

PORTFOLIO UPDATE

Things didn't turn out too badly in 2009. After an apocalyptic first quarter, the stock market embarked on a spirited recovery during the remainder of the year. When the dust settled, the SP 500 Index was up 26.5%. The RCM portfolio did even better, rising 30.1% (after all fees).

Although it is entertaining to compare the portfolio results to the broader market, the comparison isn't really valid anymore. The RCM portfolio is no longer a simple stock portfolio. Traditional U.S. stocks comprise only a minor percentage of the portfolio. Indeed, only about 30% of our holdings are invested in funds for which the primary investment goal is capital gains. The bulk of the portfolio, nearly 70%, is invested in funds for which the primary goal is yield. This includes a variety of investments such as bond funds, as well as funds that employ option and dividend strategies to generate income. This latter group of funds does have market risk, and will rise and fall with the broader stock market, but in the meantime collects yields in excess of 10%. Overall, the annual yield of the portfolio is nearly 6%. As for risk, the risk index for the portfolio measures only 66, well below that of the broader market (which is defined as 100).

COMMENTARY

The portfolio focus on yield arises from my conviction that the next few years will be generally unrewarding for traditional stock investors. We are in a range-bound market. Ten years from now, the SP 500 Index may well trade only a little higher than it is today. So, we will emphasize yield as the best way to reap returns.

While there are a number of contributing factors for the lackluster market outlook, I'll review three important issues. First, corporate earnings drive stock prices. But, in coming years, economic growth and corporate earnings growth are likely to be about half of historic, so stock price appreciation and valuations will be correspondingly reduced. More immediately, during the vigorous rally of the past nine months, the market has gotten ahead of itself and is likely overvalued. That doesn't mean it won't rise some more, but the rate of rise is clearly starting to level off, and eventually there will be a correction.

Secondly, there has been poor fiscal discipline at the federal level, creating a debt burden of historical proportions. Add in Social Security, Medicare, state and local debt, and what Fannie Mae, Freddie Mac, and other wards of the state owe, and total public debt is huge. Taxpayers are on the hook for these bills. This will depress economic growth, and will eventually drive up interest rates and drive down the value of the dollar.

Third, demographics are shifting. In 2002, the U.S. was adding 10 new working-age people for every new senior citizen. By 2023, that pattern reverses. There will be 10 new retirees for each one new working-age person. Consequently, a rising tide of retirees will be selling their accumulated assets to a shrinking population of working-age buyers – a recipe for falling prices.

Given this outlook, don't despair. It is still possible to earn attractive investment returns in this environment. The key is to emphasize yield, quality and value, and control risk – all of which we are doing. As the global economy recovers, emerging markets should provide one of the first sources of attractive growth for stock investors. Emerging markets have younger populations and growing capital reserves, elements that will drive their economies. In the past year, emerging markets have risen twice as fast as developed markets. Expectations and valuations have gotten quite high, so now is probably not the best time to jump in. When valuations settle down, emerging markets should be rewarding. U.S. inflation and a declining dollar will add to their attractiveness.

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Dr. Rollins has earned both the Chartered Financial Analyst® designation and Certified Financial Planner™ credential. He was awarded the CFA® designation in 2004. The CFA charter is the only credential for investment analysis and management recognized worldwide. Recipients of the CFA charter have successfully completed a graduate-level educational curriculum, and have passed a series of three sequential annual examinations. Pass rates average about 50 percent at each examination level. In 2005, he also successfully completed financial planning coursework and passed the qualifying examination for the CFP® credential.

Company Profile

ROLLINS CAPITAL MANAGEMENT is a fee-only financial advisory firm serving individuals. Using a consistent, patient investment strategy, our focus is long-term, high-quality, personalized investments. Clients have their own individualized accounts. ROLLINS CAPITAL MANAGEMENT handles all the daily investment decisions.

Presentation Disclosures

1. Portfolio composite returns are actual total annual returns, including stock price appreciation, dividends, corporate spin-offs and divestitures, and other occasional cash and non-cash distributions. Individual results may vary from the composite due to variations in portfolio size, and timing of deposits/ and/or withdrawals.
2. Portfolio composite returns represent an asset-weighted combination of fee-paying client accounts under management during the period specified, reported net of all withheld fees.
3. Annual portfolio composite returns and benchmark annual returns use a time-weighted calculation over the period specified.
4. Annualized portfolio composite returns and benchmark returns are calculated as the geometric mean of annual returns.
5. Portfolio and benchmark risk measures calculated using methodology provided by RiskGrades®.
6. Detailed disclosures available on request.

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