StaufferWilliams
ASSET MANAGEMENT · LLC

APRIL 2013 INVESTMENT COMMENTARY

THOSE WHO PLAY NOT TO LOSE OPEN THE DOOR TO DEFEAT

For the second consecutive year the S&P500 posted an impressive first quarter. The opening quarter of 2013 kicked the year off with a 10.03% gain, propelling markets to levels last seen in October of 2007. Unlike last year's rally when the technology, financial, and consumer discretionary sectors led the way, this year's opening quarter found leadership in high dividend yielding stocks and defensive sectors such as health care, consumer staples and utilities. Many investors will look at the S&P 500's first quarter gains and see a parallel with the beginning of 2012. We see two very different first quarter performances when comparing last year with this year.

From a global perspective, this year's first quarter stock market performance was a narrow U.S. centric event. Correlations between different global equity asset classes differed significantly from year-to-year. In 2012, the international markets, as defined by the MSCI EAFE, rose 7.38% versus 10.87% for the S&P 500 index, whereas this year the MSCI EAFE index only rose 2.61% versus the aforementioned 10.03% for the S&P 500. The index that the StaufferWilliams Core portfolio strategy most closely resembles, from an asset class allocation standpoint, is the MSCI All-Cap World Index, which only rose 3.49% in the first quarter this year, compared to 9.82% last year.

ING Investment Management's Douglas Cote wrote in his April, 2013 commentary titled, <u>Surprise! 2013 Rally Pales in Comparison to 2012 "Stealth" Rally</u>:

> *Despite all the hoopla over market performance in the first quarter, the period actually represented a marked disappointment compared to the first three months of 2012. While an equal-weighted global portfolio of ten asset classes returned a respectable 4.2% in first quarter 2013, that figure falls well short of first quarter 2012's astounding 7.8%.*

Many market watchers who view this defensive-led rally with skepticism express concern that equity markets have come too far, too fast and that we may be approaching an inflection point with the market advance running out of steam. That seems to be a very U.S. centric observation from our point of view. When equity investors view the "market" as one monolithic investment defined by U.S. centric large-cap indices, rather than the multitude of globally diversified individual companies that make up the market, it is easy for a more technical analysis oriented investor to question the risk/return dynamic of equities after attaining new record highs. However, as we illustrated last month, the advance in the S&P 500 has been very well supported by earnings growth over the last four years. That being said, equity markets are made up of stocks and we view those stocks on a company by company basis, attempting to avoid those companies whose stock price is not supported by past, present or future earnings and value creation.

We do agree that the market is nearing an inflection point, but from our perspective it is because the types of stocks that have been leading the market will not be able to sustain the advance much longer. Since the founding of StaufferWilliams in February of 2012, a recurring theme in our monthly investment commentaries has been our assertion that despite the impressive market performance, stocks continue to offer good value, and that the market continues to present opportunity for discriminating investors. We've been consistently vocal that the biggest risk facing today's investor, with an investment time horizon beyond CNBC's next commercial break, is either being under-invested to equities or not being invested at all. Whether or not the S&P 500 or Dow Jones Industrial Average is north of a certain number, our view is unchanged. We continue to believe that many stocks appear to offer good value for investors with a longer-term perspective, however not all stocks are equal in their appeal at this juncture. We are continually reviewing our portfolios; jettisoning positions that we do not believe will continue to generate sufficient value in favor of those which we can own at very opportunistic levels.

Writing this commentary in the midst of the NCAA Men's Basketball tournament reminds us that portfolio construction and the ongoing management of an equity process is quite a bit like coaching an athletic team. In order to be successful over the long-term a coach must continuously recruit the best talent (new idea generation), must constantly evaluate the existing talent (buy/sell discipline), and must develop offense and defensive game plans that best position his or her team for success (diversification and asset allocation). Most major sports put their teams through a rigorous regular season (the market) and then a sudden death post-season competition designed to result in a championship game. This championship game generally is played by the two best coached and most well balanced teams within the given sport. It is not always as easy with investing to measure success because most investors' measure success over a lifetime, with intermittent milestones along the way.

As asset managers we are continually recruiting, evaluating, and modifying our game plans. The regular season for an investment manager means that we compete every day and must decide when and if to react to external forces or just simply to stick to our proven play calling. The market changes personality like a competitive game ebbs and flows with momentum shifts. Successful coaches and investment managers seem to have an innate sense that enables them to know what to do when momentum goes against them or conversely presents them with an opportunity to seize control of the game.

Similarly, markets have their own pulse, and good active portfolio managers make adjustments to position portfolios in response to their expectations for the markets. We have mentioned in past commentaries our desire to identify U.S. equity investments that represent unique strengths that should help keep American capitalism the envy of the rest of the world, which we firmly believe will remain the case. One of the strengths that we strongly believe separates the U.S. economy from every other economy in the world is our heritage of innovation and entrepreneurialism. As we look forward, we are always on the lookout for transformational companies that are creating a durable competitive advantage centered on innovation and the passionate drive of an inventor/founder who demonstrates a clear vision of the future. When we look back in time at companies that we wish we would have been able to or had the foresight to invest in very early, Microsoft, Apple Computer and Google would most certainly come to mind in recent history. Looking back over 100 years, Ford Motor Company and General Electric would most certainly represent transformational companies of the early 20th century. What do all of these companies have in common?

We contend that the leaders who formed these companies were visionaries. They seized on the birth of new technologies in ways that changed the way people work and live, and the way society interacts. Bill Gates and Steve Jobs envisioned the transformational power of the personal computer before anyone else, Larry Page was able to imagine the almost unlimited applications of internet search and cloud computing, and Henry Ford and Thomas Edison changed the world by bringing affordable automobiles and electricity to the masses.

We are currently willing to state that we believe that there are two such companies today, that we believe have founders who possess some of the same qualities as the aforementioned inventors/entrepreneurs. If we are right, these individuals and their companies are poised to change the world as we know it. These two companies are Tesla Motors and Facebook. Both Elon Musk of Tesla and Mark Zuckerberg of Facebook are demonstrating that rare visionary quality that is so powerful and passionate to allow them to change the world around them in irreversible ways. Within our actively managed accounts, where we utilize individual securities, we are adding initial positions in Tesla and Facebook. We anticipate holding these positions for a very long-time, while taking a page from Warren Buffett and adding shares during periods when these respective stocks are on sale.

In formulating our actively managed equity portfolios, like building a winning team, we tend to group equity investments into 3 distinct categories:

- Durable Free-Cash-Flow Generators
- Opportunistic / Secular Growth Engines
- Special Situation Opportunities

Durable Free-cash-flow Generators are stocks with fundamental soundness and competitively advantaged within their given industries. These companies typically have very strong balance sheets, generate high levels of free cash flow, and give us reason to believe that they will be able to defend their leadership position into the foreseeable future.

If these stocks were athletes, they would be considered perennial all-stars who are the veteran leaders of their respective teams—the types of players that sports franchises are built around. These investments occupy a portion within a portfolio that deliver a high degree of stability, regardless of the market environment. Stocks in this category typically pay dividends with the probability of increasingly higher payouts in the future.

Durable free-cash-flow generators are found in abundance in our dividend growth process and are stabilizing factors in our core process.

Opportunistic Growth Engines are characterized by rapidly growing revenues as management capitalizes on promising new products or services, but which may not be currently throwing off positive cash flow. When we invest in these types of companies, we believe that overtime they will translate the company's competitive and/or first mover advantage into strong and growing free cash flow in the future. Opportunistic Growth Engines are more likely to experience a quarter or two where analysts incorrectly gauge upcoming earnings and revenue targets, resulting in unusual volatility in share prices. The athletic parallel would be the very promising, though less experienced players on the team--heavily recruited stars and highly touted rookies with the potential to be the emerging stars of the league. When you think about Facebook and Tesla, think about the Redskin's explosive rookie quarterback RGIII, Tiger Woods before he won his first Masters, or Lebron James in his rookie year.

Just like any great coach, we are always on the lookout for these Opportunistic Growth Engines.

Lastly, but certainly not to be overlooked, are stocks that are selected to perform well under a specific set of circumstances. Often this category of stock has cyclical characteristics. We attempt to add these stocks to portfolios while they are currently out of favor, but on the cusp of breaking out as market or economic changes occur. Plum Creek Timber and Rayonier, two timber REITS that have been prominent in our portfolios for over a year, represent Special Situation Opportunities and have been very good performers as the housing market has experienced the beginning of a turnaround in the time since we purchased these stocks. Both stocks could be characterized as defensive stocks, with yield, but we also view them as having cyclical growth characteristics. These cyclical growth characteristics made them early beneficiaries of our view on housing which came into focus at the end of 2011.

Over the last several months the U.S. equity markets have confounded many as they have seemingly ignored many of the types of policy driven and geopolitically driven risks that only a year ago would have derailed investor optimism. We believe that the markets are experiencing one of the momentum changes that we discussed earlier in the context of a sporting event. These momentum shifts, whether in sports or in the markets, are rooted in the psychological power of belief. We believe that the housing recovery and all of the false alarms of the last several years have convinced investors that it is safe to look into the future without what had become a customary impending sense of doom that blanketed the market.

If we are right about this momentum shift, it is time for "the market" to abandon the game plan, which resulted from the shock of the financial crisis period, of play-not-to-lose and begin to again adopt the confidence inspired, time-tested, play-to-win strategy.

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The author of this commentary and/or clients of Coastal Investment Advisors owned the following positions discussed in this commentary when it was published: Tesla Motors (TSLA) and Facebook (FB).

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