StaufferWilliams
ASSET MANAGEMENT · LLC

MAY 2012 INVESTMENT COMMENTARY

STAYING THE COURSE IN MAY - NOT SELLING AND GOING AWAY

The first report of first quarter 2012 GDP growth, referred to as the advance release, was published toward the end of April and seemed to indicate a slower rate of economic growth as compared to the reading for the final quarter of 2011. The actual reading for the first quarter of 2012 was 2.2% GDP growth compared to a 2.7% final reading for the fourth quarter of 2011. Stocks closed higher by the day's end after the first quarter report was released, breaking a two week losing streak, and effectively halting what was beginning to feel like the beginning of a long predicted market correction.

While we took momentary pause after the 2.2% number was released, following a much weaker than expected employment report released at the beginning of April. Our pause was short-lived however, just as it had been after the employment report a couple of weeks earlier. The reason that we are not overly concerned about this reported 2.2% number is that the headline number masks some strong growth data in key areas of the economy.

To begin to understand how to interpret government economic reports, one has to first understand that these reports are initially driven by statistical assumptions and somewhat arcane formulas which are not always intuitive. The advance GDP report for the first quarter of 2012 will be revised and finalized toward the end of the second quarter. Each quarter's GDP is measured against the seasonally adjusted GDP measure of the preceding quarter.

Since we do not know for sure what the future revisions will be, we will focus on the quarter to quarter comparisons. In the fourth quarter of 2011, final GDP grew 2.7% from the preceding quarter, but that growth was not as strong as the headline number indicated. Inventories grew sharply in the last quarter of 2011, which one could argue is a sign of weaker than expected end sales, but as far as measuring GDP growth, changes in inventories are a significant contributor to reported GDP. Asha Bangalore, from Northern Trust, did an analysis in Northern Trust's Dailey Economic Commentary on April 27th, arguing that in spite of the lower headline GDP number in first quarter 12, versus fourth quarter 2011, the most recent quarter masks underlying strength in the measure of "Final Sales." Bangalore believes that "Final Sales" are a more reliable measure of economic strength than inventory variances. Bangalore stated, "Excluding inventories, final sales advanced only 1.1% in the fourth quarter of 2011. Final sales in the 1Q 2012 advanced 1.6%, implying that demand was stronger in the first quarter of 2012 vs. the final three months of 2011".

As we analyzed the first quarter GDP report shortly after its release, our initial concern for the lower headline number was replaced with validation of our premise that economic recovery continues to progress at a moderate pace. Bangalore, in the aforementioned report, illustrated how "Consumer Spending" was stronger in the first quarter of this year than it has been since the fourth quarter of 2010. Consumer Spending, or as the report refers to it: Personal Consumption Expenditures, grew at an annualized pace of 2.9% versus just slightly more than 2% in the preceding quarter. Northern Trust's conclusion after parsing the initial reading on GDP growth in the first quarter of 2012 is that, "the U.S. economy is most likely to grow at a 2.5% pace in the second quarter, followed

by a stronger performance in the second half of 2012." We feel confident that Northern Trust's forecast is very reasonable and it fits very well with the investment thesis that we formulated as we entered 2012. Should this level of growth materialize the Federal Reserve will most likely refrain from a higher level of quantitative easing this year. Of course this assumes an absence of unforeseen external threats to our economy, such as greater instability in Europe or significantly higher oil prices.

The preceding commentary took us further into the weeds of government economic releases than we normally go, but we believe it was important to provide an explanation of why we are staying the course with our investment thesis for 2012, despite some recent disappointing economic releases. We have learned that the market tends to over-react in a reflex-like reaction to initial government releases.

To us, we expect a market reaction, but we accept this reaction as a possible opportunity if we can convince ourselves that the market has initially misunderstood or has put too much emphasis on a particular report. Headline risks, such as misunderstood economic statistics are inherently market risks that we have learned to adapt to. This is one aspect of risk management which can be managed through thoughtful research and conviction. At StaufferWilliams, we take pride in our insatiable appetite for facts and our steadfast convictions.

MANAGING RISK

When selecting stocks we believe that the management of risk is far more important to achieving goals than chasing the next Apple Computer or Google stock. This statement may seem contradictory coming from unabashed active managers who stress stock selection over broad diversification.

It is not a contradictory statement, but is does require further explanation. Managing risk is a very subjective concept. Most advisors learned and practiced investment management using Modern Portfolio Theory (MPT) concepts. The main concepts of MPT include the ideas that a diversified basket of investments can have a lower overall risk profile than the average risk profile of each component; that the market is efficiently priced; and high risk will, on average, reward investors with higher returns. We are not going to analyze MPT in the context of recent market experience, but we want to frame our discussion of how we view portfolio management in the context of the concepts of MPT, which are widely accepted.

We do fully embrace the idea that portfolio construction is how volatility is most effectively managed. This aligns us with MPT's concept of diversification. That being written, many investors latch onto the idea of diversification and equate the number of securities or investment products with the amount of diversification being created. This simplistic misinterpretation of benefits of diversification is what has really driven many banks and advisors to the practice of "closet indexing," a practice that we have been critical of in the past. Diversification, for the sake of diversification alone, leads to an excessive number of securities that provides, in aggregate, no incremental benefit and tends to produce mediocre performance at best. At StaufferWilliams, we embrace the concept of diversification, but we stress the concept of managing correlations among assets as opposed to taking comfort in the sheer number of securities owned. MPT sets a very low bar in regard to correlation when the theory states that diversification reduces risk by introducing assets into a portfolio which are not perfectly correlated. Given that only identical assets are perfectly correlated, any diversification will produce an "imperfect" correlation and thus meet the MTP definition of diversification.

We believe that by actively managing the correlation between components within a portfolio, we can reduce overall volatility, which is defined as risk by MPT. We take this one step further in that we actually believe that the growth of one's portfolio will be greater over time, all other factors equal, if we can reduce volatility of a growth oriented portfolio by simply introducing correlation sensitivity analysis into our portfolio management process. This belief is supported by the basic concept of compounding that is generally ignored by the financial industry that focuses on measuring performance using a time weighted return process. Time weighted returns are used by the mutual fund industry in order to immunize returns against the changes in the amount of assets within the fund from year-to-year. However, from the perspective of an individual investor, who truly wants to know what the return is on his or her actual assets, another measure of return is necessary, and that methodology of return calculation is called internal rate of return (IRR). IRR calculations factor in the asset level that existed during the time period of measured performance, thus the volatility of the value of the portfolio will be factored into returns, whereas using time

weighted returns, the volatility of asset levels are not considered.

The second major concept which underpins MPT is that market pricing is efficient at any given point in time. This concept tends to leads MPT to advocate passive investing, where portfolio management actions are limited to asset allocation decisions. Being active managers, we reject the idea of pricing efficiency and in fact believe that value can be added through the exploitation of pricing inefficiencies in the markets. Intuitively, value investors such as Warren Buffett would not have been able to find success if market prices were truly efficient. Followers of MPT generally reject that an asset manager can add value through security selection based upon the theoretical underpinnings developed by the authors of MPT. David Swensen, the former 20 year manager of the Yale Endowment Fund, who significantly outperformed the market and his peers over that period, dismissed the idea that security selection does not add value. Swensen made the case that in practice this theory seems to be validated only because most portfolios are over-diversified and thus the impact of security selection is essentially diluted away.

We realize that a discussion of these sometimes arcane concepts might not be as exciting as a discussion of market axioms such as "sell in May and go away" or "low stock market volume is a bearish signal," but we want to convey the why of what we do.

As far as the common refrain of "sell in May and go away," for many reasons this so-called strategy is not a strategy and can lead to a self-fulfilling "wall of worry" that the stock market likes to climb. To date this year, the U.S. stock market has advanced strongly on historically low trading volume, which is not supposed to happen for any length of time. Maybe those investors who were worrying about low trading volume being a bearish sign created an additional "wall of worry" that the market needed to climb? In this case, collective worrying actually might seem to have redeeming value after all, which conflicts with a famous quote from Vance Havner, "worry is like a rocking chair--it gives you something to do but it doesn't get you anywhere."

In terms of equity investing, we find these axioms, and so-called trading strategies, all very confusing and contradictory. This is why we focus on a small number of critically important factors which ultimately determine the future value of stock investments—management, profit, growth and the sustainability of each of these. This is why when we are asked about a certain reference to a seasonal trading pattern or some technical analysis driven rationale for either buying or selling, we will most likely politely discount the usefulness or validity of such information. When we are asked whether we are going to "go away" in the summer months, we are thinking about a family vacation, not a trading strategy.

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