Prepared Comments from 10/19/2011 Conference Call

Let me first apologize for having to reschedule this call from Monday—I had a family emergency, and attended a funeral for my cousin on Monday.

We indeed live in interesting times, and 2011 has provided both highs and lows. For better or worse, these highs and lows for investors have grouped themselves in the first four months of the year, and the next five months of the year. The first four months brought evidence of a steady, albeit slow, economic recovery. Corporate profits continued to rise handsomely, and stock prices followed suit.

In the late Spring, worries of a double dip recession arose, as they had a year earlier. This time they were aggravated by challenges in the US and challenges in Europe that the respective governments appeared incapable of handling well. The US debt ceiling and budget negotiations exposed how horribly paralyzed our Congress is currently. The Greek government debt crisis has spread, not only to 'peripheral' countries, but now to Spain and Italy, countries that could be 'too big to bail.'

The visibility of this government disfunction led to plummeting consumer confidence, which in turn strengthened the concerns of a double-dip recession, which can lead to further falling consumer confidence, in a vicious cycle. Currently consumer confidence is very close to its November 2008 low, and lower than it had been in the 28 years prior to the 2008 crisis.

In September the fear of a Greek government default ballooned, bringing with it fear of a broad recession in Europe, declines in European bank and insurance company stock prices, and some fears of a 'capital freeze' in Europe this year similar to the global capital freeze we suffered in late 2008. Recall that capital serves as the circulatory system of the global economy, and when capital doesn't move freely, the patient can suffer a stroke.

This risk remains. Untreated, this can lead to such consequences as US money market funds failing to maintain the dollar value. It was this very risk, and its greater implications, that led the FDIC to boost their backing of deposits in 2008 from $100,000 to $250,000.

Actions are necessary to resolve the European fiscal problems. None of the necessary actions will be easy, or popular. The one factor in favor of a successful resolution is that the longer Europe delays, the greater the pressure becomes to adopt the necessary steps. Certainly bailing out US financial and auto companies in 2008 was not popular or easy, but became possible as the crisis deepened. Leadership is far preferred to being backed into a corner and forced to take action, however in the absence of leadership, in time necessary action will be taken.

Enough of pointing our fingers at Europe. Let's examine things right here.

Unemployment continues to plague us, and is not letting up. The official unemployment rate has remained at or just above 9% for six months. Nonfarm payroll rose 103,000 in September, aided by the end of the strike at Verizon (which hurt the August figures). Any number of new jobs is good, however we need persistent monthly job growth of over 200,000 jobs to start making some progress on cutting our unemployment rate.

How is the future looking? The Conference Board's Leading Economic Index® for the US has seen steady growth since early 2009, after having peaked in late 2007. This is pretty remarkable given that this index includes initial claims for unemployment and consumer expectations as two of the ten components. This indicator implies that economically there are brighter days ahead of us. When, exactly, we don't know. Whether this means that we will be doing well economically in the future, or merely that things have been so horrid economically that improvements cannot be avoided, remains to be seen.

Consumers have been holding a weak hand, with their home equity evaporated, and with worries of job stability in the face of painful unemployment. They have 'done the right thing,' by boosting their savings to better prepare for these tough days. The substantial efforts of the Fed, coupled with the globally weak environment, has brought down interest rates, and in the process the proportion of disposable personal income needed for debt payments has reached the lowest level for over fifteen years.

These lower interest rates and depressed housing prices are percolating through the housing market. It is no surprise that the median rent payment is now 20% higher than the median mortgage payment, in a sharp reversal to the levels from 2005 to 2008. Home affordability, as a percentage of personal income, is at the cheapest level it has seen for 35 years. Median home prices have yet to launch a recovery, and stand 28% below their 2005 peak level. There has been little progress, as unsold housing inventories have been declining since 2008.

Oil prices had been rising earlier this year, with the presumption of steady, slow global economic growth. The current economic stumble has brought with it lower oil prices. At last, a silver lining! We have seen little benefit thus far at the gas pumps, but it should come, and with it, consumer confidence could well bounce off their current lows.

US corporations are firing on all cylinders, other than hiring. They have strengthened their balance sheet, by boosting cash sharply, and refinancing debt to the current low interest levels. They have been boosting their level of capital expenditures, not yet to 2007 levels, but at higher levels than we saw in the first half of the last decade. Companies have been working down their inventories—while this creates a weak current economy, in time this must be followed by inventory build-up, boosting the upcoming economy. Investors are beginning to see these benefits, as dividends are rising, and more companies are buying back their shares (with Berkshire Hathaway being a recent example of the latter).

Cyclical areas of the economy are mixed. It is no surprise that the housing market remains in the dumps, with housing starts at only 40% of the 35-year average. In one sense this is a good thing. When you find yourself digging a hole, the first remedy is to stop digging. Housing starts should remain well-below normal levels for two-plus years, as we work through the significant inventory of houses that individuals and banks are desperate to sell. Light vehicle sales have been recovering, but remain 17% below normal levels. Cars wear out far faster than houses, however. This has led to older cars being on the road, and in time, this will lead to a resumption of normal auto sales—just not yet. Importantly, non-defense capital goods orders have risen steadily since early 2009, and are now <u>above average</u>. Part of the reason for this is that these orders include orders going to other countries, including the emerging markets which have not been mired in the slump that we are experiencing.

Larger firms have been faring better than smaller firms. This is likely due to the greater availability of capital. Large firms typically use the capital markets, while smaller firms typically use the banking system. Small business credit availability and optimism had been rising steadily until earlier this year, at which time both measures have fallen back.

Consumer and commercial lending is loosening up, and demand is growing, from admittedly low levels. This is coupled with falling consumer and commercial loan delinquencies. Residential mortgage delinquencies, however, remain at very high levels, over 10%.

So where do investors stand? Many of them have left the building, scrambling for the exits in September, selling stocks indiscriminately, but with the strongest exodus from emerging markets stocks, other foreign stocks, natural resource funds, including precious metals funds.

In many ways investing is a zero-sum game. Investors who have sold stocks must do something with the proceeds—typically buy bonds, commodities, or hold cash. While investors bought more stock funds than bond funds earlier this year, they have resumed buying more bond funds than stock funds for the past six-plus months. Indeed, in eight of the past nine quarters, stock funds have suffered a net outflow of investor dollars. The bulk of these dollars leaving stocks have gone into bonds, which have enjoyed net inflows annually for over a decade.

To oversimplify the situation, this flow of money has brought down the price of stocks to bargain levels, and has raised the price of bonds to dangerous levels. Bond prices move in the opposite direction of bond yields—when bond prices rise, bond yields fall. At the end of September, 10-year US Treasury bonds yielded under 2%, and 30-year bonds yielded less than 3%. The bond prices have fallen this month, with these yields recovering to about 2.2% and 3.2%, respectively.

The converse also holds. As stock prices have fallen, their attractiveness has risen proportionately. While it feels that falling stock prices lead to more falling stock prices, the reality is that falling stock prices make it less likely for stocks to fall further. The reason is that as one item becomes cheaper, it becomes more attractive when compared with its alternatives. Based on earnings yield (company earnings per share divided by share price), stocks yield 83% more than corporate bonds (9.5% versus 5.2%). Historically, corporate bonds yield the same or more than stocks' earnings. This reversal is historic, and helps to 'provide a floor' for future stock prices. An investment with a floor has a much more attractive 'upside:downside' comparison than one without a nearby floor, such as bonds.

The comparison to government bond yields is far more dramatic, and highlights the likelihood that today's investors face far greater risk in buying treasuries today than they realize, and far less risk in buying stocks. It boggles my mind that investors prefer a 2% yield from a bond backed by an entity that most recently spent 55% more than its revenues, rather than a 2.5% yield from a stock market that has earned 10% profits, after taxes, on its revenues, and has historically grown its revenues and profits over the years at a 10% or so annual rate.

Late last month we 'raised the firewall,' to help protect our clients' portfolios from growing losses tied to investor panic which was building in September. While the firewall is up, we prevent boosting OR reducing a portfolio's level of stocks. The firewall provides the portfolio's stocks time to recover to normal levels, while protecting clients' need for withdrawals. The firewall separates clients' stocks from cash/bonds, and the cash/bonds are sufficient to support withdrawals for many years, plenty of time for panic to dissipate and for stock and bond prices to return to more normal levels.

Our stock allocation decisions are largely driven by investor fears—we prefer to buy stocks that are least liked by investors. Currently this has led us to boost our allocation to foreign stocks, and within them to emerging markets stocks. Within the US, we continue to strongly favor large-cap stocks, which remain cheaper than they were pre-crisis in 2007, despite the S&P 500 earning more now than they did then. On a trailing PE ratio level, US stocks are cheaper than they have been in almost 20 years.

We divide bonds into two categories—quality and opportunity bonds. Opportunity bonds include high-yield (junk) bonds which provide higher returns in good times, but can deliver painful losses in bad times. With the firewall up, we are also placing opportunity bonds behind their own firewall. Within that firewall we have boosted high yield and multi-sector bonds, but have cut back foreign and floating-rate bonds, due to our view that high yield bonds provide greater opportunities at this time. Outside that bond firewall, we have shifted some from shorter-term quality bonds to intermediate-term quality bonds, to reflect our view that interest rates are likely to remain depressed for quite awhile, and a desire to earn higher interest rates during that time, rates offered by holding longer-term bonds. Note that we go out of our way to NOT buy government bonds (and NOT buying TIPS inflation-linked government bonds), both of which come with a notable risk of price losses.

Cash pays you nothing. Bonds bring a very real risk of losses from falling prices. Commodities are quite volatile, and require a vibrant global economy to rise steadily in price. Stocks, however, are shares of companies currently with solid balance sheets, growing profits, and which pay solid, often growing, dividends, which provide a floor of protection against further falling stock prices.

This dynamic has led me to reinforce my mantra—**I refuse to sell stocks at low prices**!