2011 THIRD QUARTER REVIEW AND OUTLOOK

"The pump don't work 'cause the vandals took the handles"~~
Subterranean Homesick Blues
Lyrics ~ by Bob Dylan

A few months ago a good friend invited us to dinner at one of the best restaurants in New York City. We knew we were in for a real treat and looked forward to enjoying an excellent meal. When the day of the dinner finally arrived, the markets were in one of those moments when almost all stocks were getting hit hard on fears of a European financial meltdown. Needless to say, we were in a less than ideal mood to enjoy a great meal. I'm sure the food was outstanding but the anxiety of the moment overwhelmed the experience.

The stock market seems to be offering up a similar feeling of anxiety as it moves in huge volatile swings almost daily. Despite excellent earning trends, solid balance sheets, attractive valuations and signs of a slow upward growth trend in the U.S. economy, the equity markets continue to move in dramatic fashion based on macro-economic fears of another global financial and/or economic collapse. The seeds of those gyrations were planted many years ago.

We believe that the U.S. economy is in a structural slowing as opposed to a cyclical slowing. Part of this structural problem reflects the negative aspects resulting from the globalization of the world financial and economic markets. While we have experienced some of the benefits of globalization (i.e. low inflation), we are now experiencing the dark side of this change in the world's economic structure. The beginnings of this change probably started with the collapse of Communism in the early 1980's. With the fall of the Soviet Union, many countries that adhered to the strict economic communist doctrine began to shift toward a more (materialistic) free or quasi free market system. The most obvious example of this was the shift in China and secondly, many smaller countries in Southeast Asia. This shift resulted in a huge cheap labor pool becoming available to U.S. and European based global multinationals. The access to this huge new labor pool accelerated the globalization trend. Aside from the resulting decline in prices for various apparel and low tech goods, these markets also offered up an emerging consumer wanting goods and services from the big multinational companies that were still largely serving the markets in the U.S. and Europe. As manufacturing industries (and subsequently service industries) continued to shift to these cheap labor pools, developed nations augmented growth by continuing to leverage sovereign balance sheets. In the U.S., government programs were aimed at cutting tax rates, expanding social programs and making it easier to purchase homes. In many European countries, social welfare programs accelerated to soften the blow from the lack of economic growth. We know now that these programs were poorly thought out. The near collapse of the global financial markets in 2008-2009 underscored the weakness of these growth initiatives. Currently it is Europe's turn to suffer the consequences of offering expensive consumer programs rather than focusing on job formation and productivity. In the U.S., the result is a huge debt burden on the American taxpayer and a collapse in the artificially stimulated housing market. In Europe, the sovereign debt of Italy, Spain, Greece and others is either near or at the breaking point. Because each is part of the European Union, the problems are now Europe's and secondarily, the world's.

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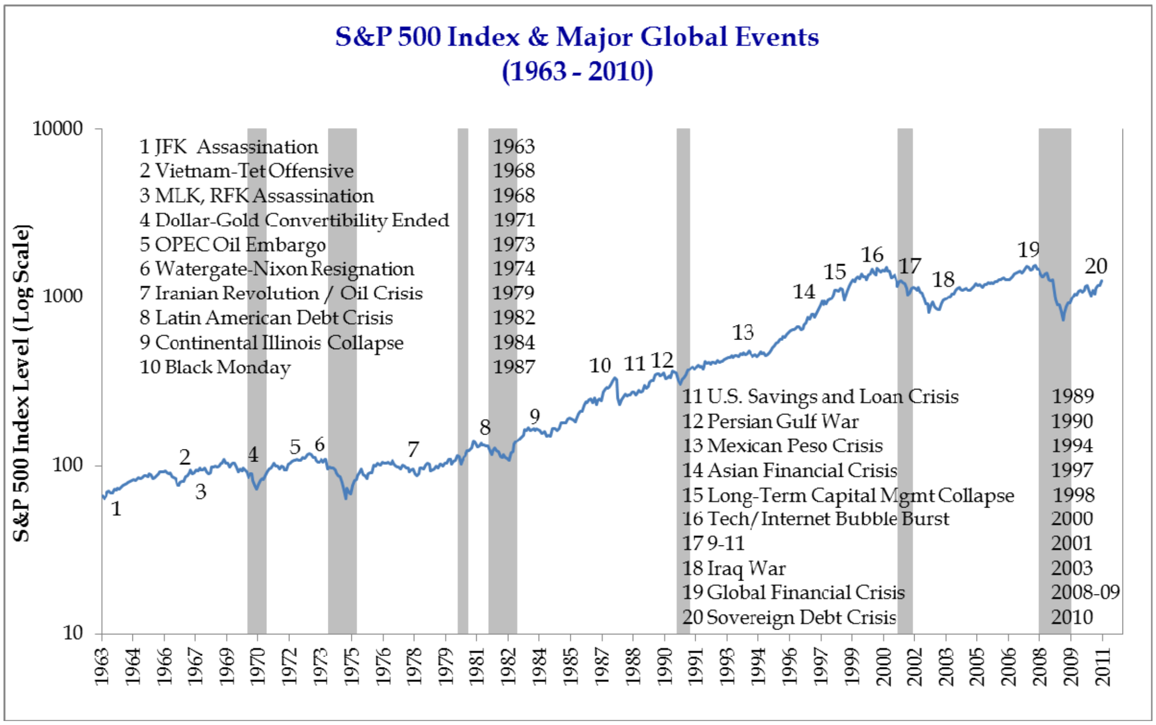
The developed nation markets are likely to find it difficult to reignite historical growth patterns in the future. The cheap labor pools in Asia and the Far East are too attractive for multinationals to ignore. Additionally, with the developed nation impediments such as onerous government regulations, social welfare programs and the reduced ability to continually finance growth via debt issuance, future growth trends should be significantly lower than in the past. While the current environment remains hostile to most investors, we emphasize that many negative factors have occurred in the past.



Source: Strategas Research Partners / Fidelity Management & Research

As the above chart indicates, the stock market continued to move upwards despite many economic pitfalls and global upheavals. However, the market last peaked in 2000. The slow growth expected in the U.S. and Europe in the future may mean more of a roller coaster market resulting in little or no real appreciation over future economic cycles. One could argue that we entered a bear market in 2000. Despite rising corporate profits, valuations in the global markets have significantly contracted. The contraction in valuation, concurrent with declining interest rates, seems to underscore that the market is constantly discounting another significant recession.

In the U.S., the government must find a way to improve the national balance sheet and encourage more business development programs that are more than just short-term stimulus efforts. It also appears that big global corporations will continue to accelerate capital investments into the cheap labor markets for the foreseeable future.

Importantly, talk about a tax holiday to let U.S. companies bring back the large cash positions now overseas is not likely to find its way into material domestic capital investment. Most cash rich multinationals already have significant cash positions domestically. Unless the business environment improves to allow a better investment return domestically, we anticipate job growth may remain below normal levels going forward.

While many may lament the ‘decline of the U.S.’ as the economic (and political) engine of the world, we see it as the beginning or continuation of a maturing of the growth in most developed nations. The emergence of a profit based economic model in many new emerging market countries is a trend that is not likely to reverse. The last significant cheap labor pools still exist in “tribal” economies largely found in Africa and the Middle East. It is unlikely to see any significant shifts in political patterns in these areas to challenge the cheap labor markets of South America and Southeast Asia anytime soon.

These two factors; huge new low cost labor pools and accelerated globalization (in reality – linkage) of the economic and financial markets represent the new global paradigm. Bill Gross and Mohammed El-Erian of PIMCO call this new growth trend the “new normal”. We prefer to see it as simply the maturing of developed nation economies. One other point to consider, this new mature growth and the globalization of the world’s economic and financial markets are relatively young, perhaps only 10-15 years old at the most. Importantly, this means we can no longer look to past historical patterns and assume those trends will likely repeat.

With that macro backdrop, we continue to suggest that a new and different investment strategy is needed. This strategy is what we called the “less is more” focus that was discussed in our last quarterly review. By “less” we mean that equity positions in a large number of stocks are likely to generate returns similar to the stock market in the future. Since the market returns of the future may be modest over a long period of time, we believe better risk adjusted returns can be accomplished by staying focused on a uniquely positioned smaller group of investments. Thus, we want to own well researched equities that can take advantage of the changing economic patterns in the U.S. as well as the global arena. Our focus also remains on category dominant companies in their respective global markets and their capability to continually generate superior returns on capital. Companies like Colgate Palmolive, Accenture and Omnicom are good examples. We also seek investments in companies that can offer new products and services *that can dominate these new economies* over time. We think EMC, Apple and eBay are good examples of this trend.

Of course, current conventional thought is to trade the portfolio more aggressively. However, we believe that the stocks we own are capable of generating strong appreciation over the long term even as global economies show more volatility than in the past. Owning scores of stocks in this new economic paradigm may not be as rewarding as in the past. Diversification is not likely to be as defensive as in the past given the global linkage of equity markets. Additionally, volatility could still have a significant impact on portfolios similar to what is currently being experienced. Hence, a focus on capital return and preservation demand a strong focused strategy of targeted growth.

Near term, we continue to be faced with a great deal of conflicting data. On one hand, the global economic recovery seems to be progressing on a slow upwards trajectory. Recent economic signs in the U.S. point to a continued upwards movement in most economic indicators. Most corporate managers are also forecasting that they see only a small slowing in growth and that is mostly in a few European countries. Indeed the stock market appears attractive given the low valuations in general.

On the other hand, both U.S. and European politicians seem to be doing everything possible to derail this current recovery. This anxiety in the overall financial markets is resulting in extremely volatile trading as macro-economic concerns overshadow the near-to-intermediate term fundamental outlook.

We are not sure how this ends up. The normal and expected scenario would be for the U.S. government to announce a comprehensive plan to deal with our debt and deficits. Concurrently, Europe should ultimately announce its own comprehensive plan of debt structuring. However, as the markets gyrate, concerns continue to focus on the lack of political will to change economic programs for the long term. The dark side of globalization may be with us longer than we imagine.

As a result, we believe that retaining a defensive posture is preferable than taking a stand near-term. We remain focused on capital preservation in the current period.

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