

DECEMBER 2012 INVESTMENT COMMENTARY

FISCAL CLIFF HYSTERIA CAUSING A MARKET STORM

Sir Winston Churchill said, “Why is it the ship beats the waves when the waves are so many and the ship is one? The reason is that the ship has a purpose.”

The so called “fiscal cliff”, what is all the fuss about? Now through the end of the year, the media will be fixated on this singular issue as if nothing else matters. From our perspective, one of two broad outcomes will result from this man-made spectacle. The first of the two outcomes is that negotiations and posturing will lead to last minute legislation prior to January 1st that partially addresses the goals of acting on the expiring tax cuts and sets in motion a framework for spending cuts, including entitlement reform. Should this occur, the stock market will likely breathe a sigh of relief and rally into the year-end. The second of the two likely outcomes is that legislation will not be able to be voted upon by year-end, which would cause the stock market to punish that inaction with a lot of volatility and a further sell-off, only to have legislators buckle under the pressure from the markets and accomplish outcome number one shortly after the beginning of the new year.

Under either aforementioned scenario, the real economy is spared the actual effects of a broad increase in taxes and sharp across the board spending cuts. This is where we tend to part company with many trading oriented investors.

Traders are driven by price changes (and ironically are often the cause of those very price changes), sentiment and momentum, whereas we are instead driven by value changes. The difference is profound. When one is focused upon value change, there is little to no difference between fiscal cliff

outcome number one and number two. Our dual purposes, of seeking long-term capital appreciation and prudent risk management, are not jeopardized by the daily waves of hysteria created by the media’s obsession with attempting to handicap a legislative deal.

The only fiscal cliff scenarios that would actually impact the value of our chosen investments is one in which nothing happens in terms of legislation and the middle class is hit hard with tax increases and the economy absorbs the entire brunt of the scheduled immediate government spending cuts. Additionally, a scenario where taxes on dividends for all investors revert to being taxed at each investor’s highest marginal income tax rate would be very negative for high dividend paying securities, such as utility stocks and master limited partnerships. We do not see either of these two scenarios being very plausible.

What tends to happen to the stocks of well-run companies during times like this is that prices fluctuate around a fairly stable value. The equities of companies that we own in client portfolios have not been immune to heightened price fluctuation over the last two months. For example, a widely owned high dividend company in StaufferWilliams portfolios that was purchased over the summer saw its stock price drop 12% shortly after the election in reaction to President Obama being reelected. This drop in price did not dissuade us from establishing new positions in this stock within portfolios that had not benefited from our initial purchase of the investment over the summer. Over last two weeks of November, this stock

gained 13% following the sell-off. We still believe that this stock is selling at a price at least 10% to 15% below its fair value. We would not add new positions in the stock at current levels; however the early November sell-off provided us with a very short window of opportunity to purchase additional shares. This example illustrates why we do not allow price movements to influence our assessment of value. Price movements in our process are invitations for us to reexamine an opportunity in order to determine whether the price change is compelling enough relative to our assessment of valuation to trigger a buy or sell decision.

We owned another stock within our biotech strategy portfolios that abruptly fell 25% in price from early October through early November, during a time when small cap biotech stocks had temporarily fallen out of favor in the market. Again, we remained focused on our assessment of value, and the drivers of that value. We were able to take advantage of this price change and aggressively added to this position within a newly established client account being managed according to our biotech strategy mandate. The sell-off in this stock bottomed in early November, and over the balance of the month the stock appreciated 75%.

Not all price dislocations during a market correction immediately spring right back. Some selling in certain stocks takes much longer to recover. This longer recovery period can erode many investors' confidence in a previous value assessment. Compounding this difficulty is the shortsightedness of Wall Street analysts, who tend to downgrade stocks near the bottom and upgrade stocks near the top in price. Investors who are driven by value versus price must be inherently thick skinned and stubborn in order to resist confusing signals caused by market price volatility and short-sighted analysts who move price targets around almost monthly.

The StaufferWilliams equity process is inherently stubborn in its convictions and buy/sell discipline. Our process is entirely focused upon long-term capital appreciation of each of our client's assets and is not influenced by quarter end "window dressing", locking in gains ahead of a performance reporting period, or following market "risk-on/risk-off" trading cycles.

As the final month of 2012 winds down and we begin to look with anticipation of what 2013 will bring to us, we are mindful that the media focus on the "fiscal cliff" through the end of the year is likely to create much greater market volatility over the short-term, however, we are steadfast in our belief that a deal will be struck in the 12th hour that will be a workable compromise between the two parties—and if not at the 12th hour, at least sometime shortly after midnight.

We wish you all a very joyous Holiday Season.



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