Our Mission: To Be Our Clients' Most Trusted Financial Advisor
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EXECUTIVE SUMMARY

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MARKET UPDATE

Double dip? Inflation? Deflation? Election results? Where goeth the dollar? The budget and the deficit? Sovereign debt? There are zillions of unanswerable questions in today's investment environment. With that degree of uncertainty, it's understandable that so many investors have moved to cash. However, with such tiny cash and government bond yields, it's not clear that this is the most rational response to the current investment opportunity set.

In fact, we see a most attractive option. We continue to see large globally branded companies as the most value-laden part of this market. Remarkably, these stocks are fairly cheap at a time when they have many tailwinds. Nearly all trends seem to indicate that the big will get bigger. More regulation will crush small companies – the giants will simply add a few folks to their legal departments. Small businesses are finding it difficult to borrow on favorable terms and rates, while giant corporations are borrowing at microscopic rates in massive quantities (see Microsoft below). Small businesses have limited access to global markets, while the S&P 500 collectively gains over 40% of revenue from overseas. We don't need to answer the unanswerable questions to invest rationally in today's market. With many large caps selling at mid-double digit PE's with better-than-bond dividend yields, they offer a compelling package of value, quality and yield.

Filters Against Folly

One of our all-time favorite books for better thinking is Garrett Hardin's Filters Against Folly. The first filter is literacy – *What are the words?* The second is numeracy – *What are the numbers?* And the third is ecolacy – *And then what?* In our judgment, much of the world's craziness could be avoided or at least tempered by rigorous implementation of these three filters.

The First Filter – Literacy - What are the Words?

The first filter is literacy. *What are the words?* We are a words-oriented society and failing to examine them carefully can lead us far astray. As Hardin points out, words are used as often to obfuscate as to illuminate. Many terms are invented as smoke screens to distract the listener from what is really going on. Hardin notes, for example, that drug makers will talk about "side effects" to minimize attention on unintended outcomes. Hardin emphatically points out that in reality there are only *effects* – "side effects" is a made up term designed to obfuscate. As another example, from time to time, government officials have used the term "revenue enhancement" when you and I know what they are really discussing are *tax increases*. (With the election campaigns in full swing, this could be a prime time to build your own list of such phrases at home!)

In the economic sphere, we'd nominate the term "quantitative easing" for the list. We'd offer as the more illuminating phrase "money printing". Time was QE II referred to a cruise ship. Today it refers to Ben Bernanke's favorite policy tool. Since round one of quantitative easing was only nominally effective, Bernanke has been vocal about suggesting that QE II may be in the offing. Investment wags are referring to this as the "Bernanke Put": if the economy begins to recover, great – the stock market rallies; and if the economy sputters, the Fed will do some sizable money printing to bail us out – and the stock market rallies. One intermediate risk appears to be that the "Bernanke Put" is already at least partially priced into the market.

Another example: many investors are seeking "safety" in bonds, resulting in an enormous bond rally over the past year or so. Through Sept. 30, year-to-date net outflows from U.S. stock funds were an estimated $61 billion, while net inflows to bond funds totaled $243 billion. Corporate pension plans had 69% of their money in stocks as of the mid - 2000's. By this July, pension plans as a group had cut their stock exposure to 45%, according to the Center of Retirement Research at Boston College. A significant part of the bond rally also includes *forced buying*. New regulations, seeking to make the financial system "safer", require banks and insurance companies to buy bonds to meet new capital requirements. In Europe something called "Solvency II" is forcing European

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insurance companies to dump "risky" assets, like stock and real estate, to buy "safe" bonds (including the sovereign issues of Greece and Spain!!). Yet, with microscopic Treasury yields, we believe government bonds really offer "return free risk". And if some of that sovereign debt does default someday, this legislative thoughtlessness will come home to roost with a vengeance.

The point is that "safe" is a function not merely of what you are buying, but also what you are *paying for it*. Buying "safe" bonds at record high prices with no inflation protection offers its own set of risks.

The Second Filter – Numeracy - What are the Numbers?

Meanwhile, there is value in quality stocks. We see a number of global branded companies that offer great value, better-than-bond yields, solid balance sheets, flexibility to deal with inflation/deflation and a call on global expansion. And one can purchase all this value at the lowest PE multiples relative to the general market in over 50 years. For example, Johnson & Johnson sells at 13 times trailing earnings – near the low end of its range for the past 30 years. J&J common shares yield 3.4%, greater than the 2.95% coupon on its recently issued 10-year notes. And it has raised that dividend for 48 consecutive years. We'll take real value over perceived "safety" any day.

More numbers. While the rest of the world is buying bonds at record low yields, corporate America is selling bonds. This is smart. The time to raise money is when money is cheap and money is cheap now. Microsoft recently issued $1 billion of notes at 0.875%. Remarkable - corporate bonds yielding less than 1%! Meanwhile the shares of Microsoft offer a 2.6% yield after a healthy 23% increase in the dividend. Over the past ten years, Microsoft has returned nearly $170 billion to shareholders through dividends and share repurchases. As with J&J, given that Microsoft's dividend is not only solid but likely to rise significantly over time, how can it be that the bonds are yielding less than the stock of this world-class corporation?

For the first time since 1958, the shares of numerous corporations yield more than the bonds of those same corporations. Back in those days, even two decades after the Great Depression, it was still widely accepted that a "bond" was "safer" than a "stock". Only after stock returns trounced bond returns for many years did this mentality shift. (For perspective, in 1988, pensions had 38% of their assets in stocks. Only *after* 25 years of wonderful stock returns, did the pensions move to 69% in stocks by the mid - 2000's.) Now, only after the 2008-2009 crash, are pensions moving en masse from stocks into bonds. We have gone full circle. Today we appear to be in a similar position as 1958, where the move to the perceived safety of bonds and away from stocks has left us with stocks yielding more than their underlying bonds.

The Third Filter – Ecolacy – And Then What?

This last filter often spools out as the law of unintended consequences. With so much regulation on the horizon, it is inevitable that in trying to do one thing, Congress may unintentionally end up achieving any number of other undesirable outcomes. The key is that in complex systems, *you can never do just one thing.*

The regulatory lapses in the subprime debacle were legion, and yet have been little discussed in polite company. Perhaps the most outrageous lapse (though there could be many nominees here) would be that of the Office of Federal Housing Enterprise Oversight (OFHEO). This agency was charged with ensuring the capital adequacy and financial soundness of Fannie Mae and Freddie Mac. It had no other purpose. No other assignment. Yet OFHEO totally missed the accounting shenanigans of Fannie Mae CEO Franklin Raines in 2004. OFHEO whiffed again in the subprime debacle, stating that things were fine shortly before Fannie and Freddie became wards of the state. An entire organization with one purpose – to monitor two agencies - and it totally blew it! Even when disaster was eminent, the agency proved utterly clueless. We'd have been better off with no OFHEO. The existence of the agency served only to create the illusion of oversight when there was none. And here we come to one of the central problems of regulation: Hardin often quotes the Latin, *"Quis custodiet ipsos custodes?" – Who shall watch the watchers themselves?*

As a final note on the potential regulatory perils of ignoring Hardin's Ecolate Filter, we site the story of the S.S. Eastland. In early 1915, Congress passed the Seaman's Act in response to the RMS Titanic disaster, where 1517 folks perished, in part, because there was less lifeboat capacity than there were passengers. In the uproar that followed, the Seaman's Act mandated the retrofitting of a complete set of lifeboats on all such vessels. Expert testimony from engineers clearly noted that the additional weight of such lifeboats would make most ships **more dangerous** as it would make them top heavy. Here the ecolate question, *And then what?,* was answered by the engineers. Woodrow Wilson signed the bill into law anyway. On July 23, 1915, on a calm, clear day, passengers began boarding the newly retrofitted S.S. Eastland, docked on the Chicago River. The ship was packed with many passengers standing on the open upper decks, enjoying the excellent weather. Perhaps owing to a passing canoe race on the river side of the ship, a number of passengers rushed to the port side. The Eastland lurched sharply to port and then rolled completely onto its side coming to rest on the river

bottom. Although the ship was only in 20 feet of water, a total of 844 passengers and four crew member died in the disaster.

IRA Conversion to Roth IRA

In 2010, anybody with an Individual Retirement Account (IRA) can convert it to a Roth IRA. Under current tax law, assets in a Roth IRA grow tax free and are not subject to the required lifetime minimum distribution rules.

That's the good news. The bad news is the converted amount is treated as taxable income in the year converted. Of course, if an IRA is not converted, distributions are taxed as ordinary income in the year withdrawn at a yet to be determined tax rate. Uncle Sam is effectively saying "pay me now or pay me later."

All things being equal, we feel a strong case could be made that if the IRA holder can leave the assets in the converted Roth IRA for an extended period of time and can pay the conversion taxes from non-IRA assets, the conversion probably makes sense. As we all know, however, all things are rarely equal.

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