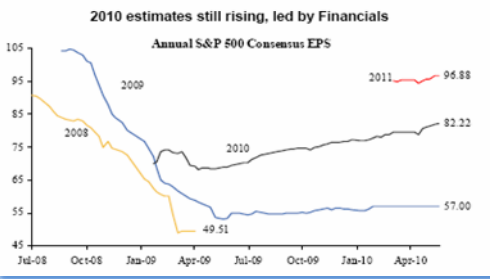


Been Here Before

June 2010- Market Outlook

We experienced a hollow victory in May as our portfolio decline of 7.1% compared favorably to the 8.1% drop in the market, and the 9% plus drop in the IYF and XLF financial ETFs. Our portfolio of mainly insurance companies is heavily geared towards the US economy, yet the rumblings overseas still managed to rattle our portfolio. During May we reduced exposure to generic P&C business lines (prefer specialty lines), and increased exposure to US brokerage business.

Outlook Up, Valuation Down: Throughout the “euro crisis” and most recently going into 2Q we were pleased to see an improved outlook for earnings – especially financials (chart below left). Insurance stocks certainly contribute to this favorable earnings trend, yet insurance valuations (chart below right) remain near historic lows.



Source: Morgan Stanley

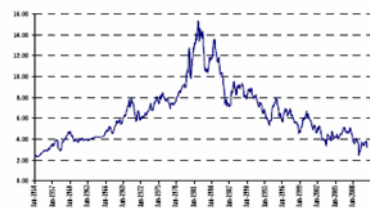


Source: WR Berkley, Bloomberg

Safety Squeeze: Our take on the drop in valuation is that equity investors continue to flee from uncertainty, despite compelling fundamentals. As a result, capital is pulled from equities and parked in “risk-free” debt securities. One data point that supports this view is the ongoing decline in the 10-Year Treasury yield: demand goes up, and rates go down (chart below left). Another supporting data point (more retail focused) from the insurance industry is demand for fixed annuities relative to variable annuities. And finally, Schwab’s most recent data indicates its customers are net sellers of equity funds and net buyers of money market funds.

Been There: In 2000 there was a shift of capital out of many equity sectors, including insurance. The outflow in 2000 was not a flight to safety, but a stampede into growth-oriented, tech-investments. However, the net result was similar: a drop in insurance stock valuations (chart below right). Sheer demand for growth pushed valuations for tech stocks up in a manner that may explain how the increased demand for safety has pushed down the 10-Year yield.

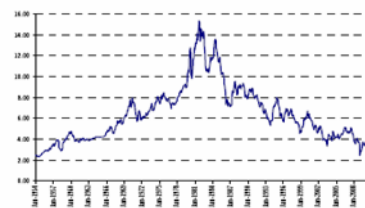
Figure 16. 10-Year Treasury Note Yield



Source: Haver and CIRA – U.S. Equity Strategy

Source: Citigroup, Haver, CIRA

Figure 16. 10-Year Treasury Note Yield



Source: Haver and CIRA – U.S. Equity Strategy

Source: SNL

If you have questions regarding the financial services sector, or would like to discuss our investment approach, please contact us at the phone number below, or visit our website. (www.PhiloSmith.com)

E. Stewart Johnson
Portfolio Manager

