

Third Quarter Investment Commentary October 2011

"It is a tale told by an idiot, full of sound and fury, signifying nothing."

William Shakespeare, *Macbeth*, Act V, Scene 5

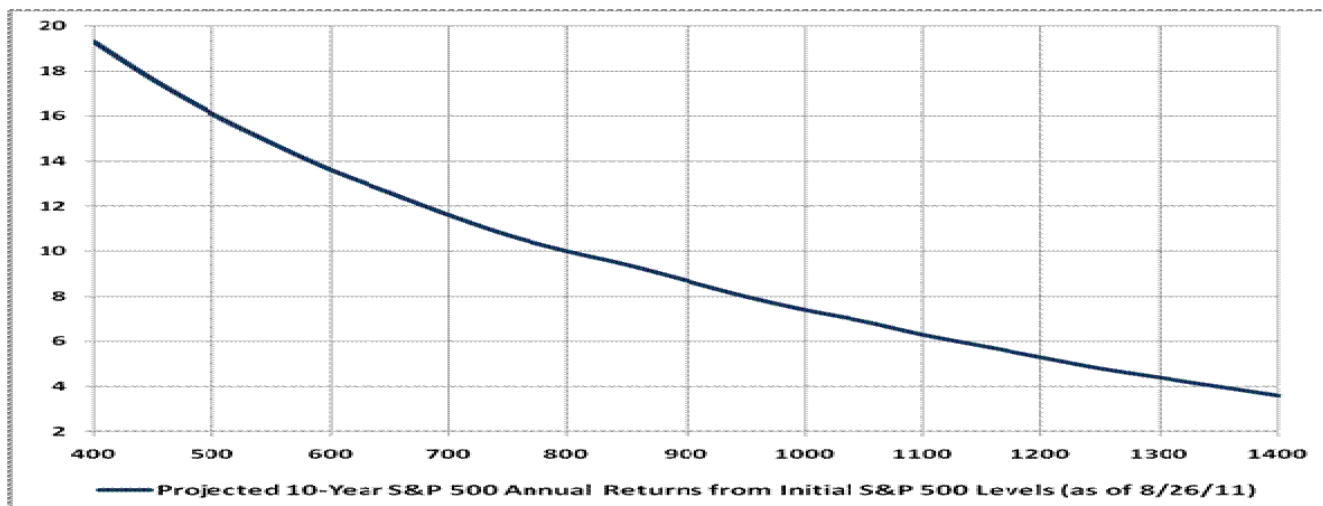
The Quarter in Review

Volatility during two weeks starting in late July made investors very anxious, as both the Dow Jones Industrial Average and the S&P 500 had intra-day swings exceeding six percent. August included five days in which declining volume (stocks going down) exceeded advancing volume (stocks going up) by at least ten times, and five days in which advancing volume exceeded declining volume by at least the same amount.

Looking Ahead

By many measures, the equity markets, particularly the U.S. equity markets, appear to be reasonably priced. The price-to-earnings (P/E) ratio of the S&P 500 is not out of line with historical averages, whether you use trailing twelve month earnings, projected earnings, or 10-year cyclically-adjusted earnings. Recent research read here in the office showed that the current level of the S&P 500 is already factoring in a mild recession. While that may be a stretch, there is no denying that the levels of valuation are nowhere near the absurdly high levels of early 2000, but are solidly within striking distance of the long-term average P/E ratio of 15.4. So, what is keeping the markets from advancing, if P/E ratios are reasonable and profit margins continue to rise? Well, the financial markets are having to digest a lot of information at once, whether it is the downgrade of U.S. debt, our country's inept leadership, the European debt situation or the potential of a Chinese economy slowing down. Volatility is back in the markets after being absent for most of the last two years.

When we think about returns on an investment, much of the return we can expect in the future depends upon the price we pay for that investment today. Individuals who purchased homes in Arizona, Florida, California and Nevada in 2004-2007 are acutely aware of this, as are those investors who bought the tech, telecom and media (TTM) stocks at their highs in early 2000. The chart below shows what type of average annual returns an investor could expect by investing in the S&P 500 at certain price levels. You can see that buying in at the 1400 level would result in average annual returns of less than 4%, due to elevated P/E ratios and low dividend yields. In contrast, investing in the index at the 400 level would result in average annual returns of over 19%, due to extremely low P/E ratios and high dividend yields. Returns like that would be similar to those from the 1982-1999 bull market. Now, getting to a level of 400 would be extremely painful, unless you were holding only cash during that period. From that point forward, however, would prove to be very rewarding indeed.



Source: Hussman Funds

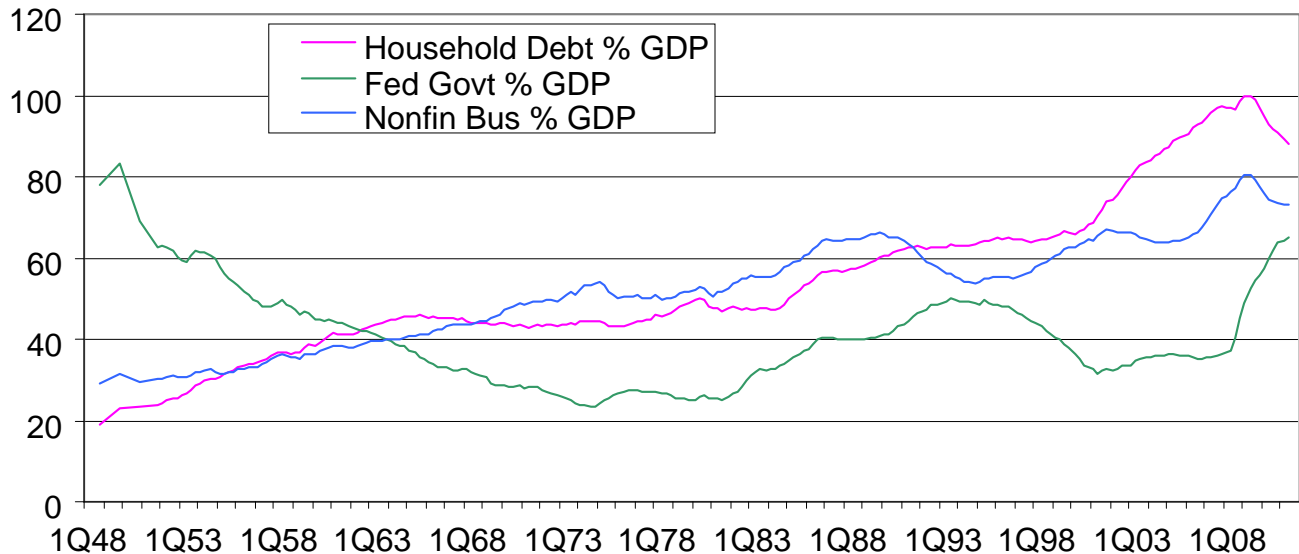
Michael J. Mauboussin, Chief Investment Strategist at Legg Mason Capital Management, has long written on the topic of behavioral finance, or the study of how human beings make financial decisions, particularly with regard to investing. In an article in 1997, Mr. Mauboussin theorized that if you were to distill all of human history into a 24-hour period, we would have been exposed to modern portfolio theory for all of two seconds. His opinion is that we are genetically predisposed to better dealing with a wild animal attack (fight or flight) than dealing with investing money. The point here is that while current financial fundamentals of the equity markets look reasonable, investors' opinions on those fundamentals can vary widely. This is why it is very difficult to make the decision to be 0% equities vs. 100% equities. During the period 1966-1982, in which the S&P 500 failed to provide investors with any real (after-inflation) returns, there were time periods in which money could be made. We continue to be cautiously optimistic, but erring on the side of conservatism.

Economic Report

The economic environment remains uncertain. After a prolonged debt debate amongst a dysfunctional congress, the federal government voted to increase the level of its debt ceiling. In addition, U.S. sovereign debt was downgraded and European debt concerns escalated once again. Recession fears increased as economic data was reported weaker than expected.

Our long-term themes have not changed. We believe we are in the aftermath of a severe financial crisis, in which excess leverage will now be reduced. The economy is not in a standard recovery. Growth is likely to be slow and fragile as debt restructuring continues. Both consumers and businesses have begun to write-off, pay down and refinance their debt, but this process likely has many years to go (see chart on the next page). The government has increased their ratio of debt leading to the debt reduction discussions in Washington and the S&P downgrade of the summer.

Debt to GDP



The outcome of fiscal policy is a significant risk to the economic outlook. The recent ineptitude in Washington has damaged confidence and increased uncertainty, postponing spending by consumers and businesses. There is little confidence in the leadership in this country as well as in Europe, weakening global growth prospects. As Thomas Friedman so eloquently stated in a recent article:

The more I read the papers the more I'm convinced the 'we the people' are having an economic crisis and 'you the politicians' are having an election – and there is frighteningly little overlap between the two.

Has our leadership lost its mind? We need to do our part in leading the world out of this crisis by stabilizing our own economy. And we need to show that we can still act collectively. The toxic paralysis in Washington is, in and of itself slowing growth. It is keeping a black cloud over the center of the country and creating a sour mood wherein people just want to hold on to what they have.

If between now and November 2012 all we are going to have from our two parties is a death duel, not a Grand Bargain – Republicans blaming Mr. Obama for the bad economy and Mr. Obama running on how crazy the G.O.P. has become – we will pay a very, very dear price.

Weak confidence leads to weaker economic growth. Both consumers and businesses that are uncertain about the future will delay discretionary purchases, which will depress growth.

Not only have the charades in Washington been harmful to confidence, but what have been passed are measures to reduce the budget deficit. Fiscal austerity is the wrong prescription for a fragile economy. In 1937 Franklin D Roosevelt sharply tightened fiscal policy resulting in a sharp economic set back. President Obama risks the same mistake with his current deficit

reduction proposal. The U.S. needs fiscal stimulus now and longer term reform to deal with the longer term debt problems.

Fed Chairman Bernanke stated in his Jackson Hole speech, “Although the issue of fiscal sustainability must urgently be addressed, fiscal policymakers should not, as a consequence, disregard the fragility of the current economic recovery. Fortunately, the two goals of achieving fiscal sustainability – which is the result of responsible policies set in place for the longer term – and avoiding the creation of fiscal headwinds for the current recovery are not incompatible.”

The Fed has continued, and will continue, to keep monetary policy accommodative until the economy is on a self-sustaining path and as long as inflationary pressures remain contained. Contractionary fiscal policy, however, is harmful to the economy.

All is not negative, however. Corporations are very healthy, reducing the risk of recession or limiting the damage one might cause. Profit margins are near record highs, short term debt as a percent of total credit is at record lows, and cash relative to short term liabilities on balance sheets are at levels not seen since the 1950’s. Corporations are using their cash to reinvest in their business, spending on capital improvements, merging or acquiring another firm, and restructuring or paying down their debt. Once confidence improves, corporations will be in a good position to further invest and hire.

Closing Comments

Gauging the financial markets at this time is more difficult than usual due to the political overhang. The economies of much of the Western world are being burdened by debt, but leaders are loath to try to solve the issues at hand, preferring to pass on the problems to the next elected official. There is no doubt that Social Security would be in a better position today if means-testing and higher retirement age requirements would have been implemented years ago. Medicare would have benefited from similar attention. Europe would not have the problems it is faced with if it would have done better due diligence in admitting countries like Greece into the EU.

After enduring a summer with multiple days in excess of 100°, we welcome the cooler days of autumn. We have plenty to look forward to over the next few months – football (well, except for the Chiefs), Halloween, fall colors, Thanksgiving, Hanukkah, Christmas, and the New Year. We hope that all of you are able to spend some time with family and friends during this season.



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