Prepared Comments from 10/15/2012 Conference Call

The US stock market is up about 6% from its mid-July level. It is up 112% since its March 2009 panic low levels, it remains 8% below its October 2007 highs.

The past quarter generally brought good news from the US and abroad. Leading economic indicators, as monitored by the Conference Board, was largely flat in the past three months, yet remains 'in growth territory.' The unemployment rate has just fallen below 8%--it is on a VERY slow downward trajectory. Our private sector has produced 1.86 million jobs in the past year, about 154,000 per month. This is in the right direction; however we need higher numbers to really cut our unemployment rate.

US companies' profits continue to perk along, growing at middle to high single digit levels. Companies remain very strong financially, with excessive cash in the bank.

The economy is recovering, with vehicle sales close to normal levels (note that consumers can't delay car replacement too long—they eventually are more expensive to maintain than to replace, especially at today's low loan interest rates). Housing also appears to be recovering from a VERY depressed level.

While consumer confidence has been rising this year, it remains subdued. Interestingly, just today the Wall Street Journal ran a headline "Consumers Showing Little Fear of 'Fiscal Cliff'"

Some of that lack of fear may be tied to investors' low level of stock exposure. Investors built up a mountain of cash in 2008-2009, and have been shifting much of this into bond funds since 2009, driving bond prices up and bond yields down, down, down.

In Europe, the central banks have 'backstopped' the troubled countries, and yields for countries like Spain and Italy have come down to the middle-single digits. The European sovereign debt crisis is far from resolved, however most investors appear satisfied that the authorities will successfully 'ring-fence' it, limiting fallout. I suspect that the ultimate solution to Europe's problems will come from beyond Europe, from a healthy global recovery which raises all ships, including the troubled European peripheral countries.

China is working to walk a tightrope, first to slow down the economy to keep China from overheating, and then to keep from slowing down the economy to a halt (preventing a hard landing, aiming to orchestrate a ‘soft landing’). It is too early to label the result, but at this time it appears that they could indeed land softly.

In this backdrop, the past quarter was extremely kind to investors, with bonds up 2% or more and stocks up 5% or more. On the one hand, it is a bit surprising that markets have risen despite two major uncertainties as yet unresolved—the November elections and the Fiscal Cliff.

Furthermore, it was really a ‘risk on’ quarter, as riskier bonds did much better than lower-risk bonds, and some riskier stocks did the best, such as emerging markets, foreign small/mid stocks, and energy stock funds. Does this mean that we have turned a corner, and that ‘risk on’ is the path ahead of us? I simply don’t know.

This is what I do know. Valuations for stocks are cheap, and valuations for bonds are expensive. Our economy is not running on all cylinders, and this has a silver lining—it means that our economy can’t fall sharply, the downside is limited, MUCH more limited than it was in early 2008.

Yet today’s investors are largely focusing on yesterday’s problems rather than today’s.

There is a silver lining here. Investing is somewhat a closed world. If investors don’t want stocks, it means that the prices are low, the P/E levels are low, and the dividend yields are high. It also means that bond prices are high (especially for US Treasuries) and bond yields are very, very low. A historic perspective leads me to conclude that we have a twenty-year bear market for bonds ahead of us.

While it can and likely will feel VERY lonely to buck the trend and own stocks, you ARE being well compensated for your patience, and faith. The S&P 500 yields over 2%, much more than investors receive from 10-year treasuries. And the yield is only one portion of compensation. The S&P 500 reflects a good portion of the US economy, and the economy is growing, and good companies in this country and abroad are able to deliver growing profits. Most US companies, at least those outside financial, housing, and auto industries, were able to actually grow their profits from 2007 to 2010.

Now this takes faith, and a willingness to feel like an oddball. The ten-year figures in the recent Market Review/Outlook are normal, despite including the worst financial meltdown since the Great Depression. Let this feed your confidence, when your confidence is otherwise threatened.

Certainly there are storm clouds, in DC, in Europe, and in China. However there are ALWAYS storm clouds. That is why stocks over time tend to well outperform bonds. That is why faith is justified. At least that is my opinion.

I would like to open up the lines for questions and answers. After the Q&A on this topic, I will provide a brief summary of what I am doing outside of Mallard at this time, and try to field your questions.