2011 End Of Year Commentary

Thankful For Breakeven Performance

For the year the stock market, as measured by the S&P 500, finished right where it started. Normally, that would not be a reason to cheer. However, consider what has happened in the past year: a massive earthquake in Japan, flooding in many other parts of the world, the US losing its Triple-A credit rating and Europe on the verge of implosion. Oh, and of course we have a variety of bickering from the village idiots in Washington.

Although hindsight is 20/20, ***we are thankful that the financial markets behaved as well as they did*** in 2011.

Furthermore, we were able to see the storm clouds hovering over Europe. As such, by late July we had liquidated virtually all of our foreign and emerging market stock and bond exposure. Not only did this move prove to be timely, it ***preserved a great deal of value for our clients*** as the foreign markets took it on the chin in the second half of the year. The broad foreign stock markets finished the year down more than 11% (and down 25% from their peak).

This has left our portfolios in an unusual, but comfortable position of having ***larger than normal cash equivalent positions***
. Although the interest we are earning from these balances is low, we welcome the flexibility and stability it offers our clients.

In looking back at what worked for us in 2011, it was the simple things that paid off—and allowed us to sleep at night. We continue to ***focus on limiting risk, increasing credit quality and improving cash flow*** . This has resulted in our portfolios having a large and healthy exposure to US based multi-national corporations that sell really boring (but consistent) products.

By focusing on these types of investments our portfolios were much more stable than the overall market, but also delivered far higher cash flow via strong and ever increasing dividends. Many of the stocks we own currently have dividend yields that are **double** the interest offered up by a 10 year US Treasury. For our clients that like to do crazy things like eat and pay the electric bill, this dividend income has been very welcome in such a low interest rate environment.

Interest Rates: We fully expect that ***interest rates will stay low*** throughout all of 2012—if not longer. The Federal Reserve is between a rock and a hard place and has taken the bold move of bluntly stating that they will keep short rates at zero through 2013. This is great news if you are a borrower and very bad news if you need to generate interest income.

Given this low rate stance, the yield on the ten year US Treasury pays a meager 1.9%--the lowest level since 1977.

Unemployment: Luckily for us, Texas continues to be one of the strongest economies in the US. However, on the national level, unemployment (total unemployment)—those who are under-employed, recent college grads, working part-time, those whose unemployment benefits have run out or those who have quit looking for work--is north of 22%. ***Basically one in five adults is struggling to find work***. Full-time employment is at the same level as January 2000, while we have had an 18 million-person increase in the labor force and a 28 million-person increase in the population. Given such a high unemployment rate, it will be very difficult for the economy to make meaningful progress in 2012.

Inflation/Disposable Income: Further compounding matters is the fact that ***true inflation (according to Shadow Stats) experienced by the average individual is running nearly 7%.*** Real disposable income is down over the last 12 months, and savings rates have fallen to about 3.5%. As such, people have very little savings going into next year, disposable income is falling and there is no stimulus scheduled. Even with the extended Social Security tax cut, that isn't a stimulus, it's merely an ongoing program. Additionally, about 35 states raised taxes last year and are scheduled to do so again. As such, the effective tax rate on consumers (factoring in state, local, and federal taxes) is up $260 billion over the last two years. Given this, it will be very difficult to see how consumer spending can sustain itself or get a lift.

Presidential Election: At this point, our guess is that ***Romney will win the Republican nomination***. However, it will be a ***coin toss as to who will win the election in November***. Incumbent presidents do quite well with 14 out of the last 19 presidents having been re-elected. Despite this, the three most recent who did not get re-elected (Bush 41, Carter, Ford) have one thing in common; the economy struggled in their tenure. No matter what tricks the Obama presidency pulls out in the next ten months, the economy will remain weak and unemployment high.

Many believe the market prefers a Republican in the White House. History suggests, however, that there is no relationship between investment returns and the party of the president in the four years of a presidential term.

World Debt Problems: According to studies by the McKinsey Institute as well as Reinhart and Rogoff, the fundamental problem in the U.S. and globally is imbalance from high debt levels. In the U.S., we have $15 trillion in gross domestic product, and $52 trillion in debt--which is 350% of GDP. Since 1998, we have gone from 250% to 350% and the debt was for mainly nonproductive investments. Our unfunded liabilities (Social Security, Medicare and Medicaid) are another 360% of GDP.

When debt-to-GDP ratios are too high, growth rates start to fall. This is occurring now. Through the third quarter, year-over-year growth rates are about 1.5%. Over the past 40 years, each time you have a 1.5% growth rate, it is referred to as "the stall speed".

We are spending about $3.6 trillion while our receipts are about $2.3 trillion-therefore our borrowing is about $1.3 trillion. For every $3 we spend, $2 is from receipts and $1 is from borrowing. We can't continue that pattern for very long.

Once you get into the 100% government-debt-to-GDP ratio range growth rates slow by at least 1%. Since we are only growing at 1.5%, this would take us down to 0.5%--which is ***essentially recessionary conditions***. We estimate 2012 GDP growth will be 0.5% to 1% in real terms, and the core rate will be about zero as we approach mid-year.

Fortunately, the US benefits from pretty good demographics. Additionally, some of the long-term debt issues can be handled with reasonable adjustments to Social Security.

Conversely, ***while the debt problems of the foreign markets have been quiet for the last few weeks, none of us should be under any delusions that these problems have been solved***. Europe has considerable problems and unsustainable debt loads—not to mention very diverse cultures that cannot get along. The foreign markets will continue to be front and center in the news for quite some time. As such, for as much time as we spend scrutinizing the balance sheets of individual companies, we are spending more time evaluating conditions in the foreign markets.

The US Stock Market: US corporate profitability continues to be one of the few bright spots in the world. Corporations are lean, have very little debt and have amassed large cash balances providing them additional flexibility.

Although there have been questions about the growth of U.S. corporate profits, many analysts estimate that ***earnings per share will rise about 7% in 2012***. Additionally, the S&P 500 currently trades at a low price/earnings multiple of 12.5 times this year's expected earnings. As such, ***U.S. stocks look cheap on a historical basis -- especially when compared to U.S. Treasuries.***

Although our clients have benefitted from cash-rich American companies raising their dividends, the S&P 500 dividend-payout ratio is at an all-time low meaning there is still room for growth too. As such, we continue to favor stocks with sustainable and growing dividends.

Furthermore, with healthy profits companies are stepping up their share buybacks, which also helps to lift stock prices.

As we assess our current portfolios and the needs of our clients, we are reasonably comfortable. We own very profitable companies and our average client has lots of cash on hand—to either stabilize rough seas—or to take advantage of opportunities as they present themselves.

Despite being “reasonably comfortable” we know that our clients have a variety of questions and concerns. As such, if you want to review where you stand please don’t hesitate to schedule an appointment to discuss.

Otherwise, we wish you all a healthy and prosperous 2012. Despite all of the problems in the world, there is no place we would rather be.

Sincerely,

Dave Warren

Dave Sather, President Warren Udd

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