ADDING VALUE

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Although final calculations are not yet available for 2010, it looks as though the capital markets are on track to deliver robust returns in every category, except cash. If this holds true, it will be the second year in a row for outperformance by the equity markets.

HOLIDAY STIMULUS PACKAGE

In the U.S., the Fed employs monetary policy in pursuit of a dual mandate: full employment and price stability. Unfortunately, neither objective is currently being achieved which is causing a great deal of angst for the U. S. economy. The normal tool that the Fed uses to pursue its mandate is the Fed Funds rate. However, at an interest rate of close to zero percent, it cannot go lower. Therefore, the Fed is forced to try other methods, in this case quantitative easing ("QE2"), which is essentially the purchase of Treasury securities in the open market. This Fed program to embark on another round of unconventional stimuli via asset purchases is diametrically different from the European approach to the same problem. This has generated vigorous debate about which program is more effective, with each side claiming that they are right. One of the challenges of living during a time of rampant globalization is that it is difficult to achieve synchronicity. Around the world, an economic experiment is being performed on a tightly coupled, highly interdependent, complex adaptive system, "a delicate machine the working of which we do not understand." If we did understand it, we would not now be in the present predicament.

One way to bring some understanding to this plethora of global economic news is to break the information into smaller pieces. For instance, let's just evaluate the monetary policy in the United States. Chairman Bernanke wrote explicitly about his intentions in a Washington Post editorial; he wants the stock market to go up. He appears ready to do whatever is necessary for the wealth effect of higher stock prices to stimulate growth, hiring, and to keep inflation expectations at around 2%. There are not many things that we are totally sure about, but sooner or later, of this we are sure: so long as CD rates, short-term money market rates, and Treasury Bills stay at 0% -1%, investors will begin to seek the higher return lure of equity securities. The undersaved, almost retired, consumption- driven Baby Boomer, simply has no choice.

"I could be wrong, but you look like a man trapped in low-yielding financial instruments."

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ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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Based on the daily circulation of pessimistic economic reports from the talking heads, not many would believe what we are about to say: the economy is expanding, liquidity is ample, inflation is under control, profits are growing rapidly, and are set to pass their all-time highs, nominal GDP is at its all time high, profit margins are at record levels, and corporate balance sheets are the best they have ever been. What country are we describing? Yes, we are talking about the United States of America. Two of the only measures of economic activity that have not recovered since the demise of Lehman in August 2008, are stock prices and the other, of course, is employment. On August 29, 2008, the S&P 500 closed at 1,283. On December 13, 2010, the S&P closed at 1,240. Close, but no cigar! But, why??? What happened to the positive optimistic can-do mindset that has fueled so much of the growth and success of the U.S.?

"I've stopped looking for work, which, I believe, helps the economic numbers."

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It is interesting to review the change in emphasis of financial planners, journalists, and other talking heads during the latest financial crisis. Most of these writers strongly recommended reducing risk in portfolios by adding bonds. They cite study after recent study that shows that bonds work in the long run, not stocks, and they have the added benefit of not losing value during a crisis. For instance, long-term treasuries, as measured by the Barclays Capital Long-Term Treasury Bond Index have beaten equities as measured by the S&P 500 Index, year-to-date through 6/30/10, and in the 3, 5, 10, 15 and 20 year time frames. It's a tie at twenty-five years. Beware of statistical interpretations! We would counter that these recommendations suffer from the same short-termism that pervades our life today. We would remind investors that the great bond *bull* market that began nearly 30 years ago was preceded by a 30 plus year bond *bear* market that took long term treasury yields from 3% to nearly 15%. The devastating losses that people suffered gave way to the saying that bonds were "certificates of guaranteed confiscation." A common feature of that 30 year bond bear market was the bond swap. Almost every year investors who owned bonds lost principal value as yields rose, so they sold their bonds in December and took a tax loss, replacing the bonds with others of similar maturity and quality. For thirty years, this process continued inexorably. Today, we are at or near, the point of inflection of the next bond bear market, which may or may not be the unintended consequence of Bernanke's QE2 program of introducing all the additional liquidity into the system.

Here is a sampling of comments from the top three bond managers in the world today:

Dan Fuss of Loomis Sayles' Bond Fund states: "I've never seen it (the opportunities in equities) look this good in half a century."

Margie Patel of Wells Fargo: "By any measure you want to look at-free cash flow, dividend yield, P/E ratio-stocks look relatively cheap for the level of interest rates. The Fed's quantitative easing policy (QE2) aims for higher equity prices, and they will succeed."

Anthony Crescenzi of Pimco, the firm with the biggest bond mutual fund in the history of the world, states: "The 30-year journey on rates is near its ending point. We are at the end of the duration tailwind."

Another comment that we just couldn't fail to include is from Bill Miller of Legg Mason. He states: "One of the most remarkable things about the investing world is how (correctly) venerated Warren Buffet is and how completely people ignore his investing advice. Since Mr. Buffett has made more money than anyone in the history of the planet solely through investing, one would think that when he says quite clearly what to invest in, people would pay attention. I guess they do pay attention, they just do the opposite. In 1999, near the top, he opined that stocks would see returns way below those experienced in the bull market up to that time. From the time of his comments in November 1999, to the end of October 2008, stocks fell over 2% per year. In October 2008, near the bottom, Buffett published an op-ed in the New York Times entitled, "Buy American. I Am.," telling people to buy U.S. stocks. They promptly accelerated their selling. On October 5th of this year, he said the following: "It is quite clear that stocks are cheaper than bonds. I can't imagine anybody having bonds in their portfolio when they can own equities." The result: people pour money into bond funds in record amounts, and sell their holdings in funds that invest in U. S. stocks. Why investors persist in doing the opposite of what the greatest investor of all time does is a greater mystery than the problem of consciousness, or the origin of life, or free will and determinism. Those at least are hard problems."

People like bonds today, not because they have carefully considered the risks and rewards of owning them, but because they have gone up so much over the last 30 years. Historical performance favors bonds. People make decisions based on historical performance and crowd mentality. A tremendous disservice is perpetuated by the idea that either stocks or bonds are for the long run. In fact, the entry point of your purchase whether for stocks or bonds, is what really matters for the performance outcome.

"And this is my cousin Dave, who handles the conventional wisdom."

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So, what will bring investors back to stocks? We believe it will be higher prices, the necessity to earn more for retirement, with a little nudge from QE2. Although we have said it many times in the past, it bears repeating. Stocks are an ownership interest in companies and as such are a long duration asset. (Bonds, on the other hand, have a terminal lifespan, with risk gradually coming down over the bond term and ultimately principal being returned to the bondholder, with interest.) Stocks are not bits of paper to be traded daily in a frenzy. As a long duration asset, the price level of stocks reflects people's optimism about the future and their attitude toward risk. It is a self-reinforcing phenomenon. One source of value is essentially the expansion of the P/E ratios. At today's interest rates, stocks appear to be a good bargain. With the nudge from the Fed to change the aggregate portfolio preferences toward riskier assets, and its stated in-

tention to use QE2 until that happens, one wonders what the bond bulls are thinking.

To be perfectly clear, we are NOT endorsing the current Fed policy. We are only using the information presented in a probabilistic, forward looking manner to derive a portfolio management strategy for our client portfolios for the next several years. In fact, we would much prefer a quieter Fed. As Jeremy Grantham so beautifully writes: "If I were a benevolent dictator, I would strip the Fed of its obligation to worry about the economy and ask it to limit its meddling to attempting to manage inflation. Better yet, I would limit its activities to making sure that the economy had a suitable amount of liquidity to function normally. Further, I would force it to swear off manipulating asset prices through artificially low rates and asymmetric promises of help in tough times—the Greenspan/Bernanke put. It would be a better, simpler, and less dangerous world, although one much less exciting for us students of bubbles."

In fact, Ludwig von Mises, one of the founders of the Austrian School of Economics, said it best: "to create real economic growth one has to attract capital and increase capital per capita, and this is best done by lowering taxation, having a stable monetary unit with little or no inflation, removing excessive regulation, and providing a lawful environment that protects capital."

So our message for this Christmas season is: Don't worry, be happy. At least until a future (inflation?) bubble, things are looking good!!!!

We sincerely thank you for your trust and confidence in our management of your net worth. We thank you for listening to us when we are lone voices in the public outcry. We thank you for holding pat to an investment strategy that looked like a poor decision at the nadir of the crisis on March 9, 2009. Without you as clients, we would be unable to operate our business in the manner and form that we believe is correct… to give objective, unbiased, well-researched advice that is not self-promoting or crowd-following. Having great clients is the real key to our investment success, and we are blessed during this holiday season and throughout the year with some great business associations.

Sincerely,

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