturing activity as noted above.

This may go on for quite some time and makes imported goods become more expensive. We are following developments in trade and currency exchange rates closely as they affect our investment positions.

### Conclusion

We believe the bull market, that started in Mar 2009, is still intact but are currently range bound between 1000 and 1275 on the S&P 500. There will be days and possible weeks of volatility but as long as there is an improvement in the economy, we anticipate further market progress into next year.



# Matthews Asian Growth & Income

## Governance and Management

Stewardship Grade:

Portfolio Manager(s)

Andrew Foster took over as the lead manager here as of February 2008. Foster, who also manages Matthews India and Matthews Asia Pacific Equity Income, joined as a manager on this fund in early 2005. Robert Horrocks, who is also chief investment officer at the firm, joined Foster in 2009, replacing founding manager Paul Matthews as Foster's deputy. They're supported by a deep and growing number of investment professionals.

## Strategy

The fund concentrated on convertible bonds in its early years and then began to pay a lot of attention to undervalued stocks with nice payouts and other types of tame securities in the late 1990s and early 2000s as the supply of converts diminished. The fund now normally invests 60% to 75% of its assets in dividend-paying stocks, 15% to 35% of its assets in convertible bonds, and small amounts in other types of bonds and preferred stocks. To combat market-timing, the fund levies a 2% redemption fee on shares held 90 days or fewer, and it uses fair value pricing when

## Performance 07-31-10

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total
2006	6.24	0.80	3.42	11.40	23.38
2007	2.46	8.89	5.67	3.10	21.54
2008	-4.25	-3.96	-13.70	-14.41	-32.07
2009	-2.00	21.57	13.88	4.24	41.44
2010	4.12	-2.51	—	—	—

Trailing	Total	+/- MSCI	+/- MSCI	%Rank	Growth
Return%	Return%	EAFE	Ex Jpn ND	Cat	\$10,000
3 Mo	1.73	5.81	2.93	13	10,173
6 Mo	7.86	8.48	-0.47	53	10,786
1 Yr	16.86	10.60	3.46	24	11,686
3 Yr Avg	3.26	13.54	5.92	3	11,010
5 Yr Avg	10.02	7.92	-0.51	78	16,120
10 Yr Avg	13.83	12.32	6.01	12	36,523
15 Yr Avg	11.73	7.77	—	1	52,789

Tax Analysis	Tax-Adj Rtn%	%Rank Cat	Tax-Cost Rat	%Rank Cat
3 Yr (estimated)	1.07	4	2.13	81
5 Yr (estimated)	7.66	82	2.14	94
10 Yr (estimated)	11.57	19	1.99	98

Potential Capital Gain Exposure: 14% of assets

## Morningstar's Take by William Samuel Rocco 04-14-10

Matthews Asian Growth & Income outshines the competition without being a rally star.

This fund tends to post lackluster results when stocks in its region dazzle. Emerging-Asia names have done especially well as stocks around the world have soared over the past 13 months, and the typical Pacific/Asia ex-Japan fund has gained 100% from March 10, 2009, through April 12, 2010. But this fund has returned 61% during this period—solid on an absolute basis, but well behind its rivals. These results are not an aberration: This fund also gained much less than its average peer when emerging-Asia equities skyrocketed in the mid-2000s and the late 1990s.

These disappointing rally returns have far more to do with this fund's reserved strategy than with management's execution, though. Andrew Foster and Robert Horrocks, like their predecessors, focus on attractively valued dividend-paying stocks, preferred stocks, convertibles bonds, and other bonds. Simply put, the tame type of common stocks

that Foster and Horrocks favor have trouble competing with bolder equities in strong stock surges, and the other sorts of income-producing securities that the managers buy face even greater challenges in such climates.

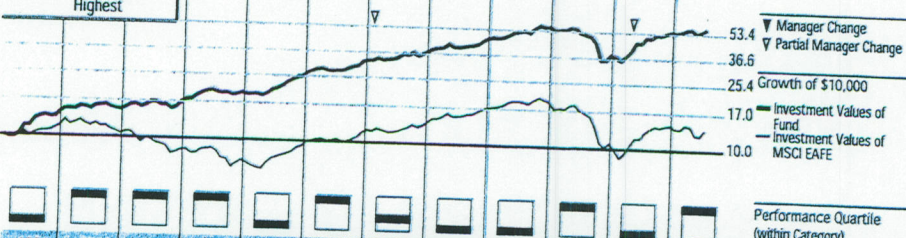
But the managers have earned great results with their strategy in a mix of other environments and overall. In addition to generally posting solid returns in moderate rallies and mixed conditions, this fund has consistently held up well in tough times. It suffered the smallest loss in the category by far in the late 2007 to early 2009 global stock selloff, in fact, due to the resiliency of most of its securities. Thus, this fund boasts topnotch long-term returns, and it has been the least volatile member of its group over time.

This fund remains one of its wild category's best. This fund has a comparatively low expense ratio and Matthews' considerable Asia expertise going for it as well as its distinctive style and strong risk/reward profile.

Address:	Matthews Asia Funds San Francisco, CA 94111 800-789-2742	Minimum Purchase:	\$2500	Add: \$100	IRA: \$500
Web Address:	www.matthewsasias.com	Min Auto Inv Plan:	\$0	Add: —	
Inception:	09-12-94	Sales Fees:	No-load, 2.00%R		
Advisor:	Matthews International Cap Mgmt LLC	Management Fee:	0.75% mx/0.65% mn., 0.25%A		
Subadvisor:	None	Actual Fees:	Mgt:0.69% Dist: —		
NTF Plans:	Fidelity Retail-NTF, Schwab OneSource	Expense Projections:	3Yr:\$372 5Yr:\$644 10Yr:\$1420		
		Income Distribution:	Semi-Annually		

## Historical Profile

Return  
Risk  
Rating  
Average  
Low  
★★★★★  
Highest



1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	07-10	History
10.04	8.93	9.72	10.31	13.82	15.82	17.14	18.68	19.78	11.49	15.77	16.64	NAV
48.88	3.73	14.29	9.01	38.62	21.44	15.76	23.38	21.54	-32.07	41.44	6.77	Total Return %
21.92	17.90	35.73	24.95	0.03	1.19	2.22	-2.96	10.37	11.31	9.66	11.77	+/-MSCI EAFE
-14.01	40.44	16.53	18.38	-5.90	4.25	-5.57	-8.36	-14.95	18.49	-27.44	5.08	+/-MSCI Ex Jpn ND
8.79	6.02	5.33	1.44	2.19	3.93	2.71	3.63	4.97	2.13	3.85	1.20	Income Return %
40.09	-2.29	8.96	7.57	36.43	17.51	13.05	19.75	16.57	-34.20	37.59	5.57	Capital Return %
88	1	13	3	85	5	64	84	92	1	97	19	Total Rtn % Rank Cat
0.62	0.60	0.47	0.14	0.22	0.54	0.43	0.62	0.90	0.41	0.44	0.19	Income \$
0.00	0.88	0.00	0.15	0.20	0.38	0.72	1.77	2.00	1.67	0.00	0.00	Capital Gains \$
1.90	1.90	1.90	1.77	1.69	1.44	1.27	1.19	1.15	1.16	1.18	—	Expense Ratio %
8.13	6.24	7.71	2.13	2.69	2.28	2.60	2.27	2.59	3.19	3.47	—	Income Ratio %
35	62	34	32	13	17	20	28	28	25	18	—	Turnover Rate %
12	12	32	176	926	1,236	1,677	2,021	2,273	1,085	2,545	3,073	Net Assets \$mil

## Rating and Risk

Time Period	Load-Adj Return %	Morningstar Rtn vs Cat	Morningstar Risk vs Cat	Morningstar Risk-Adj Rating
1 Yr	16.86	—	—	★★★★★
3 Yr	3.26	+ Avg	Low	★★★★★
5 Yr	10.02	- Avg	Low	★★★★★
10 Yr	13.83	+ Avg	Low	★★★★★
Incept	11.20	—	—	—

Other Measures	Standard Index	Best Fit Index
Alpha	10.8	8.4
Beta	0.76	0.73
R-Squared	87	90
Standard Deviation	20.75	—
Mean	3.26	—
Sharpe Ratio	0.20	—

## Portfolio Analysis 03-31-10

Share change since 12-09	Total Stocks:53	Sector	Country	% Assets
Hongkong Land 05 Cv 2.75	—	—	Hong Kong	2.55
CLP Holdings Limited	—	Utilities	Hong Kong	2.55
Keppel Corporation Limit	—	Ind Mtrls	Singapore	2.43
Hisamitsu Pharmaceutical	—	Health	Japan	2.25
Shandong Weigao Group Me	—	Health	China	2.21
Singapore Technologies E	—	Ind Mtrls	Singapore	2.17
China Petro & Cv	—	—	China	2.17
Hang Lung Properties Ltd	—	Financial	Hong Kong	2.17
Wilmar Interl Cv	—	—	Singapore	2.07
HSBC Holdings PLC ADR	—	Financial	U.K.	2.05
Rafflesia Cap Cv 1.25%	—	—	Malaysia	2.05
Japan Real Estate Invest	—	Financial	Japan	1.99
Hamamatsu Photonics K.K.	—	Goods	Japan	1.98
Hang Seng Bank Ltd.	—	Financial	Hong Kong	1.97
Nippon Building Fund Inc	—	Financial	Japan	1.92
Ascendas Real Estate Inv	—	Financial	Singapore	1.82
China Pacific Insu	—	Financial	China	1.82
Cherating Cap Cv 2%	—	—	Malaysia	1.71
AXA Asia Pacific Holding	—	Financial	Australia	1.67
China Mobile Ltd. ADR	—	Telecom	China	1.62

## Current Investment Style

Value	Blnd	Growth	Market Cap	%	Sector Weightings	% of Rel MSCI	3 Year
Large	Mid	Small	Giant	28.1	Info	27.55	—
Large	Mid	Small	Large	38.4	Software	3.74	5 0
Large	Mid	Small	Mid	23.8	Hardware	5.63	9 6
Large	Mid	Small	Small	6.6	Media	5.35	13 5
Large	Mid	Small	Micro	3.2	Telecom	12.83	23 11
Avg \$mil:	5,160				Service	44.71	—

Value Measures	Rel Category	%	Sector Weightings	% of Rel MSCI	3 Year
Price/Earnings	15.60	1.16	Health	6.67	7 3
Price/Book	2.08	1.04	Consumer	2.41	7 2
Price/Sales	2.27	1.48	Business	4.98	5 2
Price/Cash Flow	7.90	1.41	Financial	30.65	33 28
Dividend Yield %	5.51	2.16	Mfg	27.73	—
Growth Measures	% Rel Category		Goods	9.67	10 3
Long-Term Emrgs	8.28	0.49	Ind Mtrls	11.41	12 4
Book Value	3.35	0.79	Energy	0.00	1 0
Sales	3.08	0.79	Utilities	6.65	8 6

Composition - Net	Rel Category	%	Regional Exposure	% Stock
Cash	0.1	3.1	UK/W. Europe	3 N. America
Stocks	67.7	29.1	Japan	16 Latin America
Foreign (% of Stock)	100.0		Asia X Japan	81 Other

Country Exposure	% St.
Hong Kong	23
Singapore	17
Taiwan	10
Japan	16