

April 12, 2012

2012 First Quarter Review

As we started the first quarter, investors' thoughts were dominated by the crisis in Europe and the potential for a financial meltdown there spilling over to the financial institutions and markets here. Risk to the financial system appeared to be great and many investors had been calling their portfolio managers to pull the plug on equities and run to the “safety” of bonds. However, as we mentioned in last quarter's letter, there was the possibility that equity markets could rally if we were to just “muddle through.” So many investors were shaken by the news out of Europe and other gloomy headlines like the bankruptcy of American Airlines that the situation seemed ripe for markets to advance if things just got less bad. As it turned out, Europe didn't fall apart, things got less bad, and the stock market rose. Of course, a second round of a little “quantitative easing” (the so-called “QE 2”) didn't hurt either. The Dow Jones Industrial Average went up 8% for the first quarter, while the S&P and Nasdaq did better still. In a significant reversal from recent trends, bonds struggled while Treasury Bonds in particular were hit hard. The Barclay's Corporate Bond Index gained 2.54%, but the US Treasury Index fell almost 6%. The iShares Barclay's Long Term Treasury ETF, which serves as a proxy for 20 year U.S. Treasury Bonds, fell almost 7.5% for the quarter.

The financial headlines have focused on improvements in the employment rate and the relief brought by the stitched-together accord that avoided fiscal disaster in the Eurozone. Economic data appeared to show the beginnings of growth in the economy, or at least a “bumping along the bottom” in most sectors. According to government statistics, inflation has remained benign (unless you eat or drive) and the economy shows signs of “grinding growth.” The Fed has been the economic cheerleader and openly endorsed an effective “zero interest rate” policy for short term rates, similar to those new-car-financing incentives of just a short while ago. Stocks have rallied out of the gloom and fear of the fourth quarter. So, what happens next?

Traditional portfolios have been constructed of stocks, bonds, and cash reserves in various percentages based on the valuations and prospects of each, plus the investor's financial position, stage of life, and emotional tolerance of volatility. The three-legged stool worked well for years with fairly clear demarcations between the asset classes. Today's investor faces a dilemma in that bonds will likely go down if either inflation or the economy finally pick up, and cash reserves are paying so little that, although they avoid outright loss, they cannot keep pace with even the “benign” levels of inflation that we are now experiencing. That leaves only stocks which, as you know, we favor; especially the high-quality, high-dividend yielding kind. If you are happy and comfortable with it, and if it is appropriate for you to be 100% invested in stocks, then you just pick the best values you can find and hang on for the ride. However, we all know the stock market swings from over to undervaluation (from greed to fear) and there are times when optimism is so great that it appears imprudent to pile on and buy more at elevated prices. Better to wait for some “fear” if you can.

The following (compliments of the ever-thoughtful investor Doug Kass) are some factors that may rekindle some of that fear in the hearts of brave investors in the near future:

- market participants are incorrectly assessing the trajectory of domestic economic growth (it is slowing, not accelerating);
- the political backdrop is not market- or business-friendly, with the growing likelihood that Obama will regain the presidency and that the Republican Party will likely control the House and Senate (gridlock and failure to address our fiscal deficit holds risks to the capital markets);
- a monetary cliff is approaching at June's end (the "Liquidity Rally" may be over);
- a fiscal cliff is a threat at year-end;
- there remains risk of further debt contagion in Europe (as risks in Italy and Spain have resurfaced); and
- a meaningful reallocation out of bonds into stocks is no longer as likely.

This list doesn't even include the possibility of hostilities breaking out in the Middle East or Iran blocking the Strait of Hormuz. With these as near-term possibilities, we would prefer to use any of them as an opportunity to add to our favorite holdings at lower prices if given the chance.

As an alternative to money markets yielding little, and bonds with their "low" rates fixed and locked in, we are also developing a small number of investments intended to provide decent income with the possibility of their income and asset values increasing with inflation. These can include energy- and commodity-related companies paying royalties on production or pipeline revenues, funds representing senior collateralized bank loans with floating interest rates, and specialized short-term "fixed income" funds with maturities short enough and income high enough to warrant interest. Last year, there was high correlation in the performance of asset classes across many asset types. This year we suspect it will require more effective selection to increase returns.

Enclosed are your portfolio statements and reports for you to review at your convenience. Please give me a call if you have any questions or would like to discuss any change or refinement of strategy. We are also required by the SEC to ask you to let us know of any material change in your financial situation that might affect what is appropriate for the investments in your portfolio.

Tax season is upon us again, and I trust you have all that you need from us in order to file your returns. If you find you need any duplicates or other information, don't hesitate to let us know and we'll get it to you or your tax preparer quickly.

Thank you again for the opportunity to work with you and we look forward to speaking to you soon.

Best regards,

Claude Carmichael CFA