Professional Experience, Unbiased Perspective

Quarterly Newsletter to Prospects Q2 2012

June 29, 2012

"Value investing doesn't always work. The market doesn't always agree with you. Over time, value is roughly the way the market prices stocks, but over the short term, which sometimes can be as long as two or three years, there are periods when it doesn't work. And that is a very good thing. The fact that our value approach doesn't work over periods of time is precisely the reason why it continues to work over the long term."

Seth Klarman, famed Value Investor

Executive Summary

Since our last newsletter, official data has weakened to the point that we believe recession odds are uncomfortably high. While we cannot be certain this will result in a severe correction, odds are high enough to warrant continued muted risk.

- US markets have substantially outperformed major markets in the rest of the world over the past 12 months. In the short term this has hindered our performance, however the opportunity going forward in quality international assets is now even better while US assets remain the highest risk.
- The latest economic data from ECRI still points to slowing or contracting world economic growth. Europe is almost certainly in recession, the US is at stall speed at best, and Asia's growth rate continues to decline.
- We are maintaining our conservative allocation. Our predominant allocation for the Long-Term Portfolio stands at 50% Volatility Control, 50% Long Term Less Volatile, and 0% Long Term More Volatile. Moreover, we are using more conservative investments within Volatility Control.

Stocks Holding Up Best are the Most Overvalued!

Global Returns

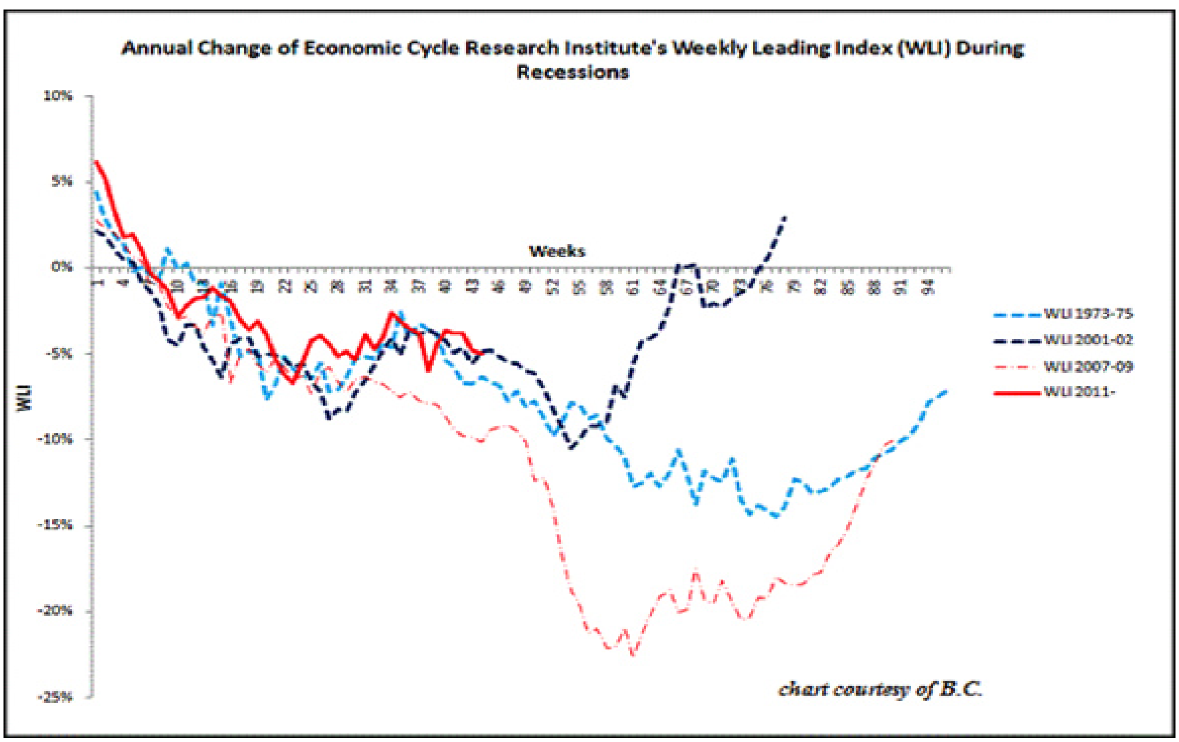
We reallocated clients' accounts to reduce risk in the beginning of the fourth quarter of 2011 immediately after we received confirmation from our research firm, ECRI, that the US, and likely global, economies were on recession track. Since then, nearly all global markets have fallen. Despite substantial overseas exposure, our Long-Term Less Volatile managers have experienced positive returns in the range of 3-11%. Our Volatility Control managers generally experienced low, positive returns as well. Therefore, most client accounts have appreciated but not nearly as much as the one outlier of all global markets, the US stock market. The table (right) lists the trailing 1 year performance for each country's major stock market as well as valuation (CAPE).

Total Ret 1 Yr (Daily) USD	Country	Cyclically Adjusted P/E (CAPE)
-38.9	Spain	5.7
-41.2	Italy	6.2
-26.4	Brazil	11.1
-28.5	France	9.5
-6.8	United Kingdom	11.0
-25.5	Germany	11.7
-12.8	China	14.3
-24.9	India	16.3
8.1	US	22.1

As you can see only the US stock market, specifically the S&P 500, has achieved positive returns on a 1 year basis. Moreover, based on an analysis of these markets prices in relation to their Cyclically Adjusted Earnings (CAPE), the US market is now much more expensive than other markets. The CAPE is the price adjusted for expected earnings over a full economic cycle and is an excellent barometer of long-term opportunity, unlike short term metrics like trailing earnings or expected next years earnings. At CAPE of 5.7 and 6.2, clearly Spain and Italy are the cheapest of the major countries. For comparison, the US stock market recently traded at a CAPE of 22.1,[1] and hasn't traded at this level since 1932, after falling nearly 90% during the Great Depression. The US traded at a CAPE of 5.6 in July of 1932, bouncing to 13 within a year. Similarly, the US CAPE fell to 6.6 in July of 1982, bouncing to over 10 within a year and slowly rising to above 13 in 1986.[2] Therefore, the most likely place to find undervalued companies going forward will be in Europe and Asia, unless the US market faces a serious correction. Moreover, when the inevitable expansion does occur stock prices in the most undervalued countries are likely to rally strongly and decisively.

How the Recession May Play Out

The odds of recession have continued to increase since ECRI first called recession. However, there is no way to know for certain that the National Bureau of Economic Research will call this slowdown a recession, when the recession will begin, or how long and deep it will go. We do know that economic data continues to weaken. The graph below illustrates how one of ECRI's indicators has historically tracked recession and its current path. Should the current path (red) follow according to previous recessions, it looks like the greatest risk is over the next ten weeks or so.



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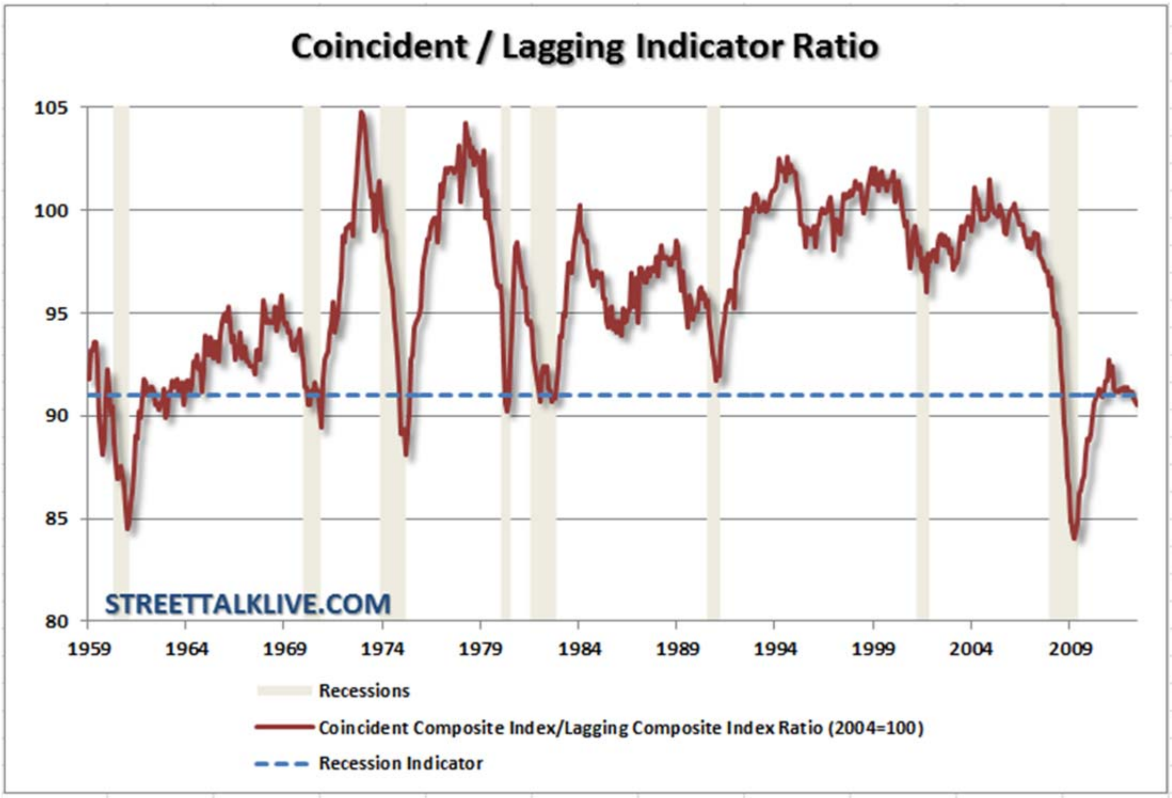
[1] Goldman Sachs Monthly Insight, Jim O'Neill, May, 2012 based on the last 30 years for developed nations and 15 years for BRICs

[2] Shiller Shiller P/E data downloaded from his website: http://www.econ.yale.edu/~shiller/data.htm

The next chart, from data provided by the Conference Board's LEI data, compares data correlated to the present (Coincident) with data correlated to the past (Lagging). Dividing Coincident by Lagging shows the direction and momentum of economic activity. As you can see, this indicator has also fallen to a level that is associated with past recessions. This graph is not sourced from ECRI but is instead another source we check to confirm ECRI.



The problem with defining a recession is that it is never done until well after the recession starts. While we are fairly the economy is sliding further, and our research illustrates that the risk to stock markets is highest during recession, we simply will not know this until well after the fact. Below is an illustration of how the "growing economy" slowly turned into a recession. Note there was no difference in what was actually happening. The "growing" economy turned into a recession through data revisions, i.e. as more data came in a clearer picture was recognized. Following is a chronological progression of GDP as reported by the BEA.

1. April 30, 2008 the BEA reported GDP growth of +0.6%
2. May 29, 2008 the BEA revised GDP growth of +0.9%
3. June 26, 2008 the BEA revised GDP growth of +1.0%
4. July 31, 2008 the BEA revised GDP growth of +0.9%
5. July 31, 2009 the BEA revised GDP contraction of -0.7%
6. July 30, 2010 the BEA revised GDP contraction of -0.7%
7. July 29, 2011 the BEA final revision GDP contraction of -1.8%

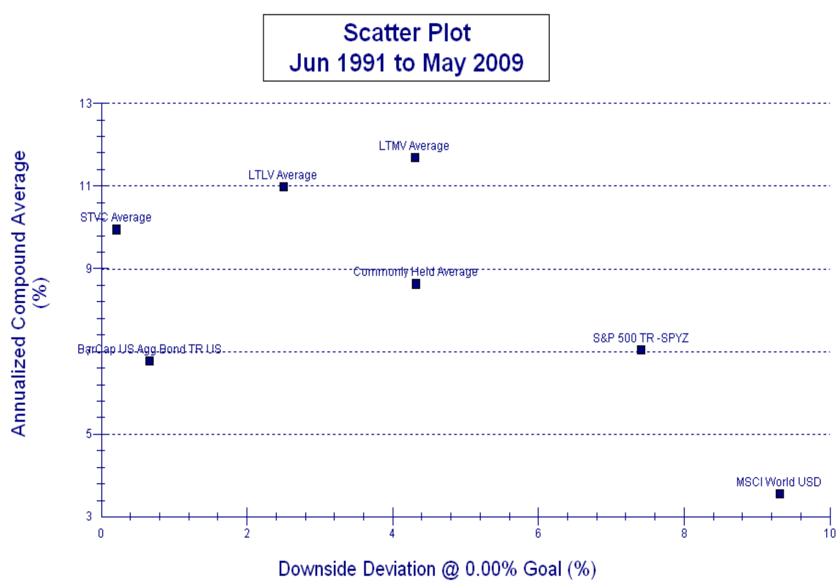
As you can see, a full 16 months had passed before the BEA finally revised Q1 2008 to a negative GDP figure, and 40 months before the BEA measured the full value of the GDP decline.

Recessions become apparent only in hindsight. This is what makes the information so valuable. Remember the Seth Klarma quote: "*…The fact that our value approach doesn't work over periods of time is precisely the reason why it continues to work over the long term."* We feel this is an excellent analogy to the ECRI recession and expansion calls. While they may turn out to have been incorrect, we believe this methodology is an invaluable risk management tool, and ignored by most investors just as the value investing approach is ignored because it does not provide short-term appeal. In summary, it is impossible to be 100% certain that a recession is occurring in real time. The best we can do is to rely on time tested tools and methodology to alert us to the probability that a recession may occur. Our research clearly demonstrates ECRI has the best track in this area. As a prudent risk control measure, we will maintain a more conservative investment allocation until we get a clear expansion call from ECRI. We look forward to that day and will reallocate investments to take advantage of it.

Portfolio Allocation and Risk

We use three types of investments in our Long-Term portfolios: Volatility Control (VC), Long-Term Less Volatile (LTLV) and Long-Term More Volatile (LTMV). Generally only VC investments are used in Retirement Spending Portfolios. All three types of investments are used in Long-Term Portfolios. Conceptually the VC investments are those which should exhibit low volatility with lower returns. LTMV investments are chosen for their ability to deliver higher returns, especially during periods of economic expansion. LTLV investments are those that have historically shown a propensity to deliver high returns with substantially less volatility than the broad market indexes; these may suffer short-term underperformance during periods of irrational exuberance but have historically done especially well over full market cycles.

LTLV investments, on a long-term ongoing basis, generally comprise about 50% of our Risk Tolerant portfolio. VC and LTMV allocations change depending on fundamental economic risk in the economy. During Expansionary periods (following Recessions and Slowdowns), LTMV generally get a 50% allocation. During Recessionary periods (which follow Slowdowns) VC investments typically get a 50% allocation. During Slowdowns a mixture of LTMV and VC investments comprise the remaining 50% allocation.



The chart (right) provides an illustration of the risk-adjusted performance of these types of investments from 1991 to 2009. STVC means VC in this chart.

Concluding Remarks

We are, above all, pragmatists. Our overwhelming priority will always be to avoid permanent loss of capital. We believe we made the right decision to reduce risk. Because we believe we are likely to endure a period of more frequent and shorter economic cycles over coming years, we believe this opportunity will be afforded more frequently and will prove useful over time.

"*Volatility plus low trend equals more recessions*," Lakshman Achuthan.

Past performance is not a guarantee of future results. Any investment advice should be rendered in a one on one environment and customized for the client receiving the advice based on their goals and investment time horizon.