KINGS POINT
CAPITAL MANAGEMENT LLC

## Quarterly Review and Outlook

Every time we sit down to write our quarterly review, it seems that a new macro event has unfolded which could shape the direction of the market for years to come. Investors have tired from what seems to be the world lurching from one new crisis to another. Events in the last few weeks were no exception.

Before we discuss these new pressures and how each relates to the overall global economy, it should be pointed out that the "experts" rarely get it right for a long period of time. This does not suggest that they are ignorant or misinformed; rather it suggests that it is extremely difficult to read the tea leaves correctly. We doubt this will change much in the foreseeable future.

As Europe goes, so goes the world! – HUH?

In the good old days when Europe was defined more by country than by region, an economic slowdown would be disruptive but hardly a global tragedy. Due to the formation of the European Union, the monetization of different currencies into one (Euro) denomination, and the addition of an alarmingly high amount of debt, Europe has become a huge tail that continues to wag the global dog.

Analyzing the possible outcomes is highly complex. However, we do believe that the normal mechanism of economic self-correction is no longer available to each member of the European Union. Historically, a weak country (i.e. Greece) would default on its debt, devalue its currency and start all over again. Russia did just that in 1998. This could only be an option now if the country in question leaves the EU and the remaining members offer to maintain the value (to some degree) of the Euro. It is not that we are worried about Greece or Spain decoupling from the EU. Rather, it is the fear of a run on many European banks (as depositors seek safety in gold or U.S. dollars) that is the greatest potential threat. The other alternative is to create a fiscal policy union. This means that some financial discipline can be employed willfully on all EU members. Countries would have to give up some financial control (cede sovereign rights to another party). As recent European meetings indicate, this would be very difficult to achieve without further extensive discussions.

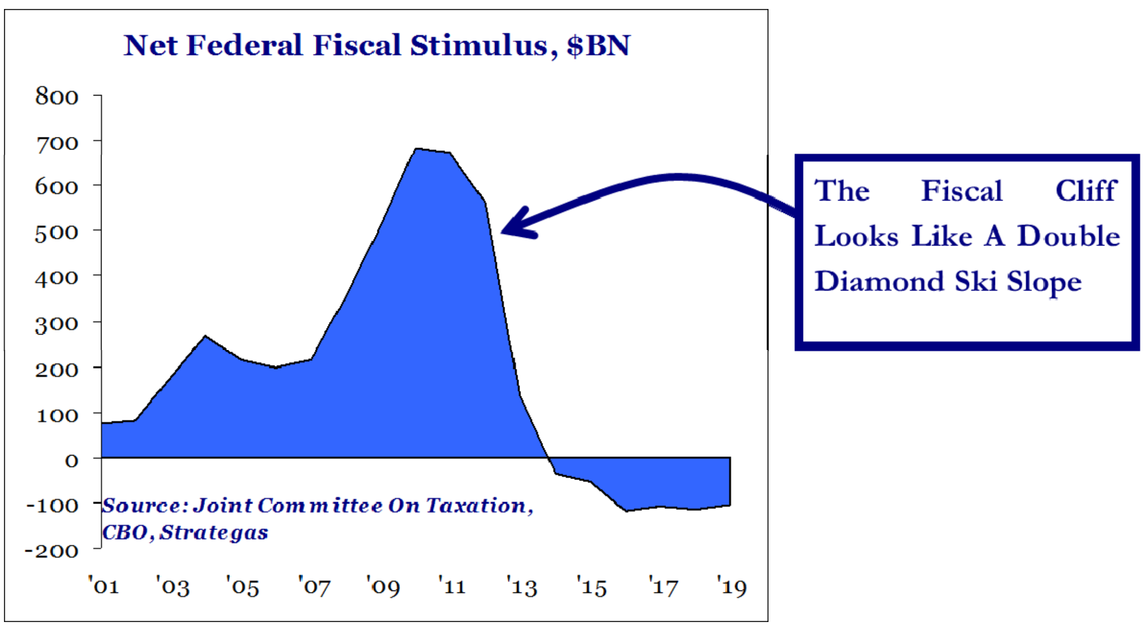
Perhaps out of necessity, the self-correcting mechanism is beginning to emerge on the entire European Union. The Euro has been steadily devaluing relative to the U.S. dollar and our guess is that this move may continue for at least the balance of the current year. The ECB has moved to reduce interest rates concurrent with its comments that subordinate debt holders in banks that received a bailout should be subject to losses.
Hence, the entire European Union is undergoing a slow process of self-correction – i.e. currency devaluation, declining interest rates and haircutting bond holders.

Regardless, we expect market volatility to remain high until a clear path to stabilization emerges. The problems of Europe are also a catalyst to the slowing economic growth now apparent in the U.S and China.

We are convinced that the members of the EU are committed to keeping the Union together. As a result, the leaders must find a way to create a more reliable monetary and fiscal union in the future. If they ultimately falter, the Euro and the European Union are likely to end up as a grand but very flawed experiment. If European political leadership can bring about true financial discipline while concurrently improving the ability to pay off most if not all the European Union debt obligations, a significant rally in equities should ensue.

**<u>The U.S Outlook – The Fiscal Cliffs of Washington</u>**

**WITH NO ACTION BY CONGRESS, THE FISCAL CLIFF IS ROUGHLY $537BN IN 2013, OR 3.5 PERCENT OF GDP**




Here at home, our politicians have to address a huge budget gap early in 2013. Of course, the devil will be in the details but generally, if Congress does not extend most or all of the Bush tax cuts, then more pressure is likely to be placed on our already shaky economic recovery. The President (whoever he may be) will set the tone.

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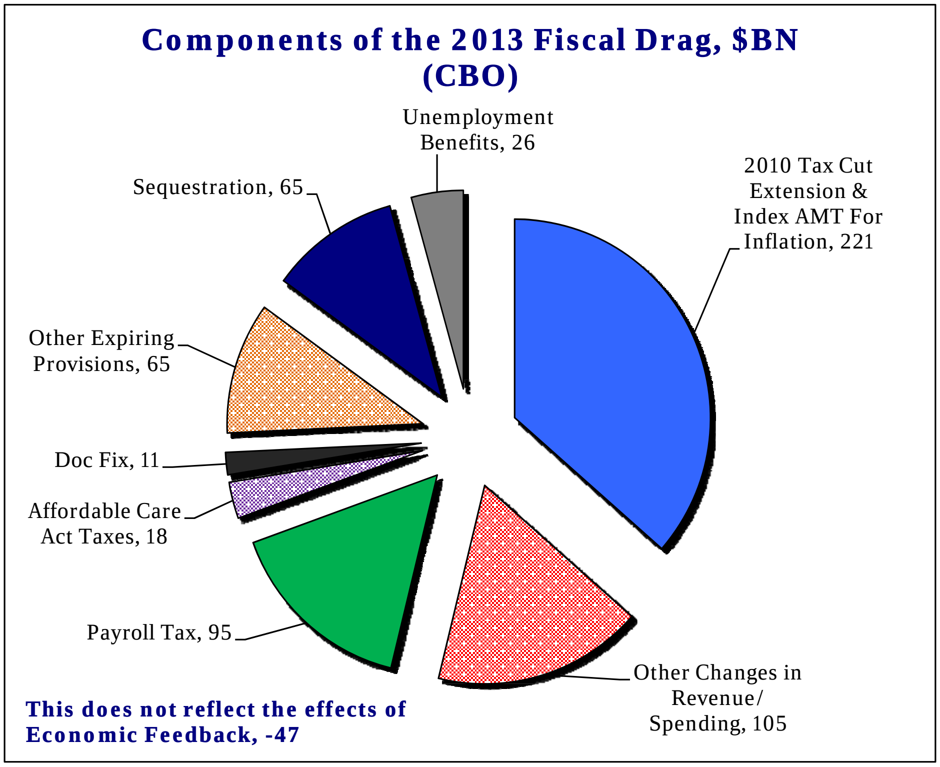


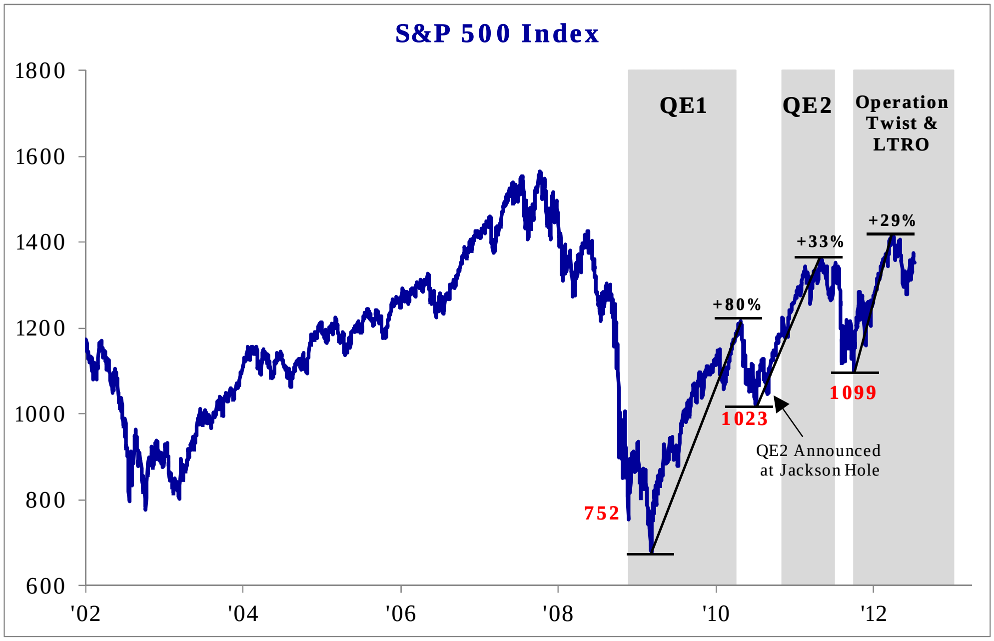

Source: Strategas

If the Bush tax cuts are extended, the existing stimulus programs remain but add little if any additional growth benefit. Moreover, our deficit problem becomes extremely difficult to solve. Alternatively, if the Bush tax cuts are left to expire, it would amount to an effective $430 billion tax increase at a time when our economic recovery is extremely fragile. In reality, regardless of who is President, some compromises will be needed to right our economic ship. Some combination of revenue increases and spending cuts may be the logical answer. We believe recent renewed interest in the Simpson Bowles bipartisan plan may well turn out to be the starting point to some effort to address our budget deficit problems. What Congress does in the first half of 2013 may well decide if the U.S. slips back into a recession next year.

## Our Outlook for the Financial Markets – Staying Defensive

The U.S. fixed income market is probably in a bubble after almost 30 years of declining interest rates. With the ten year treasury at about 1.5%, it doesn't have much more room to decline. The question is when, not if, interest rates will move higher. The Federal Reserve continues to artificially hold down interest rates in an attempt to stimulate an economic recovery. As the following chart indicates, the benefit to the quantitative easing by the Fed is having a diminishing impact on our economy.

**DIMINSHING MARGINAL RETURNS TO QE IN THE U.S.**




Source: Strategas

There is also a “dark side” to these efforts by the Federal Reserve to keep interest rates at low levels. First, it puts huge pressure on corporate pension funds and Educational Endowments that maintain historical expectations of total returns of 8 – 9% in diversified portfolios. As the bond portion rolls over, future bond purchases offer significantly lower rates than in the past. This puts pressure on these institutions to increase risk to try to capture better future returns.

Secondly, low long-term interest rates are hurting retirees seeking both safety and income. Retirees are forced into riskier assets in order to achieve necessary income goals. Lastly, low interest rates are having a huge negative impact on savings in general.

We believe that the Fed may be aggressively trying to stimulate U.S. economic growth in order to offset the lack of congressional support in establishing appropriate fiscal policy. Regardless, interest rates are not likely to fall much from here without suggesting a significant shortfall in economic growth.

The stock market seems locked into a trading range as the slowing U.S. economy, European problems and the slowing growth out of China continue to press on the U.S. and global markets. We don’t know how all these changing macro-economic trends will end. As a result, we remain focused on retaining our defensive posture in our equity exposure.

Before providing more specific views on our equity investments, we would like to veer off a bit and discuss a recent television segment that appeared on a popular financial show. The segment was a tribute to Richard Rainwater, a uniquely successful investor and entrepreneur in the last 30 years. The show invited successful financial managers and CEO's that told their stories about how they met Richard and how he was instrumental in their future success.

What struck us as unusual was that a common theme seemed to be evident in all the stories about Rainwater and about their own individual success.

The common theme was that an investor should have conviction in their analysis and conclusions, and that one should stay with your investment as long as you believe that you are correct. Put another way, these successful business people did not get sidetracked by the current noise of the world, but rather focused on what they believed would prove successful over a long period of time. As a side observation, almost all their investments <u>were relatively concentrated and took years to harvest</u>.

Borrowing a page from Mr. Rainwater and his successful protégés, we have chosen to focus on a limited number of investment themes that should do well over a long period of time. We tend to concentrate on themes that should prove rewarding over the next few years even in a benign stock market environment. One such theme is the emergence of wireless communications. This has led us to positions in such companies as American Tower, Verizon, EMC (cloud storage) and eBay (electronic payments and retailing).

Another more obvious theme is the long term, accelerating growth in emerging markets. While Colgate Palmolive has been our chief position in this area, followed by the international tobacco giant Philip Morris, we are actively seeking additional investments with this in mind.

A second and far more important focus in our equity selection process is our financial screening analysis. We screen for companies that have strong cash generation and in turn give superior returns on capital employed over their capital costs. We also look for dominant market positions and strong shareholder friendly managements. Our most recent purchase of Darden (which manages the well-known Olive Garden, Red Lobster and Longhorn Steakhouse chains) is a good example of a company possessing these financial disciplines. Darden has also been aggressively boosting its dividend in recent years. Yielding about 4%, this should be a strong core holding for us in the next few years.

Our relatively concentrated portfolio allows us to oversee our investments with a hands-on approach. We believe our disciplined approach is likely to generate strong returns over the next 3–5 years regardless of the near term macro-economic headwinds. Like

Richard Rainwater, we are more focused on the long term goal and thus try to not get too sidetracked with the current noise of the market.

Finally, we would like to say that the recent revelation by certain financial institutions that they have manipulated Libor rates is another example of a global financial system that places themselves above their clients. All too often, we have seen financial organizations put individual profit gains in front of the interests of their clients. Whether it is selling financial products to their client base, leveraging their organizations for personal gain or failing to maintain adequate controls, the individual client has suffered. It is no accident that so many have lost faith in our financial institutions.

At Kings Point, our ethical standards and our personal reputations cannot ever be allowed to be compromised. We align our own interests directly with our clients and try to view our relationships as a partnership with the individuals and families that have put their trust in us. We are ashamed of the unacceptable lapse in ethics that our industry appears to have allowed and which now appears more the norm than the exception. We hope that appropriate efforts are being put in place to rebuild our industry's poor reputation.

We appreciate your trust and look forward to serving you over the coming years. As always, feel free to contact us on any investments in your portfolio.

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