

StaufferWilliams Asset Management, LLC

Investment Commentary February, 2012

Fundamentals Front & Center-A Promising Start to 2012

For the first time in over one year the stock market appears to be moving much more like a market of stocks, as opposed to a risk on risk off stock market, meaning that the vast majority of stocks are not moving in lock-step with each other. What this means for fundamental stock pickers such as StaufferWilliams Asset Management is that our clients are again being rewarded for the time and effort spent sifting through the stocks of thousands of companies to identify the 20 to 30 which meet our selective criteria.

Is it any surprise that the market ceased the monolithic price action that characterized the stock market in 2011? The financial press recently reported, after the release of 2011 investor activity statistics, that a significant investor shift occurred away from actively managed mutual funds in favor of index funds. On January 22, 2012 Investment News published an article written by Jason Kephart titled *American Funds is the Biggest Loser in Shift Toward Passive Investment*, which stated that "Index mutual funds took in a record \$76 billion last year, and exchange-traded funds, which are predominantly passive, scored another \$121 billion. Actively managed funds, meanwhile, lost about \$9.4 billion, according to Morningstar".

Although we are always in favor of active management, we would be the first to admit that the market does not always reward the work that active managers perform for their clients over a finite period of time. However, since we are not financial advisers in a classic sense, we are not trying to chase performance by looking in the rearview mirror or trying to guess where the market is going to go before we make investments.

2011 was one of those years when index funds and ETF's outperformed most actively managed funds; therefore it is not surprising that professional financial advisers, as well as individual investors threw in the towel on actively managed funds and portfolios. It is equally not surprising that in the month of January we have seen the market punish passive investors who had become accustomed to stocks moving in tandem with each other regardless of valuation and fundamentals. Many individual stocks, which we have held in accounts for the last nine months or more, substantially outperformed the broad markets last month. We were not surprised by this abrupt change because we firmly believed that fundamentals and valuation metrics are what are ultimately weighed by the market.

It was Ben Graham who famously compared the stock market to a voting machine in the short-term and a weighing machine over the long-term. This is such a true comparison from our vantage point. A great example of the voting machine was illustrated last year when a company called Kraton Performance Polymers (KRA) was purchased for many clients in the middle of the year for approximately \$21 per share. This purchase came after the stock had been cut in half in the market because of budding fears of a double dip recession and the concerns surrounding the debt ceiling negotiations in Washington. We believed at the time that the fears of a double dip

recession were unfounded and that this company had its stock unfairly punished. We valued the company's stock at approximately \$35 per share, therefore providing over a 60% upside from where the original purchased price. Over the next couple months, the stock market continued to sell-off on recession and European Debt fears, which caused Kraton Performance Polymers to fall as low as \$13 per share at one point in September. The voting machine was overheating at that point and in many accounts we added more to our investment in this company at levels under \$15 per share, lowering our average cost to approximately \$18 per share. Later in the year, after recession fears subsided, and investors became convinced that the worst case scenario had been taken off the table in Europe, we began to see evidence that the market was showing signs of behaving like a weighing machine again. As we came to the end of 2011, Kraton Performance Polymers' stock was back above \$20 per share. As of the writing of this commentary, Kraton Polymers' stock has appreciated to over \$30 per share and we have begun to lighten up on our clients' positions.

We absolutely relish the opportunity to take advantage of the voting machine as we did in the case of Kraton Performance Polymers. Those who are always weighing investments to determine what they are worth in the context of a market, that many times is setting prices based upon emotional and short-term factors, do not get concerned over mostly nonsensical, anxiety raising, volatility. For the investor who has conviction in his investments, living through schizophrenic periods in the market can be like watching a pre-recorded football game knowing who wins the game. Thus, when your team's quarterback fumbles the ball in the end-zone, resulting in a go-ahead touchdown for the other team in the fourth quarter, it is entertaining to watch, but it engenders no feelings of despair or frustration, because you know that at the end of the game your team will win.

Not only has 2012 brought back some semblance of rational price discovery in the U.S. stock market, we have seen growth oriented investors wake up to the fact that 2011 ushered in several significant and novel new medicines treating chronic and life threatening conditions such as Hepatitis C, Prostate Cancer and Lupus. The companies who developed these treatments did so by coming to market with drugs which were only made possible through the advances in human genome sequencing over the last 10 years. These drugs are finally ushering in a new age in drug development which will allow for targeting of the root causes of the most devastating diseases afflicting the human race. The human benefit of these new scientific platforms of discovery is expected to be fantastic. Like any paradigm shift in an industry, investment opportunities will reward the informed investor and be perilous for the uninformed speculator.

StaufferWilliams Asset Management has a research relationship with Rasmussen Biotech and Pharma Consulting, LLC. This relationship enables us to gain a much better understanding of the complex and rapidly changing landscape of drug development as it relates to identifying investment opportunities. As with any cutting edge technology, separating the hype from the scientific promise is critical to identifying prudent investment opportunities. Our research partnership with Rasmussen Biotech and Pharma Consulting has already contributed to several successful investments over the last 12 months.

We will always seek out fundamental and objective research to supplement our own in-house research capabilities in order to improve investment returns for our clients. This desire to gain a better understanding of companies, industries and securities applies to both stocks and bonds alike. Many client portfolios holding individual bonds have seen significant appreciation in the value of those bonds due to falling interest rates and a modestly improving economic backdrop. At some point, these tail winds will diverge and interest rates will rise along with economic growth, which is far more plausible than the current inverse relationship between economic growth and interest rates. For this reason we will likely be a net seller of bonds in 2012 in order to lock in profits and generate liquidity to allocate to equity investment opportunities.

Beginning in February we will be introducing a new website which we plan to develop into a useful resource for our clients to communicate and access information such as this commentary, Charles Schwab & Company

account information, blogs, and links to other useful websites. You will receive an email with a link to our website as soon as it goes live.

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