DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q1 2011
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

The Rest of the Story

January, 2011

Remember the days of broadcast legend Walter Cronkite? He was "the most trusted man in America," delivering the day's news and ending each show with "and that's the way it was..." And you believed him. Today, the media has one overriding bias, and that bias is to turn a profit. To sell ad space, broadcasters have become like circus leaders in over-the-top reality shows complete with fear-mongering, sensationalism and inflammatory rhetoric to keep viewers glued to their television sets waiting for the next "shoe to drop." Recent negative snippets about municipal bonds, the stock market and the economy may engross and entertain viewers (and thereby create network advertising dollars), but they fall short of informing listeners about the full facts surrounding these gloomy sound bites: Namely, the stars may be aligning to finally cure decades-old blunders in state and local governments, the S&P 500 has risen almost 100% since its March 2009 lows and the economy is recovering by almost any metric. These sound bites can help create real opportunities in real markets if investors look beyond the entertainment value and, in the immortal words of Paul Harvey, listen to "the rest of the story."

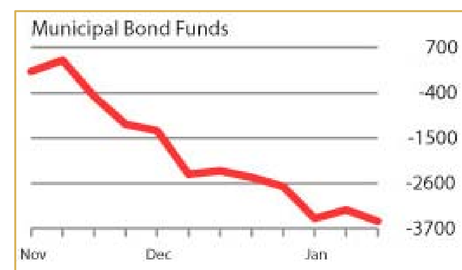
The Babe Ruth of Sound Bites

Recently, Meredith Whitney – an analyst who gained fame by predicting problems at large banks prior to others – helped fan the flames of fear about municipal bond credits in a recent "60 Minutes" interview when she stated there could be "50 to 100 sizeable municipal bond defaults…resulting in hundreds of billions of dollars worth of defaults" over the next 12 months. It was this "Babe Ruthean call" and others like it that helped spark two of the largest redemption weeks from municipal bond funds in United States history (See Chart 1).[1] While sound bites like Whitney's may have created great headlines in this historically sleepy market, it is imperative to put her comments into context to determine if this is the foretelling of a dark new reality or if it creates a significant buying opportunity:

The Municipal Bond Market

- The municipal bond market is a $2.8 trillion market. For Ms. Whitney's comments to become reality, the U.S. would have to witness a repeat of the eight year period between 1929 and 1937, (but in a compact 12 months) when 17.7% of all municipal debt defaulted,[2] a time when municipal bond underwriting standards were much less scrutinized, the economic environment was much worse and there was "widespread nonpayment of property taxes."
- According to Moody's Investor Service, only "54 of 18,400 rated municipal bonds defaulted from 1970 and 2009, or 0.3%."
- "Only four," of the above referenced defaults, "were from cities or counties and most others were on non-general obligation bonds that financed the construction of housing and hospitals."[3]

Chart 1: Net Money Flows Since November 2010



Source: Barrons, Lipper FMI, ICI

There are a plethora of reasons why the incidence of municipal bond defaults have been so infrequent, but one key reason is municipal bonds are issued to fund infrastructure projects, not operating costs. The bonds financing bridges, schools, and sewer systems are usually backed by taxes and sources of revenues that remain relatively flat even in economic downturns. "Interest payments on state and local municipal bonds generally absorb 4% to 5% of current expenditures, as was the case in the late 1970s" according to the Center on Budget and Policy Priorities. "Outstanding debt in the second quarter of 2010 was about 16.7% of gross product, similar to levels that existed from the mid-1980s to the mid 1990s."[3] In part, this is due to most municipalities having debt limitations and being "obligated by law to balance their budgets between each fiscal cycle,"[4] much unlike the Federal government which runs chronic fiscal deficits annually. As a comparison, Federal debt to GDP was 86% in 2009 and projected to be over 96% when 2010 actual numbers are tabulated.[5]

Default Versus Losing Principal

Articles on municipal debt focus on the possibility of default but tend not to discuss what a default in municipal bond parlance actually means. Default is such an ominous word, and while investing of any kind involves risk, "even in the event of default, (municipal) bond investors typically recover most of their money," according to Hibah Yousuf of

CNNMoney.com. It is difficult at best to paint the entire municipal bond market with one tarred brush since there are at least 20 major categories of municipal bonds with hundreds of subset categories with an enormous range of credit qualities among them. That being said, most defaults that have occurred since the Great Depression have been on bonds issued for non essential services such as hospitals or housing projects, were in part due to issues like fraud (which was part of Orange County California's problem in 1994) or there were feasibility problems (as was the case with the Washington Public Power Supply (WPPS) System default in the 1983). In addition to the low historical probability of default, an issuer defaulting on a bond and bondholders losing any principal are not necessarily synonymous. In the case of the most high profile bankruptcy in the past 25 years, Orange County California, investors received 100% of their principal back….with interest.

The Problem is Benefits, Not Debt

"The problem most state and local governments are having is a benefit problem, not a revenue problem (Chris Christie, "60 Minutes" Interview)." Consider these facts:

- ⇒ In 2010, 37% of public employees belong to unions versus the less than 12% union membership rate for the economy as a whole .[6]
- ⇒ According to the Bureau of Labor Statistics, state and local governments had only modest payroll reductions of 383,000 employees during this economic downturn, or less than 2% of total workers (Chart 2), while private sector payrolls have declined over 5% since 2008. (Federal Government payrolls increased 3% from 2008 – 2009, not including the military.)
- ⇒ Pension payouts alone by state and local governments increased by 135% from 2000 to 2008. [7]

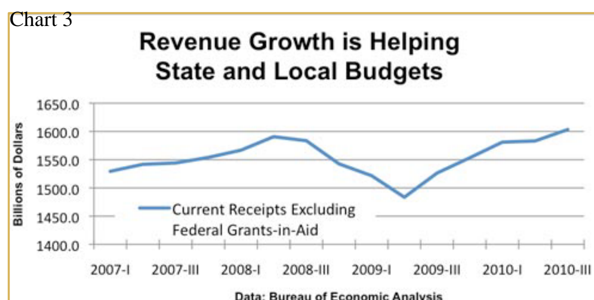
Chart 2

Source: BEA, BLS

Are the Stars Aligning For Municipal Credits?

Governors like Chris Christie of New Jersey now have the political will to take on the public employee unions to help adjust expenses of state and local governments to reality. However, this politically

Chart 3



expedient window may close as quickly as it opened as the economy improves and revenues return to more historical normal levels. Tax receipts of state and local governments rose 5.1% in the third quarter from the same quarter a year ago.[8] Sales tax receipts picked up in the last three quarters, reflecting improving retail sales (Chart 3). According to the Rockefeller Institute, through the third quarter of last year, 42 states have already shown an increase in revenues compared to a year ago. Could municipal governments in the US be heading into the perfect scenario for positive change? Government checkbooks are certainly incurring more scrutiny than in the past, revenues are on the rise, and most municipalities have done a decent job of maneuvering through the economic downturn. The stars could be finally aligning for a long-term cure for the ills of state and local governments. The showdown is on the horizon: Public employee unions versus political leaders recently empowered by their

Data on the "Fringe"

As has recently been the case with the municipal market, negative headlines and sound bites concerning the U.S. economy have filled the news wires since late 2007. Much of these negative outlooks were obviously correct at the time. But economic trends usually do not continue into perpetuity, although it seems mind-sets do. People believed the boom would last forever. Now, they think the bust will do the same. Changes in a $14 trillion market, like the current U.S. economy, will take time. Picture a luxury cruise ship, attempting to change course by any considerable amount; it does not turn on a dime. On the other hand, this large ship will not be jostled by every wave that slams into the hull. Take 2010 as an example, where the economy continued to expand even as waves from the oil spill in the Gulf of Mexico, the debt crisis throughout Europe, widespread foreclosure errors and rampant talk of a "double-dip" recession crashed along side. The quiet data continues to point to consistent firming in the economy:

- ♦ Corporations spending on Super Bowl packages – up 50 to 60% from last year.[9]
- ♦ The International Energy Agency (IEA) raised its forecast for 2011 global oil demand to 89.1M bpd (a record level of consumption), pointing to better-than-expected global economic growth. Oil companies have committed more money to 2011 drilling than any other single year in history.
- ♦ December existing home sales increase 12.3% from November, the fifth rise in six months and leaves sales slightly above the average levels seen throughout much of 2007 and 2008.
- ♦ January's manufacturing surveys show new orders, shipments, and employment has strengthened to the robust pace seen last spring. Future capital expenditures balance rebounded to an 8-month high, suggesting that the bigger tax break for business investment introduced at the start of this year is already having an impact.
- ♦ Consumption growth accelerated to a five-year high of 4.4% over the final three months of last year. The payroll tax reduction at the start of the first quarter suggests that strength will spill over into early 2011.
- ♦ Federal level, tax receipts are up 9% from prior year period.[10] Individual and corporate income tax receipts are up notably, 23 and 5%, respectively.
- ♦ M&A advisory fees from completed transactions increased 27% increase in 2010 from the comparable period in 2009.[11]
- ♦ Occupied U.S. office space increased for the first time in almost three years last quarter. Rents rose by 0.2%, the first uptick since Q2 2008.
- ♦ Nearly half of the U.S. companies that conducted mass layoffs at the depth of the economic crisis expect to start calling back workers, according to the Bureau of Labor Statistics.

electorates. Some improvement is likely to come and more comments from the Whitney's of the world will help create opportunities for informed investors in municipal bonds.

...And In Case You Did Not Know

Americans pull for the underdog and love a comeback story. Whether investors realize it or not, the equity markets are experiencing a comeback of epic proportions. The S&P 500 has nearly doubled in value since its March 2009 low. Likewise, the mass exodus from equity funds in the past two years has only just begun to reverse, with net inflows into domestic equity funds during November, December and January. [12] In part, the renewed interest in the market is being fueled by the fact that American companies are experiencing their strongest profit recovery since WWII. Last quarter (period ending Sept. 30, 2010), the S&P 500 Index companies outside the financial industry had an average profit margin of 11 percent, the highest level since 2005.[13] And capital discipline and rising operating rates that boosted margins early in the recovery will continue to promote healthy margins in 2011.

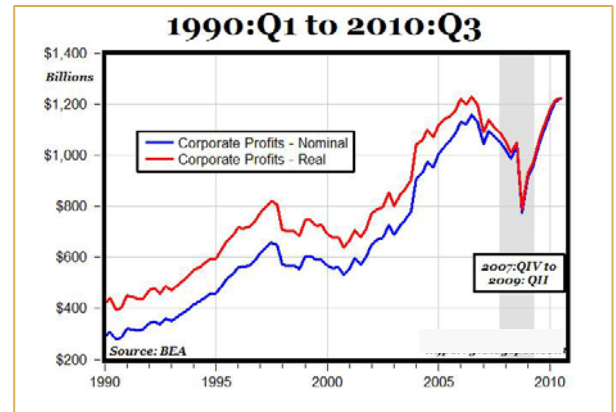
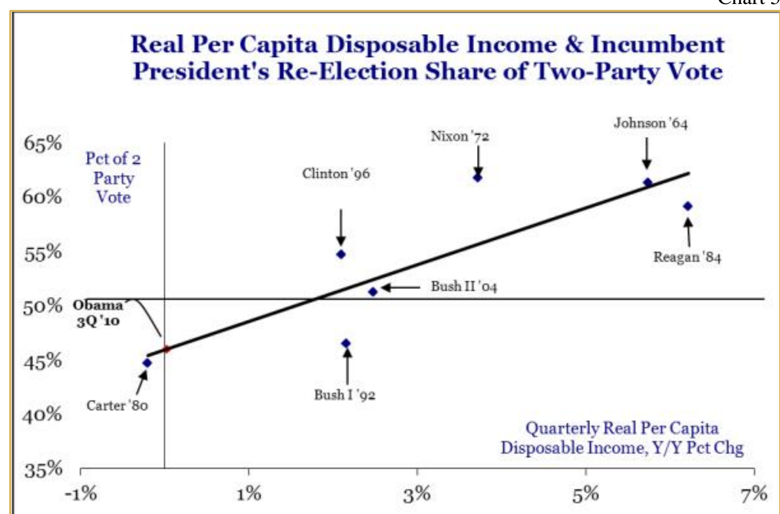


Chart 4

Profits are the key to economic growth. Profits drive investment spending, both in hiring and capital investment in plant, property and equipment. Consider these key data points as growth catalysts for 2011:

- Corporations continue to build cash. Cash levels S&P 500 non-financial companies exceeded $900 billion as of Sept 30, 2010, near record levels as a percentage of total assets. [14]
- Capital expenditure outlays fell below depreciation for the first time in 50 years last year, hinting that the net capital stock declined for a second year in a row; in the prior 60 years, the capital stock had never declined. [15]
- Due to the recent tax cut extensions, there will be a 100% tax deduction on capital expenditures in 2011.

As for how this affects unemployment, businesses will hire when the addition of workers to the payroll creates opportunities that are immediately and obviously profitable. If significantly improving unemployment rates were the standard by which voters measured who they would vote for in a Presidential election, Jimmy Carter would have been a two term President as the Carter Administration saw the highest annual job growth of any President since WWII, adding an average of 2.506 million jobs per year between 1977 and 1981. [16]

Chart 5


Source: Strategas Research

While unemployment affects voter sentiment in presidential and congressional elections, the growth of personal income seems to have the highest correlation of all economic data with the fate of the party that controls the White House, says Douglas Hibbs, a retired Massachusetts Institute of Technology economics professor. This is not lost on Political strategists. As James Carville famously noted when he was guiding Bill Clinton, "it all depends, and what it all depends on is the economy." Personal-income growth moves in tandem with GDP growth. Income growth is the key to presidential reelections and will be the motivating factor of White House initiatives over the next two years.

Conclusion

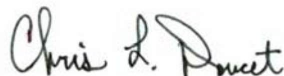
The prevailing winds of the improving economy have helped put markets on a profitable course. As is always the case, the financial journey will incur storms that have ripple effects in the markets, but the reality is real recoveries in stocks, municipal credits and the overall economy are well underway. The media will step in to make the ride rougher, but these waves of uncertainty only make good opportunities better. 2011 is the third year of a presidential election cycle and since 1948, the third year of a Presidential term has resulted in an average S&P return of over 22%.[17] The current administration has pledged to make the economy a priority in hopes that history will repeat itself. The current

administration wants what every first term administration wants…a second term. And now you know the "rest of the story."

Firm News

We wish a Happy Wedding Anniversary to Roland and Esther Doucet. Congratulations on celebrating 50 years of marriage.

Sincerely,



Chris L. Doucet
Chief Executive Officer

Footnotes

1. The Bond Buyer, "Headline Risk Drains Mutual Funds," Seymour, 1/24/11
2. Municipal Bond Handbook, ex. 44.1, p. 710
3. The Bond Buyer, Lynn Hume 1/20/2011
4. Municipal Bond Handbook, p.150
5. USgovernmentspending.com
6. Bureau of Labor Statistics, Union Members Summary 1/21/11
7. Retirement Systems of Alabama, The Advisor, 1/2011
8. Bureau of Economic Analysis
9. Bloomberg Businessweek, "Corporations Field A Super Bowl Return," 1/24/11
10. Congressional Budget Office Monthly Budget Review 12/10
11. Thomson Reuters
12. Investment Company Institute (ICI)
13. Bloomberg Data
14. Federal Reserve Flow of Funds, updated through 9/30/10
15. Morgan Stanley, Prieur du Plessis, 1/19/11
16. Forbes "Presidents & Prosperity: Underlying Data" Dan Ackman
17. Stock Trader's Almanac 2010, Hirsch & Hirsch, p. 130

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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