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**Today: Washington's Scapegoat,
Tomorrow: Wall Street's Bargain**

Washington Steals Spotlight

The shifting focus from Wall Street to Washington has overshadowed a relatively strong fourth-quarter earnings season and mounting evidence of global economic recovery. While we cannot deny the importance of the debates and decisions occurring on Capital Hill, we believe that too much of a Washington focus could leave investors paralyzed and missing the big picture. In our view, the big picture is about unprecedented monetary stimulus, accelerating economic strength in the emerging markets, and reasonable equity valuations across the globe.

Washington Unlikely to Hold Spotlight for Long

Political tides can shift frequently and quickly, which is why we believe it is dangerous to make long-term investment decisions based on the short-term political climate. It has been our experience that investment success in the stock market requires an investment horizon of at least five years, a time frame that is likely to outlast any political administration or party in power. On January 19, 2010, the nation was reminded how quickly the political landscape can change when Republican Scott Brown won Ted Kennedy's vacated Senate seat in deeply Democratic Massachusetts. With that one election, several analysts now handicap the likelihood of healthcare reform at less than 50% and believe that the prospect for other democratic agenda items, such as financial regulatory reform and emissions control, could potentially be similarly impaired.

Washington's Scapegoat often becomes Wall Street's Bargain

Because healthcare reform was President Obama's top priority, sentiment around healthcare stocks had been in the doldrums throughout 2009. In fact, regulatory uncertainty seemed to encourage investors to overlook the sector's unsurpassed record of strong growth, high earnings stability, and low share-price volatility. This would not be the first time politics got in the way of sound decision making in the healthcare arena. The last time healthcare stocks were at similar valuation levels was in 1993, when fears of "Hillary Care" sent investors scrambling. In hindsight, the healthcare reform bark in 1993 turned out to be worse than its bite and the sector's weakness turned out to be one of the best buying opportunities in a generation. **For the 15-year period that began January 1, 1994, no other S&P 500 sector outperformed Healthcare, on an equally-weighted total return basis.** In fact, over that time period, the Healthcare sector bested the performance of the broad market (as defined by the S&P 500) by more than two times.

Scapegoat 1 -- Healthcare: Beginning to Bounce Back... More Upside Likely

Thus far in 2010, rationality appears to be returning to the market, and Healthcare has become one of the top-performing sectors year to date. However, we believe additional upside for Healthcare stocks exists. The sector's "top of the class" marks for earnings growth, earnings stability, and balance sheet quality should garner it one of the most expensive valuations in the stock market, in our view. Instead, it currently trades as one of the cheapest. In fact, the sector trades at similar valuations to the Utility sector, which is not only highly regulated, but has historically experienced much slower growth.

With technicals recently turning positive and fundamentals remaining firmly bullish, we recommend an **Overweight** position in Healthcare in most retail investors' portfolios. While we like Healthcare across the board, we are particularly attracted to the exchange-traded funds (ETFs) and companies listed below due to their high quality and strong valuations.

Table 1

Industry	ETF	Stock
Broad/Core	Vanguard Healthcare (VHT-NYSEArca-\$54.61)	Abbott Labs (ABT-N-\$53.34) Johnson & Johnson (JNJ-N-\$63.09)
Pharmaceuticals/Biotech	iShares Pharmaceuticals (IHE-NYSEArca-\$57.49) PowerShares Dynamic Pharmaceuticals (PJP-NYSEArca-\$18.68) SPDR S&P Biotech (XBI-NYSEArca-\$55.86)	Merck (MRK-N-\$38.30) Pfizer (PFE-N-\$18.79)
Healthcare Technology	iShares Dow Jones US Medical Device (IHI-NYSEArca-\$53.21)	Medtronic (MDT-N-\$43.15) Becton Dickinson (BDX-N-\$75.71)
Healthcare Services	iShares Healthcare Facilities (IHF-NYSEArca-\$48.81)	Express Scripts (ESRX-NasdaqGS-\$85.56) Laboratory Corp. of America (LH-N-\$71.60)

Scapegoat 2 -- Big Financials... Regulatory Concerns Largely Priced In

With healthcare fading out of the spotlight, Washington appears to have re-directed its focus toward the largest financial institutions, such as Bank of America, JP Morgan Chase, Citigroup, and Goldman Sachs. The Federal Government and regulatory authorities have forced the big financials to divest profitable businesses, restrict executive pay, and succumb to increased levels of regulation. Not surprisingly, investors have avoided the big financials; on a price-to-relative book value basis their share prices have been discounted back to levels last seen in the early 1990 (Figure 1).

Figure 1: Relative Price-to-Book Value



Relative Price to Book Value Chart
 Our Big 10 Financials Index comprises an equally weighted composite of the 10 largest financial institutions (by market cap): Citigroup (C-N-\$3.34), Bank of America (BAC-N-\$15.42), JP Morgan Chase (JPM-N-\$39.63), Goldman Sachs (GS-N-\$153.13), Morgan Stanley (MS-N-\$27.56), Wells Fargo (WFC-N-\$28.93), US Bancorp (USB-N-\$25.18), American Express (AXP-N-\$38.21), Bank of NY Mellon (BK-N-\$29.58) and MetLife (MET-N-\$35.94).
 The composite is compared to the FactSet World Aggregate Index.

Chart Courtesy FactSet

While Washington’s intrusion may have impaired the franchises of these companies, causing them to be permanently less valuable, we think it’s important to recognize that there were also positive effects from their intervention. First and foremost, Washington ended the financial crisis and gave many of these institutions the lifeblood needed to survive. Washington also forced the large financials to take their lumps early by aggressively writing off loans and building significant capital cushions in 2008 and 2009. Additionally, regulators facilitated the absorption or elimination of numerous competitors and instituted a favorable interest-rate environment, making it easier for banks to be profitable.

Many of the large financial institutions are now in the best financial shape they’ve experienced in years and face significantly less competition in their markets going forward. Because of improving fundamentals and still inexpensive valuations, we remain comfortable **holding** the large Financials and would consider **Selective Purchase** of the companies presented in Table 2 when the current downside price momentum relinquishes.

Table 2

Industry	Exchange-Traded Funds	Stock
Broad/Core	Financial Select Sector SPDR (XLF-NYSEArca-\$14.42)	JP Morgan Chase (JPM-N-\$39.63)
Large Bank	SPDR KBW Bank (KBE-NYSEArca-\$23.42)	Bank of America (BAC-N-\$15.42)
Broker/Dealer	iShares DJ US Broker/Dealer (IAI-NYSEArca-\$26.56)	Goldman Sachs (GS-N-\$153.13)

Washington’s Darlings often turns into Wall Street’s Disasters

Where bargains can often be found among Washington’s scapegoats, the opposite often occurs with Washington’s darlings. Stem-cell research, Anthrax detection, and bio-fuels are a few recent examples of widely trumpeted industries in Washington that turned out to be major disappointments for Wall Street. We think the source of disappointment is linked to the fact that investors overpay for hot industries only to find out later that political pet projects rarely translate into “great businesses.” Alternative energy is a good example of an industry that recently came into the spotlight as oil hit \$150/barrel in mid-2008 and politicians tripped over each other to highlight their home-state solar and wind initiatives. Unfortunately, investors who purchased alternative energy stocks based on the what the politicians were saying learned an expensive lesson. Alternative energy stocks (as measured by the AMEX WilderHill Clean Energy Index) hit their relative peak in early 2008, six months before the rhetoric peaked, and have fallen by more than two-thirds since that time. (Figure 2).

Figure 2

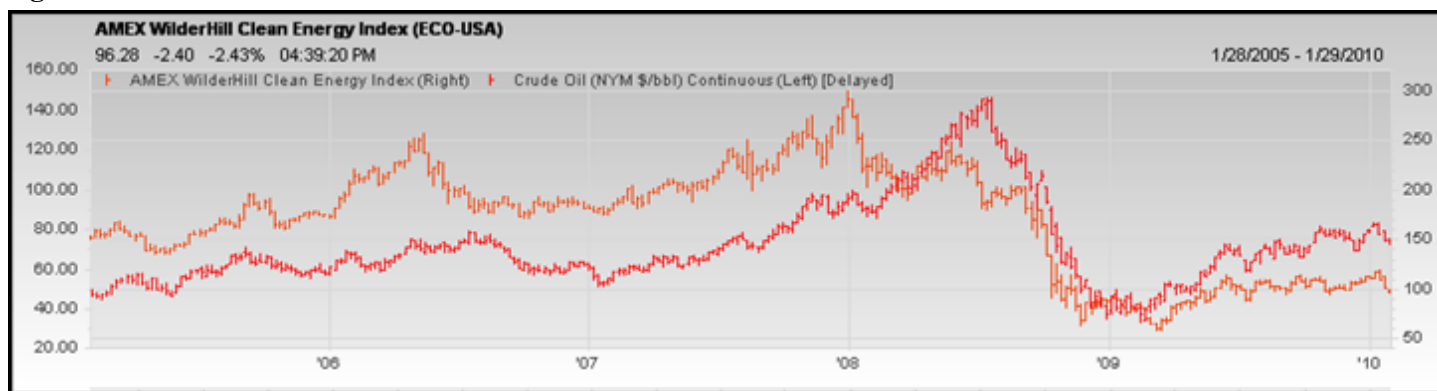


Chart Courtesy FactSet

Bottom Line

We think there are times when investors ought to think many steps ahead, particularly when trends are secular and unlikely to experience significant change. On the other hand, it can be dangerous to extrapolate trends that are cyclical and have the potential to change quickly. We think political power/rulemaking authority is one example of a cyclical/short-term trend. We think industries in the political spotlight that appear to already be discounting a worst-case scenario should be considered for potential purchase, and that the largest bargains can often be had **before** the political skies clear.

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