

October 7, 2011

2011 Third Quarter Review
“The Can is Kicking Back”

Politicians and policy makers have been accused in recent years of “kicking the can down the road” by postponing the hard choices that many think are needed to set the world’s economies back on a healthier footing. With the market action during the third quarter, it was often written that “the can is kicking back.” September ended the fifth straight month that major stock indices fell in the U.S. Although the indexes were down, there were some large divergences in the performance of large versus small company stocks. The stocks doing the best have been those of the large, high-quality, dividend paying companies that we have highlighted during the past year, while the worst performers have been the small company growth stocks that tend to attract more speculative buyers. The “large cap” S&P 500 finished September down 10% for the year so far, while the Russell 2000 Index of small company stocks was down almost 18%. Treasury bonds rose in value and declined in yield as investors sought safe havens amid the turmoil in Europe and the possibility (probability?) of a default in Greece. Worldwide equity markets fell in tandem, with the U.S. stock market showing one of the better (least bad) performances among the world’s economies.

Fearing that a renewed recession is near, and that the Federal Reserve is “out of bullets” (see last year’s third quarter letter), investors began to “price in” a gloomier economic outlook. In fact, at the end of the quarter, the well-regarded Economic Cycle Research Institute announced that the U.S. economy was entering a recession and that “there is nothing that policy makers can do to head it off.” They envision a vicious cycle of downward employment, consumer expenditures, and corporate profits. The ECRI is a very well-respected analytical organization and they have done a very credible job of reading the tea leaves of leading economic indicators in the recent past. Their announcement helped fuel a spate of selling that appears to have climaxed just after the end of the quarter.

For the first time in quite a while, the recent sell-off included commodities and even gold and silver. Gold dropped 15% in a little over a month, while silver dropped by over 30% from its August peak. The price of copper is often watched as an indicator of industrial production, and its price dropped over 30% from the levels it reached in July. Oil and agricultural commodities suffered similar price cuts from mid-summer levels. All of those declines could portend economic recession, or simply represent reversals from overbought levels. Whatever the case turns out to be, the price swings have been getting wider.

There are many reasons for the increase in volatility. One that is just now being addressed by the SEC is “High Frequency Trading” (HFT) where large investments are made on an automated basis using algorithms in an attempt to “scalp,” and some would say “force,” small moves in the markets. The effect of this practice may have been seen most dramatically in the “flash crash” (1,000 point plunge and recovery) in the Dow Jones Industrial Index on May 6, 2010. HFT is still a large part of trading volume in our markets. Also, the increased popularity of “leveraged ETFs” has contributed to volatility as well. These are “Exchange Traded Funds” that represent, in one security, a basket of other investments. Many of these ETFs employ financial leverage to amplify the price movement of their shares (in both directions). Investors flocking to or from these ETFs can have an outsized effect on the prices of the underlying investments. Volatility also increases when there is a perceived risk to the investment system. Unlike those in the decades from the mid-twentieth century forward, today’s

investors have to take into account the greater possibility of systemic disruption within the framework of sovereign nations and international banking and investment networks. Accordingly, the fact that investors may have a quicker trigger finger on the “sell” button is entirely understandable.

Sometimes, however, markets are much like the rocking ship where the passengers run from one side to the other in order to avoid capsizing, themselves becoming the cause of the instability. After several months of decline, the market sometimes acts like that ship, at least on the short term. So much money has been pulled out of the stock market that the influx of some of it returning could create a violent swing in the other direction. This comment by Doug Kass of Seabreeze Partners recently caught my eye:

Consider that retail investors have pulled \$400 billion plus from domestic equity funds since 2007 and have added \$800 billion plus in fixed income funds, for a swing of more than \$1.2 trillion away from stocks. And more money has been redeemed from equity funds in the last three months that at any three-month period since late 2008.

Imagine how powerful is the potential tide of a massive asset reallocation out of fixed income (which is earning very little current income) and equities (which have the widest spread between their earnings yield and risk-free rates of return).

The current tug-of-war between “bulls and bears” is being waged in a stock market that hit a 13 month low just last week (after declining for 5 months straight after the highs were reached last May). The “bear case” is that the ECRI is right and that we are headed into another recession. Economic activity will slow, corporate profits will fall, and so will stocks. The “bull case” includes the possibility that the market is down and cheap, dividend yields are attractive, the economy muddles through, and that a reallocation back into stocks could fuel a sharp rally. Of course, there are many variations on these and other possible scenarios, but the upshot is that we shouldn’t be surprised to see sharp rallies even in declining markets, especially after a decline as persistent as this one has been.

Our strategy of concentrating on the large, multinational, dividend-paying stocks has helped us to weather the storm better than otherwise might have been the case. We avoided investing heavily in small stocks which have been pummeled so far this year (the Value Line Index has fallen over 20%). However, the decline in commodities hurt the inflation hedges related to gold, silver, and oil. Last quarter we began to believe that the financial sector might be cheap, but we didn’t want to take the risk inherent in owning bank stocks. Insurance companies appeared to be the safer vehicle, but they all have declined into the third quarter’s end as well. Early October has brought some renewed interest in these stocks, and we want to give them some more time to show their value.

We are always balancing the preservation of capital with the need to take some risk in order to provide a reasonable return. Record-low interest rates have reduced the attractiveness of low-risk alternatives. However, the past quarter shows that there are times when it is good to have some powder kept dry to take advantage of declines. We always like having the cash available to “buy’em cheap.”

Enclosed are your quarterly reports. Please review them at your leisure and give us a call with any questions or suggestions you might have. Thank you again for the opportunity to work with you on your investments.

Sincerely,

Claude Carmichael CFA