



October 2011

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The stock market came under pressure in the third quarter as global economic concerns overshadowed yet another round of solid corporate earnings. The combination of Europe's ongoing sovereign debt troubles and the sluggish U.S. economy weighed heavily on investor sentiment and caused heightened market volatility. The resulting 14% drop in the S&P 500 has it trading back at levels similar to what we saw at this time last year.

While we'd all like the troubles facing the U.S. economy to be resolved overnight, there is not going to be a quick fix. It took years of excessive borrowing and spending at both the household and government levels to build up the massive pile of debt that is currently plaguing the economy, and it is likely to take just as long a period of increased saving and reduced spending in order to draw this debt down to a more sustainable level. While households have made steady progress on this front, there is still much work to be done. Unfortunately, this slowdown in spending will make it difficult for the economy to grow at a normal pace for some time to come as the debt reduction process continues to run its course.

The weak nature of the recovery has left the economy susceptible to outside shocks that could tip it into a recession. The possibility that Europe will fail to contain its debt crisis is chief among these potential pitfalls. While it is our expectation that any fallout in the U.S. from Europe's troubles will prove to be manageable and that the economy will continue to push forward at a moderate pace, the potential for a recession certainly remains on the table.

Despite the sluggish economy, the corporate sector continues to produce impressive earnings and dividend growth. We view dividend income as a key component to maximizing portfolio returns. In fact, since 1926, dividends have accounted for more than 40% of the total return of the S&P 500. In addition, dividend paying stocks as a whole have historically outperformed non-dividend payers, and have done so with less volatility. Given today's exceptionally low interest rate environment, dividend

income has become even more attractive. In fact, the yield of the S&P 500 Index recently surpassed that of the 10-year U.S. Treasury note for only the second time in more than fifty years, with many of the stocks within the index yielding well above its 2% average.

Another key benefit of investing in dividend paying stocks is the potential for future dividend growth. While dividend paying stocks as a whole have historically outperformed non-dividend payers, those that consistently raise their dividends have produced even better returns. Companies comprising the S&P 500 have increased their per share dividends by an average of more than 5% per year over the last half-century, handily outpacing inflation. A number of these companies have proven to be able to continue to grow their earnings and dividends even during the tough times. In fact, nearly a quarter of the firms in the S&P 500 have boosted their dividends at an annual rate of more than 10% over the last five years, a period including the worst recession since the 1930s. The pace of dividend hikes has picked up even further this year as corporations have generated record profits. And with corporate cash holdings at an all-time high and dividend payments as a percentage of profits near a record low, there appears to be plenty of room for dividend payouts to increase.

While the stock market could very well continue to be driven in the coming weeks by economic data and the headlines coming out of Europe, our attention will remain centered on company fundamentals, which ultimately determine a stock's value. A big part of this focus will be to identify financially strong, dividend paying companies that are well positioned to consistently grow their earnings and dividends in the years to come, regardless of the economic environment. When purchased at reasonable valuations, such stocks should combine capital appreciation and a consistent earnings stream to produce attractive long-term total returns.

Sincerely,

Gamble Jones Investment Counsel