GREENWOOD REPORT

KICKING THE CAN

To date, 2011 has been marked by a series of highs and lows – both literally and figuratively. We are reminded that in our dynamic and ever-evolving world, there is no shortage of problems to solve. Just when the world thought it was emerging from recession and returning to a strong, sustainable growth trajectory, the United States debt downgrade and ongoing concerns in Europe caused a negative reaction in the equity markets in August and September. *Growth will return*; it is the solution to the global economic malaise – but it will take time.

As we said in "Certainty In An Uncertain World" (February 2010), uncertainty is ever-present in investment management. It is an inescapable fact that the environment for investment presents risk and uncertain outcomes. Such is the basis for our entire profession – to assume risk intelligently for our clients. This uncertainty is often portrayed on the face of Mr. Market, a fickle and capricious metaphoric figure used to represent the collective opinions of global investors (see "On Risk and Volatility – July 2011). In 2011 Mr. Market has more than lived up to our expectations. Since the start of the 3rd quarter of 2011 there have been 200+ point movements in the Dow every three trading days on average. The far more frequent knee-jerk moves of 2011 have been exacerbated by high-frequency traders with holding periods of minutes or seconds.

It is no secret that your investment managers at Greenwood Gearhart Inc. tend to support the side of optimism when it comes to our view of the economy. And why not? In fact, it is during Thanksgiving when one reflects on what we have been given, that our optimism and thankfulness provides a stark backdrop to fear and uncertainty. In a global context, we (and the vast majority of you, our clients) get to live in America, the greatest country in the world. For all of America's problems (and we acknowledge there are many), it remains the wealthiest, most politically and socially stable country in the world with the greatest military and intellectual capital to boot. It is home to some of the best minds and entrepreneurs as well as the best universities and corporations in the world. America has a peaceful transition of power every two, four, and six years; the strongest rule of law; an intense and sustainable work ethic; and a patriotic citizenry that is the glue that binds it all together. We are fortunate to have shelter when so many are cold, have food when many are hungry, and even have investment portfolios when many are penniless. This perspective is why we have reason to be optimists.

But our optimism is not without caution. We are not blind to the issues facing the global economy and our clients' portfolios. We discuss, debate, and dissect the issues every day. We look at all facets to determine the expected outcome, the likelihood of that outcome, and the direction we should (or shouldn't) take in portfolios. It is fun work; our colleagues are bright and the discussion is lively. One conclusion we have accepted is that these problems are complex and because of their complexity, they will take time to remedy. Below describes some of the key issues we are currently monitoring.

THE ISSUES

Europe continues to be the focus of turmoil. Twenty years ago (Maastricht 1991) the Euro-zone was formed, but it lacked a fiscal union to accompany the monetary union. Some argued that due to this structure, it was incomplete from the very start and was doomed for failure. In contrast, the United States has common fiscal and monetary policy – arguably greater flexibility to combat a financial crisis through coordinated stimulus programs, tax credits, and other fiscal measures. Currently the Euro nations are in debt to each other. The "PIIGS" – Portugal, Italy, Ireland, Greece, and Spain – are the debtors while Germany, and to a lesser extent France, the lenders. To date, the approach to "fixing" the problem in the Euro-zone has been through bailouts of the debtors through the European Financial Stability Facility (EFSF). Funded by the lenders, these monies are contingent upon harsh austerity measures imposed on the debtor nations and have served to buy time while a permanent solution is debated. The term "kicking the can down the road" is an apt description of the strategy. There is an end-game in Europe but it will take time. Ultimately, we assume a restructuring of the debt, whereby lenders 1) write down principal balances to decrease the overall debt load and/or 2) increase the maturities of the debt, will form the basis for a solution. Both will require the public and private sectors to absorb significant losses that may ultimately be funded by higher taxes. This end-game (as we see it) will take significant political will and time to implement. As in the United States, action will be taken, but only at the last minute.

Meanwhile, the United States is dealing with its own economic and political problems. The super-committee charged by Congress with identifying ways to decrease our own debt burden has failed in their task. As a result, starting in 2013 across-the-board spending cuts totaling about $1.2 trillion will be triggered. These cuts, called sequestration, will primarily impact Defense and Medicare and generate additional savings by reducing interest payments on the national debt. Social Security, Medicaid, food stamps, veteran's benefits, and other tertiary programs are exempt. This is a political crisis and not a solvency crisis. The United States can and will pay its debts. The real issue is whether they will do so by raising taxes, cutting spending, paying down debt with less valuable dollars (inflation), or a combination of the three. Washington in 2011 is not a place of compromise which seems to make solvable economic problems become unsolvable political problems. So, we too have kicked the can down the road past the 2012 election.

What does it all mean for investment? First, we must prepare you for continued volatility. Given the uncertain outcomes and time consuming solutions facing Europe and the United States, Mr. Market is jittery and is ignoring fundamentals in favor of politics. For this reason, and as part of our risk management strategy, we are reviewing client accounts with income needs to ensure approximately six months of cash is available for consumption. For those clients without income needs but with long-term investment horizons, we are evaluating the market for investment opportunities. Rather than run from equities when volatility is present we seek to take a contrarian approach and look to purchase quality companies at a discount to intrinsic value – especially when they are temporarily mispriced. In our view, equities currently represent the best value available across the capital structures of global corporations. An alternative to equities, low-yielding government securities are hardly a bargain given the political gridlock in Washington:

- The 10-year Treasury bond continues to hover around a 2% yield. At a par value price of 100, this represents a Price to Earnings (P/E) equivalent of over 43x earnings with no growth.

- Conversely, stocks, represented by the S&P 500 index are priced at an earnings yield around 8.3%. At a value of approximately 1,200, this represents a P/E equivalent of only 12x earnings with the potential for growth.

- The dividend yields of many stocks in our client portfolios exceed the 10-year Treasury yield and some exceed the 30-year yield – so clients get paid a higher current yield than the U.S. Treasury as they wait out the volatility.

- Stocks allow for the benefit of capital appreciation whereas bonds have fixed coupons and return principal only at maturity. Investing in a 2% 10-year Treasury in a normal (3%) inflationary environment can be a money-losing investment since the return of principal would have only 74% of the investment's purchasing power after 10 years due to inflation.

Finally, as we near the end of 2011, we are spending time reviewing taxable portfolios for realized gains and working to minimize tax liabilities wherever possible. This tax decision is secondary to normal investment decisions but is meant to enhance after-tax returns. In your final quarterly report, available in early January, you will receive your year-end "Realized Gains and Losses" report. While this report is a cumulative report available in each of your quarterly reviews, the year-end report can be used to estimate your tax liability. New in 2011, broker-dealers (Schwab) are required to provide you with a 1099 with Realized Gains and Losses which will serve as your official tax document. As always, we are happy to speak with you or your accountant directly regarding your individual tax situation.

We wish you all a happy and healthy holiday season. Thank you for your friendship and trust in Greenwood Gearhart Inc.

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