DELTA ASSET MANAGEMENT, LLC

A WEALTHTRUST Company

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Interest Rates…

Interest rates are the most basic factor in a market economy. They serve as the base pricing mechanism for all market activity. As such, the structure of the interest rate market, ranging from short-term money market instruments to long-term bonds, provides us with information about the economic environment. Market structure includes the level of rates, the differences in rates of differing bond maturities, the differences in rates of differing bond credit qualities, and the composition of bonds themselves.

The current level of interest rates worldwide is relatively low on a historical basis. This could reflect a significant supply of credit from the world's central banks, or conversely a lack of loan demand because of a weak economy. Most likely, it is combination of the two, and implies both a loose monetary policy with risk of inflation and an expectation of a weak economic recovery.

One of the basic tenets of interest rate theory is that interest rates of longer maturity bonds are composed of a real rate and an expected inflation adjustment. From this standpoint, the current low rates imply very low inflation in the future, which on the surface is at odds with the implication of a loose monetary policy. Nevertheless, our take is that the current level of interest rates implies an economic recovery with modest growth rates and low inflation.

A few years ago, interest rates on short-term money market instruments, such as commercial paper and CD's, were essentially equal to rates on longer maturity bonds. Now the spread between money market rates and those of longer maturity bonds is very high. This usually indicates a loose monetary policy and the potential for a strengthening economy. It also indicates some potential for inflation. Our opinion is that the low short-term rates should be viewed as a reflection of a weak economic recovery.

During this economic crisis U.S. Treasury notes and bonds have been the investor's safe haven due to their perceived credit-worthiness. At the depths of the market downturn, the difference in the interest rate on a U.S. Treasury bond and a lower rated corporate issue of a similar maturity was extraordinarily high. This reflected the perceived risk of a financial collapse or economic depression. Since then, the spread between higher and lower rated bonds has narrowed significantly. In fact, they are now below historical averages in some credit quality ranges. The improved expectations for lower rated corporate bonds indicate not only a continuation of the economic recovery, but also one that has the possibility of being durable.

At the height of the financial folly of the last decade, bonds were structured with little or no protection from the investor's standpoint. This took many forms including very weak credit covenants in bond indentures, and permissive issuer options such as payment of interest in the form of additional bonds, stringent call provisions and extendable maturities. At the depth of the financial crisis, the environment had turned 180 degrees, and not only were investor protections back in full force, in many cases credit was unavailable with any bond structure. Currently credit is available while investor protections have returned to a more normal level. Investors' willingness to extend credit on more normal terms indicates they have confidence in the strength and duration of the economic recovery.

Though information derived from the structure of interest rates is somewhat contradictory, it does point toward certain conclusions about the economy. It appears that the economic recovery and subsequent economic growth might be weaker than normal, but is likely to be durable. It also appears that inflation is not a large risk for the foreseeable future, despite the loose monetary policies being pursued by central banks around the world.

Company Comments…

Comments follow regarding common stocks of interest to clients with stock portfolios managed by Delta Asset Management. This commentary is not a recommendation to purchase or sell, but is a summary of Delta's review during the quarter.

United Parcel Service (UPS)

UPS is the largest package delivery company in the world. UPS dominates in its core business of small package delivery with an estimated 60% share of the ground delivery market in the United States. The company has used its dominant position in U.S. ground delivery to expand its core business of small package delivery to Europe, Asia, and Latin America. In recent years, the company has further expanded into global supply chain services and less-than-truckload transportation.

Over many years, UPS has built a unique, integrated network for both ground and express (air) shipments. The massive package volumes flowing through this network creates a low cost structure for UPS and provides a significant competitive advantage. As a result of the need for a large-scale network to compete successfully, worldwide competition in the small package market has effectively devolved to two companies, UPS and FedEx.

The U.S. small package delivery market is a mature market with volume growth likely in line with the overall U.S. economy. UPS' competitive strengths are particularly strong in this market where the company generates the majority of its revenue and profitability. UPS has good growth opportunities remaining internationally as it expands its global network in Europe and Asia to take advantage of global trade growth and the expansion of large consumer markets such as China.

UPS has been operating in a difficult environment as the economy continues to languish from a deep recession. The cyclical nature of the package delivery business along with high fixed costs has led to significant earnings volatility. We believe this is short-term in nature and expect UPS to recover fully as the economy rebounds. Longer-term threats include work stoppages or higher labor costs from UPS' unionized workforce. Additionally, FedEx's lower cost, non-union ground labor force is an ongoing competitive threat. Fortunately rational pricing has been the rule due to the market dominance by these two competitors.

We estimate UPS can grow its revenue long-term at a mid single-digit rate, while producing cash flow margins in the mid-teens. Based on these assumptions, our stock valuation model indicates UPS' current stock price offers a long-term annual rate of return of approximately 12%.

Marriott International, Inc. (MAR)

Marriott is one of the largest and most recognized hotel operators and franchisors in the world. The company operates an unmatched breadth of premier brands from Ritz-Carlton to Courtyard and Residence Inn that appeals to wide spectrum of travelers.

Marriott's key strategy focuses on operating its branded hotels under long-term management and franchise agreements instead of owning hotels. This "asset-light" business model is relatively low-risk compared to outright property ownership. Management and franchise agreements guarantee a relatively stable base fee and limit the amount of investment capital at risk. In addition, incentive fees enable Marriott to capture some upside during periods of economic expansion.

Marriott operates the majority of its properties in the mature U.S. market. With new hotel development opportunities slowing, the company's U.S. expansion strategy is centered on converting hotel owners to Marriott's brands. Marriott's operating agreement offers meaningful benefits to hotel owners including brand strength, reduced operating costs, inclusion into a premier loyalty program and access to a worldwide online booking system.

In recent years Marriott has expanded its brands into international markets. The company's best international growth opportunity is in new hotel development in fast growing regions such as Asia. Europe offers niche opportunities through the introduction of low-end brands. Finally, the largely independent international hotel industry provides brand conversion opportunities for Marriott. The faster growth of Marriott's international segment is reducing its dependency on the mature U.S. market and expanding its lucrative full-service segment.

As to be expected during a deep recession, the hotel industry has been mired in a terrible operating environment during the past two years. Hotel occupancy has fallen sharply causing room rates to plummet, which has resulted in reduced revenue and profit margins across the industry. Though signs of life are evident, industry recovery is in the very early stages. The lack of available credit and rising hotel foreclosures continue to weigh on the industry making the timing and robustness of its recovery uncertain. However, we believe the current industry struggles are mostly cyclical. Marriott's management team, led by J.W. Marriott, Jr., has aggressively shed failing properties, improved its operating efficiency and strengthened the balance sheet, which we expect will improve Marriott's long-term performance and its position in the industry.

Taken as a whole, we estimate Marriott can grow its revenue long-term at an annualized mid single-digit rate, while producing cash flow margins close to 10%. Using these assumptions, our stock valuation model indicates Marriott's current stock price offers a long-term annual rate of return of 11%.

Spectra Energy (SE)

Spectra Energy is a natural gas pipeline company operating in the United States and Canada. The company's interests include a pipeline system extending from the Gulf Coast to the Northeast U.S. and Canada, an extensive pipeline system in Western Canada, and a natural gas distribution utility in Ontario. Spectra also has a 50% interest in a large natural gas field services company in partnership with Conoco.

Stable, regulated natural gas pipeline operations produce approximately 80% of Spectra's cash flow. Field services produce the remaining 20%, which is more volatile than the regulated operations due to the impact of natural gas pricing. Price competition is limited for the regulated pipelines, and will continue to be as long as growth in natural gas demand remains robust. Regulation of Spectra's pipelines in the United States and Canada is primarily at the federal level, and not with the often heavy-handed state authorities. Federal regulatory agencies have not historically interfered in pricing decisions, which are determined by individual contract.

Due to new supply sources from underground shale, natural gas has become an abundant and relatively inexpensive energy resource. Since natural gas is relatively clean burning, it also has positive environmental characteristics. Demand, accordingly, is growing relative to other energy alternatives including coal and fuel oil. After a false start a decade ago, natural gas based production of electricity is growing again. This will drive demand for natural gas and support growth in pipeline capacity.

Spectra's pipeline systems extend from virtually every major natural gas producing basin to some of the highest growth distributors in the United States. For the next few years, the company has a stream of projects amounting to at least $1 billion of capital spending per year, supported by contracted supply and customer agreements. Past that, Spectra's management believes that a similar level of capital investment for expansion projects will be needed. These projects are expected to deliver a 12% to 14% pretax cash return on equity for the life of the contracts. This incremental expansion of Spectra's asset base will increase its profitability and cash flow.

We believe Spectra should be able to grow revenues at a mid-single digit percentage rate annually, while averaging a high single digit percentage return on invested capital. Spectra's balance sheet contains a substantial amount of debt, which is reflective of the capital intensity of the pipeline business. When consideration of this debt and the other financial characteristics of the company's business are made, our model indicates that Spectra's current share price offers a long-term annual return of approximately 13%. This estimate depends on a number of factors including the price of natural gas, the ability of the natural gas industry to continue to exploit shale based reserves, and the continuation of regulatory regimes currently in place.

Finally, it is unclear as to whether Spectra's C-corp structure versus most competitors master limited partnership (MLP) structure is a plus or minus. As a C-corp, Spectra is better able to retain internally generated capital to fund expansion projects, but competitors with a MLP structure have a lower cost of equity capital. This gives those competitors an advantage in the cost of raising outside capital. It is telling that Williams, who also has a C-corp structure, recently spun off its pipeline unit into an MLP.

Wells Fargo (WFC)

Wells Fargo is one of the largest banks in the United States. After its acquisition of Wachovia, Wells Fargo's footprint extends across 39 states from coast to coast. Though Wells operates as a large-scale community bank, it also offers wholesale banking, brokerage, insurance and consumer finance services.

In a past letter we characterized the banking industry as commodity oriented with little product differentiation and modest growth prospects. We also pointed out that banks experience definite, but unpredictable cycles determined by the changing credit environment. Finally we mentioned that banks could differ dramatically from each other as regards their operating strategies and business cultures. From this standpoint, Wells Fargo is a standout because its business culture is strongly oriented to product sales growth combined with stringent risk management.

The recent credit cycle downturn was the worst since the Great Depression of the 1930's. Wells was relatively well positioned for the downturn primarily due to its risk management orientation. Whether one looks at it as an opportunity or a mistake, Wells did use its relative position of strength to acquire the deeply wounded Wachovia Bank at a discounted price. Unfortunately the acquisition brought Wells a credit impaired loan portfolio and weakened its own capital position. It remains to be seen what the outcome of the run-off of the Wachovia loan portfolio will ultimately be. The outcome of the weakened capital position has already been determined as Wells was forced by regulators to issue stock to raise capital levels at a less than advantageous price. Nevertheless, by our calculations, the Wachovia acquisition will prove to be value additive though it has raised the risk in investing in Wells Fargo.

Revenue gains are produced by growth in new loans and fee-paying accounts at Wells. These activities are intimately tied to the U.S. economy, which we expect to grow at a rate of 3.5% annually over the next 10 years. Wells should be able to grow more than this because increased regulation of structured financial products will most likely channel more lending into the traditional banking system. In addition, Well's sales culture should continue to produce market share gains, while the Wachovia opportunity should further contribute to sales growth through greater product cross-sell. Overall we believe that Wells should be able to grow its revenues at an average 5% rate annually over the next 10 years.

Profitability at Wells is driven by an opportunistic product and cost culture combined with solid risk management. These characteristics are illustrated by an industry leading cross-sell of greater than 6 products per customer, an expense efficiency ratio in the low 50% range, and a net interest margin of 4.4% in conjunction with a low 5-year average non-performing asset ratio of 1.6%. We expect that Wells can average a return on assets of greater than 1.5% and a return on equity of greater than 12% over the next 10 years.

With the regulator induced capital raises executed over the last year, Wells is currently adequately capitalized. Unknown are the ultimate capital requirements mandated by regulators both here and abroad. We have taken a conservative stance on this issue and assumed that capital requirements are raised further. From a financial model perspective, this forces Wells to retain all earnings for at least one year, lowering stock value commensurately. But even so, our financial model indicates that at the present stock price, Wells Fargo's stock offers a potential long-term annual return of greater than 13%.

Baxter International (BAX)

Baxter International is a multinational diversified healthcare company focused on the treatment of chronic diseases. The majority of Baxter's profitability is derived from the treatment of rare acute blood disorders and immune deficiencies. The company also manufactures and distributes injectable drugs and medical supplies. Baxter's position as a global provider of essential medical therapies is buttressed by significant manufacturing scale and a large global distribution network.

The BioScience division, which generates 60% of company profits, is the company's fastest growing and most profitable business. Baxter is the global leader in the manufacture and distribution of blood plasma-based proteins and recombinant factors (non-plasma proteins) used to treat hemophilia, immune deficiency disorders and other acute blood related conditions. Baxter's position has been built on the quality of its products, innovative treatments, and worldwide service capabilities. In addition, the complex and capital-intensive nature of the business has reduced Baxter's competitors to a few global manufacturers and restricted new entrants. Opportunities for expansion include further penetration of developing markets and increased treatment of undiagnosed and under-treated patients.

Baxter's medical delivery and dialysis businesses are made up of a diversified mix of both basic and innovative products. The company maintains large global market shares in mature but stable products, such as IV administered therapies and nutritional solutions. The company offers the broadest selection of pre-mixed drugs in the industry and continues to expand revenue from innovative drugs, such as inhaled anesthesia. In addition, Baxter is globally dominant in home dialysis for the treatment of end-stage kidney disease. Though these businesses are mature in developed markets, the consumable nature of these products provides consistent, recurring demand. In developing markets, Baxter continues to benefit from growth in all of these products.

Baxter currently faces challenges in its BioScience division. Demand has softened for plasma-based treatment of blood disorders, leading to an oversupply of inventory. The economic downturn and high unemployment have led some patients to reduce dosage, while some care providers have increased the use of cheaper alternatives such as steroids. Manufacturers, such as Baxter, have reduced pricing to work through the excess supply. Though this will temporarily hurt sales growth and profit margins, we believe the industry remains structurally sound and should continue to expand long-term.

In healthcare there is always the risk that competitors create more innovative products that disrupt the industry by replacing existing products. The company faces potent competition in present products from smaller less diversified companies; however, competition has typically been rational. Baxter has historically been the innovation leader in most its product categories, and with its research expenditure advantage this leadership should continue.

The new U.S. healthcare legislation will impact Baxter. The company will face increased Medicaid reimbursement costs and new taxes. Pricing pressure from healthcare providers is also a likely outcome. At the same time, we believe that unit growth may be enhanced by healthcare reform due to the inclusion of additional insured individuals. This issue will not affect Baxter's foreign business, most of which already operate under nationalized healthcare systems.

We believe Baxter can generate long-term revenue growth in the mid-single digits with operating margins around 20%. Based on these assumptions, our valuation model indicates Baxter's current stock price offers a long-term annualized rate of return greater than 11%.

Newell Rubbermaid, Inc. (NWL)

Newell Rubbermaid is a manufacturer and marketer of consumer products sold through retailers including discount stores, home centers, and office supply stores. The company operates in a number of consumer and industrial niches through brands such as Rubbermaid, Sharpie, Paper Mate, Levolor, Calphalon, Graco, Goody, Irwin and Lennox among others.

Newell Rubbermaid built its collection of products by acquiring relatively mundane businesses with good brands. The company then found itself with too many products exposed to private label competition and volatile commodity input costs. In response, Newell initiated a multi-year company revamp consisting of the divestiture of low margin products, increased outsourced manufacturing, better supply chain efficiency, and reduced corporate overhead. The company is nearing completion of this revamp. Despite the lengthy global recession, Newell's experienced management team, led by Mark Ketchum, has executed the plan well, increasing the company's profitability and free cash flow.

The company operates mature product lines primarily in the United States and fully developed markets such as Western Europe and Japan. Newell Rubbermaid's stronger product offerings and increased investments in innovation and brand building should drive modest growth. Expansion opportunities include the introduction of new products into Newell's existing markets while increasing the company's presence in faster growing developing markets. Though current debt levels will be a constraint to acquisition growth, Newell should produce large amounts of cash flow that will allow for small acquisitions and debt reduction.

Among Newell Rubbermaid's challenges has been the consolidation of its retail customers and their increased market power over pricing through volume purchases and store brands. The company faces strong competition that offers quality products, but fortunately pricing appears to be rational. Newell is combating these issues by narrowing its product portfolio to those products with good market share and cost attributes with limited private label exposure.

Newell is both operationally and financially leveraged, making sales and earnings volatile. However, we expect Newell Rubbermaid to grow revenues in the low single digits long-term, while averaging operating margins in the low double-digits. Using these assumptions, our valuation model indicates an annualized long-term rate of return of approximately 13% based on the current stock price.

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