C Y P R E S S

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **OCTOBER, 2010**

The best September in 71 years saw the S&P 500 gain 8.8% and helped produce a strong 3rd Quarter 2010 return, moving stocks back into positive territory for the year. The S&P 500 rose 11% in the quarter and exited September up almost 4% (total return) for the year. We have left out our popular "Good News/Bad News" segment to spend more time on specific important topical issues of energy, interest rates and dividends. The most important single comment we can make in terms of Good News/Bad News is simply that the "Three G's" (Goldman Sachs' SEC lawsuit, The Gulf of Mexico oil spill and ensuing drilling moratorium, and the Greek-Euro Financial dilemma) all either literally disappeared or were diminished – at least for the time being – in investor's eyes. This fundamental and psychological improvement perhaps outweighs all other commentary when one compares the 2nd and 3rd Quarters of 2010.

Strong Septembers And Mid-Term Election Cycles

Historically a strong September bodes well for near term equity performance. According to Merrill Lynch, September gains have typically been followed by well above average 4th Quarter market returns since 1929, 6.8% versus 2.2% after a down September, and 4.6% for all years during the seasonally important October – January period.

While ultimately fundamental factors such as profits, global economic growth and interest rates and inflation drive the performance of equities, the bullish influence of the Mid-Term Election cycle is particularly worth noting. In the 12 months following Mid-Term Congressional Elections, stocks have performed remarkably well.

The S&P 500 has Historically Performed Well After A Midterm Election

Midterm Election Cycles [1]
Total Returns [2] for the S&P 500, percent

	after 1 month	after 3 months	after 6 months	after 9 months	after 12 months
1946	-0.3	6.9	0.7	10.5	9.6
1950	1.7	13.7	19.5	21.3	26.0
1954	9.1	17.2	22.6	42.0	39.4
1958	2.8	8.9	14.1	20.8	15.7
1962	10.9	18.3	25.7	25.4	35.3
1966	1.0	9.0	19.3	21.2	21.0
1970	5.4	16.2	26.9	17.6	16.9
1974	-4.5	5.6	21.0	24.3	26.0
1978	2.6	8.8	12.1	16.0	15.3
1982	4.4	9.9	25.7	25.8	27.9
1986	2.6	13.3	20.1	33.7	6.6
1990	6.4	14.2	25.6	30.9	33.5
1994	-3.7	0.3	10.4	21.3	26.3
1998	6.1	16.9	22.3	22.1	25.7
2002	5.9	-2.9	4.5	13.4	20.8
2006	1.9	4.9	8.6	7.1	14.6
Average Return	3.3	10.1	17.5	22.1	22.5

Sources: Morningstar, U.S. Trust Market Strategy Team.
[1] Midterm election cycle begins November 1 and occurs every four years. Data cover the cycles from 1946 to 2006.
[2] Returns are calculated from November 1 onward of every cycle.

Following the past 17 Mid-Term Elections, stock market returns have been consistently and strongly positive. Going back to 1946, the average total return for the S&P 500 Index in the 3 months following the Mid-Term was 10.1%. Performance is even better over the ensuing 6, 9, and 12 months with average returns of 17.5%, 22.1%, and 22.5%, respectively.

Renaissance In Onshore Drilling In North America:
Oil Rigs Projected To Surpass Gas Rigs In U.S. By Late 2011

Just a decade ago, drilling for oil appeared to be the dinosaur of the U.S. onshore drilling industry, and represented less than 20% of all domestic drilling activity (roughly 10% at its nadir in 2005). In the late 1980's oil still accounted for almost 65% of drilling activity, but its share steadily declined to 20% by the late 1990's and then dropped permanently below the 20% level for the next 10 years. All that began to change in early 2009. Falling gas prices and strong oil prices ($65 - $75/bbl) spurred E&P companies to drill for oil and liquids. The game changing technology of horizontal drilling combined with hydraulic fracturing ("fracking") that revitalized the domestic natural gas industry and enabled the development of major natural gas shale plays has now been applied to oil and potential oil shale plays.

As a result, oil related drilling activity has doubled its market share to over 40% of the total rig count in less than 2 years. Some industry observers believe that by late 2011 the number of oil rigs could reach or exceed the number of gas rigs in the U.S., and account for 50% or more of the total domestic market. Evolving drilling techniques like horizontal drilling, fracking, and enhanced recovery are being applied to unlock the potential of a few select oil shale plays, the most significant and developed of which is the Bakken Shale in North Dakota and Montana, but also includes the Eagle Ford in south Texas, the Granite Wash in North Texas and Oklahoma, Niobrara (Colorado, Nebraska and Kansas), and older conventional basins like the Permian Basin in West Texas.

All of this activity has led to a 60% year over year increase in the total U.S. rig count, and while the oil rig count is up 126% the gas rig count has also increased a surprisingly strong 34% despite depressed gas prices. And this period includes an over 4 month long drilling moratorium in the Gulf of Mexico and diminished prospects for deepwater and offshore drilling in U.S. waters. Activity should remain strong given the favorable underlying fundamentals of the global oil market. Oil is a truly global commodity and the world's most important global commodity. It virtually represents an alternative global reserve currency, but unlike gold, actually has intrinsic value and utility. Oil benefits from growing emerging market demand and chronic supply constraints, which should combine to keep oil prices strong for the foreseeable future. In contrast, natural gas is a classically local market and the U.S. gas industry today suffers from too much gas supply.

Rocken In The Bakken

In one year, the Bakken rig count has grown from 50 rigs to around 125 and is projected by Raymond James to exceed 200 rigs by the end of 2011. The activity in this one oil shale would then be greater than the entire domestic oil rig count during much of the first half of this decade. The Bakken and other emerging shale plays could be a game changer in many ways. The Bakken is currently producing about 330 thousand barrels per day and some estimate the greater Bakken has the potential to ultimately produce over 1 million barrels per day over the next 5 to 10 years and other shales could add another 1 million barrels per day, for a total domestic increase of 2 million barrels of oil per day. To put this increase in perspective, however, the U.S. produces less than 8% of the world's oil today, and most of that production comes from Alaska and the offshore Gulf of Mexico. The rebirth in U.S. onshore oil production is starting from a very low base and is almost inconsequential to the global oil market. (U.S. onshore oil production peaked in the 1960's at almost 10 million barrels per day and fell steadily to almost 5 million barrels per day over the next 40 years).

While much of this potential increase of 2 million barrels per day may be offset by declines elsewhere, it is interesting to note that the U.S. imports about 10 million barrels per day of oil. This new production could one day replace 20% of our oil imports. So the Bakken and U.S. oil shales could be a kind of game changer, not in terms of total world oil production, but in terms of U.S. energy security and greater independence, our trade balances, and significant American job creation. Many of the energy stocks in our portfolios are significant players in the developing American shale and oil recovery plays.

Deep Pockets And National Oil Companies In North American Shales

The surge in capital investment in the major U.S. shales represents an additional crucial factor supporting robust drilling activity. During the past 18 months oil companies and major international oils – including Total of France, the China National Offshore Oil Company (CNOOC), Reliance Industries of India, the BG Group of the UK, and Exxon Mobil through the acquisition of XTO (the largest onshore natural gas and shale producer in North America) – have all made significant strategic investments in U.S. production. Investments have been made in the major gas shale plays including the Barnett, Marcellus, Haynesville, and Eagle Ford. These deep pockets mean drilling activity will continue and has staying power even in an environment of low natural gas prices. This influx of capital, the new drilling techniques that are unlocking the potential of oil shales, and favorable fundamentals in the global oil market combine to provide a foundation for a continued surge in North America drilling activity and onshore production for years to come.

Bonds: Returnless Risk

Simply put, when it comes to bonds, it is our opinion that investors have given up on making a decent return. As we write, US treasury yields are at historical lows. You can buy a five year US Treasury bond (which means you are lending your government your hard earned capital) that will give you an annual yield of 1.1%. Let us say that again, you agree to lend your government your capital for 5 years and the government owes you 1.1% per year for that courtesy for five years. You can also loan Uncle Sam your capital for ten years and receive a yield of 2.39% per year. To put this in perspective, in ten years there will be five congressional elections and the country will have at least one new president and it is possible we would be voting on a third. There will have been 40 quarterly corporate reporting seasons and about 80 Federal Reserve meetings. The older members of the baby boom generation will be in their 70's and deep into retirement. We are puzzled that investors would accept such historically and absolutely insignificant returns over such a long investment horizon.

We agree with Warren Buffet that bonds offer poor value relative to equities. Buffet was recently quoted, "It's quite clear that stocks are cheaper than bonds. I can't imagine anybody having bonds in their portfolio when they can own equities, a diversified group of equities. But people do because they, the lack of confidence. But that's what makes for the attractive prices. If they had their confidence back, they wouldn't be selling at these prices. And believe me; it will come back over time." It is obvious that bonds, like gold, are a vote of no confidence in the domestic equity markets and the state of the domestic US balance sheet. The irony is that the weakend state of the domestic U.S. balance sheet could have a direct effect on the long term valuation of bonds relative to equities.

Having accepted essentially no yield return for long term investments, bond investors have huddled in mass into a giant investment that some have characterized as the next potential bubble. In contrast to the investment idea of a "riskless return," we believe that bonds now represent "returnless risk." To us, the bond market has the feel of the NASDAQ at its peak around 2000. Valuations are stretched past historic levels, the government is doing everything within its power to keep the party going (e.g. QE2) and there is a pundit available 24/7 to reassure you that investing in 10 year fixed investments with virtually no yield is prudent. Here are two road signs of particular note. First, Mexico, that bastion of political and economic sovereign stability, just issued $1 billion in 100 year bonds. Second, IBM just issued $1.5 billion in 3 year notes with a 1% coupon. We want to emphasize that simply a return to the mean, to historical averages, represents significant capital risk to bond investors at a time when they have accepted virtually no concurrent or offsetting yield.

Dividends

Just as the 100 Year Mexican bond seems a clear warning light, we think the statistics related to dividends and, importantly, dividend growth continue to convey a great deal about the state of the market and investors. The third quarter of 2010 witnessed a near collapse in bond yields. Equity dividend yields now compare very favorably to bond yields. As noted, the yield on 5 and 10 year U.S. Treasuries is currently 1.1% and 2.39% while the yield on the S&P 500 was 2.1% at the end of the third quarter and that yield is projected to grow to 2.45% in 2011.

In periods of investor skepticism- something that certainly characterizes the times we live in today - it is easy to ignore the power of the dividend. We have long preached about the importance of dividends in investing. We generally invest in companies that grow their earnings and dividends at a healthy pace relative to the average stock in the market. Dividends often account for as much as 40% of the total return of well managed, mature, industry leading global companies. In fact, if there has been one constant theme in our investment strategy since inception, it has been our continuing focus on companies with great balance sheets, growing cash flow and strong dedication to dividend growth. Most of our portfolios enjoy a dividend yield in excess of the yield on the S&P 500. Even more significantly, 75% of our top 50 holdings raised their dividend in the last year.

A sample of several stocks and their dividend growth from 2000 to 2010, an otherwise "lost decade" for stocks, is summarized below:

Stock	2000 Dividend/Share	2010 Dividend/Share	Increase
Procter & Gamble	$.67	$1.88	2.8X
Pepsi	$.56	$1.89	3.4X
Chevron	$1.30	$2.84	2.2X
Kinder Morgan	$1.60	$4.30	2.7X

Source: dividend.com

We believe that most of the stocks we hold in your portfolio have the potential to continue to grow their dividend at above average rates and could perhaps double their dividend rate over the next decade. Given that the S&P 500 continues to sell at reasonable valuations of 13.9 times 2010 consensus operating earnings estimates of $83.45 and 12.4 times 2011 estimates of $95, we think that companies with sound and growing dividends represent good investments on an absolute and relative basis.