

July 2010: Positive Factors

"One of the great mistakes is to judge policies and programs by their intentions rather than their results."

~ Milton Friedman

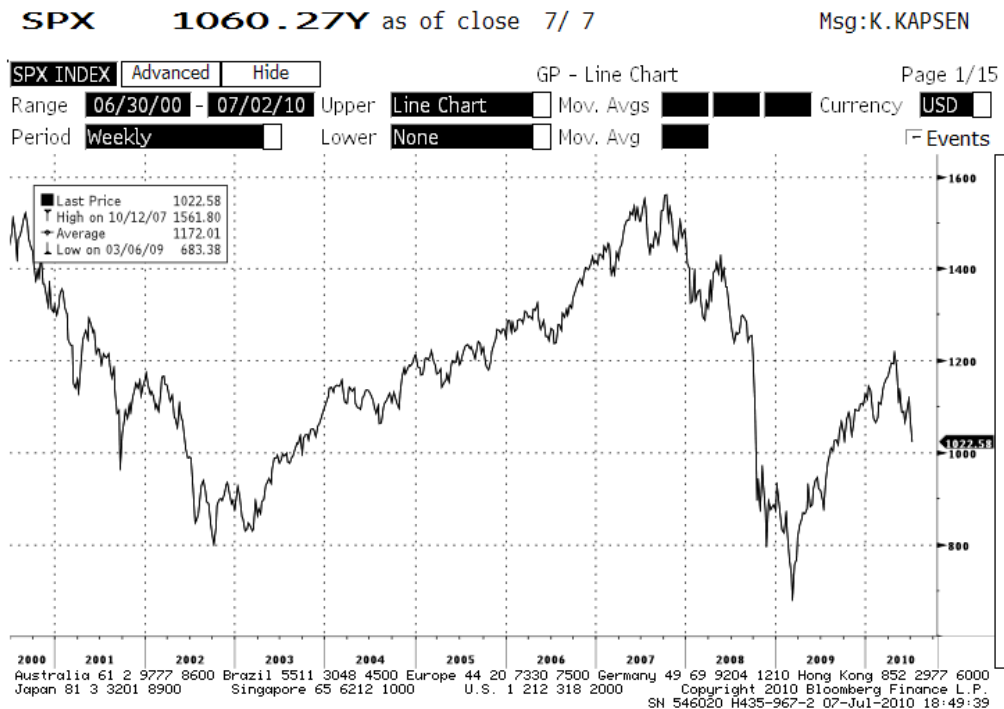
We are in favor of the government helping people who are on the down and out and who struggle to make ends meet. But as advocates of the investor class, we would prefer that the government provide support to entrepreneurialism and commerce rather than across the board tax increases to fund transfer payments. The economy and related confidence will be in much better shape if people are employed, and the best source for sustainable job growth is generally provided by the private sector. Given huge uncertainties with respect to future tax policy and regulations, businesses are understandably wary of hiring and investing for the long term. That businesses and individuals feel their income may increasingly be expropriated through tax policy has resulted in confidence on the wane, in turn hitting asset prices.

Now that a challenging six months is behind us and the negative returns are on the books, it makes sense to look around and to try to take an objective view.

It is admittedly difficult to be positive about investment markets after their dramatic downward swing of the last few months, a gloomy financial press, much talk about a possible double-dip recession, and a highly interventionist government. However, while we have no idea where investment markets will go in the short term, there are actually a variety of factors that have potential to move equity markets higher:

- 1) Rampant pessimism: investors are always surprised that when they *feel* the worst, stocks begin to rally. The current "wall of worry" by itself can be a positive indicator of a more constructive environment ahead
- 2) Mid-term elections: it is possible that the worst Congress in recent history is about to be shaken up significantly
- 3) Potential for more quantitative easing from the Fed: declining asset prices increase the probability of ultra-easy monetary policies going forward
- 4) Hard lessons learned by the current Administration: the rhetoric from the Administration may become more business friendly as its approval ratings are in the cellar. The Administration will likely figure out that for the money multiplier to work, risk-seeking behavior must be embraced and encouraged. The Administration should understand that its re-election prospects are inextricably tied to the job market (as well as to tax policy for businesses)

- 5) Legislation: uncertainty surrounding the scope of some legislative initiatives (e.g., financial reform, healthcare) will be past
- 6) Valuations: absent a return to a global recession (a low probability outcome in our view) stock prices look cheap. Investors are likely to figure out in the relatively near future that cash and government bonds will not enhance their real wealth
- 7) Pension funds need to take risk: poor equity performance over the past decade (see below chart) in combination with 0% on cash, ultra-low long-bond rates, an aging population and increased cost of living means that *pension funds are in crisis* and are forced to take risk. This should keep the stock market pretty well bid absent any exogenous shocks



While we can never know for certain the future of investment markets over the short term – or indeed even the longer term (we never would have guessed an annualized -1.59% nominal return, or an annualized -3.85% real return on the S&P 500 over the last 10 years) – we still believe a balanced approach makes the most sense in light of all the factors for which we can account. We understand the reasons why investors have become suddenly risk averse (and they are good reasons), but feel there are opportunities and positive global developments that are being overlooked. We continue to believe that owning selective, high-quality equities will remain the best vehicle for accumulating wealth over the long run. It’s not easy to endure when financial markets are uncooperative, but difficult markets don’t persist forever.

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