October 7, 2011

Fall Quarterly Commentary

"The art of living lies not in eliminating but in growing with troubles."

Bernard M. Baruch, 1870 – 1965
American financier,
stock-market speculator,
statesman and political
consultant

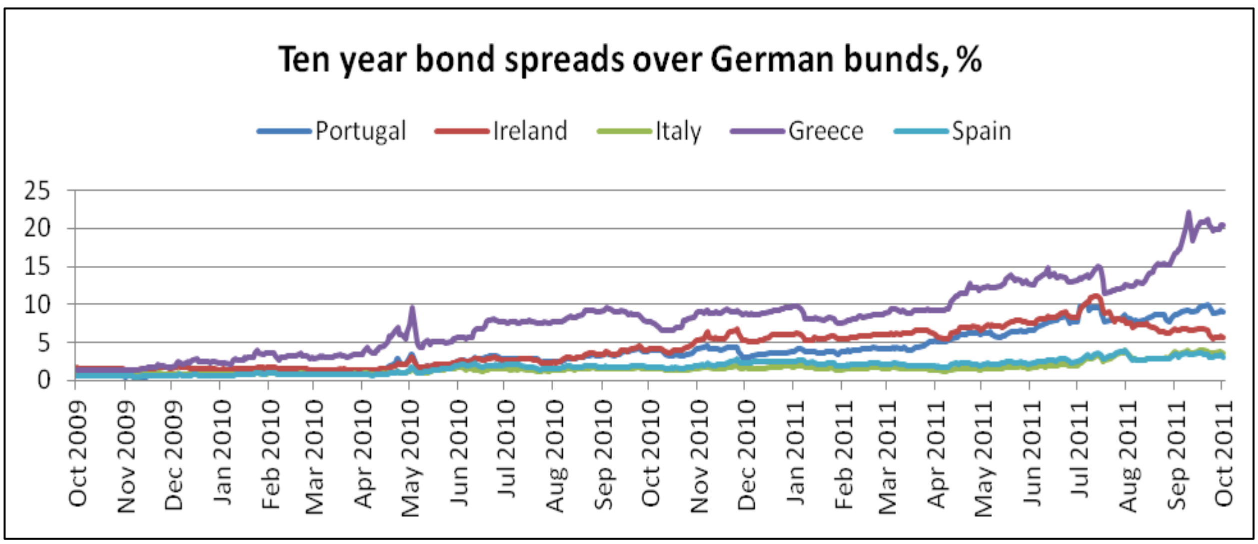
One of the most successful investors of the early 1900's, Bernard Baruch became known by the age of thirty as "The Lone Wolf of Wall Street". He went on to become a respected war-time adviser to Presidents Wilson and Roosevelt. Later in life, the "Park Bench Statesman" was known to weigh in on government affairs from the benches of Central and Lafayette Park.

660 Newport Center Drive | Suite 460 | Newport Beach | California 92660-6405
(949) 644-4444 | Fax (949) 717-5030

Bernard Baruch helped successfully manage US economic mobilization during World War I. If only he were here to advise Congress and European Parliaments in constructively dealing with today's government debt levels, perhaps we could better grow with our current troubles.

Today's investors are left wondering how many times a potential Greek default must be discounted. Current market volatility indicates no shortage of crises, and fears of domino effects emanating from a Euro meltdown hold the markets in their grip. 40% of August and September trading days saw the S&P 500 index move more than 2%. The Lehman experience from 2008 is still very fresh in investors' psyche.

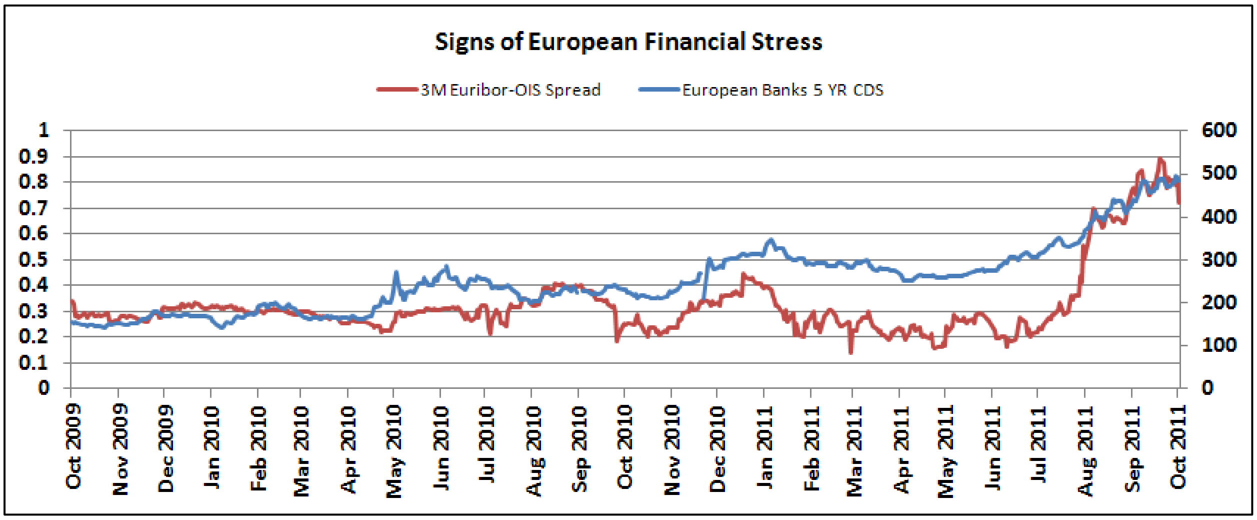
Greek ten-year bonds yield about 25% per annum at present, implying that default is imminent. PIIGS (Portugal, Ireland, Italy, Greece and Spain) bond yields are broadly rising, despite European Central Bank buying. The chart below shows bond yields relative to the perceived safety of Germany's bond market, which itself is being priced as increasingly risky.



*Source: Bloomberg Finance, LP

Why do we care about Greece? A default within the Euro context carries with it contaminating effects. European banks hold Greek sovereign debt, worth at best fifty cents on the dollar, but held at par on their books. If Greece defaults, these banks may be insolvent. And as we have seen, governments are often forced to assume the losses of their banks.

Ratification of the European Financial Stability Facility (EFSF) expansion will provide roughly 350 billion additional Euros to go with 150 billion Euros still currently available through the International Monetary Fund (IMF). Are 500 billion more Euros enough to extinguish the European debt threat? While this is potentially sufficient fire power to deal with debt issued by Greece, perhaps Ireland and even Portugal, debt levels found in Italy and Spain, which permeate French and German bank holdings, are several orders of magnitude more daunting. French and German banks alone sport a combined 600 billion Euro exposure to Spanish and Italian public and private debt issuers. Thus the talk of 'levering' the EFSF... fighting a debt problem with... leverage.



*Source: Bloomberg Finance, LP

The chart above indicates the deteriorating health of the European banking system. The red line represents the rate European banks demand when lending to each other, above and beyond the 'riskless rate'. The recent spike is a measure of distrust and reluctance of European banks to lend to each other. The blue line shows the increasing cost of insuring against default by Europe's major banks over the next five years, as priced by the 'CDS' (Credit Default Swap) market. Markets distrust European governments as well as banks; it is cheaper to insure against government debt default by Mexico or Columbia as compared to France, Italy or Spain.

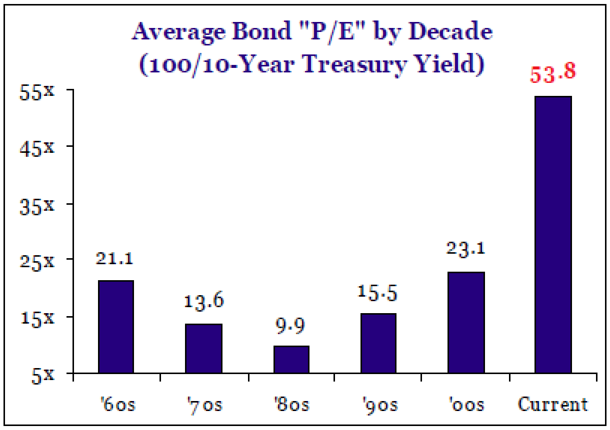
Successful resolution of the European debt crisis will require a recapitalization of European banks and carries unknown contagion

potential from larger economies such as Italy and Spain. Such multiple nation write downs have the potential of triggering aggregate bank recapitalizations of which adequate funds may or may not be available. Whether Germany, the strongest Euro participant, accounting for 30% of all Euro activity, has the willpower and ability to subsidize its weaker peripheral sister states is still an open question.

The European situation is made difficult by the absence of an entity able to take assertive action without first seeking approval of seventeen disparate political bodies. The European Central Bank would appear the logical candidate to 'do whatever it takes' to prevent systemic collapse, except for the small matter of its charter containing no such provision. Hence the creation and pending expansion of the EFSF.

How much pain must investors and the world economy experience before policy makers resort to measures producing the 'shock and awe' that might put Europe on firm footing? Recall that US law-makers initially rejected TARP until the Dow experienced its largest single-day point loss ever. While there has been talk of a TARP-like creation as the solution, a-la post Lehman 2008, there may well be much devil in the detail before we see such a creation. Germany, a necessary ingredient, has firmly resisted this course for fear of credit downgrade and being too much on the hook for loss, calling the notion of expanding the EFSF 'a lot of nonsense' and 'stupid'. In fact, in its recent ratification of EFSF expansion, Germany specifically claimed veto right over any future bail-outs. Now on the verge of recession with its stock market in bear market territory, Germany may yet capitulate despite recent words to the contrary. Stay tuned.

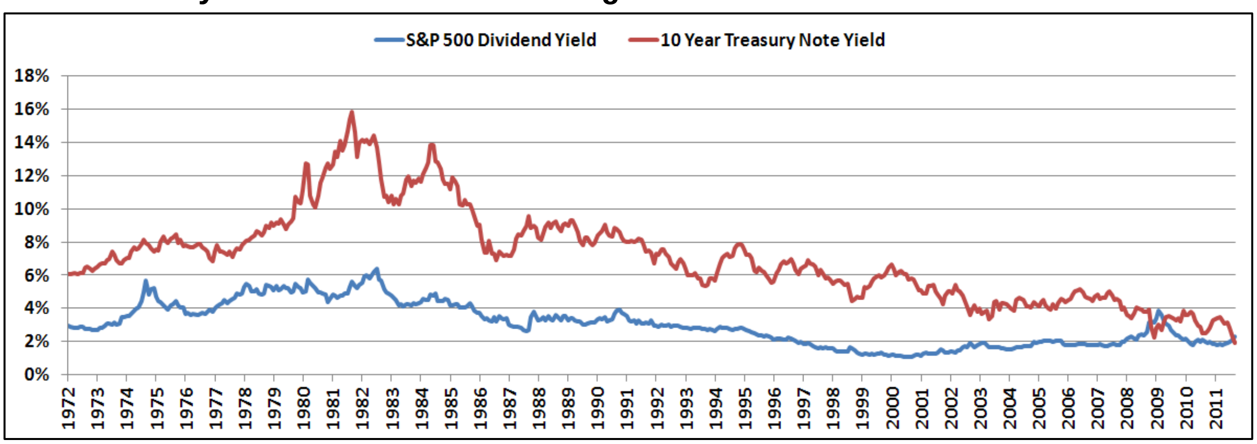
In the meantime, we are left with depressed equity valuation in the US and Europe. Stocks are not supposed to be this 'cheap' in the face of interest rates and inflation this low. In fact, stocks have tended to trade at more like 20 times earnings in the context of today's 2% inflation and 2% ten year Treasury yields, roughly 50% higher than today's valuation. Alan Greenspan's 'Fed Model', which compares forward earnings yield (inverse of P/E) to 10 year Treasury yields, suggests US stocks are the most compelling vs. Treasuries in over fifty years.



*Source: Strategas Research Partners, LLC

Despite such apparent relative valuation disparity, last quarter certainly favored Treasury Bonds; their 23.8% gain represents the best 'on record' according to Ibboston data that goes back to 1925. Meanwhile, the S&P 500 Index declined over 14% last quarter, only the tenth time since World War II a quarterly loss exceeded such a threshold. In each of the prior nine cases, stocks were higher six months later, delivering a median gain of ten percent.

Over the longer-term it would appear US equities, at roughly 13 times trailing earnings, are compelling relative to 10 year US Treasury bonds currently yielding below 2%, which could be considered to be trading at a bond 'P/E' of over 50 (see above chart). Of course, Treasuries will not lose principal if held to maturity... or has that changed?



*Source: Bloomberg Finance, LP

Incredibly, at least relative to modern market history, the S&P 500 dividend yield is peeking above 10 year Treasury yields, a phenomenon not seen in decades with the exception of 2008-09.

What's going on such that stocks are priced at surface to offer superior cash yield to Treasuries? Partly it's the Fed's suppression of increasingly longer-term rates. Further, there has been a flight to US Treasuries, still perceived as a safe-haven even after a credit rating downgrade. Current problems in

Europe are extremely serious and in addition, the work-off of the 2008 financial crisis has clearly demonstrated long-lasting and far-reaching implications. At the same time, economic data in the US and Europe continues to recede to dangerous recession-tipping levels. Partly it's the threat of broad deflation as indicated by most of the developed world experiencing record-setting low interest rates. However, there is more.

The stock market is a discounting mechanism. Just as high inflation reduced stock market valuation during the 1970s into the early 1980s, equities are now discounting uncertainties around government policy. Stocks must gauge whether policy-makers can find the way forward. Looming public debt levels, the debt ceiling debacle and Chairman Bernanke suggesting a baton-toss to fiscal support at a time of political push toward austerity have not instilled confidence. Equity markets can only withstand so many threats. A debt day of reckoning along with economic weakness has proven too much. We have a crisis of confidence which likely must be resolved in order for stocks to make meaningful headway.

We thus invest with caution, maintaining relatively high cash and gold-related exposure.

A potential source of risk relates to corporate earnings. Consensus earnings expectations currently call for growth in S&P 500 operating earnings above 10% in each of 2011, 2012 and 2013. These estimates may need to be reduced. Should we experience a recession, earnings will undoubtedly decline.

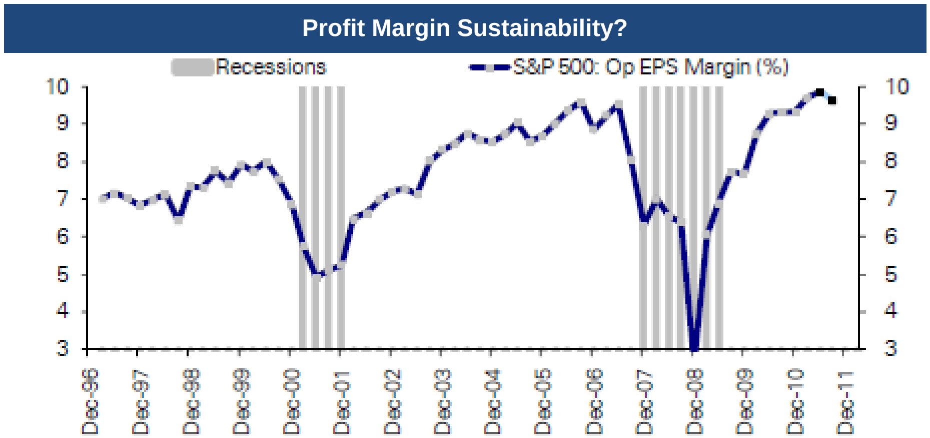
S&P 500 Earnings During Recessions

RECESSIONS	EPS CONTRACTION	TROUGH TRAILING P/E
DEC-69/NOV-70	-12.9%	13.58
NOV-73/MAR-75	-15.6%	7.74
JAN-80/JUL-80	-4.5%	7.00
JUL-81/NOV-82	-18.0%	7.13
JUL-90/MAR-91	-24.4%	13.94
MAR 01/NOV 01	-31.6%	17.56
DEC-07/JUN-09	-56.7%	10.91
AVERAGE	-23.4%	11.12
AVERAGE EX. GREAT RECESSION	-17.8%	11.16

*ADJUSTED BY ADDING BACK THE CORRESPONDING 10 YEAR TREASURY YIELD TO THE TRAILING TROUGH P/E

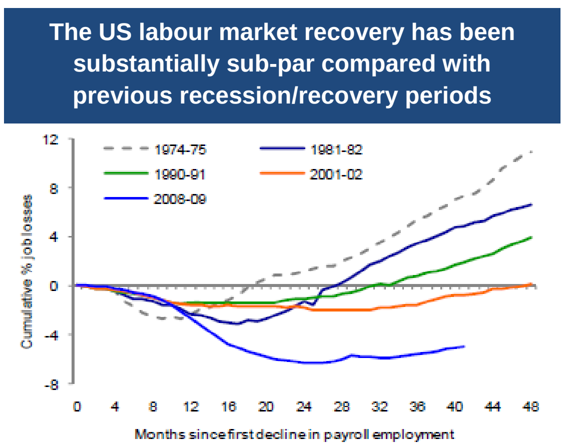
*Source: BCA Research 2011

Margins represent a prime threat to earnings. Should a recession materialize, margins will be compressed, as the chart below shows historically has been the case. With margins at fifteen year highs, they have plenty of room to fall.

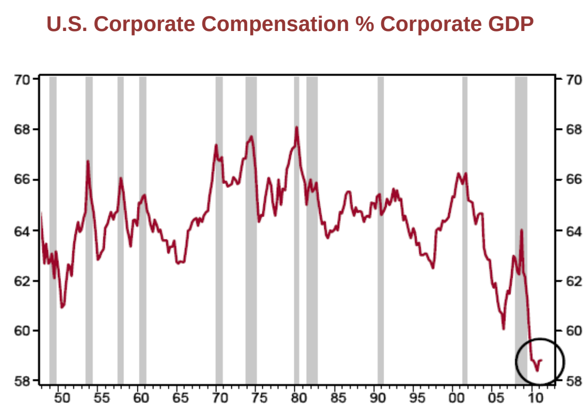


*Source: Bloomberg Finance, LP, Deutsche Bank

These historically high margins may also be under assault in an environment of economic expansion, as labor markets recover and wage pressures build.



*Source: Deutsche Bank, Bloomberg Finance, LP

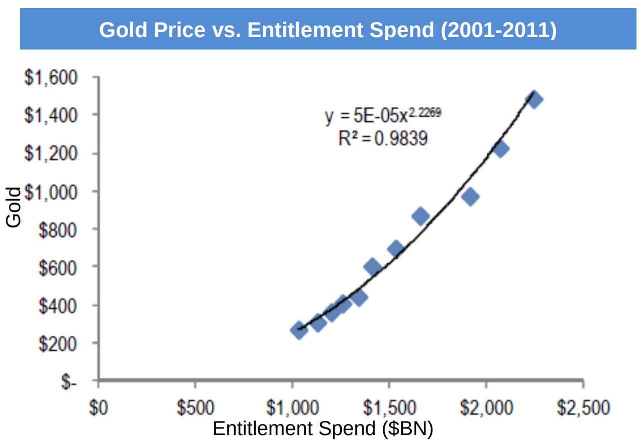


*Source: Haver Analytics

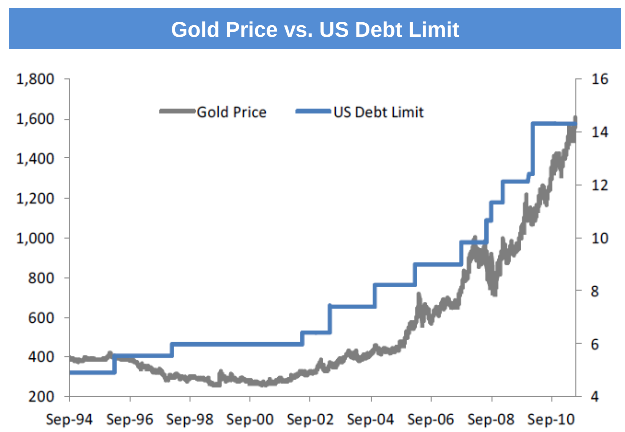
US equities are on the edge of bear market classification, down nearly 20% from their late April high. Bear markets have a way of unleashing much of their brunt such that investors are often drawn to action potentially near the terminal phase. We are about one month away from the length of the average non-recessionary bear market. Bear markets accompanied by recessions tend to be meaningfully longer but have not produced meaningfully greater declines.

It remains unclear what variety bear market we could be in for. However, confidence levels have already reached incredibly depressed levels. Confidence will return, as it inevitably must. When it does, equities will trade higher.

Gold prices are a reflection of the current lack of confidence in the investment environment and government policies. The rise of gold has closely tracked government debt and entitlement spending over the last ten years.

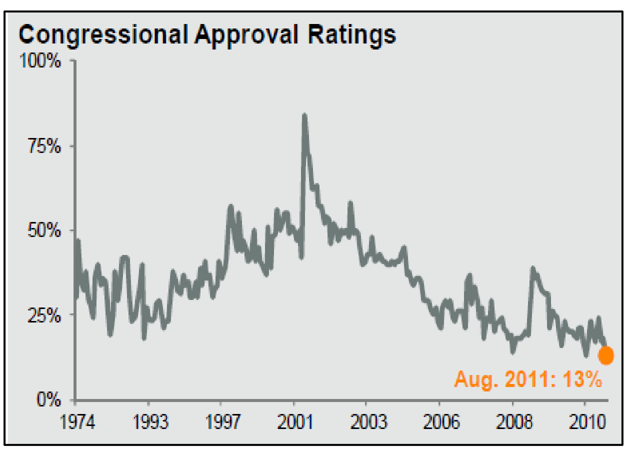


*Source: JP Morgan Commodities Research



*Source: JP Morgan Commodities Research

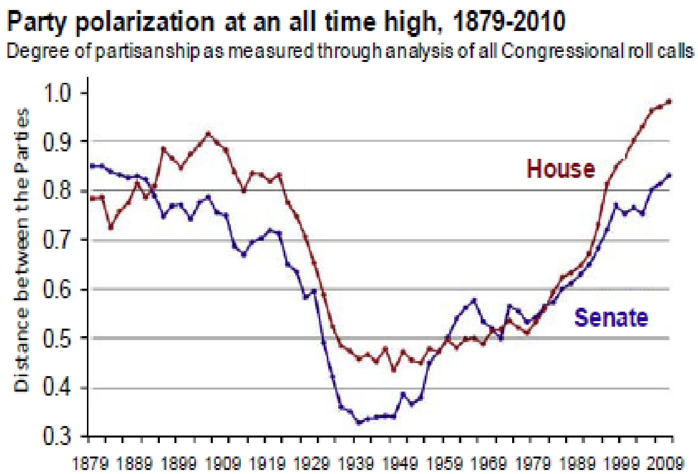
A recent Gallop Poll showed 1/3 of those asked believe gold is the 'best long term investment', exceeding the prospects of any other investment, with stocks selected by a distant 17% of respondents. Given the continued overhang of uncertain government policies and elevated debt levels, we would expect in this case the crowd may be right... for awhile at least.



*Source: Gallup, Inc., JP Morgan

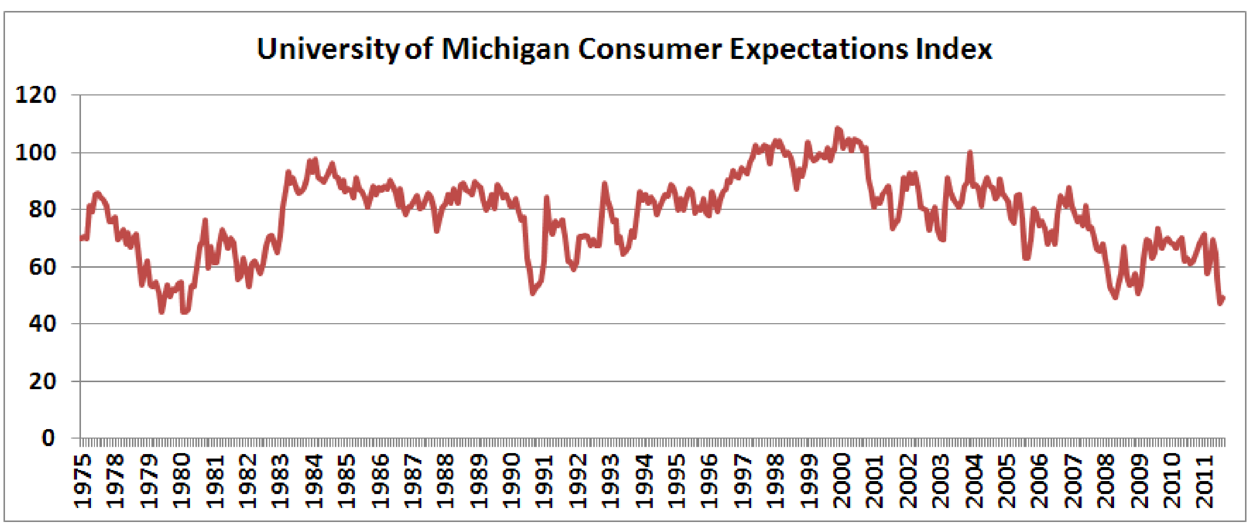
Confidence in political leaders remains severely depressed, with recent lows in Presidential as well as Congressional approval ratings.

In fact, political party differences run extreme, apparently even more so than during the Civil War... at least as indicated by the Congressional voting records, shown on the next page. This political polarization and uncertainly in the face of daunting government debt trajectories has undoubtedly further depressed confidence.



*Source: Keith T. Poole, University of California – San Diego, January 2011

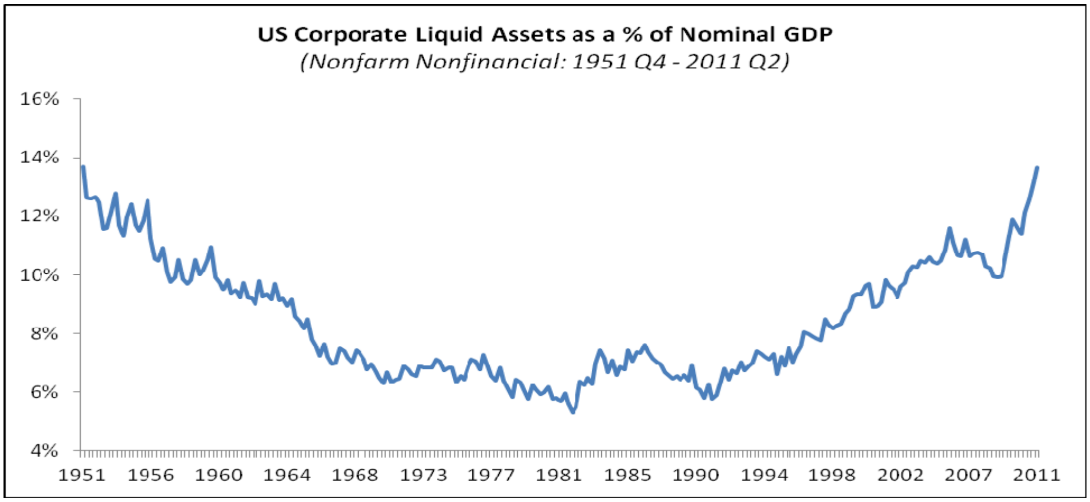
Consumer expectations are also running at multi-decade lows (shown here) as are consumer confidence readings. This bodes well as a contrarian indicator, as stocks tend to perform inversely to consumer sentiment. Such readings are at levels seen only in 1974, 1980-1982, 1991-92 and 2008-09; strong equity returns followed each period.



*Source: Bloomberg Finance, LP

Due to daunting conditions, equities have already suffered much. In fact, investor sentiment, as surveyed by Investors Intelligence in early October, registered 45% of investment newsletters bearish, a level last seen at the March 2009 bear market bottom.

Not all is bleak. Companies are positioned strongly with $2 trillion of corporate balance sheet cash and aforementioned depressed equity valuation leaves plenty of room for upside. And all is set against a backdrop of extremely depressed sentiment, shown by experience to be a good contrary indicator.



*Source: Federal Reserve

Bull markets are born out of periods of difficulty and pessimism. One of Bernard Baruch's ten rules of investing stipulated, "Don't try to buy at the bottom and sell at the top – this can't be done... except by liars." While we don't pretend to know exactly when the next bull market is coming, we do know it will come.

We thank you for your patience and understanding.

Very truly yours,

John G. Prichard, CFA **Alan T. Beimfohr**

Past performance is not indicative of future results. The above information is based on internal research derived from various sources and does not purport to be a statement of all material facts relating to the information and markets mentioned. It should not be construed that the information in this commentary is a recommendation to purchase or sell any securities. Opinions expressed herein are subject to change without notice.