



MARKET WATCH

Third Quarter 2011

THE
NAPLES  TRUST
COMPANY

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PORTFOLIO REVIEW & STRATEGY

While frequently valid, the old adage of “selling in May” and staying out of the market for most of the third quarter has had spotty and unproven results for most longer-term investors. This year, June proved to be a tough month after the very positive first five months for U.S. equity markets.

Some of the biggest headline factors responsible for current investor skittishness include: The Greek/Euro-Zone debt crisis, slowing global economic growth, persistently slow U.S. employment growth, and the looming U.S. budgetary negotiations in Washington. Despite a barely positive quarter of 0.1%, the S&P 500, including dividends, still remains up 6.0% for the year.

Bond prices, as reflected in the Barclay’s U.S. Treasury Index, have held most of their modest gains of 2.4% YTD and are approaching the current annual coupon rate on the 10-year bond (3.16%). Current yields on Treasury bonds remain close to historical lows, and most bonds continue to be relatively expensive and unlikely to deliver more than the stated current yield with the additional risk of principal erosion if rates ultimately move upward again.

Strong global demand for energy and commodities, combined with concerns about instabilities in the Middle East, caused oil prices to reach multiyear highs. We have since seen oil retreat from \$115 to approximately \$95 per barrel. The broader Reuters/Jefferies Commodities Index declined 5% for the quarter, having fallen by 7.5% in late June. Lower energy and commodity prices should have a positive impact on both consumer purchasing power and corporate profit margins in the months ahead.

Many financial assets surrendered some early year gains in the June quarter, yet some sectors within the S&P 500 fared well while other sectors were particularly impacted. The worst performing sector was Financials, down 6.3% for the quarter and down 3.7% YTD. Energy was down 5.1% for the quarter yet still maintained a strong 10.4% gain for the year. Materials, Industrials and Information Technology stocks—while originally off to a decent start—remain up only slightly for the year after giving up almost 1.5% in the latest quarter.

On the positive side we saw investor rotation into the traditionally more defensive sectors accelerating into the second quarter. The biggest leader for both the year and quarter was Healthcare which was up 7.3% and 12.7%, respectively. We have benefited by having had a favorable outlook in this sector including companies such as Johnson & Johnson, Novartis, GlaxoSmithKline, Abbott Laboratories, and Becton, Dickinson. Also faring very well were the Utility sector (up 5% QTD and up 6.7% YTD) and both Consumer Staples and Consumer Discretionary, each up 6.3% and 7.5% for the year. We have favored many fine companies here as well including Southern Company, Duke Energy, Kraft, PepsiCo and Walgreen.

It remains to be seen whether the current rotation into more defensive sectors will continue in anticipation of slower economic and profit growth ahead. On the other hand, the upcoming earnings announcement season could again surprise analysts and investors with better-than-expected earnings results, giving yet another boost to the broad market including most or all sectors. Stay tuned.

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CURRENT OUTLOOK

The U.S. economic recovery just celebrated its second birthday this past June and, as most parents and grandparents know from experience, we are passing through the “toddler-phase.” For children it is often also referred to as the “Terrible Twos.” A certain amount of independence creeps into a child’s attitude, and the need of a helping hand is not as necessary. But it also brings with it the bumps and bruises, the skinned knees, and the occasional fall-induced “fat lip.” So it seems to be going with the U. S. economy. Just when we thought we had escaped the less-than-stellar economic growth of the first quarter and were looking for better results in the recently completed second quarter, the “soft patch” arrived.

Partially to blame was the earthquake in Japan and its impact on the just-in-time international supply chain that companies around the globe were all so proud of. Other natural disasters such as flooding and severe storms also played a part in slowing down U.S. growth. Higher oil prices caused by the “Arab Spring” in North Africa acted like a tax increase on American consumers in the second quarter as well. Finally, with our economy more dependent than ever on other countries buying our goods and services, the fall-off in global growth due to higher interest rates in emerging countries and debt problems in the Euro-Zone only added to our slowdown.

It now appears that our 3%-4% Gross Domestic Product (GDP) growth projection for 2011 will turn out to be closer to 2.5%-3% as a result of the second quarter slow-down. Interestingly, the supply-chain problems in the automobile industry caused by the Japanese earthquake could end up accounting for the bulk of the 2011 GDP short-fall from expectations. The seasonal slow-down in production that usually falls in July in the U.S. was pushed into June because of parts shortages. This reduces the annualized GDP number for the second quarter. The re-starting of production in July, as opposed to the normal August re-start, should add materially to the annualized third-quarter number, but still not fully offset the shortfall in the first and second quarters. Thus, despite the fact that first-half GDP growth may only be as much as a tepid 2%, the last half of the year could see a much stronger annualized GDP figure. This timing difference may also impact profit growth numbers for the second quarter and again in the third quarter.

While we are watching carefully the machinations of politicians around the globe trying to deal with the debt-induced austerity measures that must be addressed, we also remain focused on the drivers of asset valuations such as economic and profit growth, interest rates and inflation. As the Federal Reserve, for example, begins the process of removing its extraordinary monetary stimulus with the end of the second round of quantitative easing (QE2), we expect a gradual increase in interest rates and stable inflation. Likewise, the debate in the Euro-Zone regarding the status of over-indebted member states will get resolved, in our opinion, with a burden-sharing approach closely monitored by the European Central Bank and the International Monetary Fund, similar to the Argentine debt-default in 2002. Our own debate domestically over the debt-ceiling extension for the federal government should result in a material adjustment in the U.S. deficit and debt trajectory over the coming decade. In all three examples, the resulting actions have helped to keep the “bond vigilantes” at bay.

Overall we expect long-term resolution of many of the current headline issues to result in generally rising world-wide economic activity and, with it, generally rising asset values.

GOOGLING GREECE

It's easy to read headlines about Greece's potential default on its debt, or concerns that the U.S. housing market may have another leg down, and just nervously hunker down. But while the financial media have been obsessed with back room negotiations between Greek politicians and Eurozone bigwigs, we've been focusing on some wonderful opportunities here at home in the tech sector.

For example, let's take a look at Cisco, Apple, and Google. You can find reasons not to invest in all of them, if you choose. Cisco is facing increased competition in some of its markets, and the company's push into consumer products has been a flop. Apple courts "key man risk" with Steve Jobs' recurrent health problems, and one product (the iPhone) accounts for 40% of the company's sales. Google has had zero success expanding from its core Internet search franchise, and may soon face an antitrust investigation.

You can let these fears keep you on the sidelines. Or, you can focus on the fact that these three companies all still have dominant franchises in their respective markets, and spit out cash faster than a printing press run by Ben Bernanke.

The table below shows just how cheap these three businesses have become, from one simple perspective – cash. As you see, between one-fifth and one-third of the market value of all three tech giants sits in cash, which means that these companies are actually cheaper than they appear. For example, even though Cisco trades for \$15 per share, you're only paying \$10 for the business, because the company has \$5 per share in cash

Stock	Share Price	Net Cash per Share	"Enterprise Value" per Share (Share Price Minus Cash)	Free Cash Flow (Owner's Earnings) per Share	"Cash Return" (Free Cash Flow Divided by Enterprise Value)
Cisco	\$15	\$5	\$10	\$1.60	16.0%
Apple	\$326	\$70	\$256	\$25	9.8%
Google	\$475	\$100	\$375	\$21	5.6%

Moreover, these companies all continue to pile up more cash from their wonderfully profitable core businesses. We measure the amount of cash a company creates using a metric called free cash flow, which is the amount of cash a company creates after spending what it needs to maintain and expand its business. (For example, if you owned an apartment building that generated rental income of \$200,000, and you had \$10,000 left over at the end of the year after paying all the building's expenses and replacing a few windows, that \$10,000 would be your free cash flow.)

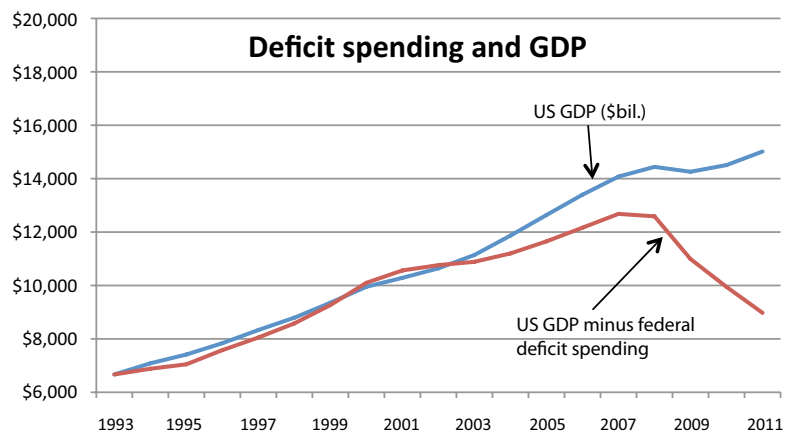
Cisco is generating about \$1.60 per share in free cash flow. If you divide that \$1.60 by the \$10 per-share value of Cisco's business, you get a 16% yield, or "cash return." In other words, Cisco throws off \$16 in cash per \$100 of market value – which is a pretty juicy return. Apple and Google are not quite as cheap as Cisco, but they also face fewer business challenges. Best of all, we think it's much easier to forecast how much cash these companies will generate than it is to forecast how the Greek debt situation gets resolved.

SAVING THE FAMILY FARM

One way to look at the U.S. economy is to imagine a \$70 trillion farm stretching to the horizon, capable of producing income (or GDP) on each acre. If the farm's size stays the same, national income roughly rises with productivity improvements (higher yields or lower costs per acre). But when the farm shrinks, two things occur – not only does current income shrink, but the farm's capacity to produce future income declines. As any farmer is well aware, selling just 50 acres of a 1,000-acre plot removes sizable amounts of cash flow from all future generations due to the power of compounding. Shrink the size of the farm for a decade or more, and it becomes mostly impossible for owners to regain peak levels of income without leverage (borrowing against the remaining land to make investments) or huge productivity gains.

Today, with annual trade deficits at \$525 billion, and the annual federal deficit running at \$1.4 trillion (a portion of that financed by foreigners), ownership of several hundred billion dollars of U.S. assets is being transferred offshore *every year*, in effect shrinking our \$70 trillion farm at an unsustainable rate. Its capacity to produce enough future income to support the aspirations of 300 million children, workers, and retirees is withering as well.

Judged in that sense, you can understand the political and financial dilemma facing policy makers as they negotiate a debt ceiling / deficit-reduction plan. Federal deficit spending (money created from nothing and injected straight into the economy) is now three times larger than the \$450 billion expected growth of GDP in 2011. Take away the excess spending, and our economy has been continually shrinking since



2008 (see chart). The choices, then, for the President and Congressional leaders are not good ones – run large deficits today to stop the economy from backsliding (in other words, borrow against – or give away – more of the farm), or implement austerity to enable higher future GDP growth (possibly causing a second recession).

Corporate equity as a hedge – These policy choices fool neither bond nor currency investors. World financiers are behaving as if our economy will naturally slow and that Washington will continue to push short-term interest rates to near zero, borrow more at these self-engineered low rates, and pump the new dollars into the system to jump-start investment, productivity, and export growth. The natural investment implication we see is a push into producing assets. The Federal Reserve understands that the “way out” involves rebuilding balance sheets, and the quickest way to help Americans is to induce equity investment and higher asset prices. Cash and bonds can no longer be considered king when both bear negative real yields. Owning the earning power of financially stable companies – especially those with sustainable, rising dividends and foreign sales exposure – is the natural hedge against currency debasement, a soft U.S. economy, and large budget deficits.

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Dear Investor,

In today's world it is important to trust your financial future to a company whose sole mission is to preserve, enhance and perpetuate its clients' assets.

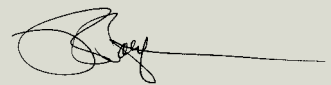
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Warm Regards,



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