

Prepared Comments from 7/15/2010 Conference Call

My last conference call was on April 15th. US stocks have since fallen 9.5% (and would be down 15% if not for a rally this month). The 2nd quarter brought a pullback for both US and foreign stocks—the problems began in Europe (with Mediterranean countries, especially Greece) but crossed the Atlantic Ocean as the quarter unfolded.

The country's unemployment rate has been falling this year, but only by ½%, and stands at 9.5%. Jobs are being created this year, even if you back out the temporary jobs created by the census, although we have a large supply of Americans who need jobs. Companies are in good shape—they have strong balance sheets, and profits are rising sharply. The Greece crisis has led economists to expect Europe's recovery to slow dramatically, and to slow our country's recovery a bit, however the consensus is that it is quite unlikely for us to encounter a '**double dip recession,**' an event which is extremely rare, and is almost always accompanied by major policy blunders (think Japan in the 1980s, and the US in the mid-1930s).

Unemployment is and will continue to be a problem. One problem is that it is an imprecise figure. When times are dire, people give up looking for jobs and drop off the unemployment figures. Then when times begin to improve, these people begin to try again, and unemployment numbers can thus worsen during improving times. Expect our jobs recovery to be shaky, but upward-trending.

Indeed the federal stimulus has been designed to fade as this year concludes, and this economic tailwind will thus end. 47% remains to be spent in the coming months. Will our economy have enough going for it to continue to increase as it has for the past three quarters which benefitted from \$420B of stimulus spending? We don't know for certain, however I have two comments on this. First, there are steps that can be taken if the recovery seriously stumbles. Just this week the Federal Reserve Bank (Fed) noted that it would seek out steps to take in this unlikely situation. The Congress would also consider a further stimulus plan if the economy doesn't continue on its current recovery path. Second, there are many factors favoring a continued (albeit slower-paced) economic recovery in the US.

What are the factors in favor of a continued recovery? With interest rates low, home ownership is more attractive than in many decades (this is helped by the downturn in housing prices). Also due to low interest rates, household debt is more manageable, relative to personal income, than it was before the downturn. I have a client with an adjustable rate mortgage which recently sharply cut the interest rate she pays. Consumer confidence is building (The University of Michigan Consumer Confidence index fell in April, but recovered fully in May, and rose 3.3% in June). The Conference Board's Leading Economic Indicator index rose in March, was flat in April, and rose in May.

The European sovereign (government) debt crisis, led by Greece, appears to be stabilized. The European Central Bank and the IMF created a superfund to provide a backstop to governments at risk of default. In return, such governments are obligated to improve their financial house, typically cutting spending and boosting tax receipts. While not popular at home, these changes must be made at some point. This backstop is designed to avoid economic meltdowns such as we suffered in 2008 (Bear Stearns and Lehman Brothers being two examples).

Despite the concerns over European sovereign debt, the global economy continues to recover. While Europe's recovery rate is expected to be anemic (about 1%), the US is expected to grow at a modest rate (2%), with 4% growth for Latin America, and growth of 7% or more for Asia excluding Japan (which is expected to grow at only ½%).

Inflation is tame, to say the least. Headline inflation (which includes food and energy) has fallen for two straight months, and is flat year-to-date. Core inflation (excluding food and energy) has fallen or been flat for the past five monthly reports. Inflation should remain well controlled for several years, likely until we have recovered most of the jobs that have been lost in the past two to three years.

Investors have several choices with their money. They can remain 'on the sidelines' (over \$9 billion is in cash/money markets). Let's look at how much you need to invest to earn \$1. In a money market over the past year, you would need to place \$1,400 in a money market fund to earn \$1. At today's yields, it takes \$55 to earn \$1 in a five-year Treasury bond, or \$25 to earn \$1 from a five-year corporate bond. Yet it only costs \$8 to buy \$1 of earnings from a large US stock. \$1,400 versus \$8. How much of your money do you want on the sidelines, or in bonds, at this time?

Yet investors have been net sellers of stock funds since 2008, and big buyers of bond funds. This has led to the current state, where bond funds are often yielding very low levels, compared with their history. This sets up investors for a serious headwind, and likely low, if not negative, returns for the next few years. In contrast, stock fund investors are buying companies with solid balance sheets, dividend yields of 2-4%, and growing earnings. Many of these companies actually grew their earnings during the worst economic crisis since the 1930s.

Stock markets do not like uncertainty. I've mentioned this many times in the past. While two major areas of uncertainty have been resolved in the past year (health insurance reform and financial regulation reform), there are two major areas still unresolved: energy reform (including cap and trade) and taxation (both income taxes and estate taxes). The mid-term election of state and federal legislators in November is a third uncertainty, although the timing of its resolution is known with certainty. I expect that the tax uncertainty will be largely resolved before the end of the year (when the Bush tax cuts are scheduled to expire), however I have no idea if and when energy reform will pass, and in what form that will be.

Our economy's path is also uncertain, however this isn't new; this is always the case. I would even venture to state that the current uncertainty regarding our economy's path is no greater than 'normal.'

Let me take a detour and read from an article this week by Jason Zweig run by the Wall Street Journal, entitled “Get Ready for a Cataclysmic Market Crash! (Or Maybe Not)”. He writes *“An extreme market forecast doesn’t merely grab your attention; ironically, it may strike you as even more convincing than a moderate prediction. A classic psychological experiment at the University of Michigan show that 54% of people preferred an extreme prediction about stock prices to a more-temperate one. They apparently believed that a forecaster must have high confidence and a solid rationale in order to justify making a dramatic prediction.”*

Well, you won’t find extreme predictions from me. I predict that the economy will grow, modestly. I don’t know how irrational investors will be, however I do know that stocks, both in the US and abroad, appear very fairly priced, especially when the current very low inflation environment is considered, and when money market and bond returns are considered.

I have often said that markets move due to emotion and economics. Emotion drives the markets during the short-term and a bit during intermediate-term, but economics drives the markets also a bit during the intermediate-term, and almost exclusively over the long-term. I don’t know how irrational investors will be (selling worthy stocks at firesale prices) in the future, however I am committed to fighting irrational crowds, and helping you to do the same.

Now for a quick rundown of the investing markets.

As you can tell, I am worried about bond investing. Sometime in the coming years interest rates will rise, and this will harm bond investors. For that reason I avoid long-term bonds and funds at this time. I also avoid treasury bond funds due to the flight to safety in recent years, which has driven down yields, and driven up risk, substantially. Given my expectation for a growing economy, I am emphasizing ‘risk bonds’, such as high-yield bonds, ‘multi-sector’ bond funds (and let these fund managers worry about sovereign debt and other foreign bonds), and bank loan funds which have adjustable interest rates, which significantly protects investors from rising interest rates. I find treasury inflation protected securities (TIPS and TIPS funds) to be overpriced and under-yielding, and avoid them at this time.

I favor neither US nor foreign stocks over the other. I can argue strongly for each, and so I am maintaining a 'neutral' balance between them, 60% US and 40% foreign. I like to diversify both areas well, with a proper balance between large and small, and value and growth. I am comfortable with an above average allocation to emerging markets stocks, and to foreign smaller stock funds.

I don't know when residential housing will begin to rebound, nor do I know when US commercial real estate will rise. I do believe, however, that it has fallen enough to justify maintaining a reasonable position (perhaps 2-3%) in real estate funds (both US and global). Despite my expectations of a few years of modest inflation, I favor a reasonable allocation to commodities/energy/natural resources (perhaps 3-5%).

More specific information is in my quarterly **Market Review and Outlook**, from last week, which is on our website, under **Client Resources > Newsletters and Articles**. I also post my conference call opening comments at the same location.

Closing Thoughts

There is a lot of noise, on the TV and radio, on the internet, in the papers. Investing should be long-term in nature, the same as home ownership. There is a difference between information and knowledge. Just because you can read 100 pages a day about the markets does not mean that you will make better decisions. Work hard to focus on the longer-term factors, the economics, and strive to turn down the volume on 'news' about emotional market movements, such as May's "flash crash".

In the coming months, focus on growth in the economy, company profits, and jobs added. This news should reinforce the reasons that you maintain a good amount of stocks in your portfolio.