GREENWOOD REPORT

June 2012

"A nickel ain't worth a dime anymore."
- Yogi Berra

To many individuals, the adage "Sell in May, and go away" is a familiar rhyme. Its meaning refers to selling one's investments in the month of May and buying them back at lower prices after an expected summer lull. With the market down in May this may appear to be sagacious advice, especially for those who invest based on cute and catchy tales. The original saying, likely coined by London traders in the early 20th century, was: "Sell in May, come back on St. Legers Day". These traders, preoccupied with their summer social schedule, would sell their positions, only to return in mid-September after St. Leger's Day, which marked the end of the summer holiday with a horse race. This was hardly an investment strategy.

As you know, Greenwood Gearhart Inc., does not invest client capital based on cute and catchy tales. We can't and don't try to time the market and thus, did not sell in April for May vacation based on *potential* one-month results. Rather, we are comfortable tolerating volatility in the search for long-term positive returns and we use it as an advantage when Mr. Market provides opportunities. Focusing our work on the fundamentals, we search the investment universe for the best-of-the-best, identifying securities that meet our criteria for inclusion in portfolios. Our equity universe *alone* begins with over 3,000 companies and narrows to approximately 250 that, at any given time, may be priced attractively enough for investment. Only a few make it into client portfolios.

As Figure 1 shows, we are approaching the third "correction" (defined as a 10% pullback) in the Dow Jones Industrial Average since the recovery began in March of 2009.

Figure 1: CORRECTIONS SINCE THE 2009 RECOVERY

Time Period	Correction	Reasons
April 26, 2010 thru July 2, 2010:	-13.6%	Europe, China slowdown, Slow U.S. recovery
July 21, 2011 thru October 3, 2011:	-16.3%	Europe, debt ceiling, S&P downgrade of U.S. debt
May 1, 2012 thru June 4, 2012:	-8.8%	Euro breakup, U.S. jobs reports

Source: Bloomberg

The common denominator during each retrenchment: *Europe*. Europe is in the thick of *their* crisis, just like the United States was in 2008-2009. The ultimate resolution is unknown, and the political climate has been further complicated by the French elections on May 6th in which a socialist (Francois Hollande) was elected to offset the pro-austerity stance of Germany's Angela Merkel. This is a profound change in the Eurozone dynamic, as the ousted French President Nicolas Sarkozy was a strong partner of Merkel's in pushing austerity. Now, the two largest economic and diplomatic players in the Eurozone will be approaching the crisis from differing viewpoints.

Adding to the uncertainty, Greece has another round of elections approaching (June 17th) because it failed to form a ruling coalition during its most recent round of elections. Without a ruling coalition, Greece does not have the ability to implement the austerity measures on which its bailout funds are contingent. Without a bailout, pressure may increase for Greece to leave the Eurozone.

Most recently, *speculation* in Europe focuses on the fate of Italy and Spain and their prospects for a Eurozone exit. These countries, considered too large for a full bailout, have seen their sovereign debt yields rise, unemployment climb, and their citizenry protest austerity measures. Investors seeking certainty in uncertain times won't find it in Europe.

With each correction, we have paused, assessed the macro environment, and judged the temporary or permanent impact on portfolios. When the fundamentals are strong and the prices are low, we get excited. In fact, throughout May, we added strategically to certain investments to take advantage of the correction. We believe these, temporarily mispriced equities, were "gifts" to client portfolios. Absent a major change in fundamentals, we plan to hold these investments long-term, as the companies' continue to execute on their strategy and grow earnings. While exposed to the global economy, *the success of the companies that make up our client portfolios does not hinge on the European economy alone*. Our exposure to Euro-area domiciled companies is balanced. Are we worried about Europe? Yes! After all, we are paid to worry. However, *we are not paid to invest based solely on worry*. If we were, we would be forced to invest in "riskless" short-term Treasuries with current negative real yields.

WHERE TO GO?

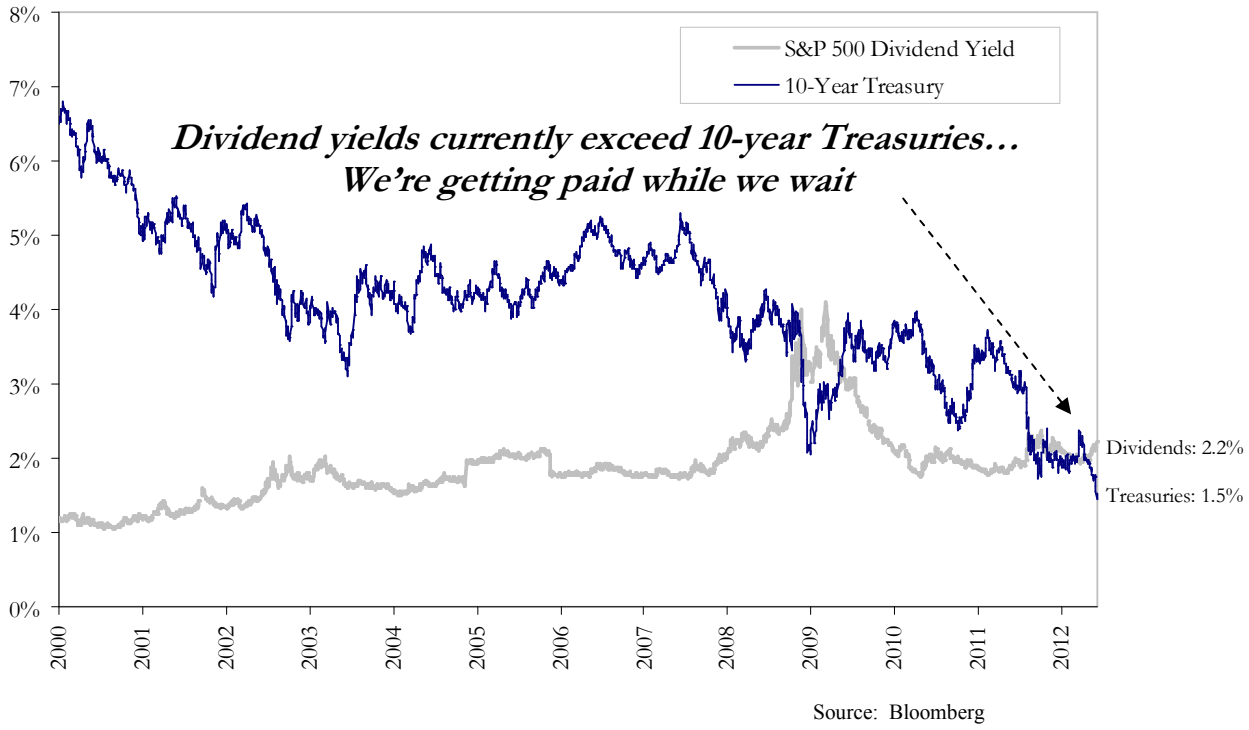
In passing conversations, we have received a common question: "where to go?" We understand and empathize with the question: everyone wants a safe, low risk, high-return investment. *Unfortunately, safe, riskless, return-generating investments, do not exist*. Risk and return are positively correlated. All investments carry risk for which the investor expects to be compensated. The more risk one is willing to accept, the greater the prospect of a gain. Greenwood Gearhart's job is to assume risk intelligently on our client's behalf. Risk can take on many forms (market risk, interest rate risk, reinvestment risk, business risk, inflation risk, credit risk, political risk, liquidity risk, etc.) and is mitigated through investment advice. Greenwood Gearhart Inc. specializes in risk management and helps increase the prospects of returns through hard work, knowledge of the investment environment, and diversification. Our answer to the question "where do we go?" is: *"You are right where you need to be, you are invested appropriately"*.

WHY ARE YOU RIGHT WHERE YOU NEED TO BE?

Reason #1: Equity investors are getting paid to wait. One alternative to stock investment is low-earning cash assets or Treasuries. In fact, the yield on the ten-year Treasury can serve as a barometer for the relative value of equities versus cash. Last Friday, June 1st, the ten-year Treasury hit an all-time low of 1.45%. The 30-year hit 2.52% on the same day. This means that the *nervous* investor, who chooses to *lend* money long-term to the U.S. Government, would earn a total return of 1.45% per year (and this doesn't take into account the eroding impact of inflation – see Reason #2).

As Figure 2 displays, the dividend yield of 500 blue-chip domestic companies (as represented by the S&P 500) is 2.21%, far exceeding the ten-year Treasury yield and near the rate of the 30 year bonds. Thus, *enterprising stock investors* "get paid to wait" for continued economic recovery and for the market to recognize the inherent value in the corporations they own. In ten years, the *lender* to the U.S. Government receives back the face value of their investment, almost certainly returned with eroded purchasing power due to inflation, and a very low income return. Alternatively, the *enterprising stock investor* has the potential for capital gains; while earning a dividend yield over 50% higher than the *lender* in Treasuries.

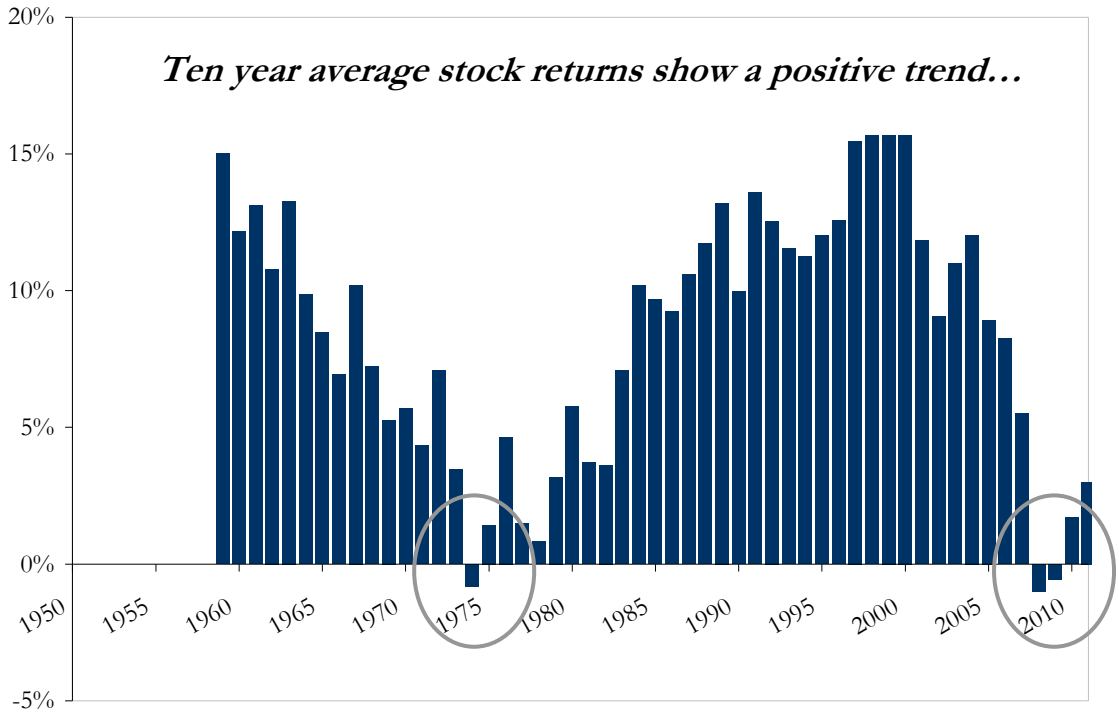
Figure 2: S&P 500 DIVIDEND YIELD VS. TEN-YEAR TREASURY YIELD
2000 to 2012



Source: Bloomberg

For further context on ten-year stock returns, see Figure 3. For every ten-year time horizon since 1950, stocks have experienced negative returns in *only three periods*, two of which are the periods ending in 2008 and 2009 (the U.S. crisis years). We're investing *our client's capital and our capital* with the long-term trend of positive equity returns and the data is on our side. Additionally, *we are getting paid while we wait*.

Figure 3: TEN YEAR SIMPLE MOVING AVERAGE OF THE S&P 500
1950 to 2011

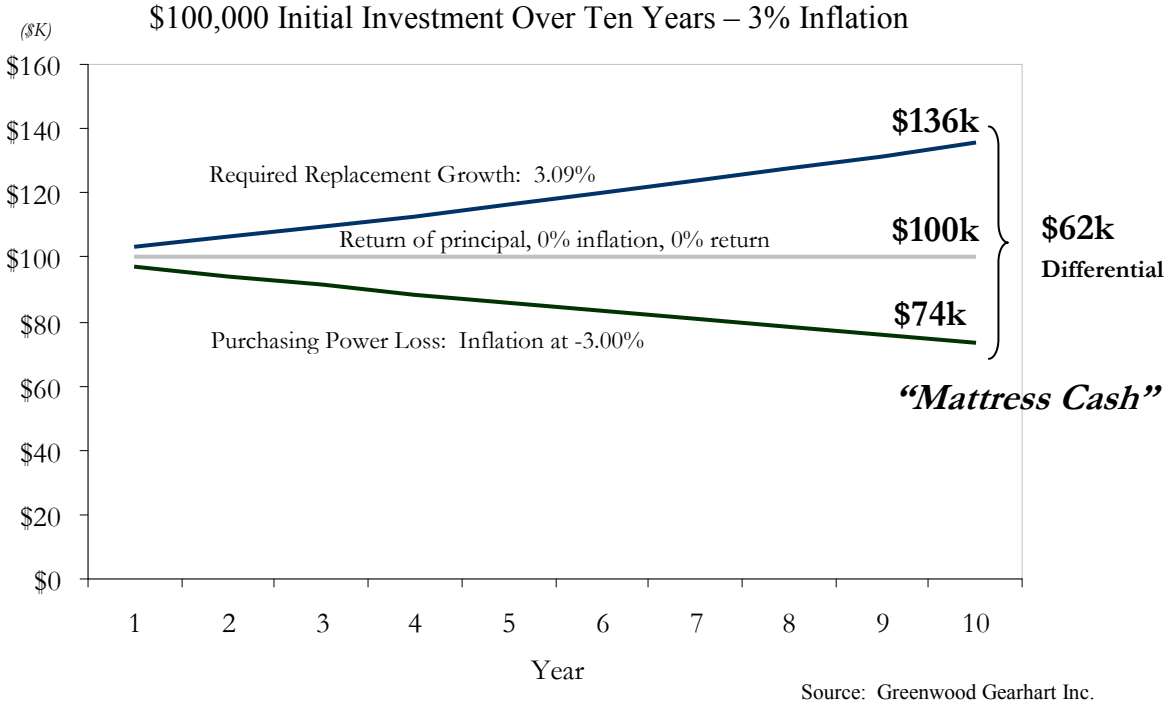


Source: Bloomberg

Reason #2: Inflation erodes investment (especially cash) value. According to Ibboston SBBI, Inflation has averaged about 3% since 1926. The negative effect of inflation on cash investments can be debilitating, though virtually unnoticeable over long-periods of time. To illustrate, consider the price of a loaf of bread in 1980 ($0.50) versus today ($2.30). A dollar in 1980 would buy two loaves of bread but, if hidden under the mattress for 30 years, wouldn't even buy one today. The price of bread has increased over-time and the purchasing power of the dollar has eroded, although the day-to-day shopper likely didn't even notice the gradual change. Meet inflation. It has the same debilitating impact on investments and should be monitored closely. The *nervous* investor (in Treasuries) described above would actually earn a negative *real* return on their investment in a normal inflationary period (1.45% - 3.00% = -1.55%). If inflation rises, the consequences are only greater. Cash and bonds can be a good hedge against *deflation*, but stocks are a hedge against *inflation* especially in industries where prices can readily be passed on to customers.

Figure 4 below shows the impact of 3% inflation over ten years (bottom line: -3.0%) versus the required return to keep pace with 3% inflation (top line: +3.09%). The middle line is "parity" which represents a return *of* principal but does not return the *value* of principal. A $100,000 cash investment put "under the mattress" for ten years would be worth only $74,000 in purchasing power at the end of the investment horizon (the shopper above would be able to purchase a lot less bread). To maintain the original purchasing power of $100,000 today, the investor would have to earn 3.09% for a final value of $136,000. The net differential in return over ten years is approximately $62,000! Inflation is insidious.

Figure 4: THE IMPACT OF INFLATION
$100,000 Initial Investment Over Ten Years – 3% Inflation



Source: Greenwood Gearhart Inc.

Reason #3: Low interest rates may be here to stay. One of the major trends in the recent history of the financial markets has been the long-term, gradual decline of interest rates. Many clients can remember the 1980's, when ten-year U.S. Treasuries peaked at 15.8% in September of 1981. The investor who locked in high rates in the early 80's experienced many years of healthy returns on their investment. As Figure 5 shows, the run-up of rates from 1965 to 1982 and subsequent fall appears to be an *anomaly.* The full perspective on interest rates shows that rates can remain low for very long periods of time. In fact, through much of the early 1900s and through the 1950's, ten year rates remained well below 5%.

Figure 5: TEN-YEAR TREASURY YIELD

Source: Bloomberg

The current period points to continued low rates. As we expand the global economy, both capital and labor reflect ample supply and increased mobility. Thus, one would not expect shortage of resources to push costs (e.g. interest rates) upward. Additionally, governmental policies globally are expected to be accommodative to spur employment, business investment, and economic growth. One has to look no further than the 1940's to find a similar period where, even in the face of expected inflation, the Fed managed to keep rates low for an entire decade (to finance WWII and spur growth). Bond investors beware, rates may have only one direction to go; but even if they double, yields will still be historically low. The timing of this movement may be very long indeed.

Reason #4: Equities are priced attractively. While Greenwood Gearhart Inc., utilizes individual securities and employs a "bottom-up" approach to security analysis, we periodically assess the relative valuation of the entire market to determine the overall attractiveness of stocks. As Figure 6 below indicates, equities are currently priced attractively based on Dividend Yield, Price to Earnings, Price to Book, and Price to Sales ratios. In fact, the current period indicates a "cheaper" market compared to the last twenty years in every measure, over every time period, except the five year average dividend yield, which is slightly higher because the 2008-2009 crisis skewed the results. As a value-oriented investment adviser, we believe Greenwood Gearhart Inc. clients are positioned even more favorably as the aggregate composition of our core holdings reflect greater value than the current market average.

Figure 6: Average Valuation of the S&P 500
Various Long-term Averages as of June 5, 2012

	Dividend Yield (high = value)	**Price to Trailing 12 Mo. Earnings** (low = value)	**Price to Book** (low = value)	**Price to Sales** (low = value)
Greenwood Gearhart Inc.	**2.57%**	**12.1x**	**1.9x**	**0.7x**
S&P 500 Current	**2.21%**	**13.0x**	**2.0x**	**1.2x**
5 Year	2.25%	15.7x	2.2x	1.3x
10 Year	2.03%	16.9x	2.5x	1.4x
15 Year	1.80%	19.8x	3.1x	1.5x
20 Year	1.94%	19.7x	3.0x	1.4x

* "Core Holdings" may not be included in all client accounts as individual circumstances and constraints differ by client.

Source: Bloomberg

The continued recovery has been *slow* but steady. We appreciate your patience and the trust you have placed in us to manage your wealth through "interesting" times. We believe you our client, and Greenwood Gearhart Inc., will be rewarded. We are monitoring cash for clients with liquidity needs and encourage you to call or email us if you have upcoming distributions that we should be aware of. In absence of these restrictions, we are investing for the future with a goal of maintaining and increasing your standard of living.

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