

# Sound Investments Inc.

Kenneth A. Gilpin CFP

Fourth Quarter 2010

## Summary

Economic fundamentals continue to signal recovery.

As mentioned, in my last 3 newsletters, big U.S. companies are flush with cash, and appear open to using it in 2011 on factories, stores, and even hiring. Profits are higher, too, after companies slashed their workforces and closed less efficient operations. Total U.S. corporate profits in 2010's third quarter rose 26% from a year earlier to 1.64 Trillion, the highest in 4 years, according to government data.

In order to have a good year there are 2 challenges we will have to overcome. The continued weakness in the Financial or Banking Sectors and profit margin pressure across many industries. No doubt some industries are going to find it tougher, but overall we feel profits will rise.

We are increasing our 2011 operating earnings to \$90, up from our previous estimate of \$87. We continue to use a conservative approach to price/earnings valuations, using a multiple of 15 to 15.5. Applying this P/E ratio range of 15 to 15.5 to our new operating earnings estimate of 90, produces our new target price range of 1350 to 1395. ( $15 \times 90 = 1350$ ;  $15.5 \times 90 = 1395$ ). Currently the S&P 500 is approximately 1250.

*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.*

DJIA 11577.51

S&P 500 1257.64

NASDAQ 2652.43

## Optimism Returns

Despite a rocky start, stock markets ended 2010 with a flourish. The economy seemed stuck in neutral, yet investors, who were able to weather storms enjoyed their second year in a row of double digit gains. At the conclusion of the strongest December since 1991, the S&P 500 was up 14% and the DJIA was up 11% for the year.

It wasn't as easy as it sounds. For instance, by Aug 2010 the Dow was down over 4%. At that time many investors were concerned that the economy would fall back into recession, even though, economic reports started to show more strength. Unemployment is still a serious problem, but private sector jobs have been growing slowly. (See chart on back of this page) Consumer spending has also slowly improved. The last 4 months was responsible for nearly all of the 2010 market gains.

All in all, stock markets were up respectably, yet finished the year with lower P/E valuations than when they were started. This was due to corporate profits grew faster than share prices did. To date, earnings forecasts are still being revised higher. The consensus is for S&P 500 earnings to grow 11% this year.

## Big Firms Poised to Spend

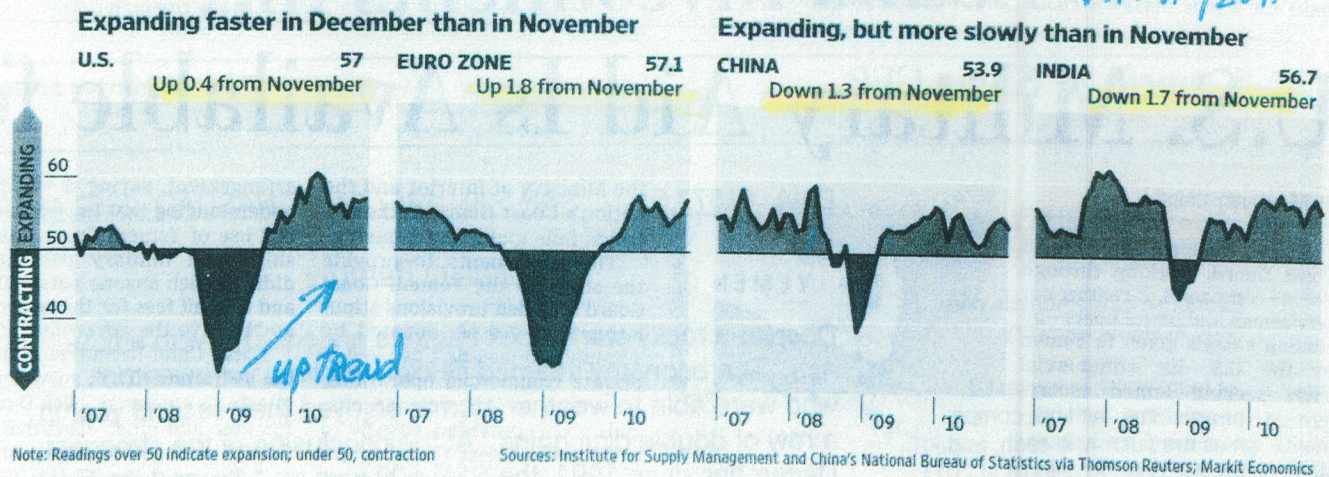
As mentioned, in my last 3 newsletters, big U.S. companies are flush with cash, and appear open to using it in 2011 on factories, stores, and even hiring. Profits are higher, too, after companies slashed their workforces and closed less efficient operations. Total U.S. corporate profits in 2010's third quarter rose 26% from a year earlier to 1.64 Trillion, the highest in 4 years, according to government data.

With this stronger foundation, coupled with new confidence about the global economy, corporations are looking to expand. Many are focusing on the faster growing economies of Asia, Latin America and Africa rather than on the sluggish markets of Europe and the U.S. Others plan to enlarge existing operations through new equipment, products, factories and research labs. (See purchasing manager index of manufacturing activity chart on the back of this page). The recent extension of the Bush era tax cuts should help revive the smoldering economy, as well.



## Still Humming | Purchasing managers' indexes of manufacturing activity

WSJ  
JAN 11/2011



## Report Says 297,000 Jobs Added Last Month, Bolstering Hopes on Economic Growth

By SARA MURRAY

Private-sector employers picked up the pace of hiring significantly in December, a report indicated Wednesday, increasing optimism that the U.S. job market finally may be improving.

Companies in the private sector added 297,000 jobs last month, according to payroll processor Automatic Data Processing Inc. and Macroeconomic Advisers LLC, a consulting firm. The gain was the largest in their report's 10-year history.

The ADP numbers don't always match the government's official tally, which comes out Friday, but the data led analysts to lift their predictions for the Labor Department's report, which they now expect will show 165,000 private-sector jobs were added in December.

A separate report, the Institute for Supply Management's survey of companies in the services and nonmanufacturing sectors, climbed to 57.1 from 55 in November—the 12th straight month of growth. A level above 50 indicates expansion. The ISM survey of manufacturing firms released earlier this week also was strong.

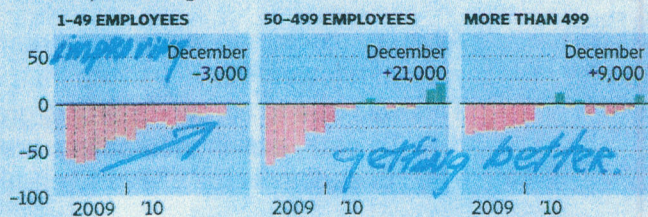
"The economy is clearly gaining momentum," said Zach Pandl, a Nomura Securities International Inc. economist. "With that should come better jobs data."

Nonmanufacturing firms were less upbeat about hiring, however. The survey found that employment at those companies continued to expand, but at a slower pace than in November. Fewer than one in five firms added workers, though hiring was strong in mining, retail

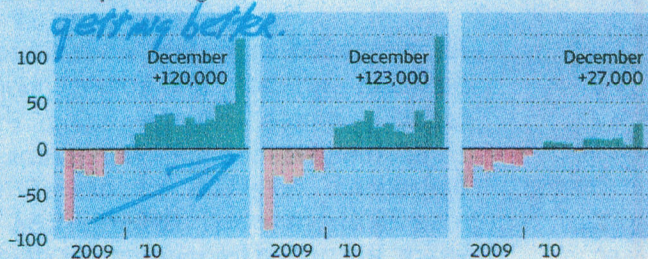
### December Boost

Monthly change in the number of private-sector jobs at small, medium and large companies since the recession ended, in thousands

#### Goods-producing



#### Service-producing



Sources: Automatic Data Processing and Macroeconomic Advisers

trade, utilities and finance.

The latest reports, along with recent declines in initial claims for unemployment benefits, fueled optimism that economic growth is picking up. Most analysts expect the government to report later this month that the economy expanded at better than an annual rate in the fourth quarter.

"I am increasingly confident that the recovery is both sustainable and likely to gain strength over the next several quarters," Federal Reserve Bank of Kansas City President Thomas Hoenig said Wednesday, according to the text of a speech he gave in Kan-

sas City. "That said, I expect the recovery to be moderate."

The ADP report said that most private-sector job gains last month came from the service sector, where payrolls rose by 270,000. Manufacturers added 23,000 jobs. Large companies, those employing more than 499 workers, added only 36,000 jobs in December. Firms with fewer than 50 workers added 117,000 and midsize firms added 144,000.

Fresh & Easy Neighborhood Market Inc., a supermarket chain with more than 150 stores in California, Arizona and Nevada, is in the process of hiring for 22 locations opening in California early

this year, said Brendan Wonnacott, a spokesman. The company is looking to add 550 to 600 employees, about 200 of whom were hired in November and December.

"This is just kind of the next step in our expansion," Mr. Wonnacott said.

Seasonal adjustments may have inflated private-sector hiring data, analysts said. "Not all of what we're seeing this month is a fluke," said Joel Prakken, chairman of Macroeconomic Advisers. But he warned, "Approach today's number with an appropriate degree of caution."

The Labor Department report will also include federal, state and local government employment not covered by ADP. Fiscal woes at the state and local level have led to job cuts, offsetting some private-sector hiring. The ISM report noted that educational services and public administration were among the sectors still contracting.

Mr. Prakken said the Labor Department's report could show 200,000 to 250,000 private- and public-sector jobs were added overall in December. Other analysts' estimates are around 150,000.

Even if those estimates prove correct, U.S. employment remains far below the 2007 peak. As of November, there were 74 million fewer jobs than before the recession, and more than 15 million Americans were looking for work. "There's a tremendously huge hole to fill," said Jonathan Basile, a Credit Suisse Securities analyst.

■ Treasuries sink on strong data from jobs report



## Big Year for Stocks? They'll have to Earn It.

The above headline appeared in last week's Wall Street Journal and I thought the article captured what has to happen to have another good year. It reported there are 2 challenges we will have to overcome. The continued weakness in the Financial or Banking Sectors and profit margin pressure across many industries.

As Woody Allen says, 90% of life is showing up and that is what the Banks have to do, show up with some profits! The financial industry is still trading at less than half it was at the beginning of the recession and most are projecting a reasonable profit. Without getting too technical, the yield curve is positively sloped. What this means is that Banks can now borrow money at 1 or 2% and lend it out at 5 to 8% or more. Analysts are saying the market could do just fine in 2009 and 2010 without the banks being part of the leadership, but to make further headway, in 2011 the Banks which make up over 20% of the index have to be involved. One of America's largest Banks, J P Morgan just reported earnings which were up 48% for the year. See the Morningstar report on FBR Small Cap Financial Investor which invests in small stable banks. We think this sector is undervalued and we like it.

The 2<sup>nd</sup> thing that has to happen is, we have to see earnings continue to rise. It was easy to show an improvement in 2010 since 2009 earnings were so low, but comparisons are harder now. The other key factor is profit margins. In a nut shell, revenue growth or sales for the S&P 500 will have to be strong enough to outpace rising commodity costs and potential higher labor expenses. For example, the airlines may have trouble raising prices fast enough to offset higher fuel and labor expenses. No doubt some industries are going to find it tougher, but overall we feel profits will rise.

## Grinding Higher

In our last quarter we made the point that, for the market to move higher, we really need a better economy. Slowly, but surely we are getting it. We are increasing our real GNP estimate by ½%, which brings our growth estimate into the 2.5% to 3.5% range for the New Year. We are increasing our 2011 operating earnings to \$90, up from our previous estimate of \$87. We continue to use a conservative approach to price/earnings valuations, using a multiple of 15 to 15.5. Applying this P/E ratio range of 15 to 15.5 to our new operating earnings estimate of 90, produces our new target price range of 1350 to 1395. ( $15 \times 90 = 1350$ ;  $15.5 \times 90 = 1395$ ). Currently the S&P 500 is approximately 1250.

In addition, we are increasing our 2012 operating earnings estimate from 91 to 96. When the 2012 estimates become more visible, as we move forward, the S&P 500 index will have the potential for gains beyond our 2011 mid to upper 1300 target range. The potential for gains beyond this range is dependent on the sustainability of the economic recovery and the ability of the Federal Reserve to manage the monetary challenges that lie ahead.

## Conclusion

We believe the bull market that started in March 2009 is still intact. There will be days and possibly weeks of volatility, but as long as there is an improvement in the economy, we anticipate further market progress into next year. We continue to stay alert to near term performance in order to respond to changing market leadership, and to use asset allocation to help cushion market volatility.



# FBR Small Cap Financial Investor

## Governance and Management

### Stewardship Grade:

### Portfolio Manager(s)

David Ellison has run this fund since its 1997 inception, and he also manages FBR Large Cap Financial. Prior to joining FBR Investment Services in late 1996, he managed Fidelity Select Home Finance for 11 years and posted strong results. Ellison has a significant portion of his net worth invested in this and other FBR offerings.

### Strategy

This fund invests in small banks and thrifts with plain-vanilla business models. Manager David Ellison seeks stocks that are trading at low P/E and price/book ratios that have steady growth prospects. Also, he looks for company management teams focused on maintaining high-quality loan portfolios.

### Performance 12-31-10

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total
2006	4.54	2.56	-0.98	5.31	11.80
2007	-6.32	-4.57	-6.61	-6.78	-22.18
2008	-2.90	-10.39	14.49	-8.38	-8.73
2009	-9.59	9.75	22.57	-1.23	20.13
2010	16.43	-9.64	0.33	11.31	17.50

Trailing	Total	+/-	+/- DJ	%Rank	Growth of
	Return%	S&P 500	Finance	Cat	\$10,000
3 Mo	11.31	0.55	0.35	26	11,131
6 Mo	11.68	-11.59	-5.46	92	11,168
1 Yr	17.50	2.44	4.78	10	11,750
3 Yr Avg	8.81	11.67	21.97	5	12,883
5 Yr Avg	2.31	0.02	10.74	11	11,210
10 Yr Avg	10.26	8.85	11.95	1	26,557
15 Yr Avg	—	—	—	—	—

Tax Analysis	Tax Adj Rtn%	%Rank Cat	Tax-Cost Rat	%Rank Cat
3 Yr (estimated)	8.48	5	0.31	23
5 Yr (estimated)	0.67	11	1.61	81
10 Yr (estimated)	8.71	1	1.40	67

Potential Capital Gain Exposure: 12% of assets

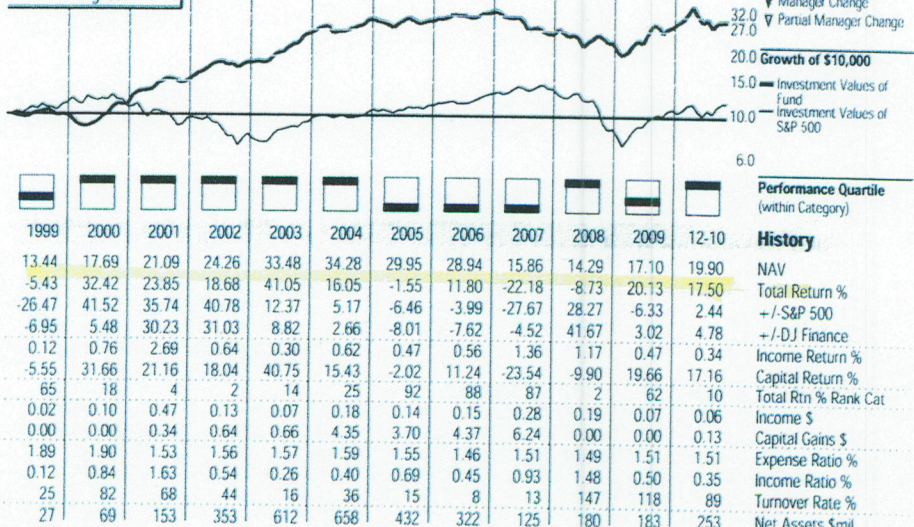
### Morningstar's Take by Ryan Leggio 07-26-10

FBR Small Cap Financial should continue to shine. A lot has changed since the nadir of the financial crisis. Back then, small banks were being taken over by the FDIC every Friday night. In a little over a year, the financial sector has recovered, thanks to government assistance, and FDIC takeovers have slowed. The fund is up 55% since March 2009. But because the fund's price and its valuation multiples look much higher now, investors are right to wonder if the strong performance can continue.

To answer that question, investors need to consider the fund's current posture. The strong recent performance has lead manager Dave Ellison to start accumulating cash as he has sold or trimmed strong performing holdings. The fund's cash stake has gone from less than 7% of assets to 15% since March of this year. As he has done so he's changed the fund's makeup and risk/reward profile. In early 2009 Ellison grouped the fund's holdings in two buckets: good banks at great prices and bad banks at even better prices. There are at least three

### Historical Profile

Return High  
Risk Below Avg  
Rating ★★★★★  
Highest



### Rating and Risk

Time Period	Load-Adj Return %	Morningstar Rtn vs Cat	Morningstar Risk vs Cat	Morningstar Risk Adj Rating
1 Yr	17.50			
3 Yr	8.81	High	-Avg	★★★★★
5 Yr	2.31	+ Avg	-Avg	★★★★★
10 Yr	10.26	High	-Avg	★★★★★
Incept	11.43			

Other Measures	Standard Index	Best Fit Index
Alpha	10.9	15.4
Beta	0.66	0.51
R-Squared	44	67
Standard Deviation	22.08	
Mean	8.81	
Sharpe Ratio	0.46	

### Portfolio Analysis 09-30-10

Shere change since 06-10	Total Stocks:63	Sector	PE	Tot Ret%	% Assets
⊕ Jpm 100% Treasury-Morgan	—	Financial	—	—	17.76
⊕ KKR Financial Corporatio	—	Financial	5.0	67.41	2.65
⊕ First Horizon National C	—	Financial	—	66.44	2.63
⊕ Northwest Bancshares Inc	—	Financial	28.1	8.05	2.58
⊕ Washington Federal Inc.	—	Financial	16.1	-11.43	2.55
⊕ Independent Bank (MA) Co	—	Financial	15.2	33.13	2.55
⊕ Oceanfirst Financial Cor	—	Financial	12.5	18.25	2.48
⊕ Flushing Financial Corp	—	Financial	11.7	28.95	2.46
⊕ Zions Bancorporation	—	Financial	—	89.17	2.42
⊕ Fulton Financial Corp.	—	Financial	15.9	19.95	2.37
⊕ Astoria Financial Corpor	—	Financial	21.9	16.09	2.33
⊕ Provident Financial Serv	—	Financial	19.3	46.20	2.31
⊕ East West Bancorp., Inc.	—	Financial	7.5	23.99	2.26
⊕ WSFS Financial Corporati	—	Financial	29.1	86.97	2.16
⊕ Synovus Financial Corp.	—	Financial	—	30.73	2.15
⊕ Associated Banc-Corp	—	Financial	—	37.97	2.15
⊕ Cathay General Bancorp.	—	Financial	—	121.72	2.05
⊕ Portfolio Recovery Assoc	—	Business	19.0	67.67	2.05
⊕ Brookline Bancorp., Inc.	—	Financial	24.1	12.92	2.00
⊕ Dime Community Bancshare	—	Financial	12.5	29.16	1.98

### Current Investment Style

Value Blind Growth	Market Cap	%
Large Mid Small	Giant	0.0
	Large	1.0
	Mid	20.7
	Small	44.3
	Micro	34.1
	Avg \$mil	935

### Value Measures

Price/Earnings	14.80	Rel Category	1.17
Price/Book	0.87		0.84
Price/Sales	1.42		1.17
Price/Cash Flow	6.15		1.81
Dividend Yield %	2.25		0.94
Growth Measures	%	Rel Category	%
Long-Term Emrgs	7.39		0.73
Book Value	-13.60	NMF	
Sales	-13.20	NMF	
Cash Flow	-20.88	NMF	
Historical Emrgs	4.38		0.45

### Profitability

Return on Equity	-0.34	Rel Category	NMF
Return on Assets	0.05		0.03
Net Margin	4.38		0.42

Industry Weightings	% of Stocks	Rel Cat
Intl Banks	0.0	0.0
Banks	52.8	2.0
Real Estate	2.1	0.3
Sec Mgmt	1.1	0.1
S & Ls	27.0	9.0
Prop & Reins	0.0	0.0
Life Ins	2.5	0.8
Misc. Ins	1.7	0.6
Other	12.8	0.5

### Composition - Net

● Cash	17.8
● Stocks	82.2
● Bonds	0.0
● Other	0.0
Foreign (% of Stock)	1.2

Address:	1001 19th St North Arlington, VA 22209 888-888-0025	Minimum Purchase:	\$2000	Add: \$0	IRA: \$1000
Web Address:	www.fbrfunds.com	Min Auto Inv Plan:	\$500	Add: \$50	
Inception:	12-31-96	Sales Fees:	No-load, 1.00%R		
Advisor:	FBR Fund Advisers Inc.	Management Fee:	0.90%, 0.02%A		
Subadvisor:	None	Actual Fees:	Mgt: 0.90% Dist: 0.25%		
NTF Plans:	Fidelity Retail-NTF, Schwab OneSource	Expense Projections:	3Yr: \$499 5Yr: \$860 10Yr: \$1878		
		Income Distribution:	Annually		