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THE FSAG ADVISOR

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Market & Economic Update

The global economy continues to improve, though more gradually, and uncertainties have arisen. Expanding unrest in the Middle East and North Africa, rising oil and commodity prices, and the Japanese earthquake crisis have increased downside risks to the economy and to risk assets. While we acknowledge volatility will be elevated in the short term, we still believe that equities have longer-term upside and that opportunities exist in some fixed income credit spread sectors.

From the point of Federal Reserve Chairman Ben Bernanke's Jackson Hole speech last August until roughly midway through the first quarter of 2011, economic expectations accelerated sharply, which helped produce a remarkable increase in equity prices of between 25% and 30%. Those trends ended in the face of the political uprisings throughout the Middle East and North Africa, the potential for nuclear catastrophe in Japan and the previously existing concerns over emerging markets. Markets loathe uncertainty, and when uncertainty increases, it is generally met with corrections and higher levels of volatility, which we have seen over the past several weeks.

At present, markets are in the midst of a tug of war. Downside uncertainties are at odds with fairly good economic and markets news – solid corporate profits, improving labor market conditions, reasonably upbeat leading indicators and ongoing high levels of merger-and-acquisition activity, share buybacks, dividend increases and other equity-friendly actions.

2011 Returns

DOW	*7.11%*
S&P 500	*5.87%*
NASDAQ	*4.88%*
Russell Small Cap	*7.94%*
Russell Mid Cap	*7.63%*
MSCI EAFE	*3.37%*
Barclay US Agg	*0.45%*
Barclay Muni.	*0.58%*

For the time being, we are adopting a more cautious outlook, be-

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Chart of Interest

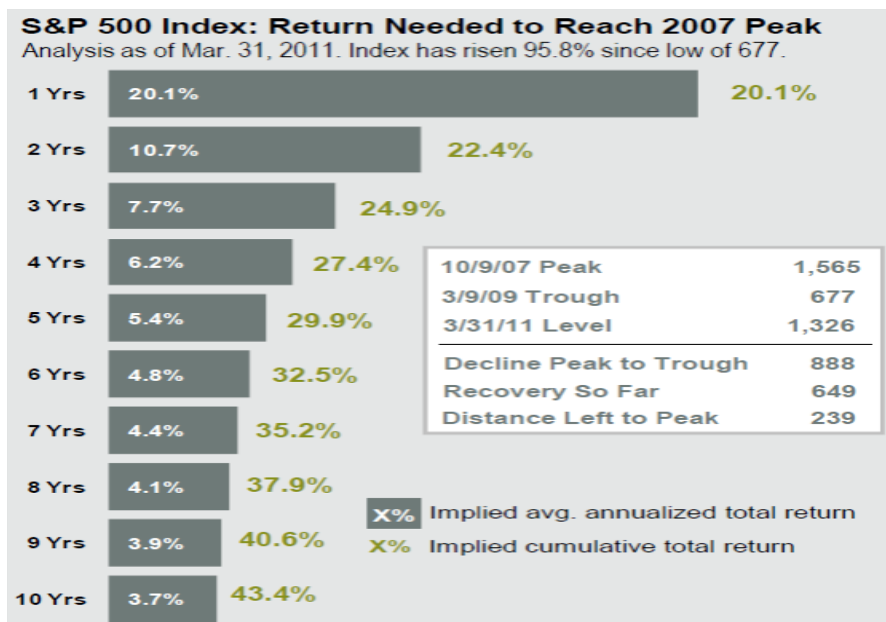

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Chart of Interest

Health-care changes that become effective in 2011

The Patient Protection and Affordable Care Act (PPACA), signed into law in 2010, makes significant changes to our health-care delivery system. Here are some of the most important changes scheduled to take effect in 2011.

The cost of over-the-counter drugs not prescribed by a doctor can no longer be reimbursed through a health reimbursement account or a health flexible spending account, nor can these costs be reimbursed on a tax-free basis through a health savings account (HSA) or Archer medical savings account. Also, the tax on distributions from HSAs and Archer MSAs that are not used for qualified medical expenses increases to 20% (up from 10% and 15% for HSAs and Archer MSAs respectively).

Medicare Part D participants will receive a 50% discount on brand-name prescriptions filled in the coverage gap (i.e., the "donut hole") from pharmaceutical manufacturers, and federal subsidies for generic prescriptions filled in the coverage gap will start to be phased in.

Also, certain preventive services covered by Medicare are no longer subject to cost-sharing (co-payments), the deductible is waived for Medicare-covered colorectal cancer screening tests, and Medicare now covers personalized prevention plans including a comprehensive health risk assessment.

Medicare Advantage (MA) plans can no longer impose higher cost-sharing for some Medicare-covered benefits than would be imposed by traditional Medicare insurance. Also, MA plans cannot exceed a mandatory maximum out-of-pocket amount for most Medicare services. The maximum amount in 2011 is $6,700, but MA plans can voluntarily offer lower out-of-pocket amounts. Also, the annual enrollment period for MA plans is changed to October 15 through December 7. The requirement that employers report the total value of employer-sponsored health benefits on employees' W-2s was to begin in 2011. However, the IRS has deferred this requirement until 2012.

lieving that stocks will remain in a sideways trading pattern for some time before upside momentum will resume. During the height of the fears of nuclear catastrophe following the earthquake, the S&P 500 Index hit a low of around 1,250. It feels to us like that point will represent a low from which markets will climb higher, but we would caution that this low may be tested. Nevertheless, over the longer term, our assessment is that none of these risks have yet derailed, or will derail, the global economic recovery or the longer-term bull market in equities.

In regards to interest rates, the labor market is improving and the U.S. may be about to transition to genuine rather than stimulus-driven growth. Unemployment has notched down, with private payrolls adding meaningful numbers of jobs and manufacturing improving notably. However, housing continues to be quite depressed and underlying commodity inflation indicators are surging. As such, we do not believe the Fed will raise rates for the foreseeable future.

Our fixed income strategy assumes the eventual tightening that will take place with the scheduled end of QE2. Given this driver, we believe volatility will be higher in the year's second half than now, and that yields will drift higher. Within our diversified, fixed income portfolios, we are defensive, minimizing interest rate risk by staying short and minimizing credit risk. We are also increasing yield by focusing a portion of our portfolios on BB fixed income investments (highest credit quality within high yield).

Among the greatest risks to the economy and risk assets, we would include the following:

• The European debt crisis worsens, due to political gridlock and social unrest.

• The U.S. debt crisis worsens, due to political gridlock, further real estate deflation and mortgage defaults, or more volatility in the municipal bond market. The dollar weakens and bond yields rise.

• The Fed errs in providing too much liquidity, resulting in commodity inflation or asset bubbles that either pop on their own or force the Fed to reverse course and pop them.

• The Fed's hands are tied by Congress, either after the next bubble pops or beforehand, and deflationary pressures win out.

• Trade frictions flare, especially between the U.S. and China, and financial markets panic. Other emerging economies take protectionist counter-measures.

• Emerging-market inflationary pressures build, especially in commodities (food and energy) and asset markets. These may lead to civil unrest and destabilizing political turmoil in countries with severe income polarity, such as is occurring in Egypt. Such a scenario is the Chinese leadership's worst nightmare.

We can also envision much more favorable scenarios, which could be triggered by significant progress in international policy cooperation or by better internal policy choices among major nations. Positive surprises would include the following:

• China significantly appreciates the Yuan vs. the dollar, allows two-way capital flows, and redirects its economy toward internal consumption.

• Congress and the president agree to landmark fiscal reform, including control of entitlements and simplification and stabilization of the tax code.

• The G20 agrees to a new framework of monetary policy coordination to adjust trade and capital imbalances and stabilize the purchasing power of fiat money over time.

• Regulatory reform is redirected toward an effective reduction of risk-reward asymmetry, and asset concentration, within the financial industry. No firm is too big to fail, and both equity owners and bondholders are at risk. The federal government's role in the mortgage market is reduced and gradually eliminated.

Sources: Black Rock, Eaton Vance, Morgan Stanley, Goldman Sachs

Retirement Plan Contribution Limits for 2011

401k Plans, 403b Plans, 457b Plans and SAR-SEPs	Lesser of $16,500 or 100% of participant's compensation ($22,000 if age 50 or older)
SIMPLE 401k Plans and SIMPLE IRA Plans	Lesser of $11,500 or 100% of participant's compensation ($14,000 if age 50 or older)
Traditional and Roth IRAs	Lesser of $5,000 or 100% of earned income ($6,000 if age 50 or older)

Stock in the News: 3M Co. (MMM)

Based in St. Paul, Minn., 3M manufactures a diversified array of industrial products. Known especially for popular consumer products such as Scotch Tape and Post-It Notes, the company's portfolio also offers liquid crystal display films, health-care technology, heavy duty adhesives, and more than 40 other technology platforms. 3M is an S&P 500 component and a part of the Dow Jones Industrial Average.

Over its long history, 3M has invented some of the world's greatest products. We think the firm's innovative culture, bottom-line focus, and low-cost manufacturing have carved a wide moat around its business that will enable the company to reap outsized rewards over the long run. Although 3M sells thousands of products to disparate end markets, the firm cites only a few dozen technological pillars that support its wide array of offerings. The company's ability to innovate new pillars and leverage the technology across multiple industries forms the backbone of its historical success. As a result, the firm has enjoyed returns on invested capital well above its estimated cost of capital during the last 10 years, while annual free cash flow averaged an impressive 13% of sales. Recent economic headwinds challenged this profitability because of the firm's inherent operating leverage, but we think 3M handled the 2008-2009 recession admirably, reducing working capital to increase free cash flow while remaining economically profitable.

CEO George Buckley hopes to utilize this strong cash flow to pursue attractive acquisition opportunities. Since his arrival in 2005, 3M has spent about 4% of sales per year to purchase outside companies, versus only 3% the five years prior. We think the company's lofty returns justify continued merger spending. Furthermore, Buckley's engineering background – he holds a Ph.D. in the subject – has reinvigorated 3M's innovation core. The company's vitality index – the percentage of sales stemming from products introduced during the previous five years – has climbed to nearly 30%, from the low-20% range just a few years ago. In order to continue stimulating organic growth, we think that 3M will focus on international opportunities. In 2009, non-U.S. sales constituted 63% of the company's overall revenue, a substantial increase from 53% in 2000, and up from 61% in 2006.

In 2011, we expect the company to generate more than 65% of its sales from international locations. Similarly, we forecast that during the same time frame, more than 75% of the company's operating profit will stem from international sources because of especially high margins in Asia and Latin America. To manage this overseas growth, 3M continues to improve its international supply chain, which we think will reduce shipping distances to customers and result in long-term bottom-line improvement. Additional research centers overseas should also help spur further growth in the firm's vitality index, as international markets already contribute about 70% of new product sales. Although the firm has recently faced headwinds due to higher raw-material costs, its short order cycle – only about 30 days, on average – puts the company in a position to become an early beneficiary of a continued demand rebound.

Key Statistics: MMM

Price	*$93.13*
Trailing EPS	*$5.63*
Estimated EPS	*$6.30*
Forecast P/E	*12%*
Current P/E	*14.78X*
PEG Ratio	*1.23X*
Dividend Yield	*2.36%*
Market Cap	*$66.29B*
52 Week High	*$94.33*
52 Week Low	*$68.96*
Beta	*0.94*
ROE	*28.6%*

Sources: Morningstar & Argus

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