

# 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

## Third Quarter Report

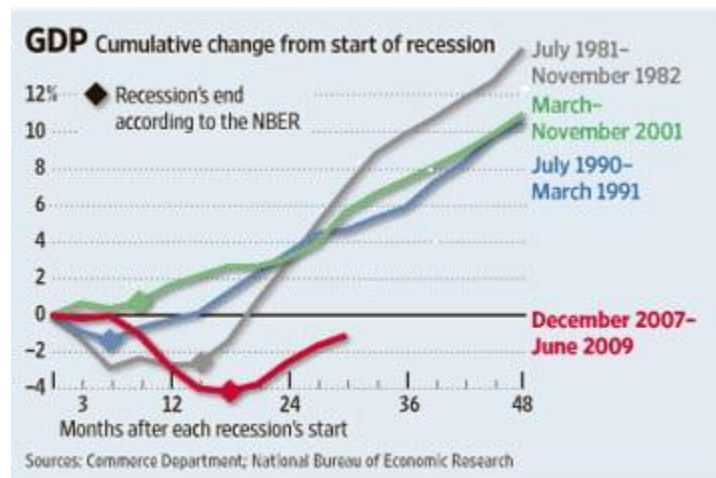
The S&P 500 finished the first three quarters of 2010 with a total return of 3.8%. The consumer discretionary and industrial sectors were the top performers while the energy, technology, and healthcare sectors continue to be the biggest laggards. We have overweight positions in both energy and technology and believe they represent some of the best prospects in the years to come.

Technology shares experienced the worst declines after the EU crisis primarily because they have the most exposure to the Euro. The Euro has rallied over the past few months to pre-crisis levels yet several of the large cap technology stocks are still down 10-20% from their highs last April. Technology has been the brightest area of the last two GDP reports with business spending on new equipment and software rising at a 24.8% pace last quarter, the highest since 1983. We continue to believe the tech sector is in the early stages of a corporate upgrade cycle.

The energy sector suffered huge declines after the BP spill and has yet to recover. We still believe the prospects for the energy sector represent an incredible investment opportunity. Valuations and future growth potential both appear very attractive. Emerging market demand forecasts are alarming and an incremental tick up in economic activity domestically and in other developed nations could put serious strains on supplies. This sector also represents a great hedge against the potential future debasement of the dollar.

Even though the equity markets have been fairly resilient this year in the wake of disappointing economic data, investor sentiment remains pessimistic as evidenced by opinion polls, light trading volume, and fund flows. The most accurate description we have heard so far is that the markets are suffering from “Post Financial Crisis Stress Syndrome”. There seems to be a heightened sense of fear that the next collapse is right around the corner.

Even amidst an economic backdrop of high unemployment and slow growth, fears of a double dip recession have decreased over the past quarter. It would be normal to see 5%-6% growth coming out of such a deep recession instead of the current 2.5% growth rate. Looking ahead, we expect growth to increase to 3% but the data will most likely remain volatile and uneven along the way. Below is a chart detailing the change in GDP coming out of the past three recessions.



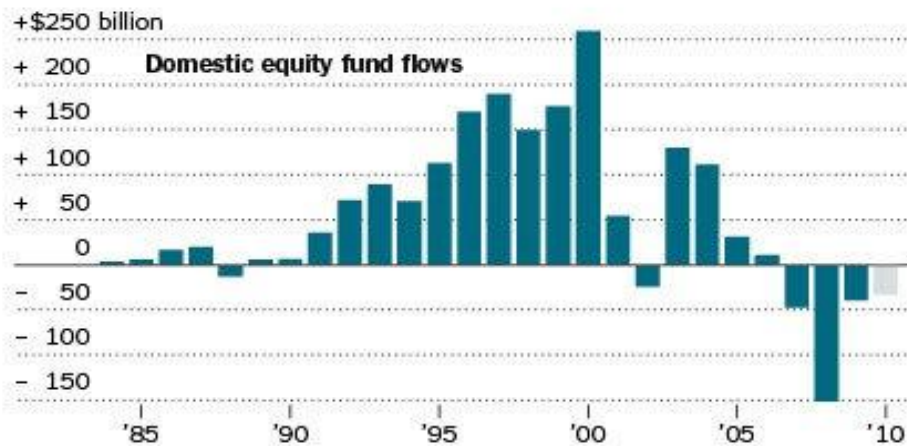
The correlation between all stocks, and risk assets for that matter, has been at record highs. This has led investors to feeling like they own “the stock market” instead of individual companies. Assets such as equities and crude that historically had a 30% correlation have increased to 70%. This has been attributed to actively trading managers putting “risk” on or off as macro forces such as the European debt crisis and stimulus programs trump anything that is company specific.

One thing is certain, all companies are not equal and it is only a matter of time before the performance of the most profitable companies decouple from the performance of companies that are losing market share and profitability. The silver lining to this story has been premium companies trading in line with average market valuations. This has enabled us to position our portfolios with the highest quality companies that have historically been too expensive to buy in the past.

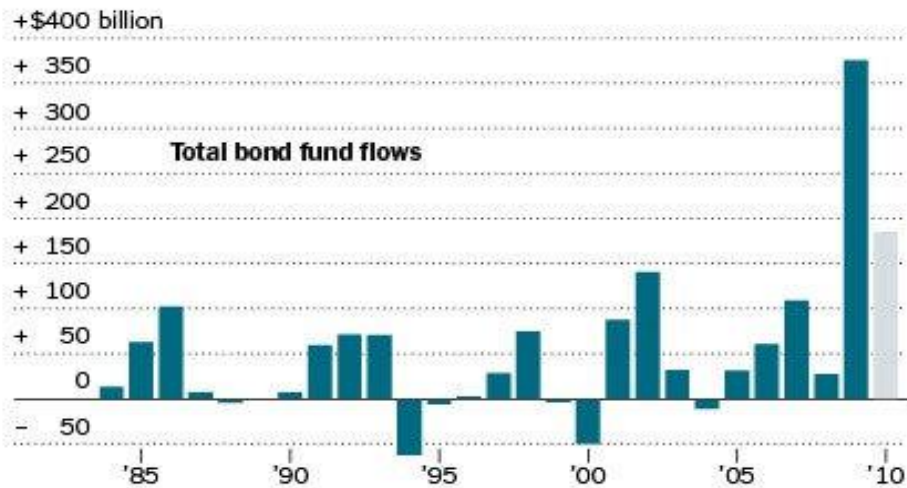
Even in an environment where premium companies are trading at large discounts to their historical averages, the bond markets continue to attract more and more capital. While we do not believe the economic landscape supports average historical valuations, the equity markets still represent the best value at today's levels. The chart below illustrates fund flows between equities and fixed income. If you were to annualize the contributions into bond funds this year it would come in around 2009 levels.

### Flight to Safety

In the last few years, investors have been pulling their money out of stocks ...



... and putting more in the relative safety of bonds.



Source: Investment Company Institute

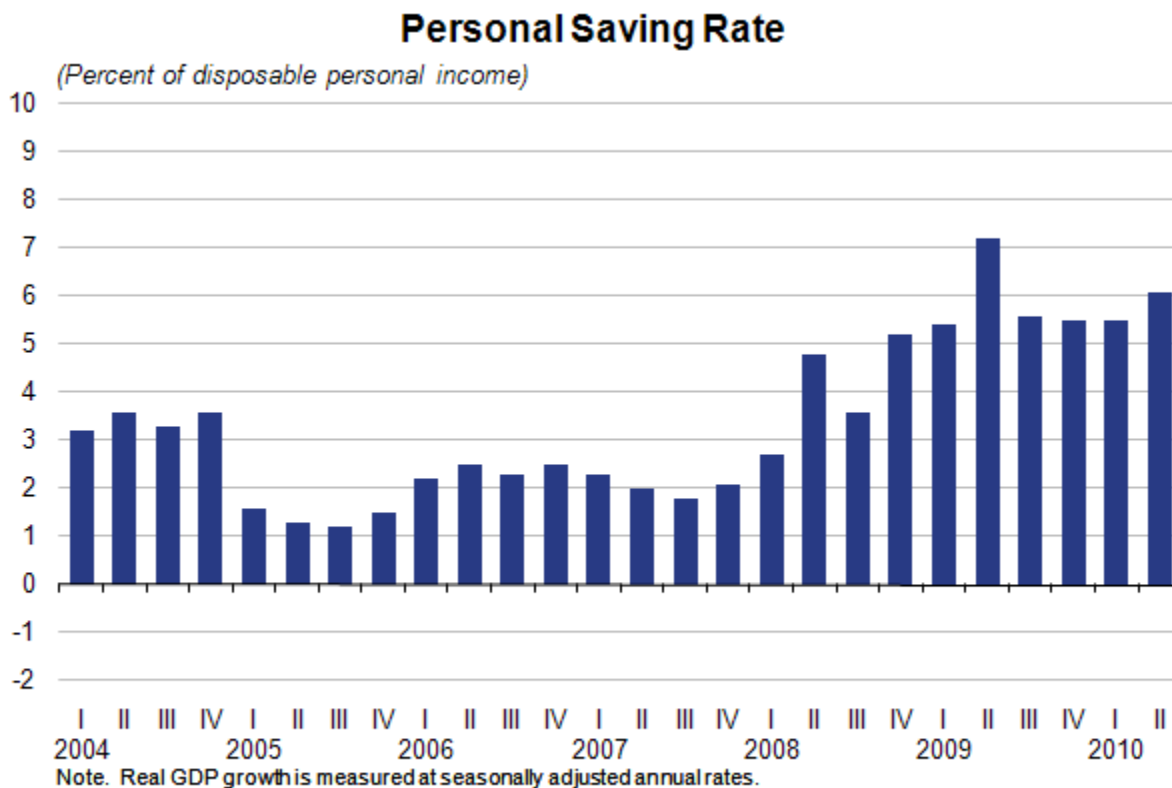
THE NEW YORK TIMES

The flows into fixed income over the past few years look eerily similar to the flows into equities in the late 90's - and that did not end well.

Most of the flows into fixed income have been going into "low risk" paper such as treasuries, agencies, and other forms of investment grade debt that would most likely fare better if we enter into another period of economic decline. We expect to get through this disinflationary environment fairly quick and fears will again shift towards inflation. At that time, investors will command rates in excess of the inflation rate and we expect the flows to reverse out of bonds, which would underperform in an inflationary environment.

Comparisons to the Japanese experience over the last few decades are overblown. First, our two countries are completely different demographically. Currently, 23% of the Japanese population is over 65 and projections for 2020 are for this ratio to increase to 30%. Their population is aging and shrinking while trends here are the opposite. Population growth is key to economic growth.

Culturally, there are significant differences as well. For example, their savings rate is closer to 40% compared to ours being around 6%. It has been said that "one person's savings is another person's income" so it is important to have a good balance between consumption and savings. Societies that have confidence in their long term economic prospects are much more likely to consume in the short term. The chart below shows savings rates in the U.S. have increased to what most economists believe are healthy levels (6%) as households repair their balance sheets.



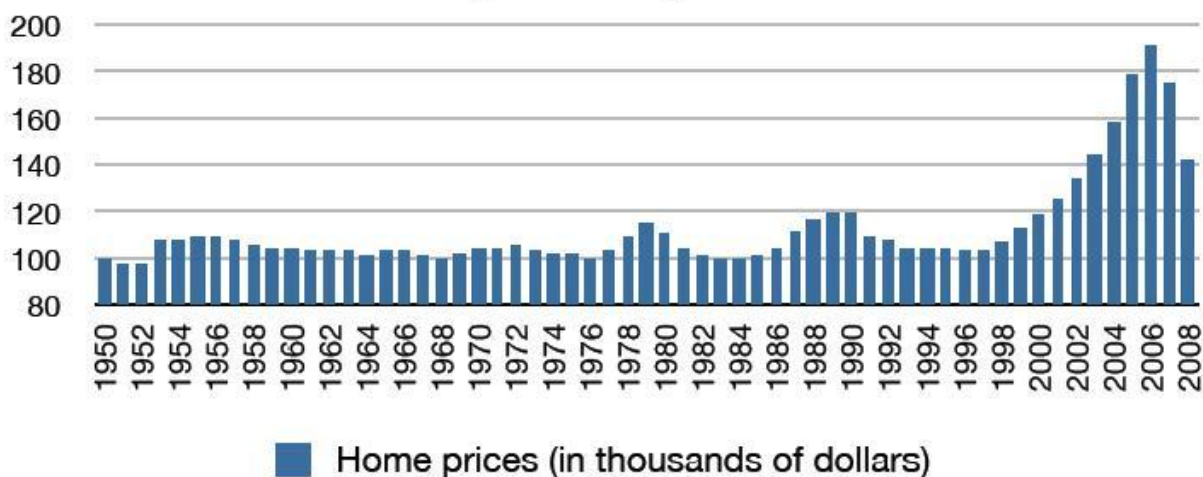
U.S. Bureau of Economic Analysis

The fixed income markets are not discounting any future inflation at today's rates. As we discussed in our Q2-09 letter, deflation is the concern over the short/intermediate term but over the long term inflation will inevitably have a higher correlation with money supply. Velocity should increase as banks earn their way through loan losses in the coming years and begin to lend at normalized rates. Some of the most respected analysts forecast bank earnings to double in the next 3 years as a result of working through the bad loans on their books.

Other markets are not signaling deflation at all. Gold is at all-time highs, soft commodities such as corn and cotton are at 15 year highs, industrial commodities are all up 30% YTD, and the implied inflation rate as measured by the 10 year TIPS has increased from 1.5% to 1.9% in just the past few weeks. Other less obvious signs such as wages in China also support the inflation camp as they drive higher prices for Chinese exports.

The key gauge of inflation (CPI) can be misleading with so much weight given to shelter (housing/rents). The most recent Case-Shiller real estate index has the largest 20 cities residential real estate markets appreciating 3.2% in the last year. It does appear that the downward trend in residential real estate has stopped and it would be reasonable to expect residential real estate to do what it has always done between WWII and the late 90's. Below is a chart showing the historical prices of real estate accounting for inflation. The average annual investment return from 1950-2000 was less than one-half of 1% per year, after adjusting for inflation.

### The history of housing as an investment



Source: Economist Robert Shiller, Yale University

While we are painfully aware of the macroeconomic headwinds and structural economic problems, things might not be as bad as the financial media portrays. This, in addition to the poisonous political rhetoric that always accompanies an election year, has been an extremely destructive force. Perhaps journalists know they will get a lot more clicks with a headline reading “Market Crash Imminent” compared to “Economic Activity Improving”. Market technicians playing on investor fears have come up with technical indicators such as the “Death Cross”, “Bearish Abandoned Baby”, and “Hindenburg Omen”. This kind of baseless research should decrease as the capital markets improve; even if they do make a right call, it is almost always for the wrong reasons.

While there have been so many famous quotes from the deep recessions of 73-74 and 81-82, we thought it would be useful to refer back to some key headlines from the Wall Street Journal and Time magazine describing the 92-93 recession.

*"Our own view is that recent tax increases have hurt both business incentives and consumer confidence, while the incredible looming health-care mandate suppresses job creation. Only a brave employer hires new workers when he has no idea how much they will cost. We do give the president's team high marks for giving the Federal Reserve a pass, a fact that has helped produce the marked plunge in long-term interest rates. Yet it's hardly reassuring that even lower rates don't seem to be lifting the real economy...."* Wall Street Journal, September 1993.

*"The US economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many "structural" burdens, as opposed to familiar "cyclical" problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought; the debt hangover; the banking collapse; the real estate depression; the health care cost explosion and the runaway federal deficit."* Time Magazine, September 1992

In September 1992, the Dow Jones Industrials was around 3,300 and six years later appreciated over 300%. Even though each recession has its own unique characteristics, it is interesting to draw the parallels to our current situation and the concerns cited above.

Looking ahead, the biggest risk to the market remains the sovereign debt issues within the EU. Other concerns include another leg down in home prices and policy mistakes out of Washington. We have lowered duration significantly on the fixed income portion of our portfolios and remain optimistic about the prospects for our equity holdings.