ADDING VALUE

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As recently reported by the Wall Street Journal, after a very volatile year, the S&P 500 is, surprisingly, within a percentage point of where it started. The Dow Jones is up slightly at 5%, reflecting the strength of one single stock, IBM. Foreign stocks remain depressed in price because of the European Union situation. These statistics are relatively positive given the collective global angst.

THE SOBERING IMPLICATIONS OF LOW MARKET RETURNS

2011 has been an unsettling year with asset price volatility coupled with slow growth. During this period of relentless media sound bites, macroeconomic over-analysis, and a pervasive sense of gloom on a global scale, we thought that this Fourth Quarter 2011 newsletter should address some strategy considerations that are embedded in your portfolio and also to reiterate where we are in this economic cycle.

2012 Portfolio Strategies

There are five strategies that we are employing in portfolio construction for the coming year.

Strategy 1: Know the role of cash.

Cash serves a purpose. Its value doesn't fluctuate in nominal terms, and for investors who are near or in retirement, the stability of cash has value above a simple interest rate. In other words, if a client needs cash on hand for planned expenditures, including required minimum distributions, they should have cash available regardless of the investing environment. On the other hand, cash currently earns a negative real yield (after inflation rate adjustment) and there is a cost to holding it. So simply sitting on cash is a losing proposition for investors that are seeking positive real returns over time and have no immediate cash needs from the portfolio.

Strategy 2: Seek some spread in the fixed income market for real yield.

It is an amazing statistic but looking at future inflation implied by Treasury Inflation-Protected Security yields versus Treasury yields, one must go out 10 years on the Treasury curve to achieve a real positive yield of only 0.25%. Chairman Bernake has indicated that this will continue for the foreseeable future. That, my friends, makes U. S. Treasury securities VERY expensive!!! For those clients in retirement with cash withdrawals, we are using mutual funds that have fixed income securities containing corporate bonds, emerging market debt, foreign debt, and some mortgage-backed securities to obtain a slightly higher return than U.S. Treasury bonds. There is always a degree of principal risk with this strategy, but the risk is currently being rewarded in our opinion. Some of the fund names that provide this real yield include: Loomis and Sayles Bond Fund, Third Avenue Focused Credit Fund, FPA New Income Fund, and PIMCO All Asset Fund.

Strategy 3: Get paid while you wait.

As we will explain in more detail later in this newsletter, dividends will be an important source of return over the next decade. The S&P is currently yielding about 2%. This 2% is about the same as the current yield on the 10-Year U.S. Treasury Bond, but it is attached to a healthy company. We believe that

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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a high dividend that is supported by cash flows (especially free cash flows) and a robust balance sheet is a better investment than a high dividend that has resulted from a massive share price decline. Some of the funds that we are utilizing that have a dividend strategy include: Thornburg Investment Income Builder, Yacktman Fund, Jensen Fund, Touchstone Sands, and Mainstay Epoch U.S. Equity.

Strategy 4: Don't overpay today for tomorrow's returns.
With long-term deleveraging and slow economic growth anticipated for the foreseeable future, it is reasonable to assume that the secular decline in P/E ratios that we have been experiencing since 2000 will continue. Owning stocks that already look cheap but have some growth potential is a great way to participate in the cyclical upside offered by stock investing. Other considerations, such as balance sheet health and competitive advantage are also important. As you know, we have a core bias to finding managers that are value-oriented and try to avoid managers that employ trading strategies. Except for 2008, when there was no place to hide, the managers in your accounts have had a history of providing good downside protection. We attempt, to the very best of our ability, to never overpay for companies.

Strategy 5: Take advantage of some alternative strategies.
Alternative asset classes and strategies are designed for the most part to offer one major benefit: reduce portfolio volatility by zigging when more traditional asset classes zag. Only recently have some of these strategies come out in a mutual fund format that allows main street investors to have similar access to opportunities previously afforded only to accredited investors. We have tried some alternative strategies in the past and, in general, the cost of implementation has been so expensive that the advantages of diversification and getting the "zig" are negated. Many times, the marketing hype of these strategies vastly surpasses the actual results. These techniques tend to have high fees and most employ leverage, which decreases returns. Furthermore, the nature of their incentive fee structure creates a peculiar asymmetry that can result in managers getting paid for volatility even if their investors lose money. We have lots of examples of the mathematics of this calculation for those who are interested.

Nevertheless, a new fund was just introduced at the end of the third quarter, Master's Alternative Strategies Fund with an expense ratio of 1.5% that seems to have some advantages. In applicable situations, we will take a position in this newly available fund.

Determinants of equity returns
Equally important to understanding the strategies we are employing in portfolio construction for 2012 is to understand what's ahead for stocks and bonds. No—we don't have a crystal ball, but we have some guideposts.

Essentially, there are **three** determinants of equity investment returns in the long run:

- Earnings growth,
- Dividend yield, and
- P/E multiples

While all three of these determinants are always present, the relative importance of them can change dramatically in response to changes in the economic landscape. Thus, the **determinants** of return never change, but their **order** of importance does. Earnings growth and dividends have had a consistently positive effect on total return throughout the history of the markets. These two components can jointly be called the investment return. The highly volatile P/E ratio has strong manic-depressive behavior characteristics. This component is the speculative return. When interest rates are declining, the P/E ratio acts as a positive market force as it did in the 1980's and 1990's. When interest rates are increasing, the P/E ratio becomes a headwind. During the past ten years, even though earnings and dividends have been positive, the steadily contracting P/E ratio has hindered market performance.

This can be shown in tabular form as follows:

S&P 500 Total Return (1980-2011)

	1980-2000	2001-2010	2011-
Earnings Growth	6.4%	0.5%	4-6%
Dividend Yield	3.6%	1.5%	2%
P/E Expansion	7.6%	-3.0%	?
Annualized Return	17.6%	-1.0%	6-8%

The P/E ratio is the wild card - a Crazy Eight or a One-Eyed Jack - and it is capable of seriously wreaking havoc on returns for extended periods of time. (Last review for eleven years and counting to be exact!!!) However, now that interest rates are so low, most future expected return should come from earnings growth and dividend yield – which could be around 8%.

So we have given up a lot of the 1980-2000 gains in the last ten years, but what are the return mathematics working in the investors' favor today? In the September 30, 2011, Semi-Annual Report from Tweedy, Browne (a mutual fund in most client portfolios), the portfolio managers give a wonderful example of the company Johnson & Johnson. It is hard to improve upon, so the analysis on page 3 of their semi-annual report is included in its entirety here:

Johnson & Johnson (JNJ)

	1999	*2011*
Earnings per share	*$1.45*	*$4.96*
P/E ratio	*32x*	*13x*
Dividend yield	*1.2%*	*3.5%*

1999-2011 EPS Growth Rate	=	*10.8%*
P/E contraction 1999-2011 (cum.)	=	*59.0%*
Dividend growth rate 1999-2011	=	*12.7%*

Avg annual total return for JNJ stock 1999-2011 = 5.1%
Avg annual total return for S&P 500 1999-2011 = -0.4%

Back in 1999, some 12 years ago, J&J was trading at $46 per share, produced earnings per share of $1.45, had a price earnings ratio of 32X EPS, with a dividend yield of 1.2%. Today, nearly twelve years later, J&J is on schedule to earn $4.96 per share, or nearly three and a half times what it earned in 1999. So, during the lost decade of equities, and during a period that saw the bursting of the technology bubble, the Y2K crisis, the 9/11 tragedy, the Iran and Afghanistan wars, the bursting of the credit and housing bubble of 2008, and perhaps the worst economic crisis since the Great Depression, this company was able to compound its earnings per share at a 10.8% annual rate. The business performed beautifully during this period, but what about its stock price?

In 1999, J&J had a price earnings ratio of 32 times earnings. Today, it trades at roughly 13 times earnings. Its price earnings ratio (P/E) has fallen off a cliff since 1999. Despite this collapse in its P/E/ ratio, J&J produced a compound return for its shareholders of a little over 5% per year over the last twelve years. This, by the way, compares to a compound return for the S&P 500 for the same period of approximately -0.4%. It was certainly not a lost decade for J&J investors. The stock price compounded at roughly half the rate of the company's earnings compound, and as a result J&J, today, appears to be pretty attractively valued.

So what should the next five years or so hold for J&J's stock performance? This is very hard to know. What we do know is that the stock currently trades at 13 times earnings, which equates to an after tax earnings yield of 7.7% and compares quite favorably to fixed income alternatives. The ten year treasury currently trades with a pre-tax yield of approximately 2%. While you cannot put J&J's earnings yield in your pocket each year, it still presents a compelling fundamental advantage over the yield of risk free treasuries, and one that Ben Graham would have likely taken advantage of. The current cash dividend yield today is 3.5%, up from 1.2% in 1999 for an annual dividend growth rate during the period of approximately 12.7%. J&J's P/E ratio during this almost twelve-year period averaged around 20X, but is at 13 today. If the current P/E ratio is simply maintained going forward, the return for shareholders would be the earnings growth of the company coupled with its dividend yield. Over the next five years, that translates in to a 13% to 14% annual total return if the company is able to continue to grow its earnings annually at a 10% rate, and maintain its dividend yield at 3.5%. If we lower our expectations of the company's future earnings to a more conservative growth rate of 5%, and simply maintain the dividend yield, the investor would still receive an annual return of roughly 8.5% in the stock over the next five years. But let's assume that the P/E ratio for J&J continues to decline, to say, 10 times earnings over the next five years coupled with a more modest 5% earnings growth and a 3.5% dividend yield, the investor would still receive a 3.4% average annual return.

This kind of math is working for us in any number of companies in which we are invested today. We cannot stress enough that the robust-

ness of this potential return math is largely a function of attractive entry point pricing in larger, steadier, higher quality and globally diversified businesses like J&J. As we have said in previous letters, these are businesses that are attractively valued, underleveraged, pay an attractive dividend yield and a sell a multitude of products to a growing middle class that aspires to the kind of life style that we in the West sometimes take for granted. More importantly, these are the types of companies that have the financial strength to weather severe market turbulence, and come out the other side bigger and stronger.

Conclusion

As we stated at the start of this letter, we haven't received much good news from the markets for the last several years. Macroeconomic factors have been unremittingly negative. Such short-term uncertainty is both inevitable and unpredictable. During such periods, it is vitally important to reinforce the difference between price and value. Prices are determined by human beings and reflect emotions. Emotions are the main driver of the speculative returns of the market. Emotions have contributed to the contraction of the P/E ratio from over 30x at the beginning of the century to less than 10x now. Investors do not want to own stock at any price. People are so scared that they are putting their money away in negative yielding TIPS. Basically, they are giving their money to the government for 10 years and saying, "Alright, give me back less money 10 years from now in terms of what it could buy, and I get no income at all in the interim." With emotions running high, investors are susceptible to new trading strategies, ETFs, alternative investment, and hedge funds, among other new things. Business values, on the other hand, are determined by the earnings and dividends of the underlying companies. Value is independent of emotion. Today there is a WIDE gap between "price" and "value." As shown with the J&J example, a decade of falling prices and rising values has made stocks a bargain. We can't predict when the market will enter a sustained upward direction, but it will and those investors who stay the course will be exceptionally rewarded.

Sincerely,
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