Prepared Comments from 1/13/2012 Conference Call

Whose idea was it to have a conference call on Friday the 13th! Oh, yeah.

The US stock market is up over 6% from its mid-October level. While it has gained 90% since its March 2009 panic low levels, it remains 18% below its October 2007 highs.

The past quarter brought good news for the US economy, with economic growth coming in around 2%, healthy sales gains for retailers on Black Friday and beyond, jobless rate falling near a three-year low, and the US unemployment rate falling to 8.5%. US companies in 2011 have strengthened, boosting their cash reserves as they have boosted their earnings. International news included the death of Libyan leader Gaddafi, rising concerns over Greek debt, China housing prices, Italian debt, and on the positive side, the departure of the last US troops from Iraq.

For investors, the biggest news is what didn't happen. The US municipal bond market did not meltdown, ignoring the December 2010 prediction of noted analyst Meredith Whitney. This led to a full recovery in 2011 from the sharp decline caused by that prediction. Other quality bonds also enjoyed a strong year, as investors continue to flock towards high quality bonds, and as a result saw yields on high quality bonds fall to historic lows, with ten-year Treasuries yielding 2%, 30-yields offering 3%, and TIPS promising returns less than inflation.

I share the sentiment a bond analyst mentioned this week—we are bruised but unbowed. Quality bonds were overpriced a year ago—they are horribly overpriced now. Stocks were underpriced a year ago—they are quite underpriced now.

Investments can remain over- or under-priced for quite some time. Stocks in the late 90s rose more than 20% annually for five straight years. That said, investors who overpay for an investment is accepting bad odds; while a bungee cord can stretch and stretch, the longer it stretches, the greater the risk that it will snap back soon, and the greater whiplash the jumper will incur.

It is hard for an investor to buck the trend, to sell bonds and buy stocks at this time. However, this difficulty is softened by the compensation. Those who sell bonds today are selling them at high prices, and are giving up a stream of historically low yields. Conversely, those who buy stocks today are obtaining them at low prices, often with secure, relatively high and growing dividends. We are being compensated for our courage. Since 1952, the worst ten year total return for US stocks when the market is trading at the current level of 11.5 PE ratio is +8.8%, and has averaged a 16.5% annual return.

The reason that the PE ratio for the market is so low is two fold. First, investors have continued to flee stocks, shifting over $100 billion from US stocks to bonds in 2011. Secondly, US companies have produced higher earnings. More profits, lower cost—sign me up!

US companies are growing their earnings because they have more customers. Companies are making purchases to boost their inventories, companies are buying other companies, consumers have more money in the bank due to refinancing their mortgages at historically low interest rate levels, and are using some of that newfound wealth to buy more than they did the last year and the year before, as more Americans have jobs than a year ago, these households have more money to spend, on necessities and luxuries. While the rate of economic growth is low, it is positive, and growing.

However, there are storm clouds, primarily in Europe. The debt crisis began in Greece, but has added Italy, Ireland, Portugal, and Spain, with other potential additions. The crisis threatens financial institutions in France and Germany, and elsewhere, including the US. Like the subprime crisis last decade, the frustration centers around the inability of anyone to point to a single figure—here is your exposure, your loss. Uncertainty creates panic, and uncertainty has been the hallmark of Europe's response to their debt crisis.

In fairness, the configuration of the European Union (EU) invites no-win situations, and finger-pointing. One of the most frustrating experiences for an employee is to have responsibility over something, but to lack the power to take care of it. The European Central Bank (ECB) is largely responsible for the stability of the European Union of countries, and while it holds the power to set monetary policy (setting short-term interest rates), it lacks the power to set fiscal policy (tax rates, stimulus, bailouts, etc). This has always been the case, however this shortcoming wasn't critical until the past two years.

The 'powers that be' are striving to arrive at a solution. One market analyst sees a 60% likelihood that in 2012 the ECB will merely muddle along, neither solving nor worsening the situation, a 20% likelihood that the crisis will be resolved, and a 20% risk that significant negative events will occur, including the departure of a country (like Greece) from the EU.

Before you set out to sell all of your foreign stocks, keep two factors in mind. Europe is only one piece of the foreign stock universe. And European companies have significant sales outside of the Eurozone. Furthermore, the worsening economic climate in Europe (with a recession expected this year) should drive down the value of the Euro, and this has a very positive impact on sales by European companies, as their products/services are 'on sale.'

Our outlook, therefore, is for good results in stocks, and disappointing results in quality bonds. We like what we call Opportunity Bonds, most especially high yield bonds. Within stocks, we still prefer large US companies, however by a lesser margin than in 2011, due to the larger losses suffered in 2011 by smaller US company stocks. We remain committed to a strong use of foreign stocks, with our current target of 42% allocation of stocks to those outside the US. We remain committed to both emerging markets stocks and smaller foreign stocks, to complement the bread-and-butter large multinational foreign-based stocks.

Since we lowered the Firewall earlier this month, we strongly recommend that investors examine the asset allocation of their portfolios, and rebalance to long-term targets. If you can stand it, consider adding a few percent to stocks now, to take advantage of the current imbalance, with stocks underpriced and bonds overpriced.

We've been wrong in the past and will be wrong in the future, but that is our current outlook.