

BLACKHAW WEALTH MANAGEMENT

QUARTERLY LETTER: 4TH QUARTER - 2010

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Blackhaw Wealth Composite	14.64%
S&P 500 Index	15.06%
S&P Global 1200 Stock Market Index	11.95%
Barclay's U.S. Aggregate Bond Index	6.54%
Barclay's Global Aggregate Bond Index	5.54%
Investable Benchmark	10.29%

Note: Returns are net of all fees and expenses; please read all disclosures related to this performance data.

2010 REVIEW

For the full year of 2010, the aggregate return of our client accounts was +14.6%, net of all fees and expenses. This compares to various market benchmarks, as shown in Table 1: Investment Performance.

As our clients know, I was not terribly optimistic at the outset of 2010 and continued to manage client accounts in a fairly conservative manner throughout the year. Given such a position, I am relatively pleased with the outcome for 2010 and hope that our clients are happy as well. Our investments in certain non-traditional asset classes benefited our performance this year, including high yield bonds, master limited partnerships, gold, and certain foreign currencies. Our fixed income strategy of focusing on low duration corporate bonds, callable municipal bonds, and foreign bonds produced modest returns throughout the year. Much of our foreign equity investments, particularly in China, delivered mediocre results. The timberland REIT

investments that I discussed in the 2nd quarter letter have lagged behind the broad advances in equity markets during 2010, and due to the interest rate environment, our domestic Treasury and agency securities added little to the bottom line. Nonetheless, I believe that our clients' portfolios performed well overall, and it is these results that ultimately matter. This is the nature of portfolio management. Investments are made with the expectation that each one should produce positive risk-adjusted returns for our clients, but in any given year certain investments naturally do better than others. One of the core investment principles at Blackhaw Wealth Management is to construct "all weather" portfolios for our clients. Since the future is uncertain, we maintain diverse portfolios containing individual investments that can be positive contributors to performance in almost any future economic environment, thereby conferring stability to our clients' accounts, and affording them the ability to weather the storms ahead.

2011 OUTLOOK & PORTFOLIO MANAGEMENT

With the end of one year and beginning of the next, it seems that it is human nature to reminisce about things. From an investment perspective, this is a time of year where market pundits and economists roll-out their predictions for all things financial: stock markets, interest rates, commodity prices, and the like. In many cases these individuals were wrong with their previous year's predictions, but nobody seems to care. I suppose this is a season for forgiveness.

With so little attention paid to past errors, economists and strategists are once again left to their devices, models, and tools to forecast financial markets in the coming year.

I recently saw an interview with one prominent equity market strategist for a major financial institution. This strategist stated a target for the S&P 500 stock market index for this year if 1,400. Given that the S&P 500 was trading at 1,257 at year end, and paying about a 2% dividend yield, a rise to 1,400 would imply a total return of about 14% in 2011 – not too shabby. Later in the interview, this market strategist elaborated further, saying that there was an 80% probability of the S&P 500 rising to 1,500 by year end, but a 20% chance that it would fall to 1,000, thus leading to a weighted-average forecast of 1,400. Although this is mathematically correct, I'm not sure that it is sound logic. Imagine that I took you to a restaurant and told you that you had an 80% chance of having a great meal, but a 20% chance of

“It's tough to make predictions, especially about the future” -Yogi Berra

getting food poisoning, with the weighted-average suggesting a 100% chance of a fairly decent meal, overall. Would you choose to eat here? Do these probabilities really help you decide if you should eat here, or skip the meal entirely? Not really.

Rather than focus on the mathematical probabilities of a good or bad year in 2011 (which would be guesses anyway) it is much more useful to think about the various factors that might make the new year relatively good or bad – with particular attention paid to the “bad” case – and describe how our clients' accounts are positioned as we begin 2011. The ultimate goal of the

portfolio management process is to create a diverse portfolio of financial assets that provide attractive risk-adjusted returns for each client, so, it isn't terribly important that we spin our wheels trying to determine if the stock market will rise by 20% or fall by 20% next year. Instead, we can merely acknowledge that there is a wide range of potential outcomes, and develop an investment strategy (and consequently a portfolio of investments) that is likely to perform well under *most* reasonable outcomes going forward, while providing the ability to actively adjust to changing conditions, as they unfold.

INVESTMENT OPPORTUNITIES

Since this is the first letter of 2011 let me be positive for a moment and talk about the opportunities that I see. First, in a surprise move (to me at least), the lame duck congress actually extended the Bush-era tax cuts to *everyone*, and substantially increased the estate tax exemption. I

have to admit that I was quite surprised by this move. For the first election in modern history, fiscal imbalances had risen in importance to become the primary factor in the minds of many voters, thus ushering in a class of tea party conservatives and other elected officials with a fiscally-conservative orientation. This made it all the more surprising that the first major piece of legislation to be passed post-election combined *both* spending increases *and* tax cuts, thereby further exacerbating the fiscal imbalances that we face! Apparently most of the lame ducks didn't care much about the message coming from their constituents. To be sure, I am happy to see the extension of the existing applicable tax rates, but I'm surprised at the same time. Having lower tax rates is a pro-growth strategy that materially increases the likelihood of strong economic growth in 2011.

It is also a near certainty that the Federal Reserve will hold interest rates low for the entire coming year because the unemployment rate is too high, and inflation (as the Fed reads it) is quite low. This one-two combination of accommodative monetary and fiscal policies should promote economic growth in the coming year.

In addition to this pro-growth economic backdrop, the market continues to offer attractive investment opportunities in select areas. I believe that high-yield bonds, both corporate and municipal, will outperform investment grade bonds in the coming year. Domestic equities should do reasonably well in 2011, particularly large caps and financials, as well as select foreign currencies.

The G3 economies – United States, Euro-zone, and Japan – have terminal fiscal policies; enormous

financial debt and ongoing deficits, coupled with stagnant growth. This creates a lethal combination of high risk and low growth, and calls into question the long-term ability of these governments to maintain financial stability. Although we can't really qualify this as an "opportunity," it is part of the reason why we continue to maintain investments in foreign bonds and foreign equities. Speaking first of foreign bonds, our primary investments are diversified across Australia, New Zealand, Canada, Mexico, Poland, Brazil, Malaysia, Indonesia, and Turkey. These investments provide real yields, protection against rising interest rates and inflation in the United States, and appreciation potential in an environment of a declining U.S. dollar.

Turning to foreign equities, our primary investments are focused in Asia and Latin America. As I've done throughout all of 2010, I continue to avoid any material allocations to stocks in Japan and Central Europe. On the surface this decision may seem limiting. After all, Europe and Japan collectively produce about 40% of total worldwide economic output, so it seems as though we are missing a big part of the investment opportunity set. However, I choose to avoid making such investments because most of these economies are scarcely growing, have unfavorable demographics, terminal fiscal policies, and social policies that virtually eliminate any chance of meaningful improvement in the foreseeable future. Consequently, our foreign equity investments are focused in markets with faster-growing economies, improving demographics, as well as social and fiscal reforms that suggest the future will be brighter than the past. This leads us to favor Latin America and certain Asian economies.

Interestingly, although our foreign equity investments are focused on areas of the world with so-far limited economic clout, these happen to be the areas of the world that continue to have the greatest promise. Brazil, as one example, is only 4% of total global economic output. I would imagine that most U.S. investors have no more than 1% or their total portfolios allocated to Brazil, if they have any Brazilian investments at all. Our clients, on average, have about 6% of their portfolios allocated to Brazilian stocks and bonds. Similarly, we are overweight certain Asian markets as well. These economies represent the fastest growth and may actually have lower long-term risk than most would believe. The future is bright for Brazilians, for Asians, and for Americans who are invested accordingly.

INVESTMENT RISKS

Now for the bad news. There are enormous structural problems that threaten the economic outlook in the United States. Without question, the single greatest threat to our economic prosperity in the coming decade is the unsustainable level of deficit spending by the federal government, coupled with the unfunded liabilities of our entitlement programs, Medicare and Social Security. It is difficult to see how these problems can be resolved in a painless manner. Lesser developed countries in this situation have always chosen the “easy” way out, which is to default on their debt obligations. My opinions on this matter would require many pages, so let’s just leave it at this: most clients have 25-40% of their accounts

invested in securities that are denominated in currencies other than the U.S. dollar. I view currency and country diversification as a core principle of wealth preservation for U.S. investors.

I remain particularly concerned about the unintended consequences of the Fed’s myopic monetary policy, and the potential for a spike in interest rates in the coming years. It is for this reason that none of our client accounts have any material investments in long-dated treasury bonds or corporate bonds – the risk in such securities is simply too high. We will continue to maintain domestic fixed income allocations for our clients that are constructed with the intent of reducing interest rate risk. How is this accomplished? We own short-term bonds, not long-term. We also own bonds that have high coupon rates, which are less sensitive to market fluctuations than are low-coupon bonds. We own bonds that have variable rates, whereby the coupon payment will increase if interest rates increase. We also own inflation-indexed treasuries (known as TIPS), as well as agency step-up notes, the latter of which currently pay a 3% coupon that automatically “steps-up” to 6% in 2013, with the entire bond maturing in 2019. There is quite a bit of protection from rising interest rates that is automatically built into such bonds. Finally, on the municipal bond side, we have focused our buying on callable municipal bonds (otherwise known as “cushion bonds”) and these bonds are far less sensitive to rising interest rates than conventional municipal bonds. In other words, our clients’ fixed income investments are being actively managed in order to maintain a very low degree of sensitivity to rising interest rates.

The price of oil is concerning as well. Roughly speaking, a \$10 per barrel increase in the price of oil will translate into increased expenditures of about \$1,000 per year for the average family of four (about \$500 of this on gasoline alone). \$1,000 per year is a large amount of money to the average family of four, which only makes about \$50,000 per year to begin with. Just in the past 3 months, the rise in crude oil prices, if it holds throughout 2011, will be sufficient to wipe out all of the gains that the average family will see from the payroll tax reduction that also goes into effect this year.

Finally, the housing market remains deeply troubled. Sales volumes are anemic, inventory remains 50% above the historically-normal level, and mortgage rates have now been rising for the past 2 months. The Case-Shiller Home Price Index – a widely followed barometer of the housing market - continues to disappoint (Chart 1). The most recent report was released on December 28th, 2010 and covers data through the end of October. The report shows the 20-city composite index down -1% in the past 12 months, with 6 major cities reaching new lows since the initial decline began back in 2006. David Blitzer, Chairman of the Index Committee at Standard & Poors/Case Shiller, said the following in conjunction with the recent report:

“The double-dip is almost here, as six cities set new lows for the period since the 2006

peaks. There is no good news in [this] report. Home prices across the country continue to fall.”

The month-to-month numbers have been trending lower ever since the end of the home buyer tax credit (Chart 2 on following page, shaded area represents the time period of the home buyer tax credit). Only time will tell if the trend moves back into positive territory or continues to

worsen, but this is a warning to anyone that believes in the sustainability of the current recovery. The tax credit appears to have quickly supported housing prices, but as soon



as the government removed its artificial stimulus to the housing industry, prices began moving downward once again. With so many aspects of our economy receiving temporary government support, it is impossible to know for sure what the true underlying economic vitality would be without such support.

Going forward, it is difficult to be very optimistic about the economic outlook, given the likelihood of ongoing slack in the housing market. Can we truly have a “homeless” economic recovery? I’m not sure that we can. Housing represents the single largest asset that most American’s own, it is a leveraged asset, and the value of our homes continue to decline as we begin the 5th year since the home price peak in 2006.

Given all of these risks, I remain somewhat less-than-enthusiastic about the prospects to make high rates of return in the next year or two. As mentioned previously, I continue to avoid long-term bonds of any kind, due the interest rate risk and poor return prospects. Our client accounts do hold a fair amount of equities (50-60% in most cases), but I

would only expect the returns from these

investments to be average over the next year or two and I would be surprised if equity markets

produced double-digit rates of return in 2011. Low interest rates and low economic growth typically lead to low investment returns. It is not possible for an economy to produce nominal growth of 3-4% per year – as the U.S. economy is likely to produce - and for a stock market to produce 10%+ appreciation per year, as so many were accustomed to seeing historically. The recently-passed tax cuts will support greater economic growth, but it only exacerbates the long-term fiscal problems that face. It is impossible to know if the near-term benefits will ultimately outweigh the long-term consequences, but suffice to say, the current policies create a situation where we borrow from the future so that can spend today. And, if you live above your means today, by definition, you must live below your means at some point in the future.

THOUGHTS ON MUNICIPAL BONDS

I would like to take a moment to address one additional matter that I have been asked about recently: municipal bonds. Lately, the subject of municipal bonds has received a considerable

degree of media attention. Investors fear both the default risk of the municipalities themselves, as well as the interest rate risk that is inherent in such bonds. This is really a new phenomenon as

muni bonds have historically received very little attention from anyone.

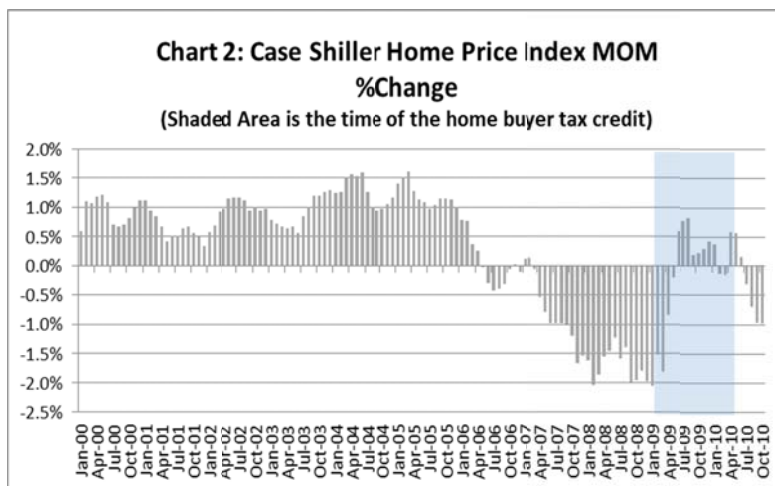
Investing in municipal bonds is like being kissed by your grandmother; it's comforting, but not exciting. Lately, however, thanks to extraordinary media attention, the subject of municipal bonds has become a decidedly uncomfortable subject for many investors. Recent headlines in prominent national newspapers include the following:

“Dire Headlines Unsettle Muni Bond Investors”

“Mounting Debts by States Stoke Fears of Crisis”

“Mourn the Muni Market”

And the list goes on. This is really a case of sensationalism by journalists hoping to sell content. It is true that in 2011 some municipalities will default on their debt and their bondholders will lose their investment. But the risk of default has been so wildly exaggerated that it has actually



created an attractive opportunity for diligent fixed income investors to selectively commit new capital to municipal bonds.

To put this opportunity in perspective, let's look at some hard numbers with a specific example in Austin, Texas. Since I live in Austin, and most of my clients either live in, or near, the City of Austin, this is a natural choice. For those readers who do not live near Austin, you should consider moving here. It's a fabulous city with a thriving economy.

At the time of this writing in late December 2010, an investor could buy general obligation bonds issued by the City of Austin maturing in 12 years' time and having a tax-free yield to maturity of approximately 4%. This City of Austin bond issue is AAA-rated, as the bond is backed by property tax revenues collected by the city – a very secure source of funds to satisfy all debt obligations. A buyer of this bond would receive a cumulative rate of return of 48% over the next 12 years and would pay no federal income tax or alternative minimum tax. Let's compare this to some alternatives. If you wanted to own gold instead, the price would need to rise to more than \$2,600 per ounce, just to break even on an after-tax basis. However, gold is a very volatile and possibly risky investment, which means that you would need to earn *additional* return to make it worthwhile. Even if gold rises to \$3,600 per ounce in 12 years' time, after paying taxes this would only provide about 2% more per year than the stable, AAA-rated, tax-free City of Austin municipal bond.

Stocks are likewise taxed, both on capital gains and dividends. Compared to the City of Austin bond, we would need the Dow Jones Industrial

Average ("DJIA") to reach 17,000 points within 12 years' time just to break-even on an after-tax basis. However, just like gold, stocks aren't supposed to merely break-even with bonds, they are supposed to provide 4-5% per year returns *above* bonds. Otherwise, what's the point? After adjusting for both taxes *and* risk, and earning 4% per year more, the DJIA would need to reach 30,000 within 12 years' time.

Don't forget that you'd also need to sell at the just the right time – the DJIA declined 55% in 18 months during the last recession, so the timing of the sale would require you to accurately predict the next recession, in advance. Depending on your outlook for the economy and our fiscal policies, gold at \$3,600 and the Dow Jones Industrial Average at 30,000 might seem like lofty expectations.

In addition to the direct bond purchases that I make for my clients, I have made one new investment in a municipal bond fund manager with a 20 year track record of producing stellar results for his shareholders. The fund pays a current tax-exempt yield of 5.3%, which would be equivalent to a taxable yield of about 8.2% for clients in the highest federal tax bracket. I believe that this manager will do quite well in the coming years and that he will be able to take advantage of the opportunities currently available in the uncertain municipal bond markets.

Of course, this is not to say that municipal bonds are the best investments available, or that investors should be content with earning 4-5% tax free, but it illustrates the attraction of having at least some portion of our investment portfolios allocated accordingly and it quantifies the high bar that must be met in order to justify large

allocations to the riskier investment alternatives that lay before us.

But wait...you might ask, wouldn't muni bond defaults reduce our actual rate of return in these investments going forward? The short answer is "yes, absolutely" - but once again let's look at some numbers here. Recent media reports suggest there could be 50 to 100 municipal defaults in the coming year. Even if true, this is really peanuts in the muni market.

The municipal bond market is approximately \$2.8 trillion in size with 60,000 different issuers. So, even if 100 issuers default next year, this would only represent 0.17% of the total.

According to a recent article in the Wall Street Journal, in the past 40 years there have only been 54 cases of Moody's-rated municipal debt default. Of them, 78% were in stand-alone housing and health-care projects. (Wall Street Journal: "New Risks Emerge in Muni's" Nov. 10th, 2010)

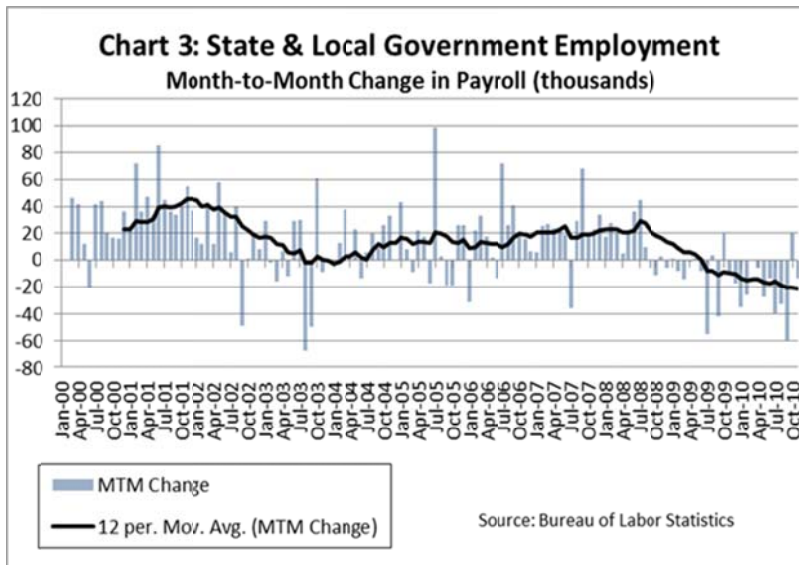
Considering the sheer number of individual issues in existence, this is an extremely low rate of default, and shows that cases of true default at the city, county, and state level is exceedingly rare. Most municipal defaults come from project-specific revenue and special assessment bonds that barely met the criteria for municipal qualification in the

first place. These are NOT general obligation bonds issued by strong municipalities.

One of the true ironies of the municipal bond debate is that even if our worst fears prove to be true, investors in municipal bonds probably aren't the ones with the most at risk - stock market investors may have more to lose here. You see, 1 of every 7 workers in the entire United States actually works for a municipality, including state,

county, and city governments, transportation authorities, law enforcement agencies, school districts, and so forth. That's right, 15% of all workers in this country work for a municipal government or

agency! Furthermore, 13% of total U.S. economic output (i.e., gross domestic product) comes from municipal spending. This means that municipal expenditures represent the second-largest component of the entire U.S. economy; consumer spending is the largest. The true risk to our financial system isn't the potential for dozens of municipal defaults, the true risk is that thousands of municipalities are forced to lay-off or furlough hundreds of thousands of employees and substantially curtail spending and benefits, thereby tilting the U.S. economy back toward recession. We are witnessing such developments already.



Indeed, state and local governments have been cutting their payrolls at an accelerating pace during the past 12 months (Chart 3, previous page), with 250,000 jobs lost in 2010 alone, on top of 130,000 jobs lost in 2009. Yet this understates the total economic impact of municipal austerity because it only counts jobs lost, excluding employees who have experienced furloughs, pay freezes, cuts to retirement benefits, and so forth. A recent NY Times editorial, "The Looming Crisis in the States," said the following, "State spending fell 3.8 percent in the 2009 fiscal year and 7.3 percent more in the 2010 fiscal year."

Turning to the issue of tax receipts, a recent Census Bureau report showed that tax collections for all state and local governments grew by +5.2% in the third quarter of 2010 relative to the same quarter in the previous year, and during the first 3 quarters of 2010, state and local government tax collections were up +2.5% over the previous year. In other words, state and local governments are not only cutting spending, but they are also increasing their tax collections. These factors will combine to support the fiscal positions of municipalities going forward, and will be welcome

news for bond investors. (Now... if only we could get the Federal government to cut spending as sharply as the states have done....)

The bottom line is this: Without question, municipal governments will continue to face painful choices in 2011, but most are confronting their problems in the only logical way: financial austerity. This is good news for municipal bond investors. But if the trend continues, as it likely will, it further diminishes the prospects for a broad economic recovery in 2011. You will no doubt see many scary headlines about municipalities in the coming months. Journalists will do what they can to sell papers. I will continue to evaluate the facts and do what I can to pursue attractive, risk-adjusted, tax-efficient investments for our clients, and some of those investments will undoubtedly include municipal bonds.

I wish everyone a happy and prosperous year in 2011. Please do not hesitate to contact me if you have any questions about your investments with Blackhaw Wealth Management, LLC.

-Ian McAbeer, CFA

General Disclosure

Any material contained herein is provided for informational purposes only, is current only as of the date hereof, and may become outdated or subsequently changed without notice. No information, opinions, or suggestions, explicit or implied, shall be deemed to constitute investment advice, or a recommendation to buy or sell any financial instrument or security, or to pursue any investment strategy. Blackhaw Wealth Management, LLC, only renders investment advice to clients of the firm.

In preparation of this letter Blackhaw Wealth Management, LLC, has relied upon third-parties to provide data about market returns and while we believe this information to be correct, we cannot guarantee the accuracy thereof.

Performance Disclosure

Blackhaw Wealth Composite: The Blackhaw Wealth Composite (“Composite”) is net of all fees and expenses, and contains all accounts managed on a basis of percentage-of-assets fee assessment. The Composite also excludes all accounts that are assessed a fee that is not based on a percentage of assets, such as a flat fee, because it would require subjective estimation to determine the true net return for such accounts. Only whole month returns are included in the Composite return for any given month. For example, if a new account is opened and funded in the middle of May, this account will not be added to the Composite until June 1st, as June will represent the first whole month that the account was managed by Blackhaw Wealth Management, LLC.

Importantly, the Composite includes accounts that have material differences in their investment strategy, and includes both taxable and retirement accounts. Some accounts may also contain restricted securities that may materially affect the Composite. The Composite is therefore not representative of any specific account, and individual clients of the firm may have performance that differs materially from the Composite, due to differences in their investment policy, tax status, liquidity needs, security restrictions, special instructions to the Advisor, or otherwise. The Composite return has not been audited, and no regulatory agency has reviewed the calculation methodology, or verified the accuracy thereof. Past performance is no guarantee of future results.

S&P 500 Index: U.S. Large-cap equity index comprising 500 of the largest domestic companies representing more than 75% of total U.S. equity market capitalization. The performance figures represented herein include the payment of dividends.

S&P Global 1200 Stock Market Index: Global equity index including 1,200 of the largest companies in the following countries: Australia, Austria, Belgium, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, Norway, Peru, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, Taiwan, United Kingdom, and the United States. The performance figures represented herein include the payment of dividends.

Barclay’s U.S. Aggregate Bond Index: A broad benchmark of investment grade, U.S. dollar-denominated fixed rate taxable bonds, including Treasuries, agencies, and corporate bonds.

Barclay’s Global Aggregate Bond Index: A broad-based measure of global investment-grade fixed rate debt markets, the Global Aggregate contains bonds from the United States, European, and Asian-Pacific issuers.

Investable Benchmark: The Investable Benchmark is intended to represent an alternative through which investors could obtain passive, low-cost, and tax-efficient exposure to global capital markets. Vanguard is an industry-leading provider of such low cost index funds, and the Investable Benchmark represent herein is a blend of two Vanguard mutual funds: 60% in the Vanguard Total Stock Market Index Fund (symbol: VTSMX) and 40% in the Vanguard Total Bond Market Index (symbol: VBMFX).