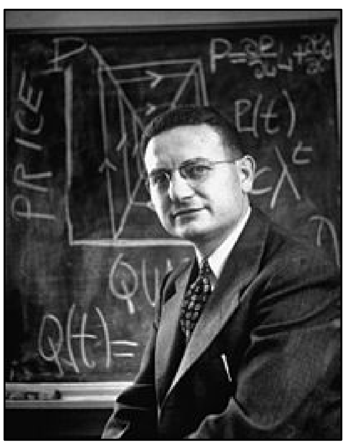
January 27, 2012

Winter Quarterly Commentary



"When events change, I change my mind. What do you do?"

Paul A. Samuelson, PhD, 1915-2009 (though often attributed to John Maynard Keynes)

Professor, Massachusetts Institute of Technology
Author, Economics: An Introductory Analysis
Advisor to Presidents and Treasury Departments
Nobel Prize winner, Economic Sciences

While appearing as a guest on 'Meet the Press' in 1970, Dr. Samuelson provided this simple but profound explanation as to why he was a serial reviser of his seminal, perennially best-selling economic text book (four million copies sold; nineteen editions; forty languages). We studied under this text and invest with his encouragement to face an ever-changing environment never far from our minds.

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Many associate the above quote with legendary economist, John Maynard Keynes. While Keynes' biographer did not find evidence of such origin, Keynes is said to have offered this riposte to his interlocutors during a government hearing. Given his combative nature, we would expect such a response. More recently, Republican Presidential candidate, Mitt Romney, reached for this same retort during a New Hampshire Town Hall meeting in refuting 'flip flopping' allegations, wrongfully attributing the quote to Winston Churchill.

Whatever the origin of our referenced quote, pliable mindsets abounded last year. Investors took to an extreme, throwing fundamentals out the window while vacillating between 'risk on' and 'risk off' positions with seemingly every political press conference. When all was said and done, the S&P 500 Index delivered the smallest annual price change since 1970 in ending the year where it began, belying one of the most perilous years we can recall. After an early-year rise, U.S. equities dropped for five straight months, tripping into bear market territory according to some classic measures (i.e. down 20%) only to immediately reverse into a now 20% recovery (unfortunately, a 20% decline and a 20% recovery does not a whole investor make). Equity market moves, dominated by the 'macro' over the 'micro', ultimately erased $6.3 trillion in global equity value for the year.

During 2011 we attempted to balance our expectation that the U.S. economy and earnings would be supportive against the threat of unsustainable developed world public sector debt levels. We wrongly, at least during last year, relied upon gold mining for protective measure. We were correct in assuming that gold would appreciate in an environment of fear. But we were incorrect in assuming that mining stocks would follow the yellow metal skyward in accordance with a relationship that had existed for decades. The fact that multiple respected sources are calling gold mining stocks the most severely undervalued they have been in decades is likely of little consolation until such predicted price appreciation actually materializes. We believe ultimately the relationship between gold and mining stocks hasn't fundamentally changed and will eventually be restored. The forces behind rising gold prices are intact and are likely to remain so for an extended period given inevitable temptation to erode the value of currency via the printing press when facing debt. The greatest incentive to own gold, namely inflation, has yet to rear its head in earnest.

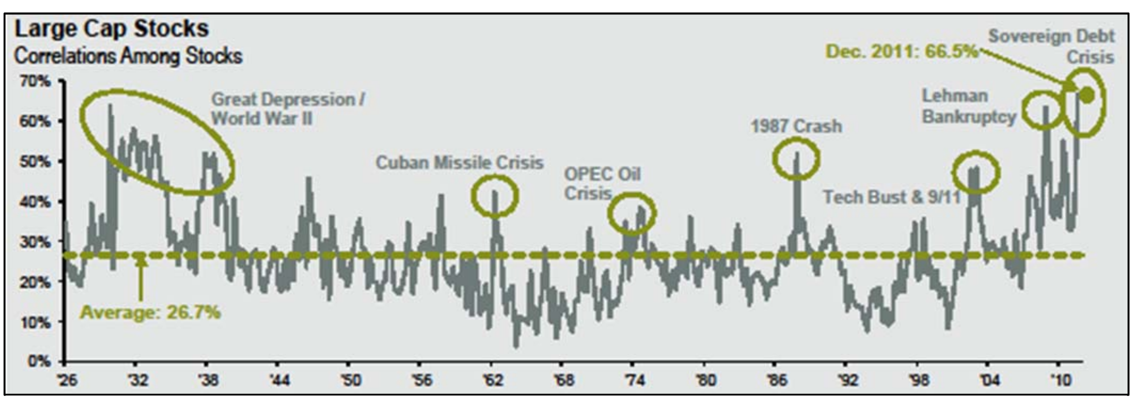
In some areas we did find it necessary to reverse course, seeking to bend but not break. In recognition of increasing European sovereign debt funding issues and banking related stress, we moved into more

cash during August. During October and November, following substantial decline in global equities that produced heavy investor pessimism and as European policy makers began to demonstrate more resolve, we began to reverse investment course, putting cash to work. It was a year for the nimble that wasn't for us or the 77% of active equity managers that underperformed the year through November according to Merrill Lynch/Bank of America.

We delivered poor results as the market favored 'blue chip' stocks paying large dividends (the highest yielding third of the S&P 500 Index outperformed the lowest yielding third by roughly fourteen percent during 2011). In contrast, internet IPOs failed to excite, dropping on average 18% from 2011 issuance through year end. Leading performance came from classically defensive sectors such as consumer staples and utilities, where we had insufficient representation. These two in-favor sectors that we do not own trade at comparatively rich valuations versus the S&P 500 Index, at over 14 times expected 2012 earnings vs. 12 times for the Index. Such drastic appreciation causes us to question how defensive these sectors are at this point. We prefer exposure to out of favor areas such as energy, which trades at just over 10 times expected earnings.

Regardless, our performance disappointed both you and us and we look forward to delivering results more consistent with our longer term record. We intend to stick to our principles in some areas but in response to changing facts on the ground, we have changed our attitude, believing dividend yield will continue to play an enhanced role in investor preference. We intend to purchase dividend paying potential cheaply by searching for companies with potential to initiate and/or increase dividend payments, as opposed to paying full price for already high yielding in-favor stocks.

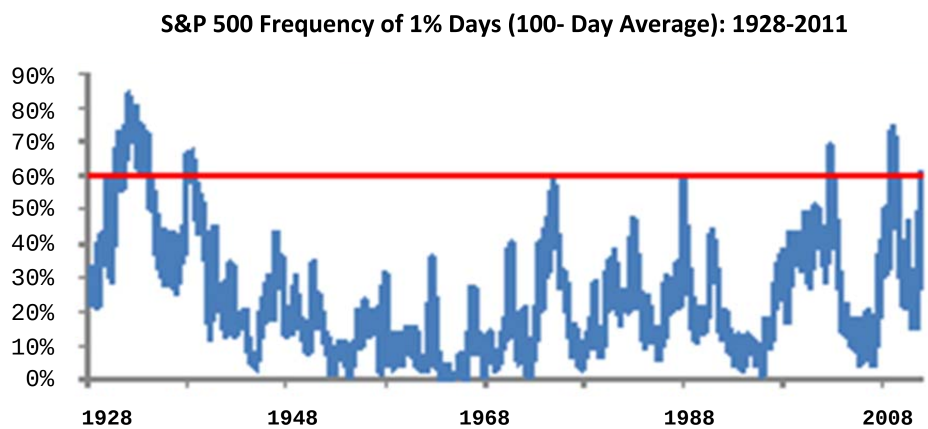
Despite the S&P 500 Index's remarkably bland end result, the year was extraordinary by other measures. Stock correlations (the collective movement of all prices in the same direction with proportional



Source: J.P Morgan

magnitude) reached levels not seen since the crash of 1929, even exceeding the crash of 1987 and Lehman bankruptcy era.

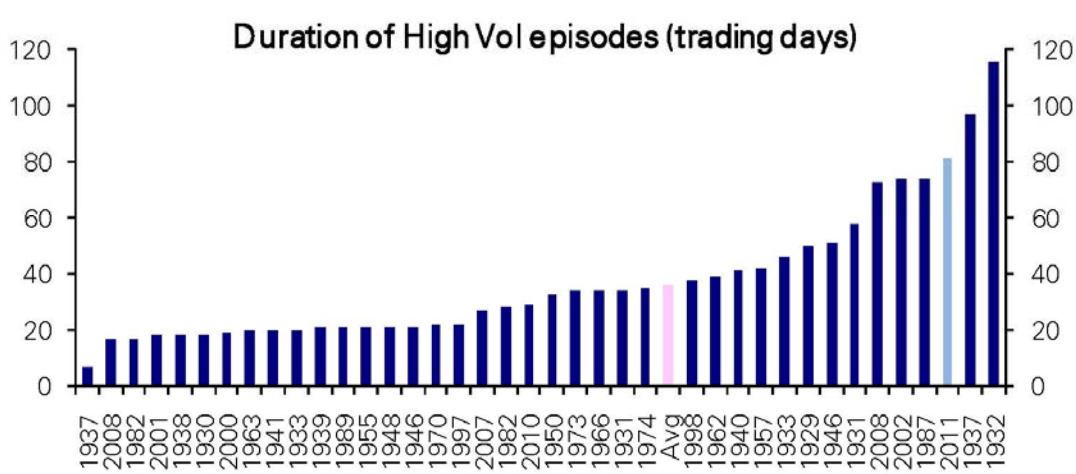
More on correlation later. Volatility was also extreme last year, with the CBOE S&P 500 Volatility Index (VIX) giving its highest readings of the last decade outside the 2008 implosion period. A staggering 60% of trading days from August through December saw moves of 1% or more, compared to 21% of all days since 1900. Amazingly, the full year produced exactly the same number of up 1% and down 1% days, 48 each.



Source: Bespoke Investment Group, LLC

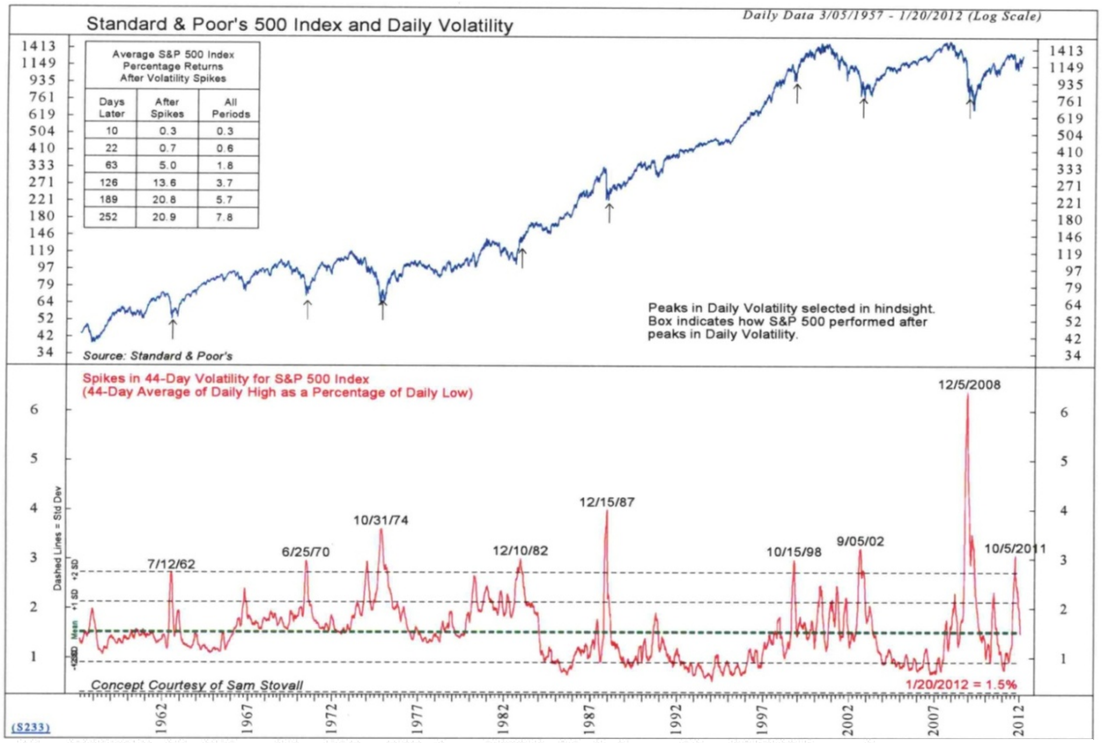
The Dow Jones Industrial Average (DJIA) experienced 12 separate declines of 5% or more during 2011, this has only happened in three other years since the 1930s.

It wasn't just the high level of equity volatility but also the duration that was exceptional. Using Deutsche Bank's definition of 'high volatility episodes', last year's 80-day tantrum exceeded the duration of any other episode since the 1930s.



Source: Deutsche Bank

On the plus side, perhaps because it can be so upsetting, forward equity returns have tended to be high from points of elevated volatility.



Murray Stahl, insightful co-founder of Horizon Research Group, recently described the difficulties stock pickers have faced due to the extreme levels of correlation and volatility.

"In the last four or five years, the active managers have suffered mightily. Virtually all of those managers with excellent historical reputations have had their reputations undone in the past four or five years. The reason is that the securities they bought have behaved in ways completely different from historical trends and from the ways that the analysts predicted. The likely cause is not that the best managers all of a sudden became poor managers; it's that no active manager can stand against a multitrillion-dollar wave of dysfunctional behavior. When that wave has exhausted itself, the fundamental of the companies might once again be paramount."

Most recently, investors have turned 'risk on', with recent U.S. economic data improving and bond yields receding in Italy and Spain. The European Central Bank in providing unlimited three year refinancing to banks, has provided a lifeline of liquidity which helps

take systemic collapse off the table at least for now. However, European sovereign and banking system solvency remain in question.

In <u>The Sun Also Rises</u>, Hemingway observantly wrote:

> **“How did you go bankrupt?”**
> **“Two ways, gradually and then suddenly.”**

Europe's governments have been gradually going bankrupt for years by continually spending more on services than they take in as revenue. Only recently have they started to suddenly go bankrupt when rates spiked and, almost overnight, servicing the debt burden became a huge, unsustainable part of the national budget. Through a number of actions, European crisis firefighters have gotten government funding rates to come down somewhat, such that most of Europe's democracies are no longer going bankrupt suddenly.

What has been done about the gradual path towards bankruptcy? Essentially the governments got together late last year and made a promise to each other not to run big deficits, and agreed that such promises would be enforced by sanctions. Unfortunately such promises were already made in the original Maastricht treaty when the Euro was formed, and the sanctions were never enforced. But investors needn't worry, according to the authorities, because the governments really mean it this time. Would this assertion calm your concerns? The bottom line is, don't expect the crisis to be truly over until governments stop going bankrupt gradually by actually running surpluses. For those countries deepest in debt, a decision that they’re not actually going to pay their bills (default) is probably a pre-requisite for surpluses. Until then, the gradual bankruptcy process will surely generate more sudden crises, despite any temporary solutions. There is a lesson here for U.S. policy makers: the lack of sudden debt crises in no way indicates that all is well.

Let us consider the ‘voluntary’ Greek debt restructuring terms currently unfolding at the time of this writing. The proposed deal includes principal reduction, maturity extension and lower coupons that effectively leave bond holders receiving something like 30 cents or so on the dollar in fully discounted terms. Thus, after receiving a second bailout and the wiping away of one hundred billion Euros or so of debt, the authorities make some optimistic assumptions about the economy going forward and conclude Greece will be on its way to debt levels at ‘only’ 120% of GDP... by the year 2020! Historically, debt at 120% of GDP has been a crisis level far beyond what is manageable for most countries, and Greece has already fallen well short of scheduled reforms, calling those official optimistic assumptions into

question. Simply put, current plans to deal with Greek insolvency are not credible. We consider it very possible that at this moment Greek officials are actively planning an exit from the Euro.

Let's focus for a moment on an aspect of this situation that has received insufficient attention in the news. The proposed restructuring for private creditors of Greece has been called 'voluntary'. Who voluntarily takes 30 cents on the dollar? This usage of the term brings to mind 'voluntary' admissions of guilt by prisoners of totalitarian regimes. 'Coerced' seems more appropriate. Why the emphasis on 'voluntary'? The government authorities involved have insisted that any deal be deemed 'voluntary' to avoid triggering credit default swaps (CDS) written on Greek debt. These CDS could accurately be called insurance contracts that are supposed to pay out if the Greek government defaults or changes the terms of its debt. The International Swaps and Derivatives Association (ISDA), the entity who decides these things, has more or less already said that they won't consider the current principal reduction being discussed a default. To summarize, they won't consider the default a default.

Why are the governments insisting on (and why would ISDA allow) this obvious perversion of the truth? They have quietly indicated they're scared of what might happen should these insurance contracts be triggered... scared of what might happen should these contracts do what they were designed to do.

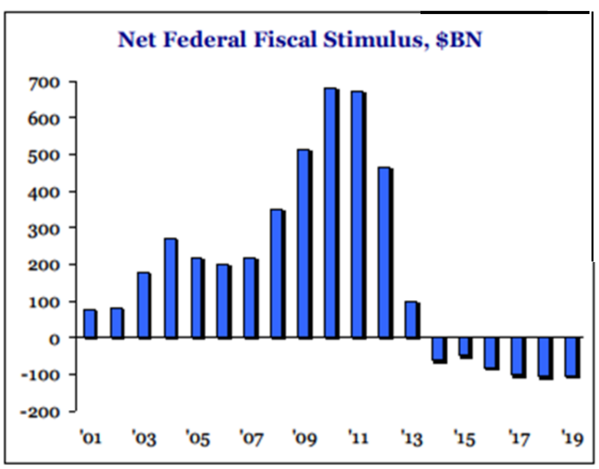
Stop to consider the absurdity and the implications.

It would be as if you had bought fire insurance on a building, say a local mall. Then, when half the building burned down, the state insurance regulator told you that you were not going to be paid, because the mall's owners had 'let' half the building burn on purpose, and therefore it wasn't really a fire and so you aren't going to be paid. Of course, this imagined scenario could never really occur because you aren't allowed to buy fire insurance on buildings you don't actually own, as the temptation for arson would be far too great. Unfortunately, we've been far more cavalier about protecting our financial system. This analogy begs the question: might some of the hedge funds that own these Greek CDS contracts be tempted to 'burn down' the Greek government's 'voluntary haircut' by refusing to agree, thereby forcing ISDA to let them collect? Stay tuned.

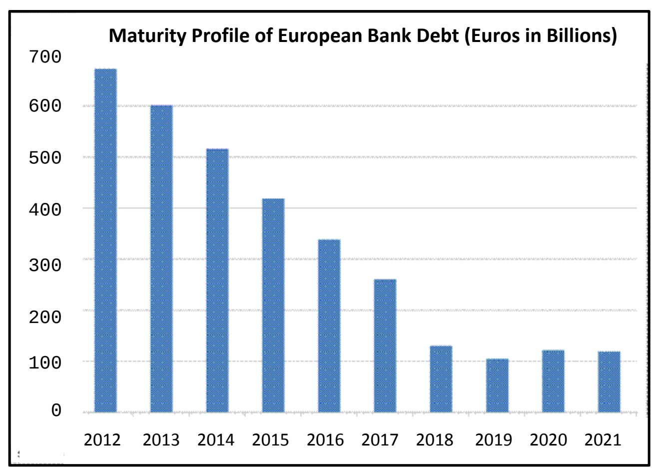
But back to the main point, the fact that all the conventional powers that be: national governments, international institutions, and even ISDA are all aligned to keep the Greek CDS contracts from doing what

they're supposed to be doing, shows just how risky the derivatives system still is four years after the financial crisis. As Charlie Munger (Warren Buffett's investing partner) has repeatedly pointed out, current accounting rules allow two firms to make these derivative bets against each other and for *both sides* to show a large profit from the same trade. What will happen if some of these trades are violently unwound by default? Obviously the profit must then disappear from at least one side. How much would this be? Which banks would be the losers? Would this cause a domino effect? Because of the complexity and fragmented nature of the system, not a single human being on this planet knows the answer to these questions, and that is really the problem.

Even avoiding a derivative or default driven banking crisis, the developed world still faces a mountain of debt. European governments are being forced by markets toward debt reduction. The U.S. is currently provided a pass which is unlikely to last forever. As Europe turns toward austerity to reduce debt, its economy will slow, as the Irish, British and Greeks already know. The U.S. is scheduled to suffer its own austerity drag as stimulus programs end and cuts kick in.



Source: Strategas Research Partners

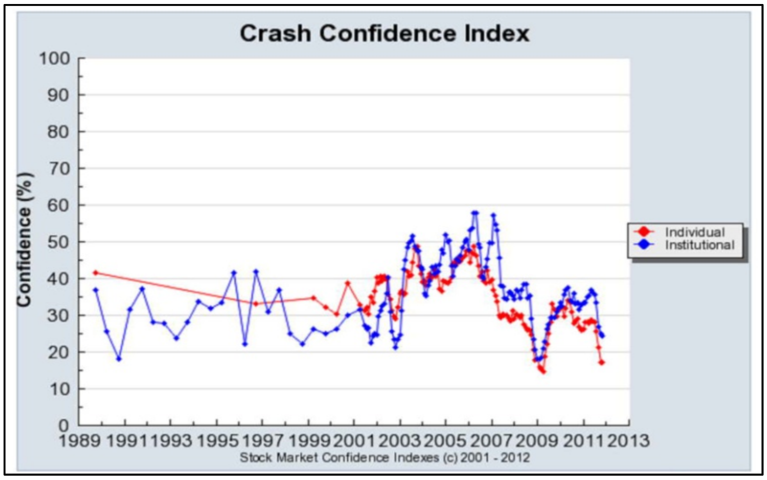


Source: Hussman Funds Investment Research & Insight
http://www.hussmanfunds.com

Despite these concerns there are reasons to consider U.S. equities and we remain actively on the hunt. We highlight seven bullish indications:

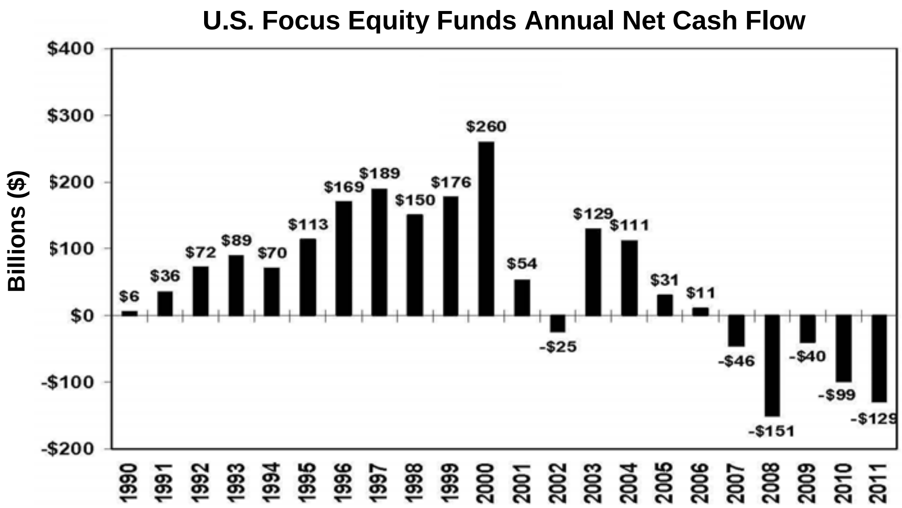
1. Low expectation: Wall Street strategists as a group expect only 3% appreciation in the S&P 500 Index during 2012 (source: Bloomberg). Investors too are extraordinarily cautious. We recently learned that the Yale School of Management maintains a 'Crash Confidence Index'; the University queries individuals and

institutions as to how confident they are that there will *not* be a stock market crash during the next six months. Fewer than 20% of individuals and 25% of institutions recently responded with such confidence that the market will not crash.



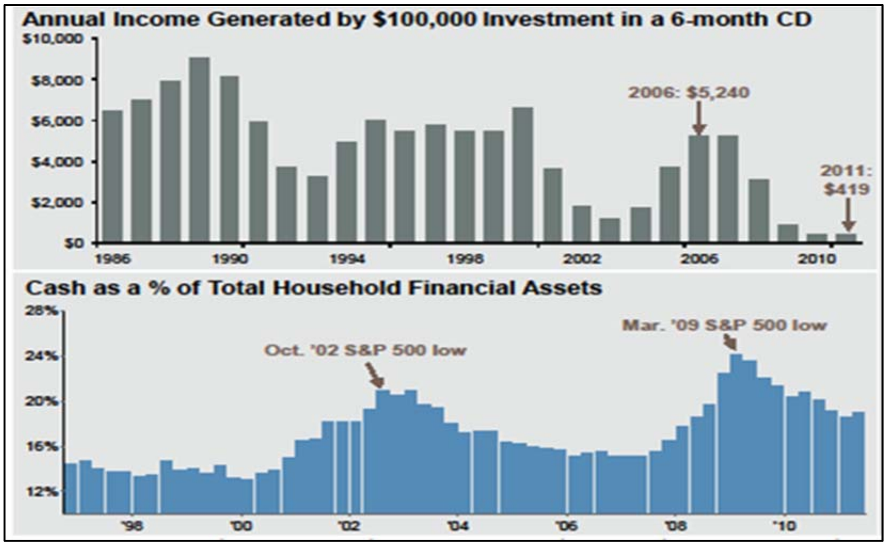
Source: *http://icf.som.yale.edu/stock-market-confidence-indices-united-states-crashindex*

2. Buying power: U.S. equity funds have experienced five straight years of net outflows and six years of weak net inflows before that.



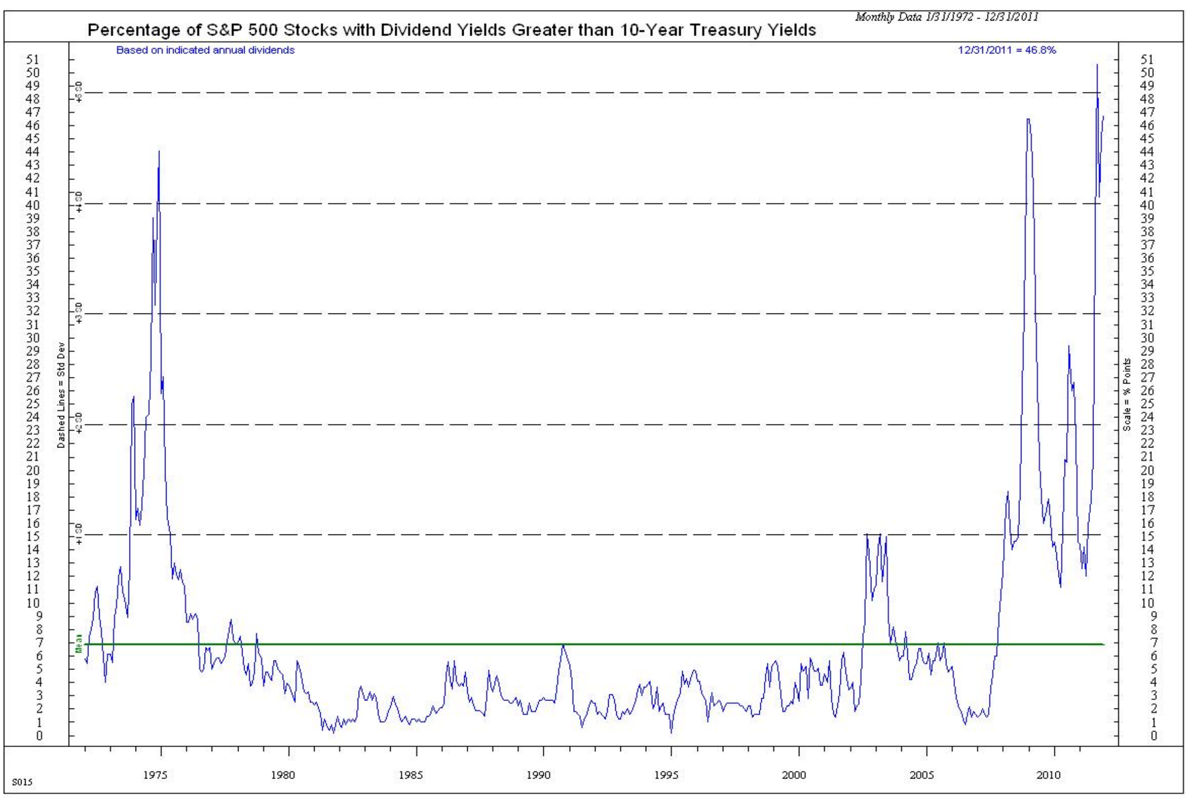
Source: Leuthold Group

A record (since 1950) 21% percent of household financial assets sit in bonds. Also, levels of cash run high and receive confiscatory after-tax-and-inflation yields which should eventually push investors toward equities. Corporations too may serve as a source of buying power. They sit on a mountain of cash which should eventually be unleashed. Net debt to shareholder equity is at 20 plus year lows and companies have refinanced to longer-term lower yields, indicating cash can go toward stock buy backs and M&A activity (not to mention dividends, given historically low pay-out ratios).

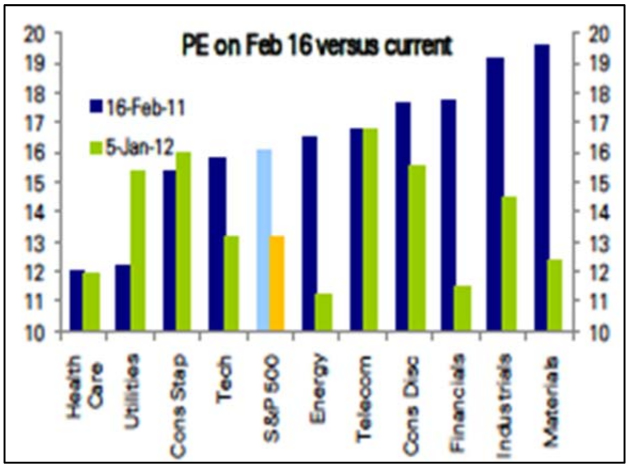


Source: J.P Morgan

3. Yield as a driver of equity demand: Nearly half (46.8% as of 12/31/2011) the stocks in the S&P 500 Index sport dividend yields greater than the 10 Year Treasury yield. This equity income superiority has not been seen in 40 years and is especially pronounced on an after-tax basis.



4. Reduced valuation: Sectors and stocks represented in our portfolio have experienced marked P/E multiple contraction. For the overall market, earnings yields are historically high. Even if margins compress and earnings recede, purchases at current prices will still deliver a historically high amount of earnings per dollar.



Source: Deutsche Bank

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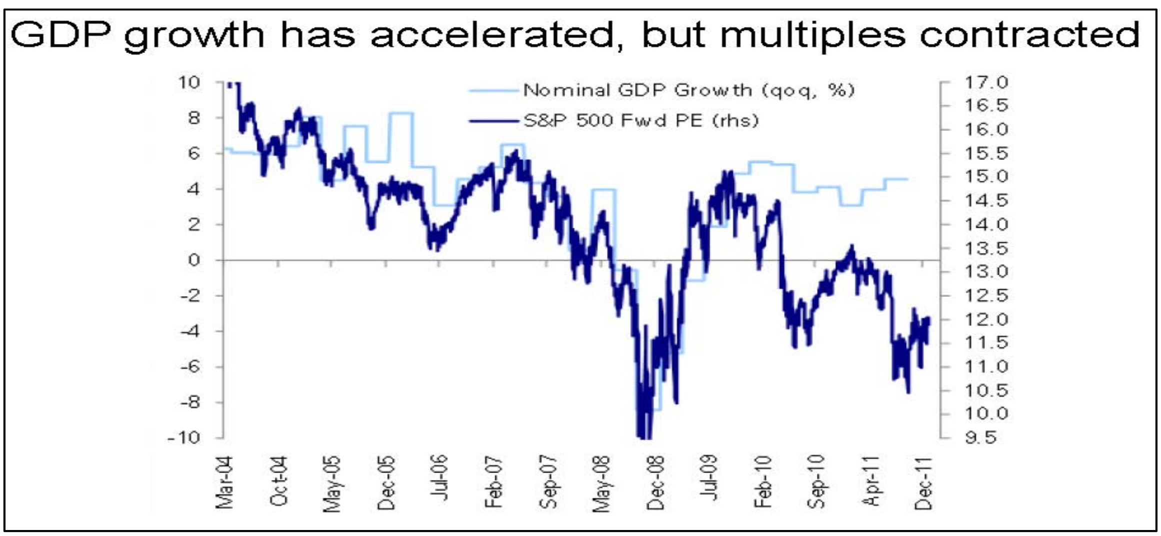

Source: Deutsche Bank

5. Insider buying: By our favored measure, insider buying relative to selling last fall reached the highest level seen in over 10 years.

6. Market internals: Equities have turned toward ‘up-market’ behavior. Recent gains have been on higher volume, participation is global (i.e. Europe, the U.S. and China equity markets are all up year-to-date unlike early 2010 and 2011) and we are seeing

broader participation, with cyclical and lower valuation stocks leading... bull market signs.

While we watched our cheap stocks mostly only get cheaper last year, we stand by the long proven principles of value investing and point out the superior long term record of equities, even after a decade of virtually no market appreciation.

I, along with the rest of the Knightsbridge investment team, appreciate the trust all our clients have placed in us. We continue to invest alongside you and are working hard to deliver results you rightfully expect.

Very Truly Yours,

John

John G. Prichard, CFA

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