Prepared Comments from 7/15/2013 Conference Call

Remember the constant theme of 'bonds are overpriced'? Well, investors finally listened in the past quarter. Overall this year, investors have dramatically cut back their bond purchases, which had been strongly outpacing stock purchases almost without fail since late 2008. Quality intermediate-term corporate bonds fell close to 2% in the 2nd quarter, while municipal bonds fell about 3%. Longer term bonds, and Treasury bonds fell more. During the quarter US stocks rose about 2½%, while foreign stocks fell about 1½%. Emerging market stocks fell 7½%, while precious metal stocks fell 35%. Since the April 15th conference call the S&P 500 has risen 7.7%, and it is up about 150% since its March 2009 lows.

Let me review the economic news of the past quarter. Inflation has been tame, averaging less than 2% over the past year. Inflation including food and energy has been even lower, under 1½%, due to falling energy prices. Unemployment has been pretty steady, at 7.6%, however this is more than ½% lower than this time last year. Private job creation has been steady for the past quarter, at almost 200,000 jobs per month. The Conference Board's Leading Economic Index® has risen over the past three months. Their Consumer Confidence Index rose for three straight months, and is higher than it has been since January 2008, before the meltdown began. In the 1st calendar quarter the US economy grew at 1.8%, much stronger than the prior quarter.

The US economy continues to recover. US auto sales are at near-normal levels, and there should be substantial pent-up demand that justifies auto sales reaching and remaining above-normal for several quarters. Home prices have been steadily recovering, and inventories of unsold homes are very near normal levels, after being twice normal levels at the start of the meltdown. While mortgage rates have risen in the past quarter, it remains much cheaper today to own a home than rent, if you qualify for a mortgage.

Due both to the sequester and sharply improved revenues, the US government deficit has fallen sharply this year.

Economics did not drive the markets, both stock and bond, down in June, but rather words. Ben Bernanke, the Fed chief, announced in June that the Fed's stimulus could be reduced as soon as later this year, and reversed as soon as 2014. On one hand, this shouldn't have been news, as the Fed has been providing regular guidance on its exit plan. More critically, the Fed ending its stimulus efforts is actually a confirmation that the US economy is self-sustaining, a state that it has lacked for over five years. Investors appear to have come to this realization, and in July most of June's stock declines have been fully recovered.

The S&P 500 is a collection of the largest US public companies. Their profits have reached a new record in the 1st quarter, due to strong profit levels. Furthermore, they have historically low levels of debt, boosting their safety. While share buybacks are fairly flat, dividend payments continue to rise. Similarly, while mergers have also stalled, but companies continue to boost their capital expenditures.

Europe is treading water, and while not making much progress on their own, the passage of time, and the US recovery, is enabling them to very slowly drift out of trouble. While they are not out of the woods, they are no longer in the middle of the dark woods. Daylight is showing through the trees.

The Chinese central bank and government continues to take steps to moderate its growth, and limit asset bubbles. This has troubled investors, who worry that China may fail to orchestrate a soft landing. Japan is incredibly showing some signs of having a functional economy. I remain skeptical, however the signs are quite promising.

Note that the Fed has used all of the tools in their toolbox to assist the US economy. This introduced the risk that once the tools had all been used, there is little they could do to further aid the economy if it remained deeply troubled. These past steps, however, provide the Fed with a wide range of approaches to gradually remove the stimulus. While the path forward is not clear, there are many paths which all will serve to permit the economy to function well on its own, while getting the Fed less involved, less manipulative. I view this as a very good situation.

Investment-wise, we remain steadfast in our belief that investors needs to maintain both stock and bond positions. Indeed, bonds offer far less return promise than they have delivered in the past thirty years. Nonetheless, when selected well, they provide greater stability than do stocks, and they therefore deserve their role as the conservative cornerstone of a portfolio.

We also remain firm in our approach of separating bonds into quality and opportunity bonds. We feel that the current situation warrants keeping bond duration shorter than normal, and permitting bond credit quality to be lower than normal. We therefore focus our quality bonds on shorter-term corporate and municipal bonds, and we like high yield and floating rate bonds within our opportunity bonds.

For stocks, we are die-hard contrarians. We believe that the valuation pendulum swings back and forth, and yesterday's losing sectors become tomorrow's leaders. The added advantage is that buying yesterday's losing sectors means that you buy stocks cheap. For this reason, we are currently buying emerging markets stocks and energy stocks, both stock sectors that have done quite poorly so far this month. Similarly, we are lightening up on US stocks, for they have led most stock markets this year, and boosting foreign stocks, which have disappointed in the past several years.

That said, we feel that it is critical that the overall plan trump any short-term tactics. Keep true to your stock/bond balance targets, and to your US/foreign stock balance targets, with only modest variations due to contrarian factors.

Volatile times such as the past two months are the best times to dedicate yourself to regular rebalancing, which inherently forces investors to sell high and buy low. This always feels foolish at the time, but when you look back, you can see the strong benefit. Hang in there!

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