

# TITLEIST

ASSET MANAGEMENT, LTD.  
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For literature and account information, please visit the firm's website.

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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2010

## First Quarter Report

The Dow Jones Industrial Average finished the quarter up 4.7% while the broader based S&P 500 closed with a gain of 5.7%. The Barclays Aggregate Bond Index returned 1.6% for the first quarter. Consumer discretionary and industrials were the two leading sectors this quarter while telecom and utilities continue to lag.

The equity indices started off 2010 with a 4% upward move the first three weeks of January and then sold off dramatically in late Jan and early Feb due to fears over Greek debt and other sovereign debt issues within the EU. The austerity measures taken by Greek authorities and stronger EU partners such as Germany and France providing a verbal backstop have helped calm the markets.

Even though Greece only represents 4% of the European GDP, this is a very big deal because other countries such as Spain, Portugal, Italy, and Ireland are in similar fiscal situations and this could lead to major banking problems within Europe and a possible collapse of the Euro.

Our second biggest concern continues to be protectionism around the globe. In today's tough economic environment it is very easy for politicians to cater to the populist rage by tacking on tariffs and restricting free trade. We learned this lesson the hard way throughout the Great Depression and hopefully governments around the world will avoid going down this path again. Protectionism has been referred to as the "heroin of economics", making one feel much better for a short period of time only to have devastating effects over the longer term.

Market fundamentals remain intact with modest earnings multiples and most leading economic data signaling a much stronger recovery than consensus expectations. S&P earnings for 2010 should come in around \$84 and 2011 closer to \$95 with financials contributing the biggest growth as they work through the bad loans on their books. A forward multiple of 12-14x in today's historically low interest rate environment is reasonably priced in our opinion.

To put this into perspective, the market has traded at an average of 16x forward earnings over the past two decades with the 10 year Treasury averaging 5.5% versus today's 3.9%. The market is trading at a discount to historical norms considering where interest rates are b/c of all the future headwinds such as higher taxes, prolonged high unemployment, and lower growth prospects.

What several of the key metrics do not take into consideration is the record amount of cash on the books. S&P balance sheets (ex-financial sector) have never been healthier with almost 1 trillion in cash which represents 11% of total assets; this is the highest ratio since 1955. This cash can be used in the future for stock buybacks, dividends, and acquisitions. Other key indicators such as free cash flow (much more difficult to manipulate with creative accounting) remain near all time highs.

Further, companies have been able to raise capital via the debt markets at record low rates over the past 9 months. There was a record 61 billion in junk bond issuance in this quarter alone; this means companies in poor financial health were able to recapitalize. The credit markets have been functioning extraordinarily well for large corporations. Unfortunately, the same cannot be said for small businesses and consumers.

In addition to record money market balances, we continue to see fund flows into fixed income funds significantly outpace flows into equity funds. This trend will end quickly when investors realize that cash and fixed income are toxic assets in an inflationary environment. The perceived "safety" of the fixed income markets will quickly diminish when investors realize how much principal they can lose in the short/intermediate term and even more so when their principal is paid back in dollars that have significantly less purchasing power.

The inventory replacement cycle we referenced in our Q2 2009 letter will be moderating over the next few quarters. The biggest risk to the next phase of the cycle occurring is anxiety by businesses and consumers relating to policy coming out of Washington.

We will continue to monitor the markets and look for solid long term investment opportunities while maintaining an emphasis on risk management