StaufferWilliams
ASSET MANAGEMENT · LLC

AUGUST 2012 INVESTMENT COMMENTARY

OPTIMISTS AND SKEPTICS REACH A FORK IN THE ROAD - WE TAKE THE FORK

ECONOMIC BACKDROP

Clearly the economy has softened during the past few weeks. Along with an unimproving employment picture, many of the most recent U.S. economic releases have been disappointing, pointing to a path for the U.S. economy that at best will continue to muddle along offering meager growth, although the likelihood of a slightly more disappointing outcome exists. The economy grew 1.5% for the second quarter, following a 2.0% advance for Q1. Leading up to the most recent release, markets were actually expecting a more disappointing reading, so markets viewed the 1.5% number favorably.

Overseas, the European crisis continues its slow, bumbling grind forward, providing the darkest clouds over the markets in the near term, meanwhile the prospect of a deepening Chinese economic slowdown weighs more heavily on intermediate term market expectations. Nevertheless, amid this seemingly ominous global economic backdrop, U.S. equity markets continue to climb the wall of worry, with the S&P 500 closing ending July just a few points below its highest level (1,385.97, S&P 500 Index) posted July 27th, in more than three months. Through the end of July, U.S. equities (S&P 500 index) have advanced 9.92% year to date.

For anyone doubting the control Europe commands on current market sentiment, most of early July saw markets advance while European pressures had dissipated following the deal European Union leaders struck at the end of June to recapitalize Eurozone banks. Later in the month, markets fell when fresh concerns surfaced that several of Spain's autonomous regions will need to seek assistance to pay creditors, raising concern that the European recession was deepening. Spanish bond yields spiked, and U.S. equities had dropped nearly 4% until the four day slide was halted when Mario Draghi, Chairman of the European Central Bank (ECB), sparked the markets stating that "ECB is ready to do whatever it takes to preserve the Euro", emphatically adding, "it will be enough." Draghi found support from leaders of the largest European economies when Germany's Chancellor Angela Merkel and President Francois Hollande of France, jointly released a statement that they are "determined to do everything to defend...the integrity of the euro zone". Global markets drifted higher through the end of July on renewed optimism.

Despite Merkel and Draghi's words of assurance, we ultimately are holding on to our belief that the European Union economy will remain in a flat to slightly negative environment well into next year, the Chinese economy will avoid a sharp deceleration, and that the U.S. economy will meander along with economic growth in the 1% to 2.5% range.

EARNINGS

As July closed, nearly two-thirds of S&P companies had reported earnings with 65% of companies exceeding or meeting earnings estimates, which is right in-line with historical results, however, 60% of companies have missed revenue forecasts. Revenues for many multi-national companies faced a stiff headwind from a stronger U.S. dollar, but we must be concerned that the trend emerging of growing weakness in revenues may be an indication of growing consumer weakness.

Because earnings are the single most important determinant on the future direction of stock prices, investors always focus intently on quarterly earnings releases. In the context of a challenging economic environment like we are facing now, corporate revenues and forward guidance often take on an even more critical role than reported earnings in divining the direction of the economy.

During the early weeks of this earnings season, some very high profile market darlings had exceeded analyst estimates, some by a rather wide margin only to be taken behind the woodshed by an unforgiving market that wanted more. One of the more dramatic beatings befell Chipotle Mexican Grill (CMG), whose stock plunged 22% despite posting an earnings beat 11% higher than consensus expectations. CMG also delivered earnings per share growth in excess of 60% as compared to the same quarter last year, and revenues which grew more than 20% over the same time period as last year. Same store sales of only 8% led to a slight revenue miss, while cautious forward guidance combined with a stock that was priced for perfection created the 22% market drop, the largest since the company came public.

Apple Computer dropped 4.3% 7-24-2012, due to revenue shortfall as consumers are apparently holding out for the iPhone5 model release expected later this year.

Early reporters Nike (June 28th) and Bed Bath and Beyond (June 20th), two other widely help, high profile stocks also saw huge price declines during this earnings season. In the case of Nike, the loss was attributed to a significant earnings miss, while Bed Bath and Beyond's revenues disappointed. Both companies cited global weakness and a more challenging forward environment as cause for their disappointing results.

The dramatic price declines that each of the above stocks experienced does not mean that the companies have suddenly become broken investments, but point to situations where prices had been driven up by investors crowding into successful past investments with little regard for the risks the elevated prices represented.

INVESTMENT STRATEGY

The current market environment reminds us that it is a market of stocks, not just a stock market, and as we stated in last month's commentary, ***"valuations always matter."*** At about 13 times next year's expected earnings, the stock market is fully discounting the recent economic slowdown and is trading at what we perceive to be relatively cheap, risk-adverse levels. As we look ahead, we believe the market provides reasonable opportunity in well selected equities and we can't help but look at some of the higher profile stumbles of the current earnings season with heightened conviction that our bottom up investment process that seeks to not only achieve good investment returns, but equally important, is also very cognizant of potential risk is the winning approach.

WHEN YOU COME TO A FORK IN THE ROAD - TAKE IT

Advances in U.S. equities so far this year have been driven by defensive posturing using large-cap high dividend paying stocks, which results in a positive market in an environment where the sentiment is largely negative. We believe that this leads to an inflection point—a fork in the road, so to speak. And in the famous words of Yogi Berra—"when you come to a fork in the road, take it." We plan to do precisely that. Our "two-forked" approach reflects a near-term defensive posture, combined with a longer-term optimistic orientation. To borrow another comment from last month's commentary, ***"we remain focused on finding opportunities in both equities and fixed income which have a fundamental margin of safety, long-term easy to understand advantages, and identified catalysts which will drive the market to assign a higher value over-time."***

Unlike other advisors, who, in an attempt to improve portfolio yields in this low yield environment, have instinctually ratcheted up portfolio risk by crowding into the perceived safety of traditionally defensive dividend stocks in utilities, telecoms, and consumer staples sectors, we have been finding opportunities where most advisors are not looking. We can't help but believe their strategy does not provide a margin of safety from a valuation perspective, and may end badly for investors as the inevitable catalyst of rising interests, or improved economic growth, will send these safety seeking investors running for the exits from these "safe harbor" investments. Our portfolios are a good blend of offensive and defensive positions, providing good upside potential, while attempting to limit the downside.

Timber REITs are a great example of defensive investments with offensive characteristics. Backed by real assets (timber and the land it grows on) currently at trough prices, timber REITs have relatively predictable return and cashflow characteristics and pay higher than market dividends. In a weak economic environment timber harvests can be deferred until demand improves, and when it does, those more mature trees increase the volume available for sale at the now higher timber prices. The bullish scenario is based on a recovery of the housing market, which is beginning to show early signs of recovery after spending years in trough levels. While a return to home building peak levels is not likely anytime soon, even a modest housing recovery should provide good upside potential in these stocks. Secondarily, the underlying real estate and timber resources of these companies offer the margin of safety we value. Plum Creek Timber (PCL) and Rayonier (RYN) are portfolio holdings currently representing this theme.

Another special situation stock we have recently uncovered is United Online (UNTD). At $4/ share, UNTD trades at 6.7 times full year 2012 earnings, with an eye-popping 9.9% yield. Originally founded by the merger of dial up internet service providers Netzero and Juno.com, UNTD is a diversified internet conglomerate with the majority of its revenues derived from the online florist and specialty gift fulfillment company, FTD.com. We believe the high yield of UNTD is well supported by its cash-flow, while the book value of the company exceeds the stock price providing a margin of safety and opening up opportunities for management to unlock value through M&A or other strategic options.

We shared our investment thesis for timber and UNTD in order to demonstrate the results of our discipline of searching all corners of the market for investments which encompass the rare characteristics which we are seeking for our clients. These characteristics are challenging to find if one limits his or her search to the largest, most visible 500 companies in the United States. Our research effort strives to find opportunities where the majority of investors are not looking.

We certainly cannot know the future of the aforementioned investments, but we draw confidence from our discipline. The qualities that we see in these investments are not dissimilar to what we saw in Companhia de Saneamento Basico do Estado de Sao Paulo (SBS). SBS is not a household name by any stretch, but it has been a core holding in many clients' portfolios since as early as May, 2009; it pays a solid dividend and has appreciated almost 170% since that time and is still not overvalued today.

CONTEMPLATING BILL GROSS' RECENT COMMENTARY

At the very end of July, PIMCO's Bill Gross's August 2012 Investment Outlook generated considerable buzz among market commentators when he asserted that "the cult of equity is dying". This latest outlook is a timely repackaging of one of his most commonly recurring themes, that the future offers a low return, high inflationary environment for equity and fixed income investors. Gross's commentary is always thought-provoking and while we won't dedicate too much time offering our thoughts in response in this commentary, we will agree with Mr. Gross that today's investors faces considerable challenges, especially for the majority of U.S. investors whose portfolios continue to be managed as if it were 1995, using traditional sector based asset allocation strategies focused almost exclusively on the U.S. stock and bond markets.

XXX OLYMPIAD

In addition to watching for the latest economic developments in continental Europe, we're also being treated to media coverage across the pond as London brings the world together for three weeks as the host city of the XXX Olympiad. The London Olympics will command center stage from the opening ceremonies on July 27th before culminating August 12th, featuring more than 10,000 athletes representing 204 National Olympic Committees.

The Olympics always represents a coming together of the global community through the vehicle of spirited competition by the best athletes in the world. The Olympics are a reminder that all that sparkles when it comes to great achievement, whether that achievement is athletic or business oriented, is not concentrated in one country or continent when the competition is global in nature. This is why we do not limit ourselves geographically, or by size, when it comes to uncovering gold medal winning investments for our clients.

Just like all countries come together every two years to compete at the Olympics regardless of political and cultural differences, we are increasingly optimistic that global leaders are coming together to coordinate policies to stabilize global economic systems and to ensure the efficient transmission of global economic activity. If we are correct, those actions will inspire confidence that a common will has prevailed to tackle the most difficult economic challenges in 80 years. We do not think that there will be a quick fix, that is not even a remote possibility, but more certainly in terms of policy actions should be comforting to the markets.

We have been skeptics on many fronts over the last couple years; however we have never stopped being optimists when it comes to investing. The principals of investing require being able to identify where the line that separates optimism and wishful thinking lies. In a low growth world, pockets of growth can be found and persistent innovation is leading to advancements in certain industries which will create and expand certain markets, providing plenty of promising opportunities to choose from. We will be focused on leaving no stone unturned as we embrace the challenge of finding growth in a low growth world.

CURT R. STAUFFER
Partner, 717 877 7422

JONATHAN M. WILLIAMS
Partner, 717 810 6705