

Quarterly Review and Outlook – Third Quarter 2010

Stock and bond markets both rose during the quarter as signs of further stimulus from the Federal Reserve became more evident from comments during public appearances and media leaks that surfaced. We are not sure whether to be relieved that further quantitative easing is coming or to be worried that it is necessary. Within this backdrop, the S&P 500 rose 11.3% during the quarter bringing the year-to-date gain to 3.9%. The outlook for further Fed purchases of Treasury bonds forced yields down and prices up. The Barclays Aggregate bond index was up 2.5% for the quarter and almost 8% for the year. I recall saying in this letter earlier in the year that returns were going to be more difficult to generate in 2010 but balanced accounts are performing well. It is clear that this recovery is different and the need for additional stimulus is a significant development for the markets to consider.

International stocks rose 16.5% during the quarter and are up just over 1% for the year. Small and Mid Cap stocks also performed well with the Russell Midcap up 13% for the quarter and 11% for the year. Small Caps as measured by the Russell 2000 was up 11.3% and 9.1% for the quarter and year. The HFRX Global Hedge Fund index has been the laggard, up 1.9% for the year.

Last quarter the markets declined during a steady drumbeat regarding the sustainability of the recovery in a deleveraging environment, declining inflation, high unemployment, and a weak housing market. The Fed continues to worry vocally about these issues and their likely posture of further quantitative easing has eased the market's mind. Our question remains...will it work this time? As we said last quarter, achieving a goal takes time, dedication, and patience whether that goal is investment returns or Federal Reserve monetary policy. We are thankful our focus is on the former.

The Great Monetary Policy Experiment

My wife loves reading books and she has a unique way of reading that intrigues me. She will read about half way through the book, and then skip all the way until the end to figure out how it ends. Only after her curiosity is satisfied and she feels good about the result will she go back to the half way point and finish the book in the normal fashion. I have always wondered why she would want to jump to the conclusion without the joys of following the author's streaming consciousness leading to an ultimate conclusion. The words are already written, so be patient and enjoy the ride.

Her desire to know where she is heading in a book is exactly how I feel towards the current economic environment. I want to get to the end where everything comes to a fitting conclusion...and of course with a happy ending. Unfortunately, these words are not yet written. The Federal Reserve is taking us down an entirely new path where they have no roadmap. The Fed has spoken loudly that they have thought a lot about what they would do. Ben Bernanke has laid out their game plan in public on numerous occasions, but it is untried and unproven. To make matters a bit more disconcerting, the Fed has been following this game plan and thus far the results are unsatisfying. In fact, Chairman Bernanke recently stated before Congress that the economic outlook is "unusually uncertain". This is Fed speak for we haven't a clue what it is going to take to get this economy moving again.

The Federal Reserve has responded aggressively over the last two years. They have reduced Fed Funds to 0%, and then embarked on a quantitative easing policy that entailed buying Treasuries and mortgage backed securities totaling \$1.25 trillion. Despite all of this and a coordinated fiscal policy program aimed to stimulate the economy, GDP growth is well below potential and disinflationary pressure continue to mount. Our Fed had assumed that throwing trillions of dollars around would have been sufficient and we do not fault them for that. So, what next?

On August 27th in Jackson Hole, Wyoming, Ben Bernanke gave a speech that indicated the Fed was considering another round of quantitative easing ("QE 2.0"). News flow has continued to be in that direction as intentional leaks made its way into the press. It is now widely believed that the Fed will announce QE 2.0 the day after the election on November 3rd. The market has been reacting to this expectation and the markets are all moving generally higher. Our question remains...will it work this time? It hasn't worked to anyone's satisfaction thus far, so who is to say round 2 will work. I am ready to skip ahead to the end and find out how the story ends.

We believe our policymakers will ultimately be successful in igniting the economy towards a path of sustainable growth coupled with stable prices and full employment. These are their stated objectives and they have some advantageous tools at their disposal. We do worry about the potential for deflation and the Fed being unable to mitigate those effects. We also have significant concerns about the unintended consequences from the huge amount of stimulus to date. We believe when you interfere with the market and prevent natural adjustments, then the risk of a negative event rises. As we all know, our most dangerous enemy is not the enemy we know, but the enemy we do not.

Finding Comfort

As we write this letter, the S&P 500 is up about 8% for the year with all of it coming after Ben Bernanke's Jackson Hole speech. We are pleased with the performance of the market, but considering the lack of economic clarity, many are rightfully questioning whether stocks are overvalued. Our overall view remains unchanged in that we are cautiously optimistic about both stocks and bonds going forward. The reason for our caution is due to the uncertainty regarding the economic outlook considering we have not had a typical response from aggressive monetary and fiscal policy. We believe that globally there is too much debt outstanding with too little income to support it. This will lead to a long-term environment that is not as robust as it has been in the past here in the U.S. and will be more volatile and uncertain. Because of these beliefs, we believe it is prudent to position portfolios conservatively to minimize negative events and to achieve your objectives.

Many market participants spend a great deal of time attempting to value the markets and we are not immune to that desire. In our view, the market discounts what it believes is most likely to occur whether it be negative or positive. Right now companies are experiencing nice profit growth (although sales growth is uninspiring) and it appears to us that this is expected to continue. As such, stock and bond prices are rightfully higher. That being said, we believe that the potential for disappointment is high if the Fed makes a policy error and the economy continues to languish.

Because I have significant experience managing equity portfolios, I become most comfortable with the valuation of the market when I find many individual companies that are attractively valued. Early in 2009, I wrote in this letter that I spent a lot of time reviewing many of the names held by our managers and believed there was a lot of value in the market. At the time, I had no idea when that value would be recognized because the macro environment was so uncertain, but I was confident that stocks were a good place to be investing. Over the last few weeks, I have done a similar review of many of the names owned by our managers as well as some that are not owned. I am not able to speak with the same conviction that I had in 2009, but right now is a great time to be looking at stocks. There are many stocks that are very attractively valued that don't need a lot of good to happen to make them good investments. They have a significant margin of safety. At the same time, there are many stocks that are "priced for perfection" and others that are better owned on the short side. In summary, our macro view regarding the economy is supported by our micro view of individual stocks; there is value in the markets but the potential for disappointment is higher than we would like.



Reaching for Yield

One of the most common discussions we are having with clients is about the low yield environment in which we live. Cash is yielding next to nothing and high quality taxable and tax-exempt bond yields have declined dramatically. So, the question we often hear is where can we go to find yield? Unfortunately there are no easy answers. In our view, the purpose of fixed income in a portfolio is twofold: 1) preservation of capital, and 2) a current stream of income. When it comes to satisfying both of these objectives with the same level of safety, we have yet to find a better liquid substitute for bonds. What we have noticed in the marketplace is many investors reaching for yield by buying high dividend paying stocks, real estate investment trusts, and master limited partnerships ("MLP"s). We find these substitutes inferior to bonds when it comes to preservation of capital because they each involve equity investments and, therefore, a lower (and less secure) position in the capital structure. When you move lower in the capital structure you increase the risk of loss of principal and we are not willing to do that for assets we believe need to be focused on preservation of capital.

In our view, bonds today are not cheap nor are they expensive if you look at current inflation expectations over the next few years. In other words, the real yields we are getting are appropriate for the risk we are taking. If these yields are deemed insufficient, then we should examine our clients' return expectations. If the probability for achieving those return expectations is inadequate, then we must consider changes to asset allocations. We believe that we are better off maximizing the yields we can achieve in every environment through thoughtful managers that can exploit the inefficiencies in their particular market. To us, this is a superior strategy to trying to time the market when yields are higher. If our outlook is correct, we could experience a low interest rate environment for quite some time. To guard against the chance of our interest rate view being wrong, we are also positioned with portfolios of moderate durations and this will continue to be our focus.

As stated earlier, we will continue to focus on positioning the portfolio in a way that reflects our cautious optimism. Our goal is always to take appropriate risk in the portfolio to meet the long-term objectives of each individual client and that will remain. We look forward to easier days for generating strong risk-adjusted returns, and we know you do as well.

As always, it is a pleasure to serve you and please do not hesitate to let us know if we can be of assistance. We look forward to hearing from you.

Best regards,

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