

Stauffer Williams Asset Management, LLC

Investment Commentary March, 2012

Stocks, Bonds, Gold – The Winner is.....Stocks

Over the last month Jeremy Grantham and Warren Buffett each published comprehensive narratives on the relative attractiveness of stocks, bonds and gold. Consistent with our opinion, the agreement of these two investment luminaries was that stocks are the most under-valued and least risky investment choice.

Three years ago this month, Curt wrote an investment commentary, as the stock market was nearing its financial crisis induced low, entitled “The Market Strikes a Somber Tone- We Find Rainbows”. In this commentary Curt discussed how unsustainably low many quality stocks were being priced due to fear and institutional deleveraging, while many of the businesses represented by the depressed stock prices were fundamentally strong. Buffett and Grantham are not currently making such a resounding statement of enthusiasm regarding stocks as Curt was three years ago, but they are both arguing that investors will earn better returns in stocks than bonds or gold.

Grantham, in GMO’s Fourth Quarter 2011 commentary, made the following statement which we greatly appreciate as portfolio managers who stress a “keep it simple” approach to investing, “Murphy’s Law of complexity is powerful: things will go badly if they can and when you least need them to, but complex things will go bad first, and worst given half a chance, as we saw in the mortgage market a few years ago. Keep it simple when you can. And owning stocks is very simple indeed”. Investors need to heed this advice when selecting investments and/or investment managers. Many of the most well documented investment catastrophes of the past could have been avoided had investors shunned complex investment products such as fund-of-fund hedge funds, leveraged bond funds, leveraged ETF’s, and funds relying upon quantitatively driven market timing algorithms. The same holds true when applied to owning individual stocks; we prefer investing in simple to understand, well run businesses and avoid overly complex companies, such as large investment banks, global conglomerates and overly acquisitive organizations.

One of the most discussed aspects of Warren Buffett’s 2011 letter to shareholders was his comments regarding gold as an investment. Fans of gold bristled at Buffett’s comments, which among other things compared gold investing to the Tulip mania. Buffett said, “The second major category of investments involves assets that will never produce anything, but that are purchased in the buyer’s hope that someone else – who also knows that the assets will be forever unproductive – will pay more for them in the future. Tulips, of all things, briefly became a favorite of such buyers in the 17th century. This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will expand still further. Owners are *not* inspired by what the asset itself can produce – it will remain lifeless forever – but rather by the belief that others will desire it even more avidly in the future. The major asset in this category is gold, currently a huge favorite of investors who fear almost all other assets, especially paper money (of whose value, as noted, they are right to be fearful)”.

Mr. Buffett's comments regarding gold did not surprise or shock us as they are consistent with how fundamental investors view speculating on the price of a shiny ore mined from the ground. In April, 2011, Curt wrote about the price of silver at the time, "unlike a bond or a stock which generates certain cash flow or interest payments to investors that can be discounted in order to estimate the present value, commodities have no such characteristics. Silver is a finite shiny metal which can be mined from the ground. The owner of an ounce of silver can store it in hopes that at a future date it has appreciated in value. However, that appreciation will not be a function of the silver itself becoming more valuable due to it paying higher interest, paying greater dividends or growing larger and more valuable. The appreciation, if it happens, will only be a function of either a depreciation in the currency of exchange used to pay for the silver, a rise in the cost of mining silver, greater industrial demand, or the hope that the next buyer will be willing to pay more to speculate (known to many as the greater fool theory)". At the time, Curt was justifying profit-taking on an investment made in June 2009, which had essentially doubled from the original purchase price. The basis for the original investment in silver was on the premise that growing momentum in the nascent economic recovery would lead to greater demand for silver, a hybrid industrial / precious metal, as the recovery regained traction. A secondary consideration was that the price of silver, which is historically very highly correlated with the price of gold, had under-performed gold significantly during the preceding year. Taking profits was meant to avoid being one of the "greater fools".

Both Buffett and Grantham have made strong cases going into 2012 for equities, relative to other asset classes. Fundamentally, we are in agreement that equities present the most compelling risk/return opportunity looking out over the next 12 to 18 months. This does not mean that we are going to make significant shifts in the asset allocation of client portfolios. Going into 2012, we began to opportunistically harvest bonds that had experienced significant appreciation and re-allocated the proceeds into additional equity positions. This situation was set up during the market environment of early 2011, when bond prices fell precipitously as a result of Meredith Whitney's now famous botched municipal bond prediction, the timing of which corresponded to a period of stronger than expected economic growth. Bonds were bought aggressively during that time period as yields spiked and bond prices fell. By mid-year, bond yields fell again in response to slowing economic growth, and torpedoed investor confidence brought about by among other things, the downgrade of U.S. debt. Within the context of the current marketplace, the yield on the 10 year Treasury Note has seemingly found a bottom between 1.80% and 2.00%, and economic growth is showing encouraging signs of sustainability. We are convinced that profits from well timed bond purchases should be selectively realized before those profits evaporate when bond yields begin to climb.

Looking out over the balance of 2012, we cannot identify any high probability events likely to derail the momentum the domestic economy has generated over the last four to five months. If we are correct, quarterly GDP readings, monthly unemployment statistics and housing related data should continue to generate positive surprises. Should economic strength persist, full year GDP expectations for 2012 will be revised higher, corporate earnings guidance will become more optimistic, fueling improved investor sentiment and with it the appetite to take on increasing allocation to risk assets. We will be keenly watching for a more optimistic tone on the upcoming first quarter earnings conference calls beginning in April.

Possible risks to our economic and earnings outlook for 2012 are higher inflation expectations, higher bond yields, and concerns the Federal Reserve will need to raise short-term interest rates well before 2014. In order to guard against these concerns, we will continue to remain opportunistic with respect to our bond sales, will seek to increase our exposure in client portfolios to investments likely to respond favorably to sustained cyclical economic strength, and will seek investments likely to benefit from higher inflation expectations. Examples of industries currently exhibiting favorable valuations, as well as the aforementioned attributes, are consumer-

oriented industrial companies like automobiles, commodity-oriented companies including steel and chemical producers, and timber and building supplies companies. We believe these industries, are rife with companies that are undervalued relative to our economic expectations.

Conspicuously absent from this list of industries are domestic financial service companies, which we still view unfavorably due to a deleveraging consumer and the threat of regulatory constraints to organic growth. We will continue to look outside the U.S. borders for acceptable opportunities among banks.

Risks to our outlook include a deeper and more long-lasting European recession than we envision and a more pronounced economic slowdown in China. Short of these risks, U.S. economic momentum appears durable and more likely to generate positive rather than negative surprises. We will continually monitor our assumptions and make the necessary modifications to portfolios should these assumptions be threatened over the next several months. Although the U.S. stock market has gotten off to a very strong start in 2012, we expect equity markets to exhibit a more "normal" level of volatility throughout the remainder of the year, pacified by reduced fears of recession and diminished risks of the European sovereign debt contagion. We expect strong equity rallies to lead to normal corrections, which will lead us to opportunistic buying based on our short and intermediate term outlook.

Please do not hesitate to contact either of us with any questions or comments regarding our outlook and corresponding portfolio strategies.

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