

Quarterly Newsletter to Clients Q4 2011

December 31, 2011

“You cannot manage returns. You cannot make returns happen. All you can do is manage risk and the degree to which you expose your portfolio if things go wrong.”

Peter Bernstein, famed Risk Manager and Author of Against the Gods, the Remarkable Story of Risk

Executive Summary

We believe most of the world is heading into recession, and while US stock prices continue to hold strong, we continue to take low risk in our portfolios until we feel confident the economy is again in expansion mode.

- 2011 was a not a good year for most investors. Many international markets lost more than 20%.
- We reduced risk in Q4 after ECRI called an imminent recession. Our expectation is that market indexes will continue to fall over the next several months. We believe this downturn should be viewed as an opportunity for our clients to minimize coming downside risk in order to take better advantage of the coming expansion.
- Recent market action may cause investors to doubt the legitimacy of ECRI’s recession call, and our subsequent measures to reduce overall portfolio risk. After further due diligence and correspondence, we continue to believe the ECRI process is sound and that downside risk outweighs upside opportunity.
- We are confident we will have ample warning to take risk for the coming economic expansion. Historically, ECRI long leading indicators have typically turned up about a month before stock prices. Short leading indicators, like the Weekly Leading index, have provided confirmation by turning up about the same time as stock prices turn. At the moment, both continue to fall.

2011 – A Bad Year for Global Stocks

Beginning with the economic slowdown that started in May, and exacerbated by the still unresolved debt crisis in Europe, international markets were very volatile in 2011. Major markets ended the year down over 20%.

The S&P 500 was also very volatile, falling 13.9% in Q3, its second worst performance since 1928. While the S&P 500 gained 11.2% in Q4, we feel this is largely due to a faulty understanding of events occurring in the real economy. The US Stock Market, specifically the S&P 500, was the best performing broad market index

we follow in 2011, experiencing a positive return of 2.1% including dividends. Historically major markets tend to follow one another, particularly in this age of globally interconnected economies; therefore it is not a stretch to believe that US markets will see further downside in coming months.

Country	Index	Total Return (USD)
Brazil	Ibovespa	-17.3%
China	Shanghai Composite Index	-20.1%
Hong Kong	Hang Seng Index	-21.3%
Japan	Nikkei	-18.7%
Korea	KOSPL Seoul Composite Index	-12.4%
Australia	All Ordinaries (ASX)	-15.2%
France	CAC 40	-19.0%
Germany	DAX	-15.6%
UK	FTSE 100	-7.5%
Italy	FTSE MIB Index	-26.6%

Many investors believe the market “prices in” recessions. While that is true to an extent, before a recession begins there is always an economic slowdown which may or may not develop into a recession. Research illustrates that bear markets associated with recessions are substantially more risky than non-economic bear markets. Since 1899, the *median* economic bear market resulted in a loss of 37% and lasted 22 months. The median non-economic (or confidence) bear market lasted for 6.5 months and lost only 27%. We believe the current economic slowdown started in April or May of 2011. Since the market peak earlier last year the S&P 500 and World stock markets have been very volatile. Recent volatility (especially the upswing in the fourth quarter) has helped US indexes. However, we feel strongly that risk is far greater than reward until we get an unambiguous signal of economic expansion because our data continues to show that the economy is tipping into recession and that a possible bad economic bear market lies ahead.

It should go without saying that we could be wrong in our interpretation because the future is always uncertain. We welcome dialogue with our clients and other investors so that we can show them the data we see and help them to interpret it.

Portfolio Allocation and Risk

For some period we had expected economic growth to be slow and uneven. Many pundits point to a “new normal” where growth will continue to be slow but positive. However, historically this has never happened. In a market economy, economic growth is either accelerating or decelerating. According to The Economic Cycle Research Institute’s (ECRI) Lakshman Achuthan *“we never muddle through. A market economy does not have static states. It either accelerates or decelerates.”* When economic growth decelerates, the ability of companies to increase earnings at an increasing rate is diminished and stock prices typically suffer. Alternatively when economic growth accelerates, companies increase earnings at an increasing rate and stock prices typically rise. According to ECRI, we are unambiguously in a period where growth is decelerating, *“forward looking indicators are signaling deceleration.”* ECRI called a slowdown in May about when the global bear market began.

Previous similar periods (like the late 1970s) had been opportunities for Margin of Safety investment managers to excel through excellent stock picking given a sufficient time window of 3-5 years. However, our research also shows that during periods of negative economic growth, typically lasting 6-18 months, no strategy works reliably. For this reason, when ECRI called an imminent recession in late September, we began substantially decreasing risk for all portfolios. Specifically, ECRI told professional subscribers we are on recession track in September, and that the recession will likely start in the fourth quarter. In subsequent interviews, Lakshman Achuthan of ECRI stated, *“if there is no recession in Q4 or the first half of 2012, then we’re wrong.”* Remember the National Bureau of Economic Research (NBER) does not typically date recessions until at least a year after they start so the rest of the world may not officially realize we were in recession until late 2013, well after the 2012 elections.

Our work shows that risk substantially outweighs reward during economic recession. The changes we made to portfolios substantially reduced portfolio volatility. All of our portfolios are positioned with substantially less risk than the S&P 500.

- Retirement Spending Portfolio: we are taking low credit and duration risk and expecting lower yield and return over the short term
- Long-Term Portfolio Risk Tolerant: we are taking about 30% of the risk of the broad stock market index until Expansion is called
- Long-Term Portfolio Risk Averse: we are taking about 15% of the risk of the broad stock market index until Expansion is called

Economic Update – Recession Imminent

Before implementing Economic Risk Based Asset Allocation (ERBAA) we went through a rigorous process. First, we examined ECRI calls as they were made without the benefit of hindsight. Second, we developed a theory regarding what happens to stock prices after these calls. Then we tested it to see how it would have worked historically. Finally, we developed a model for reallocating based on changes in the economic growth rate. To reiterate what we have said before, ECRI calls inflection points in the economy based on movements of leading economic indicators. By analyzing hundreds of leading indicators, and with no incentive but to make the right call (unlike other forecasters who may have a bullish or bearish bias), ECRI can call a pick up or a slowdown in economic growth as it is happening. We use the word “call” to describe when ECRI tells its subscribers, and later the general public, that a change in economic growth rate is occurring. We want for our clients to understand this is not be confused with a “call” of when a recession is dated because this is a separate process done by the National Bureau of Economic Research, which again, is generally done about a year after a recession is later found to have started.

We use ECRI’s calls to describe three distinct periods of the economic cycle:

- **Expansions:** periods where economic activity is accelerating. During expansion stock prices would be expected to rise. Expansions follow Slowdowns or Recessions.
- **Slowdowns:** periods where economic activity is slowing but remains positive. During slowdowns the upward momentum is muted, but stocks may rise or fall before the next inflection point. Slowdowns always follow expansions.
- **Recessions:** periods where economic activity is falling below zero, i.e. growth is negative. During recessions, stock prices typically fall before an Expansion ensues. Recessions follow Slowdowns, but not every Slowdown turns into a Recession, some turn into Expansions.

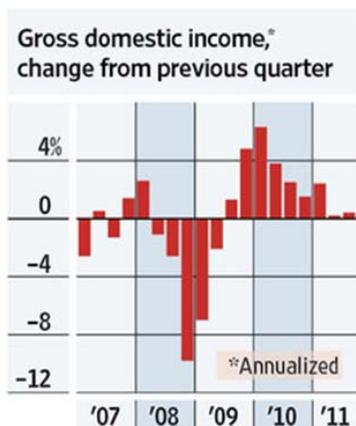
According to our analysis, ECRI has called 19 economic growth inflections since 1994. With only one exception, each of these calls has resulted in price action that would be expected. The call that did not result in expected price action was the Expansion call in late 2001, where stock prices actually fell. This expansion was very short and could be interpreted to have been an error by ECRI. Suppose we consider this to be an error, then so far, ECRI has been “right” 18/19 times, or about 95% of the time.

Few recognize a recession as it actually begins. In fact, when a recession begins, GDP is generally reported to have been positive and is

Recession Start	GDP
November 1948	0.6
July 1953	-2.4
August 1957	3.9
April 1960	-1.9
December 1969	-1.9
November 1973	3.9
January 1980	1.3
July 1981	4.9
July 1990	0.0
March 2001	-1.3
December 2007	2.9

only revised downward much later. For the last 11 recessions since 1948, in the month that these recessions began, GDP was initially reported negative only 4 times (table right).

Moreover, it might be logical to question whether GDP accurately measures what is happening in the



Source: Commerce Department

real economy. Another metric we follow, Real Gross Domestic Income (GDI) shows a much higher likelihood of recession. GDI measures the output of the economy as the costs incurred and the incomes earned in the production of GDP. GDI increased 0.2 percent Q2 and 0.2 percent Q3 2011, a far cry from the GDP numbers reported. For a given quarter, the estimates of GDP and GDI may differ for a variety of reasons, including the incorporation of largely independent source data. However, over longer time spans, the estimates of GDP and GDI tend to follow similar patterns of change. For this reason some economists, such as those at the Minneapolis Federal Reserve, feel GDI is more timely measure of actual economic output.

ERBAA and Coming Expansion

ECRI monitors dozens of leading indexes that provide information regarding the time and likelihood of inflection points in the economy. We are currently on recession track and there is not yet any indication of an upturn of leading indexes on the horizon. Before an expansion, and a cyclical upswing in stock and risk asset prices begins anew, a sequence of events will unfold:

1. Long Leading indicators will turn up. During recession, this typically happens 8 months before the economic expansion and one month before a cyclical upswing in stock prices
2. Short Leading indicators will turn up (confirming the expansion). The Weekly Leading Index growth typically turns up about the same time or a month before stock prices turn up.
3. Finally, the economic growth cycle will turn up and everyone will begin to realize we are in recovery. This will likely be several months later and stocks will have already risen substantially.

Other more obscure ECRI indexes suggest an upturn in stock prices is not likely until at least Spring or Summer of 2012. We are watching these closely and are prepared to increase risk in portfolios when we get a clear signal of a persistent, pervasive, and pronounced change in these indicators.

Perhaps even more importantly, and to underscore the importance of ERBAA, ECRI research implies there will be more frequent and shorter economic cycles in coming years. *“Volatility plus low trend equals more recessions,”* Lakshman Achuthan.

Concluding Remarks

We believe there is downside risk to owning equities. In order for us to capitalize on this view, we reduced risk in all portfolios. This inevitably may cause short-term underperformance during market rallies. Moreover, we would expect for most portfolios to fall in value over the coming months if equity prices do fall. Please understand every decision we make is the process of much labor and is an investment in our relationship with each of our clients. We fully understand we cannot know the future

but can only attempt to maximize the odds of success by making logical choices based on current information that we process. Thank you for your continued patronage. Please contact us if you have any questions or concerns. Happy New Year.

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.