JULY 2013 INVESTMENT COMMENTARY

DON'T BE CONFUSED, TAPERING (LESS QE) IS GOOD FOR INVESTORS

We have discussed in this commentary on different occasions the actions that the Federal Reserve and other central banks around the world took over the last 5 years in order to soften the effects of the housing bubble, financial crisis and "Great Recession" and to foster recovery. These monetary responses have included explicit and implicit guarantees, zero interest rate policies and bond buying, otherwise known as quantitative easing (QE).

Depending on who you listen to, the Federal Reserve has largely succeeded or has only prolonged the healing process and created greater long-term issues that will need to be reckoned with eventually. We are not going to delve into that debate here. What we are going to address is what we know to be true. The United States exited the Great Recession in June of 2009 and its economy has grown below potential for the last four years, but that below potential growth set in the context of sluggish global growth, has outperformed the vast majority of other developed nation peers. Inflation has remained low and the unemployment rate has fallen over 2.5% to 7.5%, one of the lowest in the developed world.

Compared to the last several decades, our economy feels sluggish and stubbornly unresponsive to the massive fiscal and monetary policy efforts that have been applied. If we were to grade our economy, we would be hard pressed to assign anything higher than a C- based upon an historical context, but if we applied a curve based upon the performance of other comparable economies since the financial crisis, the U.S. would get an A-.

This difference between the absolute grade of C- and the A- on the curve is what makes the jobs of politicians and policy makers so very difficult. That being said, the ability of monetary policy to positively impact economic performance without creating dangerously large financial imbalances is limited. What Federal Reserve Chairman Bernanke signaled to the world in May is that those limitations are close at hand and that extraordinary monetary stimulus needs to begin to be reversed. Fed Chairman Bernanke signaled a change of course after seven straight months of U.S. stock market advances, and strong auto and housing sales, amid continued record money flows into bond funds and defensive high yield equities. The one-way trade into risk oriented yield securities had driven longer term interest rates and yields on high yield debt to record lows, had inflated valuations of REITs and high yield stocks to record highs, and was clearly flashing warning signals that imbalances were reaching critical threshold levels.

In our opinion, these warning signals and the strong recovery in housing has given the Federal Reserve the impetus to act and the confidence that the economy can now keep its balance without the full effects of monetary training wheels.

Our clients have heard from us for almost a year about unsustainably low interest rates and high valuations of traditional high dividend stocks. Being contrarians by the construct of our value discipline, we began tactically reducing bond allocations and avoiding equity securities which are traditionally interest rate sensitive. Our efforts began 8-10 months early if measured against Bernanke's May comment, but attempting to time such events is a fool's game and not something that we would ever attempt as fiduciaries of our clients' assets. We have conviction in our view, but we have no allusion that we have the ability to time portfolio actions on a month-to-month basis. Our approach to steering portfolio strategy during periods of shifting economic realities or market excesses is one of charting our 12-24 month course, putting

on blinders that keep our focus on what is ahead, continuously validating our assumptions, and making incremental adjustments along the way.

We telegraphed the direction of our path forward earlier this year when we suggested that a winning strategy would be found in "playing to win rather than playing not to lose", in other words to abandon the perceived safety of defensive investments in favor of opportunistic investments created by a sustained economic recovery.

Several months later the Fed decided that it was time to throw some cold water on investors who were complacent because Fed policy was rewarding the play not to lose mentality. In May Fed Chairman Bernanke signaled that at some point in the not so distant future, the Fed would begin to taper its bond purchase program (QE). Markets around the world responded with tremendous volatility, highlighted by panic selling of those very asset classes that had benefited from the extraordinary monetary policies that had become the norm after five years. The yield on the benchmark 10 year US Treasury note rose more than 100 basis points in a little over three weeks from 1.60% prior to Bernanke's hint of the taper to a peak of 2.62% before settling into a more narrow trading range.

Longer duration fixed income securities, and those securities that had been the beneficiary of leveraged positions, were caught in a more significant downturn as de-leveraging caused mass liquidations, which rapidly pushed interest rates higher than fundamentals justified.

At StaufferWilliams, we have expressed our concern on many occasions with what was going on in the markets related to investors stretching for yield regardless of valuation. We were witness to the continuous flow of money pouring into bond funds and high yield stocks based upon "real time" levels of interest rates. Our strategy was to minimize exposure to long duration bonds and avoid high dividend stocks within sectors that have historically been considered slow growing defensive sectors; because we knew that the fundamentals did not justify the prices being paid to own those securities. We resisted following the herd over the eventual cliff and continued to lower our portfolio's interest rate sensitivity.

After witnessing the market's disorderly reaction to Bernanke's comments on June 19th, which reinforced his statements from mid-May, the Federal Reserve attempted to soften the rhetoric by sending out other Fed Governors to remove any certainty of policy or timing that the market appeared to extrapolate from Bernanke's previous comments. At the end of the day, Bernanke had always maintained that any change in monetary policy will be "data dependent", which means that if, and only if, economic performance matched or exceeded Fed forecasts, will the Fed begin to lower the level of bond purchases. Since we do not rely upon leverage to manufacture returns for our clients and we do not pretend to be able to time market volatility, we heard what Bernanke was actually saying instead of reacting to what he might be inferring.

Marc Chandler, Chief Currency Strategist at Brown Brothers Harriman, wrote on June 29, *"yields rose more than the Fed expected. Officials implicitly and often explicitly assumed that the market understood what the Fed was trying to do…. rather than the market misunderstanding the Federal Reserve; it may be the Fed that misunderstood the markets. Fed officials appear to be relying on some kind of fair value model of interest rates to deduce that the market has over-reacted. However, there is another model, albeit less formal, that offers insight into the price action. It is not fair value, but internal market dynamics, such as positioning and liquidity that explains the dramatic market response more than the discounting of net present value of some future expectation. Even if the fair valuation model is valid over the longer term, it seems perfectly reasonable and rational that in the shorter-term it is overwhelmed by position adjustments."*

Mr. Chandler is highlighting what we regularly discuss and that is the inevitable confounding conflict between fundamentals, value and price action.

From our perspective, we believe that the market activity of the past month and a half or so illustrates a "tale of two markets". For at least the last two years it has been no secret that interest rates would not remain artificially low indefinitely. Most investors knew that the Fed would at some point need to slowly step back from its unprecedented monetary intervention policies. For fundamental investors, such as StaufferWilliams, we acknowledged that reality and began to position portfolios appropriately ahead of that eventuality.

However, the short-sighted herd mentality of the majority of investors continued the game of chicken with the economic inevitability well into 2013. The herd abruptly reversed course at the first public utterance by Fed Chairman Bernanke that the Central Bank may have the luxury of beginning to "taper" monthly bond purchases sooner than later. The market's knee jerk reaction to Bernanke's statements was swift and sharp as bond yields rose dramatically and the investors that had crowded into high yield areas of the equity market, such as utilities, consumer staples and REIT's, scrambled to sell the

same investments that they could not get enough of just a month earlier. At StaufferWilliams we were neither surprised by Bernanke's comments, nor were we panicked into abruptly altering our portfolios because we knew this situation would come to pass at some point in time. We were not naïve enough to think that we could accurately predict exactly when the Fed would credibly signal that they were going to begin to change course, so we did not try to time the event, we just prepared for it.

This last month and half illustrates the difference between different types of investors. Investors such as StaufferWilliams take a longer term fundamental view of the investment landscape and attempt to anticipate durable changes that may alter those views. When changes are on the horizon, fundamental investors slowly adjust portfolio exposures in an incremental manner ahead of the changes. Other investors, and we use that term loosely, tend to belong to the "church of what is working now" investment mentality. Momentum and technical analysis motivate these investors and reaction, not preparation, is standard procedure. The playbook for non-fundamental investors is to live in the moment. They don't ask questions, they just shoot. They don't try to understand; they just let fear of what they don't know or understand dictate actions.

By the time you receive this commentary we anticipate that the equity market will be have largely recovered from the June swoon and will be looking ahead to the reporting of second quarter earnings. We always look forward to the rationality that tends to accompany quarterly earnings reporting, as investors turn their attention toward those things which actually can generate wealth creation over the long-term for equity investors. Looking through the fog of "tape talk" we see economic strength in housing and consumer spending. As the year progressives we anticipate economic strength to trump the fear of the prospect of more normal interest rates.

We are not positioning portfolios based upon a fear of "the taper", we sincerely hope that the Fed is able to scale back its bond purchases. This will mean that the economy is continuing to improve, more people are employed and the businesses that we invest in are experiencing growing demand for their products and services. It is after all economic activity, consumer demand and innovation that drive capital appreciation as an equity investor, not quantitative easing and extraordinarily low interest rates. We hope that our steady hand and rational view of the outlook for the economy and markets is evident to our clients as they monitor their portfolios over time. Reactive investing leads to excessive volatility within portfolios that can lead investors through an exhaustive cycle of euphoria and despair, whereas a forward focus based upon a consistent rational interpretation of events smooth's out the volatility and results in a more predictable outcome.

We hope that everyone had an enjoyable Independence Day holiday and is enjoying summertime activities and time with family and friends.

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