



## Equity Market Overview – 2Q10

*There are potholes on the road to recovery*

Although market and economic sentiment took a decidedly negative turn during the 2nd quarter, the result was a market trading at extremely attractive valuations with a Price-to-Forward Operating Earnings ratio of only 12.2x! While the headwinds facing domestic and global economies should not be dismissed, “potholes” provide excellent opportunities for long-term investors and we remain confident the economy will continue to grow. Indicators that the U.S. economy remains on the road of recovery include:

- Operating profits for the S&P 500 increased 92% in the 1st quarter compared to the quarter year ago.
- Sales growth for the S&P 500 averaged 12.4% in the 1st quarter with only minimal inflation.
- 83,000 private sector jobs were added in June, making it the 6th consecutive monthly increase of non-governmental jobs in the U.S.

While these headlines paint an optimistic picture, they are delivered with multiple caveats. Yes, earnings are rebounding, but from extreme lows, and the jobs report is less transparent due to the temporary effects of census workers. These factors should not cloud the fact we continue to recover from one of the most severe economic recessions of our time. James Cooper of the *Financial Times* points out that corporate profit growth in the 1st quarter (encompassing all profits over the entire country) reported by the Bureau of Economic Analysis was the strongest in over 60 years.

### **European Debt Crisis – A Small Pothole**

European sovereign debt is the most discussed pothole, with Greece being the primary focus. It should be noted that Greece’s GDP is only 1.8% of the European economy and

0.60% of global GDP. The markets also remain uneasy about several other members of the European Union such as Spain, Portugal, and Italy. Contagion remains the most significant concern as investors worry the global economy will be adversely affected by Europe’s woes. As a significant trading partner, Europe is very important to the U.S. economically and the debt crisis will assuredly have an impact on the recovery, but we do not believe it will cause a double dip recession. Additionally, European monetary authorities have taken steps to stabilize the situation and have indicated they will take any further steps necessary to prevent contagion.

### **Oil Spill – A Bio-Hazard Pothole**

Also discussed relative to the economic recovery is the catastrophic oil leak in the Gulf of Mexico. This unfortunate accident will affect the people and economy of the Gulf Coast for years, if not generations to come. We view the creation of the \$20 billion escrow account as a positive for both victims of the spill as well as British Petroleum (BP). It removes any perceived conflict of interest if BP were to distribute the funds themselves, and establishes a third-party organization to hopefully provide reparations more efficiently.

While it is too early to know the final cost to BP or the extent of financial destruction to the Gulf Coast region, we remain optimistic that the relief wells currently being drilled will prove successful.

### **Flash Crash – A Ridiculous Pothole**

On May 6<sup>th</sup>, the Dow Jones Industrial Average (DOW) suddenly plunged almost 1,000 points without an apparent catalyst. The market-fall erased \$1 trillion of value before quickly rebounding. Investors were left perplexed and

# RUSHMORE INVESTMENT ADVISORS, INC.



frustrated. Several theories emerged on what caused the drop with various stock exchanges pointing fingers at the other attempting to deflect responsibility. Ultimately it may not be determined what precisely led to the sudden sell-off but we welcome the new SEC rules introduced in response. Certain trading procedures must be uniform across exchanges to insure orderly and rational price discovery. It is crucial the SEC, as well as the exchanges, provide robust trading platforms that protect investors' interests and increases transparency.

## The Road -

### *Tepid Recovery with Double Dip Unlikely*

Unlike the subprime/housing induced recession, our current economy is in the midst of an economic recovery fueled by corporate earnings growth and a moderately improving labor market. In 2008, our economy was adjusting to not only a bubble in mortgage related debt but also a bubble in commodity prices. Double dip recessions are extremely rare and while growth will likely decelerate, we believe the recovery has enough footing to remain on track.

Furthermore, inflation remains muted. The U.S. Federal Reserve (Fed) will continue to keep interest rates low, further stimulating the economy. Lending has remained frustratingly constricted, particularly to small businesses. There is ample room for banks to begin prudently adding to their loan portfolios.

Finally, "growth scares" are a normal part of larger economic recoveries. Since 1945, most periods of economic expansion and corresponding bull markets were interrupted by one or two short-term corrections of greater than 10%. It is the classic inability to see the forest for the trees situation as investors question the sustainability of the economic recovery despite evidence to the contrary. As the economy shifts from rebound growth to normalized and sustainable growth, it is particularly

easy to focus on month-to-month fluctuations as evidence of a broader slowdown.

## Earnings Growth - Positive

Earnings estimates for the next twelve months again rose during the quarter with the S&P 500 expected to post operating earnings of \$84.82, up 8.6% from the 1st quarter's next twelve-month forecast. Additionally, 2010 calendar year EPS estimates have risen to \$81.86, up from \$79.70 three months ago. This represents earnings growth of 46.4% over 2009 and 28% for the next twelve months.

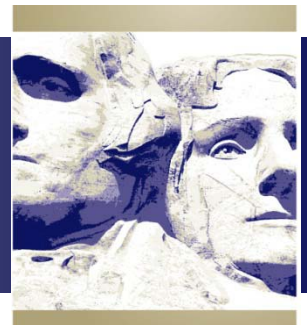
Chart 1:

Economic / Earnings Outlook - As of 6/30/10						
	2006A	2007A	2008A	2009	2010E	2011E
Annual Real GDP	2.80%	2.00%	1.10%	-2.50%	3.20%	2.90%
CPI	3.23%	2.87%	3.85%	-0.30%	1.80%	1.70%
<b>S&amp;P 500</b>						
Earnings Reported	\$ 81.51	\$ 66.18	\$ 14.97	\$ 49.26	\$ 67.38	\$ 77.64
Earnings Operating	\$ 87.72	\$ 82.54	\$ 49.49	\$ 55.91	\$ 81.86	\$ 96.36
Operating Chg. Y-Y (%)	14.77%	-5.9%	-40.0%	13.0%	46.4%	17.7%
P/E Reported	17.40x	22.19	60.34	22.64	17.66	17.39
P/E Operating	16.17x	17.79	18.25	19.94	14.54	14.01
Dividend Yield	1.75%	1.89%	3.14%	1.95%	2.00%	1.75%
	Close	Close	Close	Close	Close	Est
	12/31/2006	12/31/2007	12/31/2008	12/31/2009	6/30/2010	12/31/2010
S&P500	1,418	1,468	903	1,115	1,031	1,190
12 Month Forward Reported P/E	21.43	20.24	21.38	20.05	14.60	15.33
12 Month Forward Operating P/E	14.80	14.50	10.98	14.81	12.15	12.35
DJ Industrial	12,463	13,265	8,776	10,428	9,774	11,100
Fed Funds Target Rate	5.25%	4.25%	0.0% - .25%	0.0% - .25%	0.0% - .25%	0.0% - .25%
10 Year T-Note	4.71%	4.03%	2.25%	3.84%	2.95%	3.50%

Source: Factset and standardandpoors.com

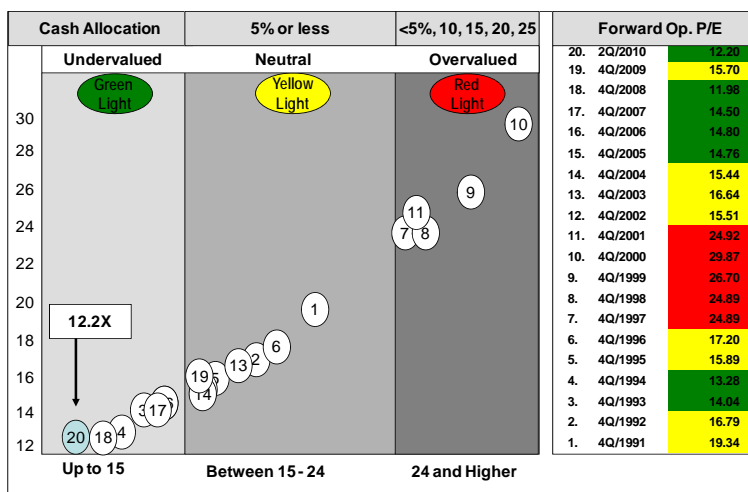
Considering the significant earnings growth expected, it is extraordinary that market valuations are extremely low by historical standards. The Price-to-Forward Operating Earnings ratio fell to 12.2x from 14.7x last quarter, ending the quarter in the lower portion of Green-Light area (See chart 2, next page). It should be noted that on average the next twelve

# RUSHMORE INVESTMENT ADVISORS, INC.



month market return is 13% when the market is in the Green-Light area. That compares to an average market return of 9.6% when valuations are in the Yellow-Light zone and negative <2.5%> when the market trades in the Red-Light area.

Chart 2:



Source: Rushmore Investment Advisors, Inc.

## Summary of Style Performance

All of the broad market indices were down in the quarter. The S&P 500 was off <11.9%>, the Dow Jones Industrial Average lower by <10.0%> and the NASDAQ down <12.0%>. All sectors were lower this quarter but as is the case in most down markets, the safe haven sectors such as Utilities and Telecommunications fell the least with returns of negative <3.9%> and <4.3%>, respectively. The debate over financial regulation reform weighed on the Financials sector which was down <12.7%> and the oil spill had a similar impact on the Energy space, down <12.6%>. Not surprisingly, cyclical sectors such as Materials and Industrials were also laggards and dropped <14.5%> and <12.0%> in the period respectively.

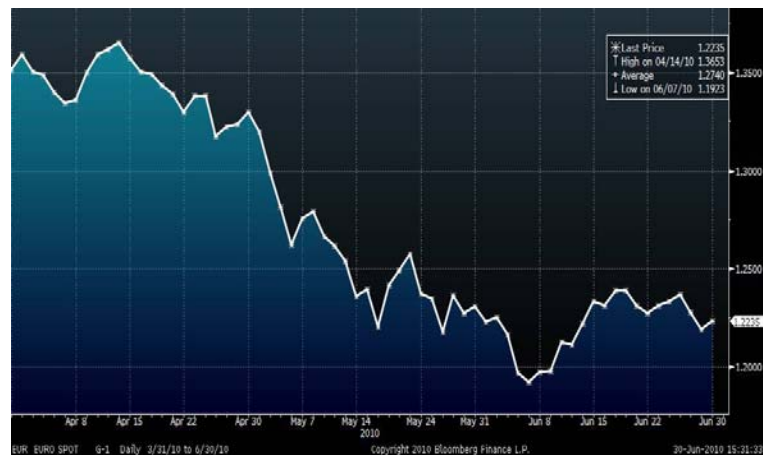
Somewhat surprising, small caps stocks were down less than larger cap stocks. As investors flee risk, traditionally smaller

cap stocks fall further than larger cap names. However, with larger companies generally having a greater exposure to the European economy it follows that they will succumb to higher pricing pressure.

## Non-US Markets

With most of the sovereign debt fears focused on Eurozone countries it is not surprising that European markets were down across the board. On a local currency basis, the MSCI Greece Index was down <35.6%> in the quarter. Italy and Spain fared better, down about <15.5%> each. The negative returns in European markets were exacerbated in U.S. dollar terms due to the drop in the value of the Euro (See chart 3). The MSCI German Index was down only <5.9%> on a local currency basis but off <15.3%> when measured in U.S. dollars.

Chart 3:



Source: Bloomberg

Despite having significantly higher economic growth than the U.S. or European countries, most Asian and Latin American markets had significant market declines in the 2nd quarter. The Chinese Shanghai Composite was down over <22%> and the Brazilian market dropped <13.8%>. The Chilean market was the exception, rising 6.2% as optimism grew surrounding the strong rebuilding efforts being planned after February's major earthquake.

# RUSHMORE INVESTMENT ADVISORS, INC.



## Outlook

The 2nd quarter can most assuredly be characterized as having several “potholes.” As we stated earlier, the European debt crisis will slow the recovery, but we believe there are several catalysts likely to emerge over the next several quarters that have the potential to spur the market higher in the 2nd half of 2010 and into 2011.

- Gulf of Mexico Oil Spill Resolution. Relief wells are expected to be complete by early August possibly allowing for the well to be plugged, and providing psychological relief to Gulf Coast residents as well as the nation as a whole.
- Passage of Financial Reform legislation. Like all legislative debates, the uncertainty caused by Congressional haggling pressures the market. With a bill expected to be signed by the President in midsummer, investors will gain greater clarity on the impact from the new regulations.
- The labor market will slowly continue to improve. As we have previously highlighted, during the worst of the recession companies slashed headcount, cut discretionary spending and hoarded cash. A year later, profits have drastically improved and cash as a percentage of corporate assets remains at a 50-year high of 7%. Non-financial corporations have \$1.7 trillion in cash earning virtually nothing. A combination of better profit prospects, muted wage inflation, and plenty of capital will encourage employers to start hiring. Everyone would prefer job creation sooner rather than later but it is encouraging the unemployment rate has fallen to 9.5% from over 10% in late 2009.

While the market has been challenged and the market sentiment eroded, the market has had a significant pull-back

and is highly attractive from a valuation standpoint. Not only is the Price-to-Forward Operating Earnings ratio very low, 134 companies in the S&P 500 have a dividend yield higher than the 10-year U.S. Treasury. In other words, 27% of the S&P 500 has a yield above 2.95%. Given a choice between a bond investment yielding about 3% with little opportunity for price appreciation versus an equity investment yielding approximately 3% *and* price appreciation potential, we will opt for the equity investment. Additionally, companies have begun to increase their dividend, which is further evidence corporate management teams and boards of directors feel more secure about future earnings.

It is impossible to know what the future holds but we believe the majority of bad news concerning European debt is behind us. Nevertheless, it has intensified the debate over whether we should expect deflation or inflation. Those forecasting much higher inflation point to the high levels of public debt and the highly accommodating monetary policies, while the group warning of deflation highlights the weak employment picture, government austerity measures and the absence of inflation in consumer products or wages. Both sides of the argument are prone to painting extremely gloomy scenarios based on one set of assumptions. We take comfort in the likelihood it will be somewhere in the middle with the economy experiencing moderate inflation.

Thank you for your continued trust in Rushmore Investment Advisors. We know these market conditions are challenging. Please let us know if there is anything we can do to better serve you. Performance and characteristics for all Rushmore portfolios can be found on the following pages.

*The Investment  
Committee*

# RUSHMORE INVESTMENT ADVISORS, INC.



## RIA Portfolio Characteristics & Performance

Each of the Rushmore Investment Advisor's (RIA) portfolios outperformed their respective benchmarks during the quarter. The overall direction of the market was discouraging but we are encouraged by the increasing number of investment candidates exhibiting robust growth characteristics. Our investment process includes targeting companies that can consistently grow revenue and earnings as well as exceed Wall Street expectations.

In the latest quarter, 89% of Rushmore portfolio holdings met or exceeded analysts' earnings estimates versus only 72% for companies in the S&P 500. Over the last ten years, RIA holdings have met or exceed analysts' estimates 87% of the time. We believe that identifying companies whose growth has not yet been fully recognized and possess superior financial characteristics will outperform the overall market. The

following table highlights the higher-quality RIA portfolio holdings with higher EPS growth, larger profit margins, and attractive growth-valuation ratios.

### Portfolio Attribution

During the quarter, RIA portfolios benefited from holdings in the Healthcare sector. Novo Nordisk (NVO), a Large Cap Growth (LCG) and Non-U.S. ADR Growth Portfolio holding, advanced during the quarter due to positive developments with its diabetes treatments. Thoratec (THOR) also benefited performance as sales of its revolutionary heart device continued to surpass expectations. An underweighting in the Consumer Staples sector detracted from relative performance, particularly in the LCG portfolio, as investors shifted away from the Consumer Discretionary sector.

### Summary of RIA Portfolio Characteristics

6/30/2010	Large Cap Growth	SMID Cap Growth	Non-US ADR Growth	S&P 500
Wtd Avg Market Cap (\$ in Bn's)	\$49,678	\$3,554	\$31,042	\$74,452
P/E Multiple T4Q (Reported EPS)	19.81x	29.59x	19.53x	25.02x
Forward 12-Month P/E Multiple	14.99x	21.83x	15.11x	15.97x
EPS Growth LTM %	7.71%	23.45%	16.46%	-16.35%
EPS 5yr Growth %	15.08%	17.62%	14.77%	11.09%
Return on Equity T4Q	27.02%	17.30%	18.64%	16.07%
Net Profit Margin T4Q	15.78%	10.51%	12.29%	8.64%

# RUSHMORE INVESTMENT ADVISORS, INC.



Investment Portfolio	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception
US Large Cap Growth (Gross)	-10.70%	-6.95%	11.15%	-7.00%	2.83%	-0.02%	3.56%
US Large Cap Growth (Net) (Inception Date 5/31/98)	-10.82%	-7.20%	10.51%	-7.63%	2.00%	-1.03%	2.47%
Russell 1000 Growth	-11.74%	-7.65%	13.62%	-6.90%	0.38%	-5.14%	0.01%
US Small / Mid Cap Growth (Gross)	-8.15%	-4.95%	7.88%	-12.01%	-1.60%	-	2.32%
US Small / Mid Cap Growth (Net) (Inception Date 12/31/00)	-8.37%	-5.39%	6.83%	-12.82%	-2.59%	-	1.20%
Russell 2500 Growth	-9.77%	-1.82%	21.44%	-7.09%	1.81%	-	1.47%
Non-US/ADR Growth (Gross)	-9.57%	-7.03%	17.91%	-8.28%	4.55%	-	4.49%
Non-US/ADR Growth (Net) (Inception Date 3/31/05)	-9.76%	-7.42%	16.89%	-9.04%	3.75%	-	3.68%
MSCIEAFE Growth	-12.27%	-10.48%	8.95%	-11.35%	2.04%	-	1.81%

**Disclosure** - RIA is an SEC registered investment advisor. Composite performance results for the RIA products include actual total returns for all full discretion, non-wrap accounts in this strategy. These gross- and net-of-fee composite returns are calculated on an asset-weighted basis and include transaction costs and their investment of dividends. Past performance is no guarantee of future results. Further information on performance is available upon request.

Performance data quoted represents historically achieved results and is no guarantee of future performance. Future investments may be made under different economic conditions, in different securities and using different investment strategies. The value of an investment may fall as well as rise. Please note that different types of investments involve varying degrees of risk and there can be no assurance that any specific investment will either be suitable or profitable for a client or prospective client's investment portfolio. Investor principal is not guaranteed and investors may not receive the full amount of their investment at the time of redemption if asset values have fallen.

Performance is expressed in US dollars. Actual performance may differ from composite returns, depending on the size of the account, brokerage commissions, investment guidelines and/or restrictions, inception date and other factors. Care should be used when comparing these results to those published by other investment advisors, other investment vehicles and unmanaged indices due to possible differences in calculation methods. Consultants and investors supplied with these performance results are advised to use this data in accordance with SEC guidelines.

RIA claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list and description of RIA composites and/or a presentation that adheres to the GIPS® standards, contact the firm at 1-800-564-8266.