4th Quarter 2011

The Hardest Letter Ever

Preparing to write this letter has been as hard as any letter we have written in the last 20 years. Have you ever watched a tug-of-war? This is the fun event where two teams stand on either side of a huge mud pit while holding a rope. Each team pulls on their side of the rope in the attempt to launch the losing team into the middle of the mud. Without question, the world that we live in today is engaged in a tug-of-war of massive scale that leaves investors wondering which side is going to end up in the pit. Simply put, the world economy is trying to improve and is showing signs of life. At the same time the politicians and unprecedented government debt levels are working assiduously to pull the economy into the mud!

Thus the reason this letter is so hard to write. Which side will win? If Europe blows up we need to be bearish. If the politicians will sit down and make some common sense decisions that have real teeth, we need to be bullish. Candidly, there is not much we like less than relying on politicians to do the "right thing". Historically, favorable outcomes in these scenarios have proven to be very low.

Unfortunately, that is where we find ourselves today. We are dependent on politicians to fix a problem that is simply too big for normal economic expansion to fix. Politicians have created such a massive problem that only other politicians can possibly fix the devastating effects via dramatic policy changes. This is tragic, but it is also true. So, as investors, we find ourselves somewhat forced into a bystander's role where we can try to predict company profits, macroeconomic trends and asset class pricing all we want, but ultimately the direction of asset prices is going to be largely decided by what the politicians do or don't do. One word summarizes our view of this predicament…Revolting! Later in this letter, we will talk about what we think investors should do in this environment.

2011 in Review

In general 2011 was not a very good year. The S&P 500 started the year at $1258 and ended the year right where it started, at $1258. The U.S. fared better than most of the world, where sharp declines in major averages were experienced in the range of 10 -15% with even larger declines in emerging markets. Credit spreads widened in response to the European debt crisis and the world was in "risk off" mode for most of the year after the downgrade of the United States credit rating from AAA to AA.

On the flip side of the political and debt related pressures, U.S. companies performed pretty well with reasonable growth in operating cash flow, a further decrease in leverage on their balance sheet and a growth in dividends that surprised many investors. Treasury bond prices skyrocketed (yields dropped dramatically) in the second half of the year after the downgrade of the U.S. credit rating. Yes, that is correct. As backward as it sounds, the very instruments that were downgraded were the vehicles that delivered massive gains. This was a result of the flight to safety that occurred as the world decided to go into "risk off" mode.

We don't like making predictions at year end, but our clients and the media request that we do so. So, how did we do in 2011? We entered the year with a **3** on the CAZ Scale, not bullish but not bearish. We summarized our overriding concerns for the economy and the markets in the following statement:

From our 4q 2010 letter:

- *And that is our last point, and the concern we have expressed for the last year and a half. If we find ourselves in the summer of 2011 with virtually all of the stimulus money spent and yet not much economic growth to show for it, we will potentially have another colossal shift in perception. If we don't see meaningful job growth and economic progress and just have a few trillion dollars of new debt that has to be repaid eventually, investors are not going to be pleased.*

That is precisely what happened in August. The political wrangling around the debt ceiling was ugly, and even though the ceiling was raised temporarily, the downgrade by Standard and Poor's still occurred. This led to the crisis of confidence in the markets during the 3rd quarter. A cautious stance was warranted in 2011, and our stance became more cautious the day the downgrade occurred when we lowered our rating on the CAZ Scale to a **2**.

<u>The Spring is Coiling but …</u>

So what is our 2012 outlook? Tell us what the politicians will do, and we will tell you what the market will do! Yes, we know it is impossible to predict the behavior of human beings, and especially hard to predict the behavior of those who are elected for a living, but that is what will drive prices in 2012. Ultimately, we will see a winner prevail in the tug of war referenced above. Either the politicians and debt levels will drag the economy and markets into the mud, or the politicians will throw themselves into the mud. Meaning, they will make meaningful reforms regardless of political backlash in order to save the economy and markets, not to mention jobs!

What is so interesting to watch is the economy subtly beginning to improve beneath the surface while demand begins to build. We refer to this as the "coiled spring". As demand builds, the spring coils tighter and tighter. In a normal economy, this is what causes expansion as the coil springs free and the demand for goods and services increases. This creates more jobs, which creates more demand, etc.

However, this time the spring is not able to uncoil because of the enormous weight on top of it. This weight is caused by the same politicians and debt levels referred to above. If the politicians could convince the world that they had a real solution to the debt crisis, the spring would uncoil and people might be surprised at the strength in the markets. There is an enormous amount of money that wants to be put to work and would do so if there was some sense of stability. This exists at the corporate and individual level. Yet, the money remains on the sideline because of the uncertainty. In the second half of 2010 the market experienced a very sharp rally based on a change in perception. The elections, decent quarterly profits from companies, QE2 and “the game changer” (the extension of the tax cuts in November of 2010) caused perception to change to become more optimistic. Nothing had really improved, but people thought it might, and they acted upon those feelings. A quote from our 4q 2010 letter, can illustrate the power of perception:

Put another way, a decent environment with faith in the future, whether warranted or not, creates a really nice rally!

This is what happened in late 2010, and it can happen again in 2011 IF the spring is allowed to uncoil.

Gridlock is bad. Since when?

Normally, we like political gridlock. In general, we feel the less that politicians do, the better the economy will do. However, we find ourselves in a unique and uncomfortable position. We need meaningful reform and, as much as we despise it, the only way to get sizable enough reform for the problems we face is for the politicians to pass legislation. Government debt levels must be reduced, and they have grown so large that simple capitalism and reasonable growth just are not enough. Therefore, we need a complete overhaul of the tax code and entitlement programs to promote fiscal responsibility and growth. Those changes can only occur through legislation.

So, we find ourselves today with a Democratic President, a Republican Congress, and a closely divided Senate. There is practically no movement on policy and nothing is really changing, especially in an election year. As stated, normally we like gridlock, but we know the markets want to see reform. So, we find ourselves even more focused than usual on the election in November. We are not sure the world can tolerate another four years of what we have right now, with complete gridlock and no policy changes. The harsh reality is that if nothing changes the tax cuts will expire, the debt ceiling debate will rage every time we hit a decision point and debt levels will continue to compound at an unsustainable rate. All of this could prove too much for the economy to overcome, and we could very well slip back into a long and painful recession.

The only way we see that there will be major reform is if the American people show up to the polls in record numbers and cast a ballot that clearly indicates their desire to fix the problems head on. One side of the aisle must have a clear mandate, and control, in order to enact real reform. Staying dormant where we are is simply not an option. The ticking time bomb that is our debt problem is not going away, and by 2017 the problem will be much larger and become even more painful to fix. We have time to fix the problem if we get serious and make tough choices, the kind of choices that many politicians don’t want to make.

So Now What?

Are you confused yet? Does it seem like we are talking out of both sides of our mouths? Guess what? You are right. Now you understand why it has been so hard to write this letter. The economy is trying to get better, but the political landscape is simply holding it back and may very well make it worse. We are a **2** on the scale for just this reason. We would much rather err on the side of caution and protect capital the best we can if things are not favorable. We are not far from being a **3**; we just can't justify increasing risk levels until we get some true clarity from the political landscape in the U.S. and Europe.

We have identified an anomaly in the markets that has occurred only twice in the last 40 years, and it provides an interesting opportunity for investors. As a result there are still some good strategies to employ. We encourage a focus on quality and diversification between traditional investments and alternative investments that do not have a high correlation to the broad stock markets. In the traditional world, focus on the highest quality equities available. Structure the investments to at least get some cash flow from dividends and other income producing strategies. Further, concentrate on finding cash flow streams that are likely to be increased at a rate that is significantly faster than the expected rate of inflation. We want clients to get "paid while they wait" as well as protect their purchasing power, and we are working on several ways to do this for clients. We will be contacting you, if we have not already, to discuss how this might be a fit for your situation.

As always, we value your relationship with our firm. The trust you show in us is something that we truly appreciate. Thank you for allowing us to be a part of your lives, and please let us know if you have any questions. We will continue to strive for excellence in all that we do. We wish you and your family a wonderful and prosperous 2012!