First Trust

Quarterly Market Overview

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Mr. Carey has nearly a quarter century of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. As CIO, Bob and his staff supervise over $30 billion in assets.

Mr. Carey has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and Canada's Business News Network and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep*.

Act now and you can buy a piece of the action for the low, low price of 1995

As big proponents of owning stocks over the past two years, we are pleased to report that our sentiments have proven to be both accurate and lucrative. Believe us when we say that we caught our share of flack for being so optimistic. The S&P 500 posted a total return of 93.1% from the bear market bottom on March 9, 2009, through December 31, 2010. When you expand to include small- and mid-caps, the returns are even better. The S&P 400 and Russell 2000 returned 130.5% and 134.0%, respectively. But here is the encouraging part: those investors who opted out of stocks and did not return after they bottomed have a chance to reconsider.

The chart to the right shows the price-to-earnings ratio (trailing 12-mo.) of the S&P 500 dating back to February 3, 1995. The index's price level rose from 478.65 on 2/3/95 to 1271.50 on 1/7/11, and yet the price multiple on the index closed 1/7/11 at 15.85, just below the 15.89 it registered on 2/3/95. The simple fact is that corporate earnings have been much better than investors expected. The earnings growth estimate for the S&P 500 in 2010 is 47.0%, according to Standard & Poor's. Its estimate for 2011 is 13.3%. The average between '94-'08 was 10.2%, according to CompuStat and Bloomberg.

The Federal Reserve reported that the amount of cash holdings at non-financial companies in the U.S. stood at $1.93 trillion at the close of Q3'10, up from $1.80 trillion at the close of Q2'10, according to MoneyMorning.com. Cash constituted 7.4% of the companies' total assets – the highest percentage since 1959. While we acknowledge that this recovery is somewhat controversial because of the absence of jobs at this juncture, the amount of cash waiting to be tapped in Corporate America should not be ignored.

As of the close of 2010, the S&P 500 stood 19.65% below its all-time high of 1565.15 on 10/9/07. Remember, the S&P 500 has never failed to fully recover from a bear market. Brian Wesbury, Chief Economist at First Trust Advisors, just released his 2011 forecast calling for a fair value estimate of 1675 for the S&P 500. Brian uses a capitalized profits model that assumes a conservative 5.00% yield for the 10-year T-bond in 2011. It stood at 3.30% on 12/31/10. If accurate, that would represent a gain of 33.2%. Now, before you shake your head in disbelief, consider the following recap from 1995: S&P 500 posted a total return of 37.6%...with an earnings growth rate of 15.5%...and an average yield of 6.57% on the 10-yr. T-bond. We do acknowledge that past performance is no guarantee of future results.

The price return of the cap-weighted S&P 500 in 2010 was 12.78%, but the average stock in the index was up 19.25%. Bespoke Investment Group broke the index down into deciles by market cap to see which groups lifted the index higher. The worst performing deciles were 1-4, with the largest companies posting the smallest gain, up 8.9%. The smallest companies in the index were up 24.2%. The best performers were the seventh decile, up 28.1%. Since the S&P 500 is cap-weighted, any surge in cash flows to large-caps in 2011 could bring the strong returns mentioned above into play.

Source: Bloomberg

The new year is similar to 1995 in two other important ways: It is the third year of a presidential cycle and it happens to follow a major event involving the clean-up of derivatives gone bad.

The last time the S&P 500 posted a negative return in the third year of a president's term was 1939. Since 1928, the S&P 500 posted an average annual gain of 14.1% in year three of a presidential term, according to moneyandmarkets.com. The average jumps to 17.7% when it is a Democrat in the White House. The return in year three more than doubles the average of any of the other three years. From 1946 through 2009, 62% of the economic growth in the U.S. economy was garnered in the final two years of presidential terms, according to *The New York Times*.

Derivatives! Can't live with them, can't live without them. In December 1994, Orange County, California declared bankruptcy after losing a reported $1.6 billion from bad derivative bets involving the direction of interest rates. The strategy had worked for a time, enabling Orange County to goose its returns. That helped attract capital to its investment pool. The Orange County Treasurer managed money for some 241 local government entities. The primary bet was that short-term rates would stay low, but they did not. The Fed tightened aggressively in 1994. The bankruptcy lasted approximately 18 months and settlements (77 cents on the $) involving more than 30 securities firms helped these government agencies and municipalities get back on their feet. But there was an extended period where services had to be cut in light of the losses sustained. Sound familiar? While the Orange County case is much smaller in stature than the subprime mortgage meltdown involving CDOs and credit default swaps, it was an alarming event in its time. The U.S. economy and markets have always demonstrated an ability to bounce back from crisis. It is happening again as we speak.

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Covered Call Closed-End Funds

Every investment product trading in the marketplace is built to do a specific function. Often times the function/objective is right in the name: Growth & Income, High Yield or Tax-Advantaged. Some products are trickier to figure out. Covered Call portfolios come to mind. Most investors know that these products utilize a strategy of buying common stocks and writing covered calls to generate premium income, but they are more multi-dimensional than they seem, especially in terms of how they behave in certain market climates. And they have changed over the years.

In the last century, covered call funds were structured as open-end funds. That meant the fund was processing new purchases and executing redemptions on a daily basis. It was difficult to manage these funds in that structure because sudden changes in flows could easily disrupt the portfolio manager's strategy. For example, it could influence the percentage of stocks with calls written against them, which would directly impact the level of distributions that could be paid out to the shareholders. As a result, most covered call portfolios trading today are structured as closed-end funds that trade on exchanges. No inflows or outflows to navigate, and no need to maintain a sizeable cash position.

Having said all of that, there is probably no better example to illustrate how confounding these products can be than 2010. Remember, the primary objective of covered call portfolios is high current income. Many investors operate under the notion that they can collect said income and still capture some upside in the stock market in a good year. And sometimes that is the case. But it is less likely when the market is staging a rebound from a bear market and returns are above the historical norm. The S&P 500 was up 15.06% in 2010. That gain is 52.6% more than the 9.87% average for the index since 1926, according to Ibbotson Associates. When that level of return can be had, it is not surprising that some investors, especially institutional ones, will sell their Covered Call closed-end shares and shift to pure play equities. That is why the 1.48% return (see chart above) also lags the 5.86% return on the BuyWrite Index (proxy for covered calls). Notice, however, that the Covered Call closed-end funds outperformed both over the past 3- and 5-year periods. While Covered Call closed-end funds may not be for all seasons, they can be as viable an option as any of the other income vehicles.

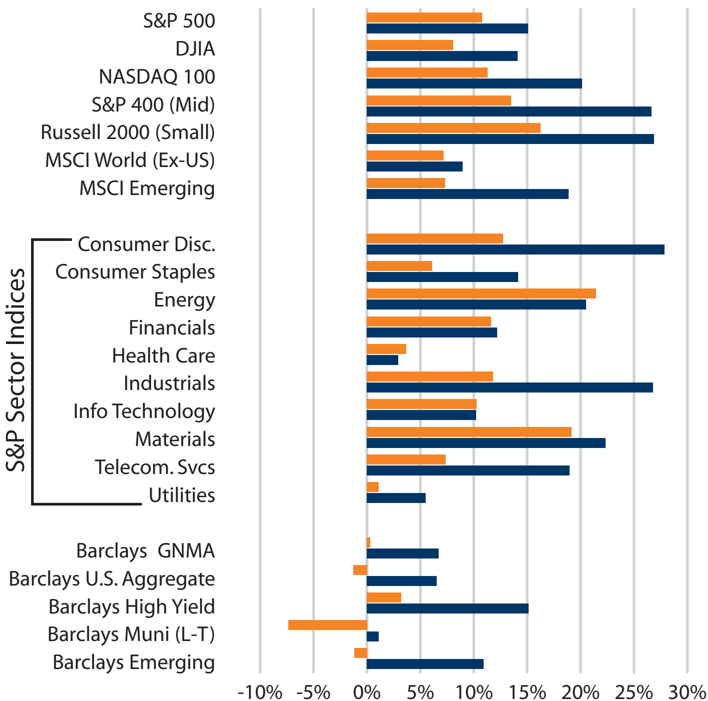
Total Return Performance	2010	3-Year	5-Year
U.S. Treasury: Intermediate	5.29%	4.95%	5.42%
S&P 500 Index	15.06%	-2.84%	2.29%
The CBOE S&P 500 BuyWrite Index	5.86%	-1.66%	2.81%
Covered Call Closed-End Funds	1.48%	0.57%	3.27%

Source: Barclay's Capital, Bloomberg and Morningstar FundData

A brief commentary on the claim that buy-and-hold is dead

The comparison to 1995 on the front page makes for a nice segue into another topic: buy-and-hold investing. The advent of online securities trading has inspired the broader trading community, which now occupies the bulk of the airtime on the financial networks, to proclaim that investors who purchase a security or packaged product with the intent of holding it for a number of years are destined to fail. Well, in 1995 we witnessed the onset of the Internet Revolution. If an investor had been able to purchase shares of the Dow Jones Composite Internet Index on July 31, 1997 (index launched in July 1997) and held those shares through 12/31/10 (161 months) they would have posted a cumulative total return of 223.7%, or 9.14% annualized. By the way, that return includes the period known as the dot-com bomb. The index fell 93% from 3/31/00-9/30/02. How about gold? Had you bought an ounce of gold bullion on 12/31/95 and held it through 12/31/10, your gain would have been 266.2%. Another theme that seems to have played out fine is biotechnology. In June 2000, a press conference was held to announce the discovery of the human genome. The process, which was a joint effort between public and private sector research, lasted roughly a decade. It was touted as a major breakthrough for future drug discoveries. Had you been able to purchase the NYSE ARCA Biotechnology Index (formerly the AMEX Biotech Index) on 12/29/00 and held it through 12/31/10, your gain would have been 104.6%. Suffice it to say that none of these examples can be construed as failures. Some things take time. Think about it the next time you pick up your smartphone to order movie tickets.

Total returns for *Q4* and past **12 months** (12/31/10)



A Look Ahead:

The outlook for earnings (year-over-year comparison in $)...

	Q1'11E	Q1'10A	**Q2'11E**	Q2'10A	**2011E**	2010E
Financials	**4.35**	3.66	**4.39**	3.81	**18.05**	15.52
Information Technology	**6.36**	5.54	**6.85**	6.11	**28.90**	25.62
Health Care	**7.97**	7.08	**8.23**	7.23	**32.96**	29.03
Consumer Staples	**4.78**	4.37	**5.31**	4.81	**21.30**	19.35
Consumer Discretionary	**4.28**	4.09	**5.09**	4.63	**19.73**	17.89
Industrials	**4.43**	3.71	**5.04**	4.61	**20.01**	17.74
Telecom. Services	**1.98**	1.91	**2.06**	1.98	**8.29**	7.65
Energy	**9.53**	8.42	**9.90**	9.29	**40.23**	35.16
Utilities	**3.38**	3.41	**2.88**	2.66	**13.23**	12.59
Materials	**4.14**	3.20	**4.41**	3.47	**16.07**	12.65
S&P 500 Index	**21.99**	19.38	**23.33**	20.90	**94.70**	83.63
S&P 400 Index (Mid-Cap)	**11.91**	9.22	**13.11**	10.93	**53.85**	43.90
S&P 600 Index (Small-Cap)	**5.04**	3.45	**5.65**	4.28	**23.03**	17.30

Source: Standard & Poor's (1/4/11)