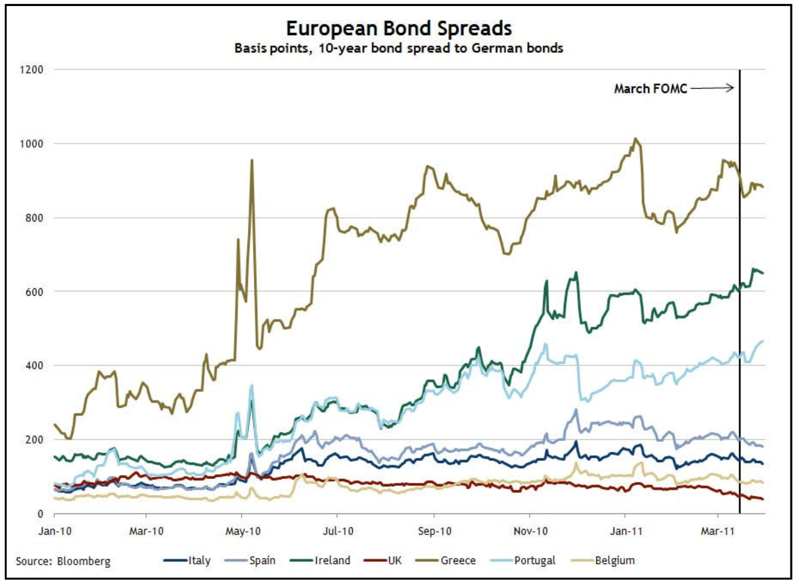
The Long & Short of It

Quarterly Newsletter

First Quarter 2011

The performance of stocks in the first quarter of 2011 was a testament to the ability of the Fed's easy monetary policy to drive up all prices. Despite widespread unrest in the Middle East, resumption of sovereign debt fears in Europe (see accompanying chart), Japan's natural disaster and nuclear crisis, as well as rising food and energy prices, domestic stocks were able to muster a mid-single digit return for the quarter. International stocks generally fared a bit worse, hovering near low single digit returns, while bond returns oscillated between slightly positive and slightly negative. All-in-all, solid results for any quarter, but especially impressive given the frightful news environment. Interestingly, more and more stocks seem to be moving together in large groups as opposed to having their own story to tell. This movement seems mostly based on the degree to which a group of companies stands to benefit from the Fed's current zero percent interest rate policy.



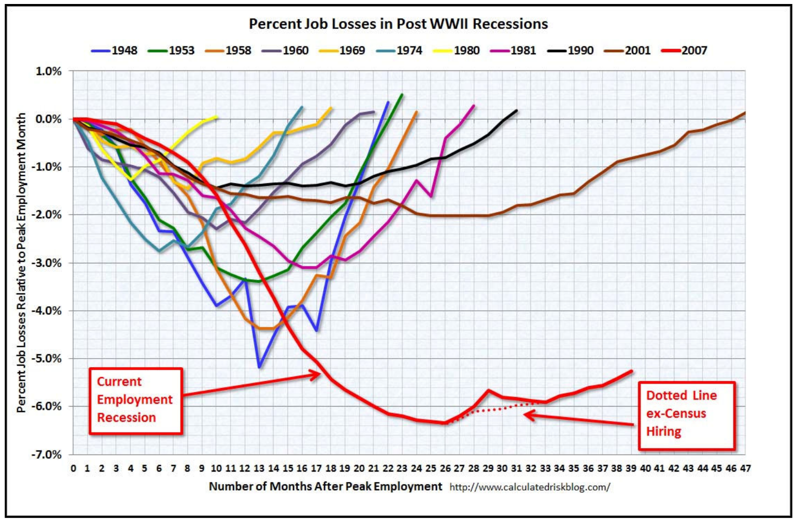
Monetary policy is not the only area where the government's policies and actions have become the primary driver of results. The item currently dominating the news cycle is the prospect of a government shutdown – something few believe would last long or have much impact on the budgeting process due to Washington's ability to corrupt the perspectives of even the well-intended politicians. As pointed out by Thomas Donlan in the March 7, 2011 issue of Barron's, from fiscal 2009 to 2011, discretionary programs grew by about $100 billion while entitlements grew by about $200 billion. With a projected deficit of about $1.5 trillion, he notes that "all our taxes only pay for Social Security, Medicare, Medicaid, veterans programs, federal retirement programs and a few lesser 'mandatory programs.' This year the U.S. is borrowing for all of its regular government programs, all federal and military salaries, all military and civilian procurement, and all the interest on the national debt."

So it appears likely that 2011 will be the first time that the federal government could have cut discretionary spending to zero and still run a deficit just to meet mandatory entitlement programs. Plans for these programs to grow over time are set and can only be changed if Washington were to come together on how and when. In addition, Obamacare will add to these mandatory expenditures significantly over the next ten years. Concerns about Washington's ability to make effective decisions are one factor that affects investors and asset prices, thus economic growth. Concerns also arise from the uncertainty surrounding policy changes that affect flows of funds and investor confidence. With political parties trying to take the country in very different directions, there exists great uncertainty over policy simply because of the dramatic changes and reversals in policies each time one party regains the upper hand. Policy uncertainty drives down asset prices by discouraging investors needed for wealth creation.

George Washington's Farewell Address, delivered in 1796, is an extraordinary composition from an extraordinary man. It can easily be found on the internet and we recommend it to all. The address covers a broad range of topics providing keen and timeless insights. Among many of the topics addressed are admonitions against excessive debt, unpleasant taxes, and the dangers of political parties. Washington suggests that the party system resides outside of the constitutional structures and as a result only *"(s)erve(s) to organize faction(s)…in the place of the delegated will of the nation…to make the public administration the mirror of the ill-concerted and incongruous projects of faction(s)."*

George was right. Policy changes too often drive economic decisions to create a desired result, but not necessarily to increase the industry of the country. For example – corporate capital expenditures can be fully expensed in 2011 instead of depreciating the investments over a period of years. This should bring forward significant amounts of capital spending from 2012 into 2011, stimulating growth this year but leaving a vacuum in 2012. Good for some numbers this year, but hardly a *"consistent and wholesome plan digested by common counsels, and modified by mutual interests."* The bottom line is that the government is too big, too indebted, and, due to parties, way too unpredictable.

From the "Job Losses" chart at right, we see that the job market is beginning to recover. Though it has done so at varying speeds over the last 60 years, the degree of consistency in completing the recovery process provides significant reassurance that employment should continue to improve. We remain skeptically hopeful, focused on the fundamentals and valuations that provide investors with the long-term advantage of reduced risk and winning long-term results.



Speaking of valuations, the *Wall Street Journal* recently stated that small caps are now trading at an average 21 times estimated earnings for the next 12 months, while shares that make up the S&P 500, the most common benchmark for large-cap funds, are trading at 14 times forward earnings. This translates into a nearly 60% premium for small-cap shares, compared with 5% historically. Shares in our model portfolio are even larger and cheaper than the S&P 500, and have stronger balance sheets. The S&P 500's weighted average credit rating from Egan-Jones Ratings Service is about an A-, while our portfolio stands two notches better at A+. Another concern recently reported by the *Wall Street Journal,* which cited the latest *Elliott Wave Theorist* report, is that a "bullish consensus" has also crystallized among a wide range of investors and financial professionals:

> "Individual investors (AAII poll)—*most bullish in six years*
> Newsletter advisors (I.I. poll 20-week average)—*most bullish in seven years*
> Futures traders (trade-futures.com poll)—*most bullish in four years*
> Mutual fund managers (% cash)—*most bullish ever*
> Hedge fund managers (BoAML survey)—*most bullish ever*
> Economists (news-org polls)—*unanimously bullish*
> Top global strategists (three national year-ahead panels)—*unanimously bullish*
> Even most 'bears' on the economy are *bullish* on stocks because of inflation!"

With valuations a bit frothy for the "Risk On" crowd and investors of all stripes feeling good about the market, we are happy to see a few of our portfolio holdings reaching targeted "fair value" levels. It offers the opportunity to lock in some recent gains and redeploy funds into stable names that have been severely out of favor lately. Though it may be a bit choppy over the next few months, attractive individual opportunities abound. For these names, the long-term return prospects look quite promising.

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