A Crisis of Confidence Does Battle with Fundamental Investing

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Stembrook Investment Commentary – November 2011

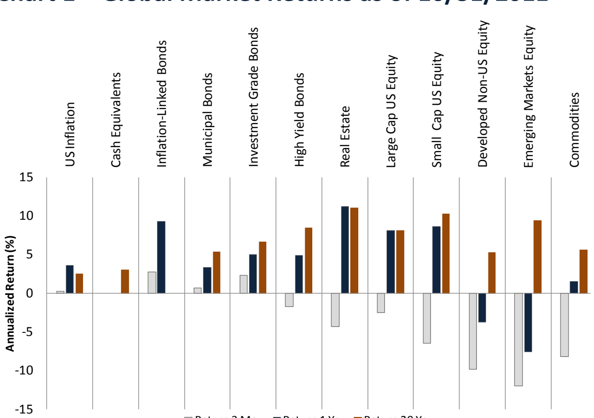
Financial markets are exhibiting a level of volatility consistent with a profound loss of confidence. With 2008 and the failure of Lehman Brothers still prominent in investors' minds, confidence remains fragile (see Chart 2) and fears of another banking crisis still dominate the market's psyche. We think it is highly unlikely that there will be a repeat of 2008, as central banks around the world stand ready to flood markets with liquidity to avert such an event. However, other real challenges continue to contribute to a decline in confidence. These confidence crippling issues can be summed up in three main points: the European Debt Crisis, a slow US economic recovery, and political uncertainty.

> We entered the latest volatile period with reduced exposure to High Yield, Emerging Markets and Small Cap stocks…we maintain an overweight to US Large Cap Stocks and Municipal Bonds.

Should market prices decline in light of such events? Yes. In theory, all publicly available information is incorporated into market prices. In reality, markets are influenced by people and people are subject to anxieties and overreactions that can lead to acute mispricing of assets. We believe current market pricing falls somewhere between these two extremes.

As investors, it is our job to process the available information in a thoughtful way in order to gauge the relative value of various investment opportunities. In that light, I will address each of the three issues in order of their gravity.

Chart 1 – Global Market Returns as of 10/31/2011



European Sovereign Debt Crisis

The European debt crisis is aptly named. It is a very real problem and will require political will and significant capital to resolve. Defaults, either voluntary or involuntary, are almost certainly a part of the resolution. Our contention is that the desire for self preservation will drive leaders to make choices that bring this structural problem to a manageable level.

Europe has made headway, moving from a reactive stance to a proactive stance in fighting the sovereign debt crisis. In other words, leaders have acknowledged they have a problem and have taken steps, albeit measured steps, towards resolution. Most recently, a combination of voluntary debt reductions by public bondholders, government backed insurance and an inducement to attract outside investors to purchase bonds are all on the table. There are many details yet to be hammered out, but the path of policy points towards support for weaker Eurozone countries and containment of the debt crisis. (see the table on page 2 outlining the key institutions addressing the Euro crisis)

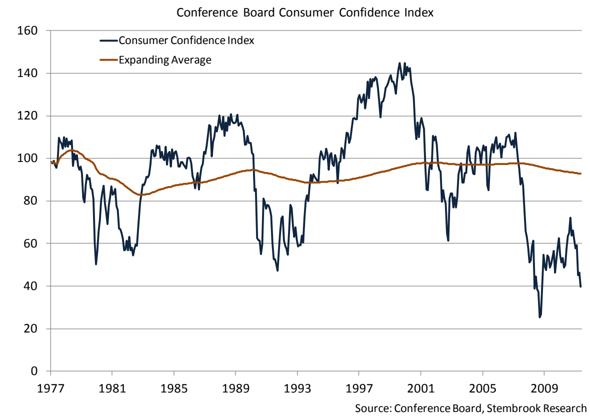
US Economy

A slowing US recovery is also a significant concern. Most importantly, a lack of sufficient growth would have far reaching implications for our already struggling housing and employment situation.

US economic indicators have been vacillating since the start of this year. The first quarter brought encouraging growth, the second quarter a concerning slowdown and the third quarter, a stronger, but hardly robust performance. The following is a discussion of a number of indicators and how they relate to economic growth and investment returns.

- Gross Domestic Product, or GDP which is often mentioned in the financial press, does not equal corporate profits or US stock market returns. GDP represents the total goods and services produced in the United States. As is exhibited in Chart 3, corporate profits have historically represented approximately ten percent of total GDP. Of these profits, approximately one third to

Chart 2 – US Consumer Confidence



one half come from outside the US, and a significant portion of expected growth comes from Emerging Markets
- This is a double edged sword. On the one hand, it means that US corporations – and by extension shareholders – are not completely dependent on the US economy for growth. On the other hand, outside factors such as a recession in Europe or a slowdown in Emerging Market countries can adversely impact earnings and thus stock prices.
- US corporate profits are the highest they have been, ever. Yes, ever. When adjusted

European Sovereign Debt Crisis - Key Institutions

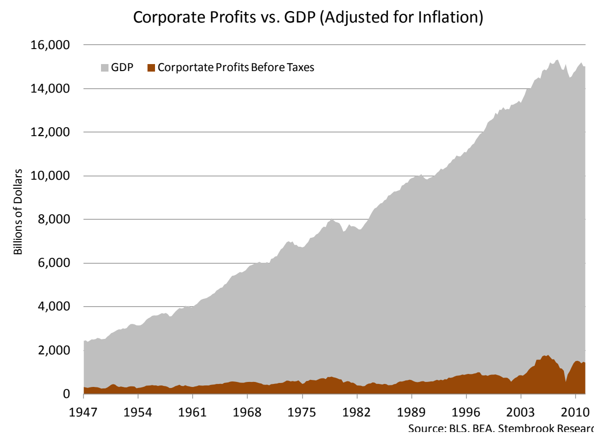
- Eurosystem
  - The monetary authority comprised of the European Central Bank and all National Central Banks of countries that have adopted the Euro as their currency.
- ECB – European Central Bank
  - Similar to the Federal Reserve in the United States, the European Central Bank is responsible for controlling prices and economic stability through monetary policy within the Euro zone's 17 countries.
- NCB - National Central Bank
  - Each country in Europe, both Euro and non-Euro, has its own central bank.
- EFSF – European Financial Stability Facility
  - An emergency funding source created to provide lending to failing countries.
- EFSM – European Financial Stabilization Mechanism
  - Has the ability to lend Euros guaranteed by the European Union.
- IMF – International Monetary Fund
  - A multinational organization of 187 countries that was created to promote global economic growth. When a country is in economic peril the IMF can step in and provide assistance.

for inflation, they approach the height of earnings in 2007.

- Cash on corporate balance sheets is historically high, indicating that companies are in solid financial shape. As of the end of June, non-financial corporations held more than $2 trillion in cash and liquid assets on their balance sheets. This represents more than 7% of total assets, the highest level since 1963.
- Household debt levels are improving. Debt service ratios, which measure debt payments as a percentage of disposable income, have normalized. (see Chart 4)
- US Monetary policy remains very stimulative.
- Institutions are borrowing money by selling bonds at very low rates and longer maturities. This allows companies to lock in low yields for long periods of time.
- US Banks are in significantly better condition, with Tier 1 leverage multiples[i] well below pre-crisis levels (see Chart 5).
- Commodity prices have moderated, making it easier for consumers to afford fuel to heat their houses and drive their cars. At the same time, lower input costs for corporations lead to lower product pricing or higher profitability.
- State and local spending is down. This is painful in the short run because the primary way governments are cutting is by reducing or freezing staffing costs (i.e. cutting jobs). In the long run, this should translate to increased productivity in the public sector and improved balance sheets. Recognition of this fact is reflected in the rebound in municipal pricing throughout 2011.
- Equity valuations remain attractive on a historical basis, with measures such as price/earnings ratios, dividend yields and price/cash flow ratios at or below long-term averages. Lower valuations point to higher future returns.

Three critical problems that we continue to highlight remain unresolved. Housing and employment both remain stubbornly short on growth, and for good reason. The increasing debt load at the federal level is a counterbalance to improving household and corporate balance sheets. These issues will take years to resolve and as we have discussed in other commentaries, they present their own significant risks.

Chart 3 – Economic and Corporate Growth

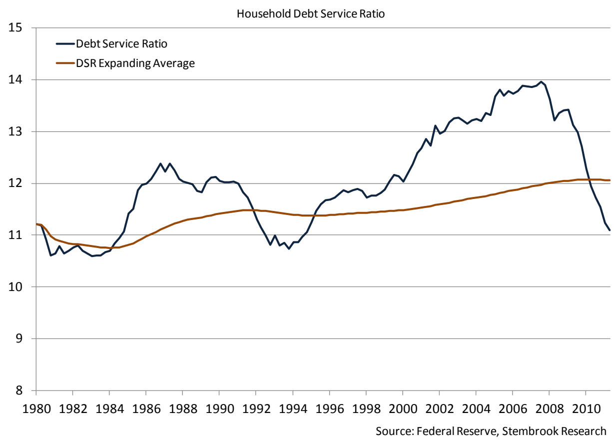


The US invented modern capitalism and spread it around the world, but hasn't played the game as well as it could have when it comes to maintaining a competitive workforce in a global economy. A rational response is to focus on creating a society with higher educational standards and thus more qualified workers to fill higher value jobs. Alternatively, wages will eventually fall to match comparatively declining skills in a global workforce. Hopefully, we as a nation will choose the former over the latter, while easing the transition for those stuck in the middle.

Political Uncertainty

The third is a crisis of our own making. The poster child of a sub-optimal governmental process was the US debt ceiling debate. A self-imposed debt ceiling led to a politically and philosophically driven spectacle of policy making. Politics have always been ugly and our modern ability to see how the sausage is made makes the eating even harder to stomach. This particular issue is out of the headlines for now, but looming in the coming days is news

Chart 4 – Household Debt Service Ratios



surrounding the findings of the bi-partisan Super Committee. This group of 6 Republicans and 6 Democrats has until November 23rd to recommend a plan to reduce the deficit by $1.2 trillion. If no deal is reached, automatic cuts across a range of federal programs to generate an additional $1 trillion in cuts will, in theory, be triggered. Stay tuned.

Bringing the US government's chronic budget deficit into the public eye may, in the long run, prompt the reforms that have remained so politically difficult that we have not made the hard choices.

Government plays a key role in our economy in that it oversees a legal and regulatory environment where the rule of law and property rights allow businesses to grow and thrive, fostering investor confidence not only domestically, but across the globe.

Corporate leaders cite the lack of clarity with regard to corporate taxes, healthcare, etc. as a factor in their reluctance to make long term capital allocation decisions. While some of this message may be political posturing in its own right, the logic of the argument is unassailable. Having a clear view of the rules of engagement would give corporate leaders more information and thus more conviction in their investment decisions. Such decisions would direct cash on corporate balance sheets towards new projects and thus drive job growth.

What Are We Doing Now

Research drives our decisions because reasonably analyzed data is what can be used to predict future price behavior with some level of accuracy. The unsettling reality is that it often takes time, far longer than we're comfortable waiting, for predicted outcomes to materialize.

When we invest, we are not just thinking about the state the European debt crisis, the US economy or political challenges. It is more important to weight how much the market is discounting prices for each of these concerns. Our research shows that the price at which you purchase an investment has a stronger impact on future returns than any other factor that we've measured to date. Said another way, valuation matters.

We entered the latest period of volatility in August with a lower risk posture. We had reduced our exposure to High Yield, Emerging Markets and Small Cap Stocks. At the same time, we maintain an overweight in US Large Cap Stocks and Municipal Bonds. These relative valuation decisions have helped portfolio performance in this volatile time.

An overarching reality is that stocks continue to be more attractively valued than bonds from a long term fundamental perspective. Again, it may take time for this reality to be realized, but it will occur.

We will continue to use the results of our research to overweight assets with prospects for higher returns and underweight those that represent less attractive investments. This is a long-term endeavor.

Tax-Efficient Investing

As part of our investment process we are constantly on the lookout for opportunities to reduce the tax burden on our portfolios. While volatility doesn't feel good, it does give us an opportunity to tactically take losses that can be used to offset other income or capital gains. This is done while maintaining exposure to the market. We have taken advantage of a number of opportunities this year and will continue to do so up until December 31st.

This year also brings new legislation regarding custodian's requirement to report the cost basis on your investments. This legislation will be phased in over a three year period. This year, custodians will report cost basis on equities. In 2012, mutual funds will be added and in 2013, cost basis on fixed income investments will be reported. Since tax efficiency is a strategic focus for Stembrook, we are ahead of this curve. All of our clients' holdings are currently reconciled with our custodian's cost basis systems. This means that accurate cost basis information is maintained at your custodian and no further effort is required on your part.

When accounting for your portfolios, there are multiple ways to calculate the gains and losses on your taxable investments. In the past, we have used a method called, "High Cost" which is very effective at reducing the amount of taxes currently paid on realized capital gains. We have recently changed to an even more efficient method called, "Tax Lot Optimized" which marginally improves the tax efficiency of your portfolios. If you have specific questions about this, please do not hesitate to call me.

Chart 5 – US Commercial Bank Leverage

Investment Planning

The foundation of every client's investment strategy is their *Stembrook Strategic Investment Plan*. This plan takes into consideration your current portfolio, your expected saving and spending and various scenarios for market returns, given your high-level asset allocation. Please contact me if something has changed significantly with your unique state of affairs so that we may adjust your plan accordingly.

As always, I welcome your comments and questions, and appreciate your continued confidence in our investment management and advice.

Sincerely,

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[i] Tier 1 leverage multiple is a measure of the amount of assets as a percentage of equity held by a bank. It is measured by dividing Adjusted Assets by Tier 1 Capital, where Tier 1 Capital = Equity + Reserves – Intangible Assets and Adjusted Assets = Total Assets – Intangible Assets.

Chart 1 Index List: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones UBS Commodity (Total Return) Index.