StaufferWilliams
ASSET MANAGEMENT · LLC

JULY 2012 INVESTMENT COMMENTARY

VIVA JUNE! BACK ON TRACK?

In our last commentary we stated that "a combination of likely scenarios in Europe and a continuation of mediocre economic performance domestically should bring this correction to an abrupt end in June."

For those who have not caught on yet, with the European debt crisis, the characters involved are largely posturing and negotiating through the media. The media is a cooperative accomplice because those in the media can frame each and every strategically leaked quote to achieve maximum sensational impact. This leads to the media reporting the most sensational, and many times, the most fatalistic comments coming from the dueling sides in the debate. This tendency toward sensationalism, combined with our country's own brand of political hyperbole, a general consensus will result that reflects the most unlikely and dire scenarios in a given situation, as it relates to Europe.

We listen to the same "financial news" as everyone else; however, our reaction is typically one of "consider the source." Politicians will always posture, and the media will always sensationalize. This combination can be very dangerous to one's objectivity when it comes to making investment decisions.

At a time when most media sources reporting on the upcoming mid-June Greek elections and the European Union (EU) Summit at the end of June were biased toward the pundits who saw no hope for a unified EU, we stayed true to our long-standing position on the subject. Those calling for continued strife and the eventual break-up of the EU staked out positions that called for Greece to exit from the European Union and for Germany to remain unwilling to do what was needed regarding the sharing of liabilities among EU members in order to sure up the banking system and lower borrowing costs. We wrote in our June commentary, "The mid-June elections in Greece are likely, in our opinion, to create a coalition government that will be willing to continue with needed fiscal reforms in that country, while European Union members are likely to moderate their previous "austerity only" stance in favor of a slightly more balanced approach of fiscal reforms and economic stimulus actions."

In regard to the duration of the stock market correction which began at the end of April, we stated that "temporarily taking European headline risk off the table will likely breathe renewed life into the equity markets by the end of June." On June 29th, Bloomberg News published an article titled "S&P 500 Caps Best June Since 1999 on European Agreement." In this article, the authors said of the strong end of month market action on the last trading of June, "the S&P 500 jumped 2.5 percent, the most in 2012, to 1,362.16. It rallied 4 percent this month for the biggest advance since February."

MEANDERING CONTINUES

When investing we must constantly assess and reassess the future environment as it relates to economics and earnings growth. In terms of equities, we discuss valuations quite often; however we cannot put a valuation into context without first having a strong conviction concerning growth expectations. Growth expectations are quite easy to get right when sentiment is at extremes of exuberance or pessimism. Today, equity valuations have become extremely under-valued relative to a non-recession outlook, which is our expectation. We have not been overly optimistic, or overly pessimistic regarding the economy, instead we have maintained an outlook that envisions a continuation of modest economic growth, meandering back and forth between 1% and 2.5% growth for the next several quarters. During the past several months, we've witnessed a deceleration of economic growth from what we had experienced during the final quarter of 2011, and earlier this year. We attribute this period of slower growth to a combination of domestic economic activity which was pulled forward by the uncharacteristically warm winter in the U.S., the deepening recession in Europe, and slowing growth in China. Our non-recession outlook in the U.S. relies upon Europe's recession remaining relatively shallow and China intervening to stimulate their economy in order to ensure that growth remains at an annual pace above 8%. Regarding U.S. actions and events contributing to the health of our economy, we believe that the Supreme Court's decision to uphold the Affordable Healthcare Act actually eliminates uncertainty in the private sector. We see the "fiscal cliff" issue being deferred into 2013 to give the new Congress, and the President who is sworn into office in January, time to address these issues in a more comprehensive and permanent way. Should events unfold over the next six months as we envision, we believe that the equity market has more significant upside potential than downside potential.

WHAT'S WORKING, WARY OF TUNNEL VISION

What is working in today's markets is a value-seeking, opportunistic, bottoms-up approach to security selection within the framework of a clear commonsense view of the macro environment over the intermediate term. What is not working is a traditional top down asset allocation approach based upon typical historically driven business cycle indicators. On one hand, the stock market has technically been in a bull market for three years, however on the other hand the stock market has not yet eclipsed the October 2007 highs. Valuations are well below historical levels, with growth stocks much more attractive relative to modest growth expectations than they have been for many decades. We do not attempt to glean any confidence from looking at historical patterns and trying to apply those "time-tested" axioms to the post financial crisis business cycle and markets. Without reliable market cycle guideposts, many advisors who historically have relied upon top down market cycle patterns to drive their investment strategy have been stymied. Today's post financial crisis market and economy have rendered those patterns largely ineffective.

The challenge for many portfolio managers in a low growth, low interest rate environment is to rationalize the high valuations of large, mature low growth dividend paying stocks. Because investors who cannot generate sufficient income from traditional investment grade fixed income have bid up the stock prices of high dividend paying stocks, these stocks look very richly priced relative the stocks of higher growth companies. Normally, leading up to the end of a bull market, these slow growing stocks are typically ignored in favor of high growth stocks, leaving these large-cap value stocks looking very attractive relative to their growth stock brethren. This historically has been the pattern because in aging bull market, characterized by strong GDP growth and tighter monetary policy, we experience higher market interest rates which make dividends less attractive income alternatives. Michael Santoli of Barron's wrote in his June 16th article titled "The Market and its Tunnel Vision" regarding the valuations of traditional safe-haven higher income equity sectors, "These sectors are trading at 15-year-high valuations relative to the broad market, based on forecast earnings, which could become a drag on future capital appreciation."

When we say that we are bottom-up, opportunistic and agnostic, we mean that we systematically avoid the tendency toward tunnel vision and group think in regard to how we select our securities. Tunnel vision and group think is very dangerous for investors over the long-term, as it leads to crowded trades. Crowded trades have a way of convincing investors that there is safety in numbers and that valuations do not matter because the crowd is always smarter than the individual. What we have learned over the course of our careers is that crowds suffocate objectivity and valuations always matters. When objectivity is maintained the contrarian individual will almost always get the last laugh, while the crowd is in tears.

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. These opportunities are not found by parsing market sectors or by applying top-down rational, but instead they are found by looking at the markets without a bias toward particular sectors, countries or market-cap sizes. Very attractive opportunities are rarely found where everyone else is looking. A good example of finding opportunities in places where most people are not looking is Mizuho Financial (MFG). Mizuho is a $40 billion market cap Japanese bank that we bought in many actively managed accounts during 2011 shortly after the devastating Japanese Tsunami occurred. Unlike many U.S. banks, Mizuho is growing earnings and pays a very attractive 4.21% annual dividend at the current share price of $3.39. We took advantage of opportunities to purchase this large Japanese bank at share prices between $2.80 and $3.25 per share over the last 15 months. Shortly before the Tsunami disaster struck this stock was trading over $4.00 per share. We are willing to get paid a 4%+ dividend while we waited for the stock to recover to post tsunami levels. We do not own any shares of U.S. banking institutions, however in addition to Mizuho, we own Banco Columbia (CIB) in many actively managed accounts.

We are looking forward to the second half of 2012 and continue to see great potential within our clients' portfolios. As always, external events and market volatility will play a significant role in how rapidly values that we have identified are realized. We do take actions with portfolios to attempt to mitigate inherent volatility; however it is impossible to substantially eliminate this variable without significantly reducing a portfolio's expected returns.

We wish everyone a happy Fourth of July holiday and look forward to getting together with our clients over the summer.

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