

BLACKHAW WEALTH MANAGEMENT

INVESTOR NEWSLETTER: 1ST QUARTER 2011

IN THIS LETTER:

- 1st Quarter Events
- The End of the Nuclear Renaissance
- The Future of Natural Gas
- Investment Considerations

1ST QUARTER EVENTS

"There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know."--Donald Rumsfeld, Secretary of Defense under Presidents Gerald Ford & George W. Bush

During the first quarter of 2011 I believe that we have experienced all of the types of uncertainties described in the opening quote. The continued financial pressures on state and local government agencies were "known knowns" and nothing material has changed. The overall rate of default in the municipal bond markets is far below the doomsday predictions of certain highly vocal pundits. Furthermore, across the country, state, local, and municipal agencies continue to cut their payrolls and raise taxes as they struggle to maintain fiscal balance. As I said last quarter, these government agencies will continue down the path of fiscal austerity, and this is a positive development for municipal bond investors.

Recent events in the Middle East could be described as "known unknowns." No autocratic government can last

forever, and during the past quarter we have seen governments toppled in Tunisia and Egypt with continued violence in Libya and Bahrain, and considerable social unrest across the entire Middle East and North African region. Finally, the situation in Japan was an "unknown unknown." At the beginning of the quarter there was certainly no way to foresee that an earthquake, tsunami, and subsequent meltdown at a nuclear power facility would weaken the world's 3rd largest economy, causing the Japanese stock market to decline by 15% in 2 days. In light of recent events, I would like to utilize this letter to discuss the past quarter, some of the "known unknowns" that may affect financial markets in the months and years ahead, and discuss how our client accounts are currently positioned with respect to certain opportunities that I see in financial markets.

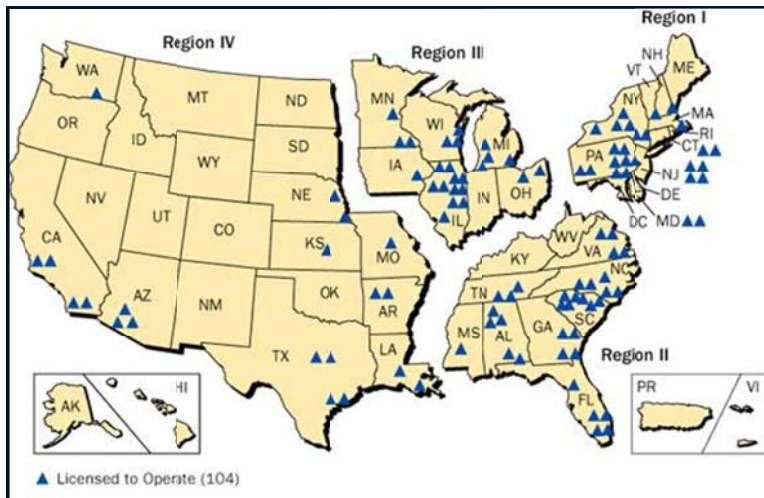
THE END OF THE NUCLEAR RENAISSANCE

The situation in Japan is tragic in many ways. Although it is too early to know what the financial consequences will be, history demonstrates that these sorts of shocks tend to have only temporary effects on an economy. However, catastrophes of this nature also have a way of permanently affecting human behavior. Case in point: the partial meltdown at Three Mile Island in 1979 – which produced relatively little radiation beyond the plant itself – proved to be a turning point in the domestic nuclear power industry in the United States. Three Mile Island crystallized public safety concerns and provided a boost to the anti-nuclear sentiment that was already growing within the United States in the 1970's. The ultimate result was simple: no new nuclear power plant

has been permitted for construction in the United States since the Three Mile Island incident in 1979. In fact, of the nuclear power plants currently operating in the United States, all of them broke ground before 1975. Even the most youthful nuclear plant among our fleet is now approaching 40 years of age!

There are currently 104 actively operating nuclear reactors in the United States. Despite more than three decades without a single new plant constructed, the installed base of nuclear generating capacity still produces 20% of all the electricity consumed in the United States. The following map shows the various locations of the 104 operating nuclear reactors in the U.S.

For many years now there has been talk of a “nuclear renaissance” in the United States. After being unpopular for so long, nuclear power has enjoyed some renewed popularity in recent years, becoming one of the few topics upon which both conservatives and



liberals seemed to find common ground. Conservatives like the fact that nuclear power could reduce our dependence on foreign oil while liberals like the fact that nuclear power is cleaner than coal and produces no greenhouse gas emissions. Unfortunately, nuclear power is not without its own problems. Aside from the obvious need to handle and store nuclear waste (read about Yucca Mountain if you want to know more), nuclear power safety considerations contain an asymmetry that make it unpalatable for many people. Specifically, things don't go wrong with nuclear power plants very often, but when they do go wrong, they tend to do so in spectacular

fashion. Thirty years of perfect operating safety can be wiped out in minutes by one human error or other event, leading to a release of radiation. This is the case in Japan right now. A once-in-a-century magnitude earthquake created a tsunami that crippled a nuclear power plant that was never designed to withstand such a great earthquake or tsunami in the first place.

Nonetheless, I have to admit to being somewhat surprised by the reactionary nature of recent events. Germany has temporarily shut down all of her nuclear plants which had been placed into operation prior to 1980, representing about 40% of the nuclear fleet. China, the world's current leader in nuclear power development, has suspended the issuance of new nuclear power plant approvals until officials can strengthen safety standards and ensure that all of the lessons to be learned from the situation in Japan could be understood and

implemented accordingly. (I suspect China's decision will be short-lived and the country will move forward, lest she continue choking from the pollution being produced by her dirty coal-fired power plants.) Chinese officials have also announced that they might double investments in solar energy over the next 5 years, an area in which China already leads the world.

Rightfully or wrongfully, I predict that there will be no nuclear renaissance in the United States. This will only further increase our dependency on other sources of energy and ultimately lead to higher prices for all other energy commodities, particularly oil and natural gas. If

there is one common conclusion that we should all take away from the recent events in both the Middle East as well as in Japan, it is this: the United States is becoming increasingly dependent on its own domestic energy sources, as well as select foreign sources in the Western Hemisphere, such as Canada, Mexico, and Brazil. Middle Eastern oil is a terribly unstable source of energy, despite its abundance and low cost. Nuclear power facilities are very expensive and socially unattractive. Coal is also relatively expensive, and quite dirty. Natural gas, by contrast, is clean, abundant, and domestic.

At this point, my readers might think it fair to criticize my conclusions about this matter and label them as reactionary. After all, by declaring the nuclear renaissance essentially over before it ever really began, am I just piling onto the current popular sentiment that stems from the media coverage of the events in Japan? Am I simply being short-sighted and ignoring the long-term climate problems, which nuclear power would surely alleviate? Am I ignoring the fact that, even after the incident in Japan, President Obama himself still affirmed his support for nuclear power and its role in our domestic energy policy? Simply put, no. I am not being any of these things. I am being a pragmatist and evaluating the long-term reality of the facts. Don't believe me? Well, perhaps you'll believe John Rowe...

“NATURAL GAS IS QUEEN RIGHT NOW...IT IS GOING TO BE THE DOMINANT SOURCE OF ENERGY FOR ELECTRICITY, ON THE MARGIN, FOR THE NEXT 10 AND ALMOST SURELY FOR THE NEXT 20 YEARS.”-JOHN ROWE

THE FUTURE OF NATURAL GAS

Mr. John W. Rowe is the Chairman and CEO of Exelon Corporation, that latter of which is the largest owner of nuclear power plants in the United States, including 17 of the 104 aforementioned reactors currently in operation. John Rowe is widely considered to be an expert in the energy and utility industries and is a self-described

“nuclear guy” – which probably comes as no surprise given his employment as the CEO of Exelon. On March 8th, 2011, precisely 3 days before the earthquake and tsunami in Japan, Mr. Rowe gave an interview and speech before the American Enterprise Institute.

During the interview Mr. Rowe said the following:

“On the margin, natural gas is the probable source of supply for any new [electric] generation that we might build...natural gas is 50-60% of the price of new nuclear, it's cheaper and much cleaner than new coal...its cheaper than wind and much cheaper than solar. Natural gas is queen right now...it is going to be the dominant source of energy for electricity, on the margin, for the next 10 and almost surely for the next 20 years. It simply is more economical than all of the alternatives and is likely to be so for every year within a 20 year period.”

Looking beyond the next 20 years, Mr. Rowe had the following things to say:

“Up until 2 or 3 years ago, I simply could see no alternative to a major nuclear resurgence at some time, but as we look at a world with relatively slow growth in demand for electricity, wind that actually works, solar that has gone from 40 cents per kilo-watt hour to 20 cents...you do begin to envision that there may be a more complex technology base out there that might be economically competitive with nuclear, and socially thought to be preferable.”

Mr. Rowe went on to describe his “vision” of a future technology base for electricity generation and it focused on a combination of wind, solar, and natural gas, with natural gas being the “bridge technology” that alleviates

our reliance on coal, oil, and nuclear power, and buys time over the next two decades while wind and solar technologies become increasingly efficient and economically competitive.

Later, in a prepared speech, Mr. Rowe laid-out the case for natural gas, with the following points:

- New gas finds, both conventional and shale gas, have dramatically increased our domestic natural gas supplies. The U.S. is now the third-largest producer of natural gas after the Middle East and Russia.
- Natural gas enhances energy security; unlike oil, nearly all of our natural gas supply is produced here.
- Natural gas can reduce our dependence on oil if we fuel our vehicles with it: replacing 3.5 million heavy duty vehicles with natural gas vehicles would save more than 1.2 million barrels per day of oil – more than the United States imported from Venezuela or Saudi Arabia in 2009.
- Natural gas is the cleanest fossil fuel. It emits 80% less sulfur dioxide and nitrogen dioxide than coal, and 55% less carbon dioxide than coal.

Finally, Mr. Rowe commented that this isn't some theoretical idea that may or may not happen. As usually happens, the free market has already made it a reality and as a result Mr. Rowe says that "natural gas has already jumpstarted the transition to clean energy...18 companies have announced their plan to retire or mothball nearly 12 giga-watts of coal-fired generation nationwide – they are simply no longer economical. Gas usage in the utility sector was up an average of 6% year over year for the first half of 2010 compared to 2009." Numerous utilities have announced plans to retrofit coal-fired power plants to burn natural gas, or to accelerate

the retirement of aging coal plants, which cannot meet new emissions standards.

Now, if all of these comments were coming from an executive at a wind, solar, or natural gas company, it wouldn't be particularly newsworthy. But as I said, Mr. Rowe happens to be the CEO of Exelon, the largest nuclear power plant operator in the United States, and this makes his comments very interesting indeed; even more so when you keep in mind that he made these remarks before the tragic events in Japan. If Mr. Rowe won't build a new nuclear power plant in the United States, who will? The answer is – nobody. There will be no nuclear renaissance in the United States. There will be an energy transformation, of sorts, and it has already begun, with natural gas leading the way. Natural gas is simply too cheap, clean and abundant for there to be any other outcome. Furthermore, the U.S. Energy Information Administration (EIA) reports that natural gas consumed for electricity generation represented 23% of the total electricity market in the U.S. in 2009, which is the highest percentage share of natural gas since 1970.

INVESTMENT CONSIDERATIONS

With respect to our investments in client accounts at Blackhaw Wealth Management, I'd like to make a few comments. First, we do not hold any primary investments in domestic nuclear power plant operators or engineering & construction firms that would be adversely affected by recent developments, nor have we ever held such investments in our client accounts. Furthermore, our international investments have no direct exposure to Japanese equities. In fact, our two core Asian mutual funds specifically exclude Japan from their investment mandates and therefore hold no Japanese equities at all. Consequently, the recent events in Japan have had no direct impact on our investment holdings. We do, however, own a fair amount of oil and gas companies,

principally focused in the Western Hemisphere, as well as plenty of Asian equities outside of Japan. It is this focus on Western Hemisphere energy that I would like to discuss further, principally North American natural gas.

As my clients know, I believe that Master Limited Partnerships (MLPs) are an attractive area to look for investment opportunities. Historically, I have focused on mid-stream oil, gas, and product pipelines that have limited commodity price sensitivity and an emphasis on rate-based contracts. These pipelines are essentially like toll booths – they collect a fee for every barrel of oil and every cubic foot of natural gas that moves through them. Each quarter, most of these net fees are paid-out to the investors (you) in the form of a tax-deferred distribution. I believe that this is still the best way to position our clients for the future growth of natural gas consumption in the United States. I honestly have no clue if the price of gas will be higher or lower in the next year or two, and

won't even venture a guess. Most credible forecasts suggest that natural gas prices will remain low for a very long time, perhaps a decade or more, which suggests that it may not be a good idea to invest in companies engaged in the business of natural gas *production* at this time. However, due to its low price and abundance, I believe that

natural gas *consumption* will grow at a much higher rate than overall energy consumption in the U.S., and we should own those pipelines that will benefit from the transportation of these growing natural gas volumes.

At this point in time, most of our non-IRA client accounts hold 4-6 different MLP investments, which have a combined 80,000 miles of natural gas pipelines, 600 billion cubic feet of natural gas storage facilities, dozens of treatment, processing, and gas compression assets, and

currently handle up to 40% of all the natural gas consumed within the United States. Many of these MLP investments were held last year, with two new investments made during the 1st quarter of 2011. These MLPs have an average annual cash distribution yield of 6% and it is reasonable to expect these cash distributions to grow by more than 10% per year going forward, due to their inflation-adjusted rate escalators, volume increases, and capacity expansion projects. I believe that this is the best way for our clients to earn an attractive rate of return and tax-advantaged yield, while directly benefiting from the gradual transition to a natural gas-focused energy base in the United States.

There are a few important points that need to be understood about my perspective on the energy industry and my belief in the inevitability of natural gas to be the most attractive “new” fuel source for the coming decades.

First, although this may seem like a U.S. centric investment, it really isn't. The U.S. economy doesn't need to grow at all for these investments to do very well. Even in the absence of any economic growth whatsoever, demand for natural gas will continue to grow because, on the margin, we will have a decline in coal-fired and nuclear electricity generation in this country. Coal

and nuclear are less economic, and coal is much more damaging to the environment. Second, it is highly probable that the price of crude oil will continue to march steadily higher over the next 10 to 20 years. Even if U.S. oil consumption remains flat, emerging market economies will continue to grow and consume more oil themselves, causing the global price of oil to continue its upward trajectory. With every increase in the price of crude oil, natural gas becomes that much more

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economically attractive as a transportation fuel source. Third, because of the global nature of the crude oil markets and instability in the Middle East, the United States will always face the risk of price and supply shocks. As investors, by owning companies that are focused on domestic natural gas (as well as Canadian and Brazilian crude oil) we are inherently hedging some of the risk of adverse developments in the Middle East. While it is impossible for the U.S. to ever achieve energy independence, natural gas will make us less dependent and thereby improve the nation's energy security.

In addition to the MLP investments described herein, we have recently made one new investment in a Canadian light crude oil producer (not oil sands), which happens to be the largest producer of light and medium crude oil in western Canada. The company has substantial growth opportunities, a talented management team, an attractive valuation, and a 4% dividend yield. I continue to look for other investment opportunities in U.S. and Canadian natural gas, as well as oil-related investments throughout the Western Hemisphere. I am optimistic that we'll find more investments in such areas.

Finally, as I have mentioned in previous letters, we have substantial investments in Brazil; whose economy, financial markets, and middle class are all expanding at a swift pace. As it relates to the subject of energy, there are a few aspects of Brazil's economy that are worth noting. First, Brazil is now a net exporter of crude oil and is expected to become a larger contributor to the global oil supply in the years to come. Second, during 2010, approximately 50% of all the new oil discoveries around the world were made in Brazil. Third, Brazil is the world's largest exporter of ethanol. Finally, 80% of all the electricity generated in Brazil is produced by hydro-electric facilities, making Brazil the "greenest" of all major economies. Being "green" ensures that Brazil possesses something that most developed economies will

never have: energy security. And because Brazil possesses energy security, she has a unique competitive advantage over many other countries, including the United States, Japan, China, and most of Europe (with the notable exception of France). In a world faced with dwindling energy supplies, growing demand, and persistent geopolitical risk, energy security will prove to be a strategic advantage for any economy, as well as for our clients' investment portfolios. We are invested accordingly.

As always, if you have any questions about this letter or anything else related to your investments at Blackhaw Wealth Management, please do not hesitate to contact me.

Sincerely,

Ian McAbeer, CFA
President
Blackhaw Wealth Management, LLC

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