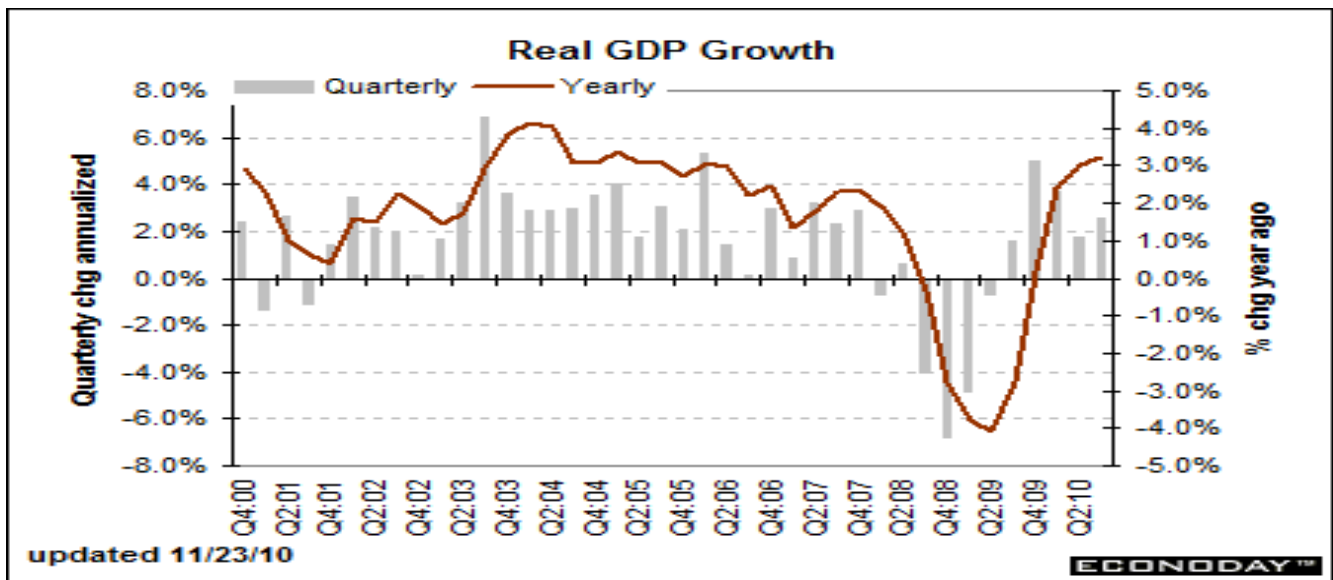


**Fourth Quarter Investment Commentary  
 January 2011**

*“People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them.” - Jean Monnet*

**The Quarter in Review**

- During December, stocks (as measured by the S&P 500) managed to close at their highest level since the implosion of Lehman Brothers back in September 2008, but were still about 20% below their high, set in October 2007.
- The double-dip recession (negative GDP) seems to be out of the picture at this point. As the graph below indicates, economic growth has recovered nicely after the “Great Recession”. Although a slowing in the growth is certainly possible, at the moment there is a higher probability of higher-than-expected growth than there is a recession.



**Looking Ahead**

As we look forward to 2011, returns from stocks could be good (not great) and returns from bonds could be just so-so, but not the disaster that the financial media would have you believe. Returns may not come to investors in a linear fashion, but in fits and starts. The fear that we

have for 2011 is the outliers, the “fat tails”, the unlikely events that can have big impacts. What are some of those events? Here is a list, not meant to be exhaustive by any means:

- Double-dip recession (low probability, high impact)
- Japan debt load becomes unsustainable (high probability, high impact)
- Chinese inflation accelerates (high probability, high impact)
- European sovereign debt problems spread (high probability, high impact)
- Budget reduction measures hurt growth (low probability, high impact)
- Oil tops \$100 per barrel (high probability, moderate impact)
- Military strike against Iran (low probability, high impact)

Unfortunately, there are no “low impact” items on the list, and we could be hit with a combination of events. However, we cannot look at just the dark side when evaluating 2011. There are also some positives, as listed below:

- Positive trends in the labor market
- Expanding corporate profits
- Steady consumer spending
- No Irish or Greek austerity measures (yet) in the U.S.
- Low interest rates

The results from the most recent survey by the consulting firm McKinsey indicate that executives worldwide are gaining optimism. McKinsey found that respondents are a little more positive on the state of their nations’ economies than they were three months ago, with just over half now saying conditions have improved and 63% saying their countries are now in recovery. They are a little less positive about the near future, though: two-thirds expect inflation to rise in 2011, and concern about sovereign debt defaults and exchange rate volatility has risen sharply in the past three months, no doubt in response to the ongoing turmoil in the Eurozone. Perhaps also in response to that turmoil, the share of executives expecting an upturn in 2011 has fallen to 25%, down from 35% in September.

While we acknowledge that massive fiscal and monetary stimulus has the potential to fuel inflation, we are not concerned about this issue for 2011 and even into 2012. However, if the stimulus is not withdrawn as unemployment comes down and manufacturing increases, there could be inflation problems down the road. Also, as we were reminded recently, we just went through a period of inflation from 2002 through 2007, via the housing boom, an event which will not soon be repeated (we hope!). The longer-term risk for inflation is if the Federal Reserve loses its independence to politicians.

My son and I (Kevin) are avid viewers of the BBC’s *Top Gear* program, which stars three middle-aged men who test the latest in exotic automobiles and engage in some absurd automotive challenges, all while infusing the show with a British sense of humor. The program is enjoyed weekly by over 350 million people worldwide. In a recent episode, Jeremy Clarkson, the chief buffoon of the show, drove the Reliant Robin, a three-wheeled car (technically a motorcycle) that was popular in the U.K. in the 1970’s. The design flaw was that the single wheel was in the front, making it prone to falling over, which it did within about 60 yards of Clarkson’s first drive. Hilarity ensues over the next 10 minutes, with the Robin flipping over on the street, in a parking lot, and even in the middle of a cricket match. Finally, Mr. Clarkson took the vehicle to a mechanic who installed what would be described as training wheels to the front. From then on, as Mr. Clarkson described it, “The car worked well, right up until the point that it didn’t.” The final clip was of the car flipping off the street into a canal,

where Mr. Clarkson supposedly drowned. I may have struggled to build an effective analogy here, but this is an apt description of how the financial markets sometimes act.

## Is the Stock Market Expensive?

The value of the stock market is measured using several different metrics. The most widely known is the price-to-earnings ratio, or P/E ratio. However, even this can be confusing, since the “E” in the equation can be earnings over the past twelve months, or could be future earnings. There can also be a big difference between “reported” earnings and “operating” earnings. The average P/E ratio since the 1870's has been about 15. But the disconnect between price and trailing-twelve-month (TTM) earnings during much of 2009 was so extreme that the P/E ratio was in triple digits, higher than 120, in the spring of 2009. In 1999, a few months before the top of the Tech Bubble, the conventional P/E ratio hit 34. It peaked around 47 two years after the market topped out and earnings had declined. As these examples illustrate, in compressed time frames, the P/E ratio ceases to be an effective measurement of the value of the stock market.

The explanation for this is simple, as earnings can sometimes fall faster than the price of a stock. In fact, the negative earnings of 2008 Q4 (-\$23.25) have never happened before in the history of the S&P 500. Because of this fluctuation in earnings, Professor Robert Shiller of Yale University uses the inflation-adjusted, average P/E ratio over the previous 10 years. This has a tendency to smooth out the big moves in earnings, such as we saw in 2008-2009. For December 2010, the Shiller P/E ratio says stocks are now trading at 22.7 times earnings, well above the long-term average, but not that out of line with the P/E over the last 15 years. In normal (which is what?) economic periods, the Shiller P/E is between 14 and 16 times earnings. Per David Rosenberg of Gluskin Sheff, coming out of the bursting of a credit bubble, the P/E ratio historically is 12; coming out of a credit bubble of the magnitude we just had, the P/E should be at single digits, if history is a guide. However, corporate earnings are still doing well. Ed Hyman of ISI Research recently estimated that S&P 500 aggregate earnings for 2012 should be about \$100. Using the long-term P/E average of 15.4, that means the S&P would be reasonably valued in 2012 at 1540, about 23% higher than today's levels.

Another valuation metric is dividend yield. Up until the 1970's, the dividend yield on stocks typically exceeded the yield on investment-grade corporate bonds. Most stocks were purchased for their yield, not their growth potential. At the moment, the S&P 500 dividend yield is only about 2%, while the 10-year U.S. Treasury bond is at about 3.4%. The value of dividends has been debated over the last 20 years or so. Supporters of dividends point out that many a CEO has wasted company resources on projects or acquisitions (e.g., Sprint buying Nextel), when it would have just been better to return some capital to shareholders via a dividend. Conversely, would investors in Apple have been better served by a dividend, or by investing those funds into research and development that ultimately produced a product like the iPad?

Clearly, the evidence regarding stock market valuation is inconclusive at best. From a historical perspective the market appears expensive; however, history has rarely experienced times such as these. Over the last 15 years we have had the Federal Reserve drive interest rates low, thereby encouraging speculation in many asset classes. This has become known as the “Greenspan put” or the “Bernanke put”. While historically reliable valuation metrics show either an excessively or mildly valued market, there is nothing in the evidence from the last couple of decades that says stretched valuations can't become *extremely* stretched, as we saw in early 2000.

What we all search for is a way to participate fully when the markets are going up, but to limit our losses when the market experiences a downturn, particularly a severe one. Every once in awhile, a client or potential client will ask me if this is possible. The answer is yes, but it carries a cost, just like insurance on your house or car. A few weeks ago, I had this discussion with a friend of mine, who is the Chief Investment Officer of a firm like ours (although much larger) on the East Coast. He said his analysts had been looking at this very issue over the last six months. The answer was that yes, you could protect your portfolio from those losses and still be fully invested at all times. The problem is that it would cost you about 2% annually to do this, on average. His conclusion was that most people were not willing, or able, to submit their portfolios to that type of performance erosion over time. I would have to agree with him on that.

## What We Read This Quarter

No books of note were read this quarter. However, we have officially gone digital with regard to future reading, with a combination of iPads and Kindles. The goal is to have a uniform, portable, digital reference library that we can all access and discuss. It will be just like high school, when we are assigned a book and then deliver a book report in two weeks.

## Closing Comments

There are many positive indicators for the financial markets at this point, not the least of which is the beginning of the third year of the Presidential cycle, which we discussed in our third quarter commentary. Although investor confidence is high now, this could change as the year evolves, and there are always those outliers we have discussed. This may require us to be a little more nimble than usual with portfolio adjustments. Regardless of the circumstances, we look forward to another year of working with our clients.

*“The pessimist sees difficulty in every opportunity. The optimist sees opportunity in every difficulty.” – Sir Winston Churchill*



Kevin S. McGrew   Bruce E. Bower   Paul L. Watkins   Patrick L. Warren   Matthew D. Ison

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