



2011 Fourth Quarter

January 2012

2011 was truly a “macro market” year, full of uncertainty and volatility. The world stumbled from one worry or crisis to another without clear resolution to any of them. The year was filled with some very major, unprecedented events that will surely change the world as we once knew it. While this can be frightening on some levels, it should also be understood that this is in many respects, simply the cycle of life. As the mantle passes to the next generation, the older generation does not necessarily understand nor like the changes that are before them. As an example, the tumult of the 1960’s ushered in great change in the United States and the baby boomers behind it all were neither quiet nor peaceful. The 1960’s were actually a decade of great promise and optimism which was reflected in the stock market as it increased 120% (with reinvested dividends) from 1960 to 1970. On the other hand, the 1970 through 1981 period was marked by three recessions, great social change, the end of the Vietnam War, an oil crisis, and rising inflation. By 1979, those who still remained invested in the stock market had realized only a 50% rise in their wealth, all of which came from dividends. As inflation really began to take hold in 1979, many investors were terrified that the US would not recover to anything similar to the 1950’s when life seemed more secure and predictable. The 1980’s brought tremendous economic turmoil with high unemployment, rolling recessions, high interest rates, and a very weak dollar. Investing in stocks was shunned. People’s memories focused only on what could go wrong and safety of principal was paramount. But, those who did remain invested in stocks for that decade enjoyed a gain of 256%! Clearly some of the best times to invest are when worry and fear outweigh optimism and complacency.

If this recap of the 1960’s to the 1990’s sounds familiar, it should. As we have said many times before, history repeats – not exactly, but close enough so that lessons can and should be learned. We clearly do not believe that just because we have seen similar circumstances in the past, we should be Pollyannas by default. Details are always different, timing is always uncertain, and sometimes, history can paint a very bleak picture. But, we do strongly believe that our current problems will be dealt with given enough time. People’s memories are short and they eventually get used to their new circumstances. Also, time creates a normal replacement cycle, not only of machinery and equipment, but of new consumers, leaders, and business managers who do not have the same preconceived ideas or memories of their elders.

What risks keep us up at night? Likely the same ones that keep others up. We tend to focus more on financial risks, but actually, we believe that many of the concerns that are constantly in the news are being managed as rationally as is possible under the circumstances. More worrisome to us is over-regulation, political gridlock, the Eurozone righting itself, and the rising reliance on governments worldwide to solve all problems. Longer term, these are more insidious risks that can eat away at our clients’ wealth through higher taxes and higher inflation. Will Rogers once said that investors are well advised to worry first about the return *of* their capital and second the return *on* their capital, and since the 2008-09 meltdown, investors have certainly taken that to heart. Now however, investing only with return of capital in mind may very well substantially raise the risk of loss-of-purchasing-power through rising interest rates and inflation. We believe that our clients have hired us to help them navigate these volatile and uncertain waters, keeping in mind their long term wellbeing as well as the short term protection of their capital.

Interest rates have been in a thirty-plus year bull market since 1980. After the essentially flat stock market of the 1970's, discouraged investors could at least turn to money market funds, CD's and bonds for higher returns. But even then, those who invested "safely" in only short term instruments found that safety was fleeting. Once inflation abated and rates started their decline, many investors wished that they had moved into riskier assets sooner. They did preserve their principal, but they found that the purchasing power of that principal was much less than a few years earlier and that moving back into stocks at much higher prices was psychologically difficult. Interest rates today are near all time lows. By keeping rates low, central banks are trying to foster growth by pushing investors to take more risk. Eventually rates will rise due either to inflation or to a saturation of debt which will make purchases of longer term bonds today potentially very poor investments.

During the remainder of this decade, baby boomers will once again strongly impact our society. Now turning 65 at an increasing rate, their need for income is coming at a time when governments have taken away their ability to earn a positive real return on traditional safe investments. At current levels interest rates have little room to fall further; thus, the next major move must be up. While we do not expect such a move anytime soon, it will happen eventually and its timing will not be predictable. The German philosopher, Friedrich Nietzsche, had many well known quotes including "*That which does not kill us makes us stronger*" and "*There are no facts, only interpretations,*" both of which are useful here. Given what the world has gone through, we should eventually be stronger for it. Regarding facts, I am not sure that I agree that there are no facts, but I do agree that interpretation is key.

Fact #1: Interest rates are at levels not seen since the 1940's.

Fact #2: AAA rated debt (even sovereign debt) should no longer be considered risk free.

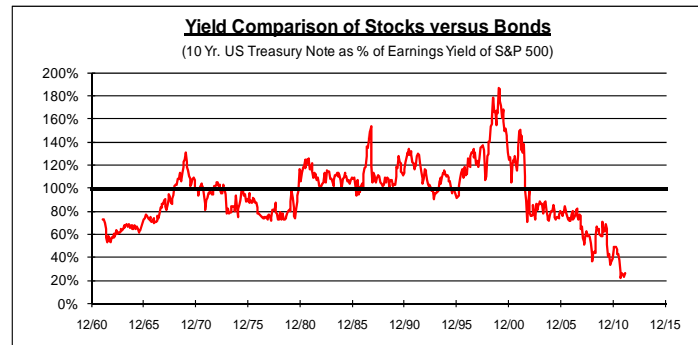
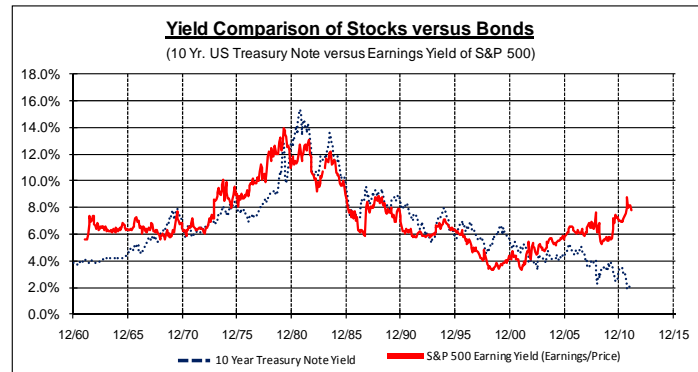
Fact #3: The dividend yield on the S&P 500 Index is comparable to the 10 year US Treasury Note.

Fact #4: The valuation on stocks is extremely low as compared with interest rates.

Our interpretation of these facts is as follows: Facts #1 and #2 – We last saw today's level of interest rates in 1950 - more than 60 years ago. How soon and how much is unknown, but the next major move in rates is up. Governments are keeping rates low in hopes of fostering economic growth, but low rates alone will not accomplish this. Only confidence and the belief that an investor can obtain both the return of their capital and a return on their capital will. Our current problem was created by credit. We will likely not solve a credit problem with even more credit and therefore, the traditional view that debt, even AAA rated debt, will generally return your principal may be in jeopardy. Equity capital historically is the safety valve in times of economic stress and equity did serve this purpose in 2008 and 2009. But, unlike corporations, governments do not have traditional equity capital; they have their taxing power and the ability to print money. Given the liabilities that have been created in many developed countries, the ability to tax may not be enough to forestall great sacrifice or even default in some circumstances. We are witnessing this in both the Eurozone (Greece, Italy, Spain) and in a few select regions of the US (Illinois, California). We feel that eventually default may become a reasonable alternative for some entities that cannot lower their liabilities any other way. In the long run, this would be a good thing for society as investors recognize that all investments bear some level of risk. In the short run, it will be painful. Printing money may be the ultimate end game so that the current debt being issued can be repaid with deflated dollars, but that still begs the question of what happens to government deficits as the trillions of dollars in outstanding debt matures and is repriced at higher interest rates.

Facts #3 and #4 - The price of stocks today is compelling, whether one looks at dividend yield or earnings yield. For only the second time since the 1950's, the dividend yield on the S&P 500 is once again comparable to bond yields. Dividends are rising and have plenty of room to rise further. Following the fall off in dividend payouts around the recession, dividends have been growing at a 13% annual rate since early 2010 and dividend payout ratios remain well below their historical trend levels. Companies such as Intel,

WalMart and CVS have raised their dividends even more strongly at 21%, 22% and 32% annual rates, respectively, since 2010. Fear has also driven the valuation of the S&P 500 down 50% since the early 2000's, which explains why the price of stocks has barely moved despite earnings doubling during the prior decade. The divergence between the S&P 500's current multiple and that indicated by its historical drivers (bond yields, payout ratios and the deviation of earnings from trend levels) is at extreme levels only seen during World War II, the Korean War and the post-Lehman collapse. This extreme divergence is illustrated in the following two charts showing the market's Earnings Yield (Earnings divided by Price) against the yield of the 10 year US Treasury Note. The first chart is a time line of these two measures and shows that we entered new territory several quarters ago and that the spread between the two is at an all time high. The second chart shows the ratio of these two measures against the past 50 years. Normal seems to be around the 80% to 120% range. Clearly, with the ratio below 30%, investors are placing a very, very high premium on bonds as compared with stocks. While some may argue that earnings could decline sharply in a recession, in order for the ratio to return even to the 60% levels of the early 1960's, earnings would have to decline over 50% with no change in stocks' current prices. Our view is that the fear driving investors to bonds may be nearing a crescendo.



In closing we feel that 2012 will be a year of optimism, even as we move through the Presidential election with all of the rancor and rhetoric that the campaigns will bring. The US economy is probably in a self-sustaining recovery that should not be disrupted even if Europe enters a mild recession. The banking system in the US is very well capitalized now and large banks are not taking the same risks that were prevalent several years ago. Housing problems will not be resolved any time soon, but they are being substantially reduced and the overhang of underwater mortgages will present less and less of an impact on economic growth as time passes. The memories of 2008-09 will dim and investors will slowly move toward higher risk based assets as they realize that it is the only way to satisfy their need for income. We believe that US large cap stocks have been so out-of-favor for more than a decade that it is very likely that they will be among the best performing asset classes in coming years. Overall, we are seeing more rational behavior and pricing returning to the financial markets which to us suggests that the era of risk-on/risk-off trading strategies that ignore companies' fundamental earnings power is coming to an end. We welcome the return to a stock picker's market.