Breathe Deeply…

No question, the market action the week of August 8th was the "real deal." The S&P posted its sixth worst day in history (down 6.65%)—capping the worst three-day decline since November 2008. Global markets haven't fared any better; and the rout continued in Asia. Headline-grabbing market declines and volatility can become further self-fulfilling by creating more uncertainty and hand wringing. We hope we can lend some clarity to the current situation and will get a bit more tactical in our advice.

Don't Blame the Debt Debacle

To be clear, the nearly 20% decline in equity markets over the last several weeks has little to do with the debt-ceiling debate (although it was plain ugly to watch). Nor has the decline had anything to do with the rating downgrade of US debt—despite the tedious coverage it's receiving in the media. Rather, the market's correction reflects a recognition that economic growth around the world is slowing. We've had ample evidence long before the punky July manufacturing data kick-started the stock market decline. To investors around the world it appears there are too few (new) policy options and an enormous dearth of political will and leadership to arrest the slowdown. We can only hope political and monetary authorities hear the message the markets are sending us.

This Isn't 2008

Importantly, unlike 2008, there is abundant liquidity in the system and all the elements of the short-term corporate and bank-to-bank credit functions are healthy and operating normally. And many of our largest global companies are sitting on a heap of cash. Our yield curve remains steep (i.e., not reflecting a significant economic slowdown); and a new recession isn't necessarily imminent. On an intermediate basis we think the overall market is more realistically priced for the slow-growth environment we see ahead; and on a very near-term basis we think equity markets are way oversold and the sentiment too negative.

Downgrade Makes No Difference

Most people didn't need a rating agency such as Standard and Poor's to tell them that the growing U.S. debt compared to our GDP posed a challenge to the country's credit worthiness. Naturally, we've fielded many questions about how we view this week's credit rating downgrade of the U.S. to AA+. Our simplest answer is: it makes absolutely no difference at all! The markets know a heck of a lot more about risk and return than all the rating agencies in the world ever will. S&P's open condemnation of the political dysfunction during the debt-ceiling debate as a reason for their downgrade is frankly old news to the market.

Risk of A U.S. Default is Nil

The risk of actual default, i.e. a missed principal or interest payment, by the U.S. is essentially zero. We can print an unending supply of dollars to make our debt payments. But there is a distinction between the credit worthiness of the U.S. and the certainty that it can pay its debts. The more money the U.S. has to print to make payments on its debts, the less every dollar will be worth in terms of what it will be able to buy. (We've suggested for years that inflating our way out of our debt problem would emerge as a true policy option—which is now being espoused in some policy circles). Further debasing our currency will lead to even more negative real returns on bonds. The question remains: how long before buyers of our debt demand a higher return to compensate them for the risk of getting paid back in cheaper dollars?

S&P Does Not Control the Universe

The notion that S&P will be moved to downgrade other sovereigns which will trigger some doomsday, knock-on crisis among European banks strikes us as absolute hogwash! And the notion that bond ratings would have any effect on a country's cost of capital is absolutely ridiculous. For sure, investment policy issues will arise around the need for AAA-rated allocations, but we would counsel our clients not to take action on the basis of this downgrade.

The Hunt for Higher Returns

Since the financial crisis began in 2008, the market for U.S. debt has been driven by investors seeking liquidity and relative safety. Investors have been willing to accept the very low returns–and even negative interest rates on the shortest treasury securities even before the effects of inflation. Liquidity has its place in every portfolio; but our primary mission is to provide our clients with the highest possible real returns that we can find. So we've avoided U.S. securities over the last several years in favor of corporate bonds and stocks.

Well Positioned for a Market Shift

As we mentioned last week, by the end of June we viewed overall market valuations as a potential headwind to higher returns. Over the last quarter, our research consistently concluded that many mid- and small-company stocks were selling at prices that reflected overly optimistic growth expectations. On its way to becoming oversold, the market decline since July peeled away much of the valuation we would ascribe to these growth projections. Rather than invest in companies upon which the market had placed such high hopes, our approach was to primarily own companies with stable profit margins and those that were generating plenty of free cash flow. The so-called "risk trade" into companies whose earnings are driven by commodity prices and/or dependent on the high volumes of an expanding economy started to unravel in the span of a month and reached new lows on Monday.

Our portfolios were well positioned for this market shift as we maintained low exposures to the Financial sector, and had reduced our Energy and Materials positions near the market peak of these sectors in the early spring. In the heat of battle on Monday we moved some money away from a few defensive stocks into several highly-selective stocks in each of these sectors.

So far, this market correction has added about 3% per year to our 5-year Expected Return for the S&P 500—which brings it back almost in line with historical return levels. Today, the balance sheet quality, growth prospects and valuations in our portfolios compare very favorably to the S&P 500. Dividends and share buybacks, among other good things, derive from free cash flows; and our portfolios generate lots of it.

Some Equities Bordering on "Cheap"

Obviously, there's a lot more value in equities today than at the end of July–and many appear downright "cheap" to us. We can find true growth stocks trading near our "no-growth valuations" for them. That is, there is very little expectation of earnings growth priced into the shares, so any real growth these companies produce should provide solid investment returns over the longer-term.

We Take the Long View

Our greatest advantage is to be able to take the longer-view. We are philosophically committed to the idea that company fundamentals drive equity returns over time. And if you look company by company, many businesses are in a much different position than in 2008. There are still companies worth investing in and we are doing so. But perhaps more importantly as your financial advisors, we are here to help each of our clients deal with the psychological whiplash of market volatility.

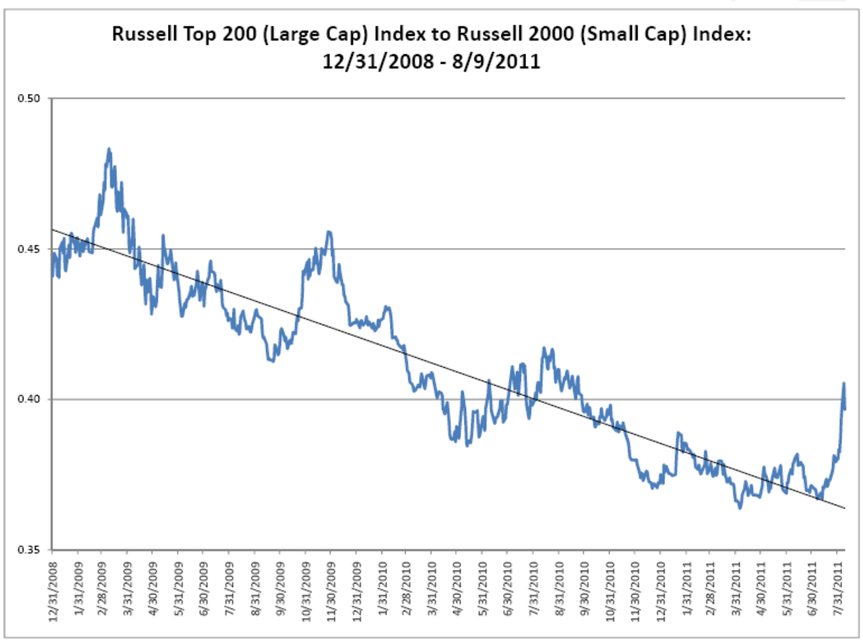
Our longer-term view also helps us distinguish between an economic outlook and an investment outlook. While a slow-growth economy may be upon us for some time, many of the high-quality businesses we own in our portfolios are valued at less than 10 times their earnings. This means that even if these companies don't grow, we can expect a 10% earnings yield on our investment–not bad considering the yield on 10-year treasury is now 2.4%. Indeed, the difference between the 10-year treasury and the earnings yield for the entire S&P 500 (sometimes referred to as the "equity risk premium") is as wide as it has been in a generation. Whether we actually enter into a recession or not, our view is that many stocks now are priced at levels that present excellent potential upside return versus downside risk.

Focus on the Fundamentals

As professional analysts and portfolio managers, we feed off of Wall Street's "short-termism." Stock prices are hugely more volatile than what is actually going on day to day in companies. This volatility gives us the opportunity to ply our trade of really getting the fundamental story right–so we can buy, avoid or sell on our rationale and thoughtful criteria, not market whims.

In Conclusion

We are far better at making asset allocation decisions and picking stocks than we are at timing short-term market moves. In fact, we've yet to meet anyone who's had much long-term success trying to time the markets. So, yes, our equity portfolios have been essentially fully-invested; and they have suffered losses in this most recent debacle. However, on balance our portfolios have fared meaningfully better than most market indexes. Our concentration in large-capitalization, high quality companies is working well for us as we expected it would under these circumstances. We continue to manage our taxable portfolios for return and tax efficiency. We shall continue to be opportunistic in adding positions in companies that we favor but will also be adding in some selective cyclical names (industrials, defense names, etc.) that have been hit particularly hard in this downturn.



It is often said "you can't eat relative performance"—to which we say one ought not to have money they need for food invested in stocks! However, we also would say, to turn a phrase, "a penny not lost in a market downturn is a penny earned in the algorithm of compounded returns over the long-term."

Of course, we will keep you apprised of our thinking as developments unfold; but we encourage you to call me or your Relationship Manager with any questions you might have in the meantime.

To our clients we say, again, thank you for the privilege of serving as your investment counselors.

Sincerely,

Pete

Peter E. Robbins, CFA
Chief Investment Officer

Market Log – 8/10/11

S&P 500: 1120.76
10 year T-Note: 2.114%
Crude Oil: $81.59
Gold: $1,792.10

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