Quarterly Investment Commentary

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August and September were rough months for the stock market. The S&P 500 finished down -13.9% for the quarter, with international stocks faring even worse – developed international markets were down -18.9% and emerging markets -22.5%. Volatility (the day-to-day variation in stock prices) remained elevated going into October, with daily price moves greater than 2% not uncommon. Despite Standard and Poor's downgrade of U.S. debt in early August, the bond market performed well, returning +3.5% for the quarter as investors shed risky assets in favor of those perceived as "safe," which still includes U.S. Treasuries.

Investors responded to ongoing fears about contagion from Europe and a slowdown in U.S. economic activity. As the quarter came to a close, worries of a hard landing for the Chinese economy also surfaced. Compounding the severe challenges that developed economies face is the apparent unwillingness and/or ineptitude of policymakers on either side of the Atlantic to reach across party or sovereign lines to forge necessary solutions. In the U.S., confidence in our political leaders is at a generational low (a recent poll pegged the public's approval rating of Congress at just 12%). We often think that journalists over-hype the impact that Washington has on the real economy, but the debt debacle inflicted a meaningful toll on business and consumer confidence. In Europe, compromise is even more challenging, as the political system is much more complex, rooted in inadequate governing bodies and steep cultural differences.

Business is booming for one sector of Wall Street – purveyors of gloom and doom. There is no shortage of things investors can worry about. Washington has yet to put forward a credible plan to grapple with long-term deficits that both sides of the aisle would consider. In the short-term, political wrangling seems to render any innovative policies aimed at jump-starting the economic recovery dead on arrival. While the Federal Reserve will likely continue to look for new monetary programs that can get the recovery back on its feet, we believe that Chairman Bernanke and gang are effectively out of bullets. With interest rates at multi-generational lows, it is not clear what else the Fed can do (i.e. if firms and individuals won't borrow with 30-year Treasury rates below 3%, even lower interest rates likely won't help).

It is increasingly unlikely that Europe will be able to avoid some form of an adverse credit event. Greece's problems appear too big to solve without some kind of fundamental restructuring. That in and of itself doesn't spell doom for Europe – Greece's economy is actually quite small relative to the broader continent. The risk is that problems stemming from a Greek default, if allowed to occur in a disorderly fashion, would quickly spread to larger, more important European sovereigns (Italy and Spain) and systemically important banks. It is impossible to handicap how this might affect the U.S., but in a worst-case scenario we would not be immune.

These fears caused U.S. economic growth to slow dramatically in the third quarter. Economists significantly raised their estimates for a possible "double-dip." Corporations held back on deploying cash and hiring workers. And the U.S. housing market has yet to show any significant signs of resurgence, a major impediment to any potentially strong recovery.

The downside risks to the economy have clearly grown. Despite this, we still believe that the most likely scenario for the U.S. economy is to continue muddling along. We didn't see the strong recovery in the near-term that some saw a few quarters ago and we don't see a collapse in the coming quarters that some foresee now. Even if the economy does technically tip back into recession, we think that the real effects will be much more muted than those seen in 2008-09. Indeed, the average American worker may respond by claiming that he didn't know the recession had ended in the first place. Company executives that we have visited with claim that their operations are much leaner now than they were going into the 2008 recession, suggesting that there is much less fat to cut in the event of a slowdown. Companies have been reluctant to invest in labor and capital coming out of the recession, which is the key reason the recovery has been anemic but also the key reason a double-dip might not be as painful as some fear.

Most importantly, we believe that the U.S. financial system is much better capitalized now than in 2008, giving the economy much more resiliency to potential external shocks. Debt challenges in the U.S. and especially Europe could cause serious economic and financial dislocations, but we don't think this is the likely scenario – the problems are addressable as long as policymakers own up to the challenges.

Of course forecasting the future is an endeavor filled with uncertainty. Current sentiment seems worse than our expectations, but the last few years have made it clear that things can quickly deteriorate. Yet while Wall Street grapples with the question of whether the economy will tilt back into recession or not, we are busy asking a different question – are stocks attractive even if one assumes that things will get worse? Especially after the recent market sell-off, our answer is yes.

Despite current risks, we believe the fear prevalent in today's markets presents opportunities for the patient investor to build long-term value.

As of September 30th, an investor could purchase a 10-year Treasury bond for 1.9% or a 30-year Treasury bond for 2.9%. If inflation averages 2-3% per annum over the next 10-30 years, these bonds will essentially return *nothing* for the investor in real terms. While we still don't expect interest rates to rise markedly in the near term (which would lead to capital losses for bond investors), we nonetheless are not interested, to say the least, in locking up money for 10 to 30 years at 0% real returns.

Relative to bonds, stocks look quite attractive. In fact, the 2.3% dividend yield on the S&P 500 is now above the 10-year Treasury rate (at 1.9%), the only time besides the first few months of 2009 that has occurred since the fall of 1958! So a stock investor gets a yield above that of a Treasury bond, plus earnings reinvested into the business that should grow with inflation. Because the two assets have different risk characteristics, it is an apples-to-oranges comparison. But nonetheless we believe it speaks to the relative attractiveness of stocks.

It is certainly possible that bonds could be so overvalued that stocks may not be attractive in an *absolute* sense, even if they are attractive in a *relative* sense. We do not think this to be the case. It is possible to put together a portfolio of companies with decent balance sheets that make necessary, understandable products that trades for around 10-12x earnings. In other words, for each dollar invested in the market, the investor is receiving an earnings yield of 8-10%; some of those earnings will be returned to the investor in the form of dividends and share repurchases, the rest reinvested in the business. We believe that this represents a historically attractive level for stock purchases.

Now the lackluster economy will no doubt make it hard for corporations to grow their earnings at levels seen over the last few decades; indeed, some companies may be at risk of downward revisions to their expected 2012-13 earnings. But we believe that an 8-10% earnings yield gives the investor an adequate margin of safety to earn attractive returns *over time* in a variety of economic scenarios. Indeed, we believe that some sectors of the market are as cheap or cheaper than they were at the depths of the 2008-09 crisis, despite the fact that the economy and financial system are in much better health now.

In our last market missive, we highlighted Berkshire Hathaway (BRK/A, BRK/B), Warren Buffett's company, as a stock that we found attractive. We argued that at a price approximately equal to book value, investors were getting a stable of high-quality, cash-generating businesses navigated by perhaps the most skillful capital allocator in history at a bargain price. Validating our sentiment, Berkshire recently announced a stock repurchase program for only the second time in the company's history, explaining that "the underlying businesses of Berkshire are worth considerably more" than the current share price. Additionally, Buffett noted that he had bought a net $4 billion in equities during the third quarter, well above his pace during the first half of the year. He also invested another $5 billion in Bank of America (BAC), lending support to our contention that U.S. banks are on much firmer footing than 2008-09 and represent attractive long-term values despite a number of near-term risks. Staying true to his mantra, Buffett is being "greedy only when others are fearful."

Now it is important to note that even if we are right and stocks are cheap, that by no means precludes them from getting cheaper. The market is notoriously fickle. This has manifested itself most recently by stocks selling off by as much as 3 or 4% on news that the market often *already knew or expected*. The investor could decide to wait until the "bottom" to buy stocks, or in Wall Street parlance, until "downside risk" has been minimized. There's only one problem – how does anyone know when the bottom hits, except in hindsight? In our view, they can't. In the spring of 2009, equities were up +35% from their bottom in two months before investors could even blink. Very few were able to look at stocks on March 6th, 2009 and say "okay, here's the bottom."

Accordingly, investing in such markets is difficult. It is hard to buy stocks only to watch them fall. Emotional temperament is perhaps more important than IQ when it comes to investing. In the early 1990's, bank stocks fell by 50% in just a few months and traded at significant discounts to book value. Investors were convinced that many banks would not survive the real estate crisis stemming from the collapse of the Savings & Loan industry and the weakening of the broader economy. Institutions with outsized exposures to worrisome regions, such as Wells Fargo (at that time a regional bank focused in California), got particularly beat up. Yet despite a host of uncertainties and extreme volatility, investors that were able to maintain or add to investment positions in banks that were adequately capitalized and prudently managed did significantly better than the market over the ensuing years (even if purchased before the industry sell-off). From the fall of 1990 through 1997, bank stocks in the S&P 500 returned over 5x their investment, versus under 3x for the broader index. Wells Fargo returned *in excess of 30% per year over the next 10 years*, outpacing the stock market by a significant margin.

We believe that our clients benefit from stock price volatility because of our diversified portfolio policies and our strategy over the past year to keep some "dry powder" in the form of cash. We continue to rebalance our portfolios so that they are in-line with our long-term targets, which in this environment means taking funds from cash, bonds and absolute return alternative investments that have recently performed well and buying more stocks. This allows us to be a net purchaser at advantageous prices as others exit the market. Longer-term, we end up owning more shares in quality businesses. This commitment to stocks as prices fall, as well as our strategic allocation to international equities, has lead to some performance headwinds over the last few months. We are okay with this as we are confident that such decisions will add value over the long-term.

We have warned investors for a number of quarters now to expect ongoing volatility. The heightened debt load of developed economies relative to their productive capacity will result in volatile prices for investment assets – in other words, prices on so-called risky assets like stocks will continue to move around a lot as investors try to grapple with the current economic situation. The environment also raises the risk of external shocks, such as a European dislocation. We are intently focused on the risks that could surface in investment markets, making sure that we (a) continue to keep dry powder in the form of cash and a strategic investment to bonds with reasonable maturities, (b) maintaining an allocation to absolute return alternative investments that we believe can do well even when stocks do not and (c) investing in companies that we know and understand that we believe will be earning materially more profits in 5-10 years.

Despite current risks, we believe the fear prevalent in today's markets presents opportunities for the patient investor to build long-term value. A talented investor once noted, "You make most of your money in bear markets – you just don't realize it at the time. That's because you're given a chance to buy first-class properties at distressed prices." But investing during such periods requires the emotional fortitude to experience short-term losses as the cost of long-term gains.

Please don't hesitate to contact us with any questions. As always, we thank you for your continued confidence.

Sincerely,

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