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www.tamgmt.com

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or write or call:

TITLEIST ASSET MANAGEMENT, LTD.
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609 Castle Ridge Road, Suite 315
Austin, Texas 78746
512.494.1003

7373 Broadway, Suite 108
San Antonio, Texas 78209
210.826.2424

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2011

First Quarter Report

The S&P 500 returned 5.92% over the quarter, the strongest first quarter since 1998, while the Barclays Aggregate Bond Index returned a meager 0.42%. Defensive sectors such as utilities and consumer staples continue to underperform while energy and industrials were the biggest outperformers. The energy sector alone accounted for over 44% of the S&P 500's returns, an incredible statistic considering it only represents a 13% weighting. The energy sector, oil service in particular, continues to represent the largest percentage of our portfolios.

Overall, the equity markets posted a very strong performance considering the geopolitical turmoil in the Middle East/North Africa, the natural disaster and nuclear events in Japan, continued deterioration in EU sovereign debt, and a significant move up in the price of crude. There have been a lot of crosscurrents in the economic data over the past few months. However, it is too early to determine whether or not this is a reversal in certain trends or a continuance of the uneven recovery.

Equity valuations - currently trading at 13.5x forward earnings - are far from rich relative to historical measures, especially when compared to bonds. That being the case, we do feel the market deserves to trade at a discount to its historical valuations due to the structural economic issues, national debt, and increased geopolitical uncertainty in areas that supply a large amount of the world's energy.

M&A activity topped \$260 billion this quarter, the most since the collapse of Lehman in Q3 2008. S&P 500 companies authorized 38% more in stock buybacks in Q1 2011 than they did over the same period in 2010. In addition, companies are increasing or initiating dividends at a pace we have not seen in years. We expect both of these trends to continue as corporations start spending the record \$940 billion cash hoard.

Other bullish trends include what appears to be the beginning of a major shift away from bonds towards equities. As we highlighted in our Q2 2009 letter, the flows out of equities and into fixed income were unsustainable. Those proclaiming "retail investors are always late" and that these flows should be a contrarian indicator are wrong in our opinion. One quarter of modest net inflows after the record redemptions over the prior 10 quarters is hardly a signal of froth. The chart below provides some good perspective as to how mutual funds, pensions, and households have positioned themselves over the past 15 years.

Mutual Funds Asset Allocation		
	Equity Funds	Bond Funds
1996	72.8%	27.2%
1997	76.6%	23.4%
1998	78.2%	21.8%
1999	83.3%	16.7%
2000	83.0%	17.0%
2001	78.7%	21.3%
2002	70.2%	29.8%
2003	74.7%	25.3%
2004	77.3%	22.7%
2005	78.5%	21.5%
2006	79.8%	20.2%
2007	79.5%	20.5%
2008	70.3%	29.7%
2009	69.2%	30.8%
2010	68.5%	31.5%
2011	68.9%	31.1%

Source: Investment Company Institute

Corporate Equity Holdings as % Financial Assets		
	Private Pensions	Households
1996	43.5%	20.2%
1997	43.2%	23.0%
1998	45.1%	25.0%
1999	42.8%	28.4%
2000	44.1%	24.5%
2001	47.1%	21.2%
2002	43.2%	17.1%
2003	46.4%	19.2%
2004	47.5%	19.1%
2005	45.3%	18.7%
2006	44.8%	20.1%
2007	41.7%	19.0%
2008	35.1%	14.0%
2009	33.6%	16.6%
2010	32.6%	17.9%

Source: Federal Reserve Flow of Funds Accounts, Table L.118

Most importantly, the Federal Reserve remains extremely accommodative. Despite hawkish comments from a few fed officials, we do not anticipate any meaningful changes without Bernanke sending clear signals to the market in advance. Even if they decide to end the second round of quantitative easing in June, the Fed is still a long way from being restrictive. Those that claim it's time to move out of risk assets when the Fed starts to tighten are flying in the face of history. Historically, it is not the first Fed tightening that matters; it's the last.

With regard to the Fed, we do not have a historical precedent of zero interest rates and quantitative easing to look back on and draw determinations. Our central bank has a dual mandate of price stability and maximum employment. They were failing to meet both of these mandates last summer so it does not seem unreasonable whatsoever to expect them to use all of the tools in their arsenal.

We think it is very important to realize that, especially in today's hyper-partisan climate where both extremes manipulate the data to play on people's deepest fears, the Federal Reserve is not to blame for our fiscal situation or any of the anti-business legislation that has been passed. Contrary to what is often reported in the press, quantitative easing does not mean our government is borrowing more money directly through the debt markets.

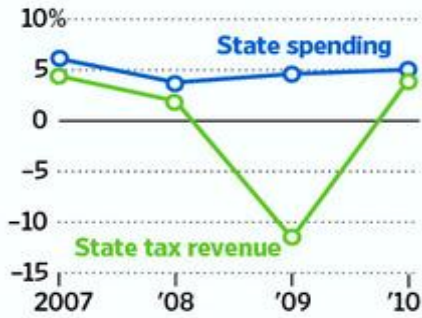
It has also been widely reported that the Fed, through their aggressive policies, is to blame for higher food prices. Even though it is very difficult to quantify the effects of their policies on commodity prices, we would argue that ethanol subsidies - causing the use of over 40% of our corn crop on a fuel that does not impact the supply or price of gasoline - contribute much more to the appreciation of agricultural commodities than any Fed program. We do not pretend to know how the Federal Reserve's aggressive policies will play out and would take issue with anyone that does. We expect them to continue using all means necessary to meet their Congressional mandate.

The municipal bond markets have experienced deep sell-offs over the past few quarters however the situation does seem to be improving. State and local tax revenue almost climbed back to the peak hit several years ago due to the reviving

economy. Total tax receipts for state and local governments hit \$1.29 trillion in 2010, just shy of the \$1.32 trillion generated in 2008, according to the Census Bureau Data.

Income Upturn

Percentage change from a year earlier



Note: Includes spending from federal funds and bonds.
Sources: Census Bureau (tax revenue); National Association of State Budget Officers (expenditures)

Cash Flow

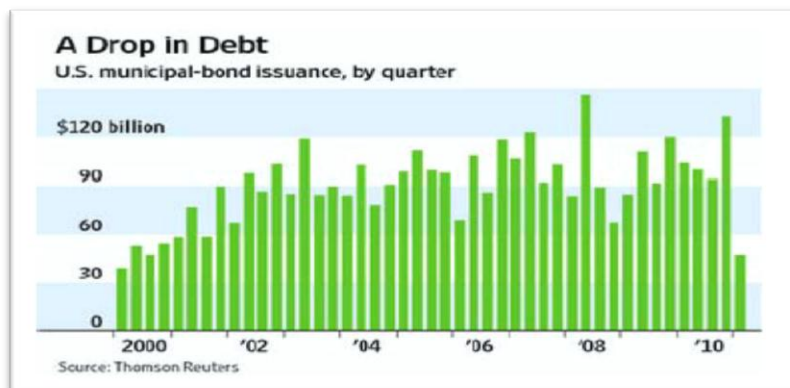
State and local tax revenue, percentage change from a year earlier



Source: Census Bureau

Even though the news has improved, the fiscal situation at both the state and local level has deteriorated to such an extreme that it will take years to bring budgets down to normalized levels. States are primarily funded by sales and income taxes and therefore tend to grow along with an expanding economy. At the local level, the nation's 89,000 cities, school districts, and other local governments are heavily dependent upon property taxes which tend to lag an expanding economy. It typically takes a few years of falling home prices to show up in property tax receipts and the latest Census figures suggest that is now happening.

The recent events in Wisconsin and Ohio are encouraging, but there will undoubtedly be several defaults and as a result there could be some great opportunities in this space during the second half of this year. The chart below illustrates just how much the appetite for municipal debt has decreased as investors start to weigh the creditworthiness of so many state and local governments.



Source: Thomson Reuters

With regard to the recent events in Japan, we are not overly concerned about any material impact on global growth. Japan is the world's 3rd largest economy contributing 8% to global GDP. Growth estimates in Japan will be revised down 5%-10% short term so it could impact global growth somewhere between 50-80 basis points. This translates into a trivial change in global GDP from 5% to 4.95%.

How the Japanese finance their reconstruction efforts could have far bigger implications on the capital markets. Japan has a 200% debt to GDP ratio, with over 90% of Japanese Govt. Bonds (JGB's) owned by the Japanese public. In comparison, our debt to GDP is currently 90% with over 50% of our treasuries owned by foreigners.

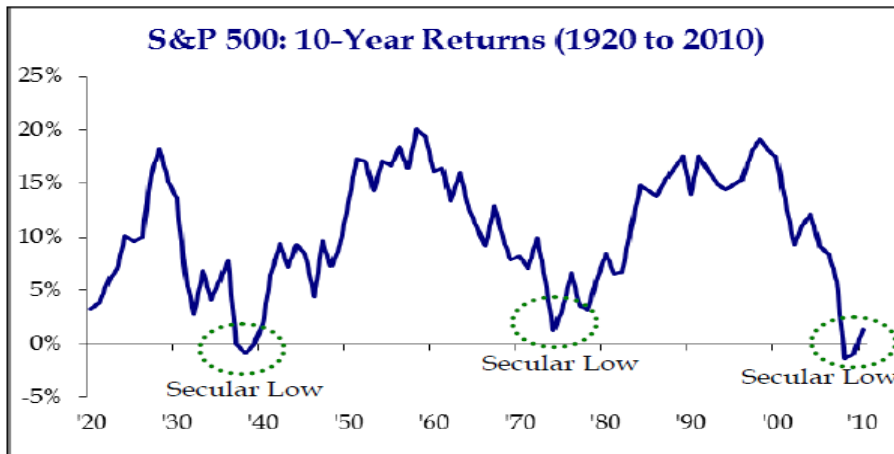
This is significant because the Japanese are going to have to issue a lot more debt and the public might not have the means to meet this demand as they have in the past. Short term, the yen has moved higher as the Japanese government has been forced to sell off assets and repatriate them back into Japan. Longer term, this could put even more upward pressure on the yen as JGB's are forced to pay higher and higher interest rates to meet their borrowing needs. A strong currency poses a big problem for export economies such as Japan's.

The biggest threat to economic growth is energy prices. According to AAA's daily fuel gauge survey, gasoline prices have risen from \$3 last December to \$3.58 this March. As a result, most economists are shaving their growth forecasts down from an average of 4.0% to 3.5% - a 12.5% decline.

To put this into perspective, a \$1 increase in the price of oil translates into a 2.5 cent increase in gasoline; each \$0.01 increase in a gallon over the course of a year costs consumers approximately \$1 billion dollars per year.

Another way of quantifying the impact of higher energy prices would be to weigh it against the recent payroll tax cuts. Oil averaged \$80 in 2010 and if it were to average its current price of \$103 throughout 2011 it would wipe out half of the tax reduction and have a meaningful impact on discretionary spending - a major problem for an economy where consumption represents over 70% of GDP. Of course, the psychological impact it has is just as relevant even though it is difficult to measure.

In conclusion, the US economy has a long track record of being resilient. Economic output and earnings are much better now than almost everyone anticipated just a few years ago. The period from 2000 through 2009 represented the worst 10 year period in the equity markets history, an incredible statistic considering we have endured the Great Depression throughout the 30's, WWII in the 40's, and the stagflation era 70's. The chart below illustrates the 10 year trailing returns and gives us a good perspective of what we have endured.



This is one of the more compelling charts for the longer-term bulls.

As Jason Trennert of Strategas Research Partners recently noted, even after the historic gains in the equity markets over the past few years people remain skeptical with the rarest animal on Wall Street being the “unabashed bull”. It does appear that investors are getting Armageddon fatigue and this should translate into calmer capital markets. The simple truth is that bears will always sound more intelligent than bulls. Regardless, we respect those that put themselves on the line by taking calculated risks on their client’s behalf; it doesn’t take any talent to be permanently conservative.

The recent events in the Middle East/North Africa and Japan are a good reminder that the biggest economic risks are always unknown and therefore our strategy is always subject to change as the economic data, market fundamentals, or geopolitical events dictate. Thank you for your continued confidence in our firm.