Prepared Comments from 4/16/2012 Conference Call

The US stock market is up over 6% from its mid-January level. It is up over 100% since its March 2009 panic low levels, it remains 12% below its October 2007 highs.

The past quarter generally brought continued good news for the US economy. While corporate earnings took a breather, some of this was due to corporate hiring, which is positive for the US economy. In fact, we saw continued decreases in the unemployment rate and continued increases in the US workforce. Overall economic growth came in at 3% in the 4th quarter, and is expected to range from 2-3% in 2012. Inflation appears to be under control, for now. Through March it increased 2.7% in the past year, 2.3% if you exclude food and energy.

One of the reasons why the US economy has a chance to continue its growth is that not all of the economy is growing. Specifically, housing remains deeply depressed. Counter-intuitively this is a good sign. It means that when it FINALLY begins to recover, this is fresh fuel to the campfire. It also means that less of the economically-sensitive sectors are faring well, and thus less of the economy is susceptible to a pull-back, a double-dip recession. As I have said many times, a slow-growth recovery has a much higher likelihood of persisting than a red-hot recovery. Yeah slow growth!

Globally, we have seen continued high tensions with Iran, and with North Korea. The Iranian crisis has led oil prices to rise—the markets are pricing in the impact of an expected eventual strike on Iran's nuclear facilities, by Israel or the US. The emerging markets are striving to orchestrate a soft landing, pulling back on the high growth rate they enjoyed a year ago, while avoiding their own recessions.

One of the top worries of course lies with Europe. Greece's situation became clearer in the past quarter, with a shotgun wedding write-down of Greek debt forced onto bond holders, and with the European Central Bank and related institutions continuing to pump in money to the financial system to avoid a Lehman Brothers-like spreading crisis. Through the end of March this seemed to be working, however contagion to Spain is the current leading worry this month.

Investors enjoyed an excellent quarter, with double digits gains for most categories of stock, and modest gains of under 2% from quality bonds, gains of 4% or more from lower quality bonds, and actually losses from some long-term and government bonds. I would characterize this as a quarter in which investors finally acted rationally.

And yet they didn't. Investors continue to add more money to bond funds than to stock funds. This is simply irrational. Bonds offer set income streams from assets that lose money to inflation, while stocks offer rising income streams from assets that can keep up with, or exceed inflation.

We continue to feel that the US economy will continue is gradual recovery, and we are hopeful that Europe will continue to muddle along, two steps forward here, two steps backward there. There is simply too much money at stake to permit the entire structure to come crashing down.

Given this outlook, we continue to favor stocks more than bonds. We are holding most clients' stocks a little above long-term target levels. We also favor economically-sensitive bonds, such as high yield, and floating rate. Despite, or because of, the challenges overseas, we continue to direct 42% or so of client stocks in foreign stocks and stock funds. While this feels high to most US investors, it actually is still very US-centric. In the past decade, the foreign stock markets have grown from 46% to 54% of global stock markets, and so our 42% level remains more than 10% less foreign than the world. We also prefer to invest in foreign bonds.

Our current overall stock approach follows:
2%, relative, above long-term levels
42% foreign, 58% US
73% large-companies, 27% mid and smaller
3-5% of stocks in real estate (US and foreign), and 3-5% in natural resources

For bonds, we direct 65% into quality bonds:

- 35% in intermediate-term high quality
- 20% in short-term high quality
- 10% in inflation bonds, but not Treasury inflation bonds which are grossly overpriced

The other 35% is directed to Opportunity bonds

- 19% in high yield
- 10% in multisector
- 5% in foreign
- 1% in bank loan

Investors remain shell-shocked after the 2008-2009 crash, and this has produced outsized opportunities in stocks, and in more aggressive bonds. While it can take a long time for investors to restore a normal level of stock to their portfolios, current stock investors are benefiting from relatively cheap stock prices and above average dividend yields, while shell-shocked investors are holding overpriced and under-yielding quality bonds, and cash.

When these timid investors eventually add dollars to their stocks in the coming years, they will very likely be paying much higher prices than you are paying today for stocks. I say “let them!”

The fair value pendulum remains far from center, providing attractive opportunities to investors who can separate their head from their hearts. The market results of the past three years vividly show the value of setting and following a calm investment approach.