AUGUST 2011

Market Commentary and Review

By Brad Bickham, CFA, CFP®

"None of the old rules work any more, but then they never did."

SUMMARY:

Washington grabbed defeat from the jaws of victory when they passed a debt reduction bill in late July. European politicians are similarly showing an inability to deal with their problems. Standard & Poor's gave the U.S. a black eye for the political performance and the combination has unnerved investors.

However, the market declines cannot be justified by the fundamentals. Computerized trading is causing the recent extreme volatility. Ultimately, fundamentals will determine the outcome and we try to analyze them for you on the following pages.

In This Letter

Dear Clients and Friends,

Equity markets have exhibited tremendous volatility lately. Stocks advanced to 52 week high levels in early May, then slid 8% over the next 45 days, then rose about 7%, and have now fallen 10% in just the last two weeks. The headline we keep reading is that this drop portends another recession. We do not share this view, but we agree the economy has slowed and risks have risen. We will lay out the facts for both sides of the argument as best we can and summarize our conclusions.

But first, an update of returns…the following table summarizes returns for the year-to-date, last 12 months, and the last five years (all returns through August 4th, 2011):

	1st Qtr 2011	Last 12 Months	Last 5 Yrs. Cumulative
Large Cap U.S. Stocks	-3.5	8.6	4.0
Mid Cap U.S. Stocks	-4.8	11.5	22.3
Small Cap U.S. Stocks	-4.4	12.6	14.7
Nasdaq 100	-0.2	16.3	50.3
Foreign Stocks - Developed	-7.5	1.3	-6.9
Foreign Stocks - Emerging	-9.1	3.1	47.1
U.S. Bonds – Taxable	5.4	5.6	36.9
U.S. Bonds – Tax-Free Municipals	8.0	3.4	27.5
REITs	-0.4	7.0	-8.5
High Yield Bonds	1.0	7.3	40.6
Commodities	2.2	25.4	-7.4
Hedge Fund Index	-1.4	6.5	44.8
Gold	15.8	37.6	149.9
60/40 Balanced Index	0.1	8.4	21.6

Recent events

Washington seems to always be able to capture defeat from the jaws of victory. By the time Congress agreed on a deal to raise the debt ceiling, the country and the markets were so demoralized by the fiasco there was a drop in stock prices. It was but another reminder of the ineptitude of our politicians and the divide that makes reaching compromise almost impossible. It was a deal that made no one happy.

It was met with disdain by the markets in large part because it was another opportunity lost to actually deal with the problem. Instead it just kicked the can down the road. All rational analysis has concluded there has to be some combination of increased taxes and a reduction in spending on entitlement programs and defense spending. Until both parties give up their hard line stances we will not solve the problem.

During the first half of the year, there were other significant events contributing to economic disruptions. The turmoil in the Middle East led to a sharp rise in oil and gasoline prices, and the earthquake/tsunami in Japan led to economic disruptions around the world. Commodity prices remained elevated, and the news on the housing market was generally weak with prices remaining below year ago levels. Add to that riots in the streets of Greece in the face of forced austerity measures along with an ineffectual European response and you have the recipe for market turmoil.

THE FOUR PILLARS

How do we make decisions with this never ending news cycle? How do we sort through the noise? Several of us have been managing investments for over thirty years now. We have developed a process of analyzing four principles to help us allocate capital in our portfolios. They are all inter-related.

The Economy

Growth or Recession? This is a slight over-simplification, and there are a thousand moving parts to analyze, but if we get the direction right we will get many other things right. We believe we are not double dipping. We are in a soft patch of growth, but it is still growth – barely. We will expand on this in the next section.

Earnings growth

The value of a business is the value of its future cash flows, discounted into the present. Here is a summary of operating earnings for the S&P 500 for the last few years and the current prediction for this year and next:

Year	Operating EPS	Change
2007	82.54	-6%
2008	49.51	-40%
2009	56.86	+15%
2010	83.77	+47%
2011	98.98	+18%
2012	113.79	+15%

Interest Rates

Most of the time, but not always, interest rates track inflation. The market generally demands a return higher than inflation. The Federal Reserve has the ability to set short term rates, but the market sets longer term rates. In our last newsletter, we said we were worried about inflation due to rising oil and commodity prices. No longer. The recent economic weakness has brought oil and other commodities lower. There is too much slack in the system for inflation to get traction. Rates may rebound from the current artificially low levels, but a move to 3% on the 10 year Treasury yields would not be classified as a move to higher rates in our book.

Valuation

There will never be universal consensus on a single valuation method. There are some very smart people, including a famous Yale professor, that have come up with an argument favoring averaging the last 10 years of earnings. This method shows the market to be over-priced. The problem I see with this method is a lack of common sense. Certainly the past is important in predicting the future, but an investor is buying a future stream of cash flow. And, when the last 10 years has not one but two recessions does not it make sense to consider that?

Investors are looking into the future and re-calibrating their assumptions all the time as new information develops. That is why there is so much volatility in the markets and why the market is often wrong. Currently, analysts estimate earnings of about $100 over the next twelve months. This makes the P/E ratio 11x to 12x. This is historically very cheap. If the $100 does not materialize then it will not be so cheap, but unless it is materially less the market is still undervalued. So, let us analyze the possibility of a significant drop in earnings.

There are two issues that will determine earnings, revenues and profit margins. Let us start with profit margins, which are near all time highs. Net profit margins have averaged about 6% since 1994 and are currently near 8%. So on the one hand we should assume they will not go much higher, but on the other hand there is no reason to assume they must go lower. Financial leverage is at its lowest level over the same period, as is asset turnover, capacity utilization, labor costs, and interest rates. Corporations have the ability to keep margins at this level for the foreseeable future. The next issue is revenues, and economic growth equals revenue growth. In the end, this is what we think it comes down to. Will the economy grow or not? A plus sign or a minus sign?

Reasons there will not be a recession:

- Strong corporate profits and balance sheets.
- Steep yield curve.
- Falling oil prices in 2nd half of 2011 vs. 1st half.
- Stabilization in Japan after earthquake.
- Inflation and interest rates are low. The Fed has announced they will not raise rates before 2013.
- Employment is slowly rising. 2.1 million jobs have been created in the last two years.
- ISM indexes still pointing to growth.
- Leading economic indicators still pointing to growth.
- Credit is slowly improving (measured by commercial and industrial loans).
- No tax increases this year.
- Debt ceiling raised through 2012. Less government "noise".
- No significant change in federal government spending until 2013.
- Housing numbers stable the last couple of months.
- Auto numbers stable and slightly improving.
- Strong growth in emerging markets creates growth in exports and manufacturing.
- U.S. is 70% services and retail spending. Most of this is non-cyclical.
- Capital spending has increased from $400 billion in 2009 to over $1 trillion this year.
- Back to school spending and holiday spending are not that far away.
- The energy sector is strong. Texas, Oklahoma, and other oil & gas producing states (including Colorado) are benefiting.
- The government will try to come up with something that will help create growth and jobs… next year is an election year. They are feckless, but it is possible something positive could happen.
- Historically, the average length of expansions is 44 months. The current period is about 24 months. Double dip recessions are extremely rare.
- Debt service has declined from 14% of personal income to 11.3%, almost equal to the lowest levels recorded since 1980.
- Housing affordability is at its best levels in over 35 years.

Reasons there might be a recession:

- ISM indexes are positive, but just barely. All have fallen to their lowest level in two years.
- Consumers have increased savings and lowered credit. Credit is really hard to get for many individuals and businesses.
- The Federal Reserve has stopped its second round of quantitative easing, and appears to have few if any alternatives left for stimulating the economy.
- Federal and state governments are cutting employees and expenditures. This takes money out of the economy.
- European growth is slowing and they are a major trading partner.
- Housing is at best stable, it could drop further and it is definitely not a source of economic growth.
- Home equity has fallen from $13 trillion in 2006 to $6 trillion today. People will have to continue to save to replace this lost equity.
- The political fiasco in Washington adds to uncertainty and a lack of confidence to both businesses and individuals. As we get further into 2011 and into 2012 the "noise" will increase, little will be accomplished from the Federal government.
- Debt reduction globally implies slower rates of growth.
- With the drop in home values and the high unemployment rate, people are demoralized. Many people may be permanently unemployed.

One thing you might notice from the list above is that it is not a list of what markets are doing. Several pundits spend a lot of time telling what the market is doing as if that is proof of something. It is not. Changes in the market are a leading indicator, but they are often false signals.

Bottom Line – there is not a clear one, but our view is we will continue to stumble along with slightly positive growth for the foreseeable future. The positives are greater and more compelling, but the negatives suggest a slow growth economy.

Debt

If the equity markets are not falling due to a coming recession, then what explains the recent drop? It is more likely due to the debt crisis in Europe and now to the downgrade of the U.S. rating by S&P. There is concern that governments will not have the political will to dealwith these issues, and that the result will be something like we saw in 2008 with the collapse of Lehman Brothers.

It is important to differentiate between what happened in 2008 and today. The U.S. government cannot technically default because it can print money. The debt ceiling complicates this a little, but governments have options that corporations do not have (ie. printing money). Europe has additional complications because there is a monetary union (the Euro) without a union of tax and spending policies. It is difficult for them to structurally agree on adjusting a number of countries' policies. It has to go through 16 parliamentary votes. However, they have created a mechanism for funding countries that need additional capital for the next two years. Additionally, the European Central Bank is currently buying Italian and Spanish bonds in order to reduce rates, and they have approved other backstop measures. Will it be enough? We cannot know for sure, but it appears to us that enough has been done to fund countries with too much debt for at least the next two years, and there is tremendous pressure on them to come up with a more permanent solution.

Finally, while we can explain the correction as due to a re-adjustment to growth expectations and fears about government debts, we firmly believe the extreme volatility is driven by computers not humans. This volatility will subside as it always has (and soon we hope!).

Strategy & Analysis

By Kreighton Bieger, CFA

U.S. Stocks: As we write this, the U.S. stock market has undergone a dramatic and sudden selloff, as you are no doubt aware. We are officially in correction territory. The S&P 500 was down -3.6% through Friday August 5th. Stocks are down more than 15% from their April 29th peak, and the S&P is up only modestly over the last year. Global equity market participants are quite concerned about global growth, debt problems and irrelevant credit agency noise. But we also know that we make money buying assets when they are cheap and others are fearful, and selling them when others are greedy. In our mind there is very little doubt that stocks, measured on a P/E or discounted future cash flow basis are quite cheap.

As Q2'11 earnings come in, with 80% of companies reported, we are on track for record quarterly earnings, surpassing Q2'07's high. In Q2'07 the P/E on the S&P looking at trailing 12 months earnings was 17.6x; today that number is 13.2x. So on a P/E basis stocks today are 25% cheaper. Historically the one year forward P/E on the S&P is about 16x; today that number is 11x. We presented earnings growth estimates earlier, so we can see that forward estimates are positive, but not outrageous, with growth expected around 15-18% over the next two years. We feel that even if earnings estimates come down slightly, which is always a possibility when panic ensues, we are still buying high-quality, global companies for a discount to their long term value.

As our covered companies report their earnings we revisit our intrinsic valuation models each quarter. These are models we rigorously revisit and update and we now see 25% discounts on average. Even if we are modestly off in our estimation, we believe substantial upside for stocks exists from here.

With record levels of cash on company balance sheets, $1.67 trillion according to S&P, and U.S. capital spending at a trough relative to GDP, companies are likely to return this cash to shareholders as buybacks or dividends, or deploy it into productive investments such as jobs and equipment. We are in fact starting to see this, as capital spending was up 45% year over year in Q1'11.

Investment Grade Bonds: We have been underweight most investment grade bonds, especially Treasuries, and have generally been holding shorter maturities for the last year. We continue to believe that bonds are overvalued, but the recent mania and corrections have temporarily driven yields still lower. The aggregate index rose 5.1% through August 5th, longer Treasuries 8.5% and corporates 5.3%. As we stated in our last newsletter, our research indicated that the fear in municipal bonds was overblown. We held or added to municipal bond holdings and have been rewarded. The muni bond index rose 7% through August 5th. While we occasionally see pockets of value in bonds, especially state municipals or longer corporates, we continue to see high grade bonds as overvalued and will continue to be underweight. For example, with the 10-year U.S. Treasury bond yielding about 2.5% it pays a cash flow that is only modestly higher than the nearly 1.9% dividend offered by the S&P (and 3%+ of many utilities and staples stocks), yet the price is very likely to fall over the next 1-2 years, whereas we see tremendous

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upside in many stocks. In general, we continue to choose alternative strategies in favor of overvalued bonds.

Alternative Strategies: In addition to covering returns here, we will also spend a bit of space explaining our thinking on Alternative Strategies, from a definitional perspective as well as from a functional one. Through August 5th our Alternative Strategies basket rose about 3%. While this modestly trailed the bond aggregate, it handily outperformed the Credit Suisse Hedge Fund index against which we also measure it, which fell -1.54%. This is a mix of strategies encompassing a variety of asset exposures, including commodities which were up 1.8%, oil which fell -6.3%, gold, up 16.6%, and others including emerging market bonds up 6% and a few diversified strategies up 3-6%. Our aim here is for 40% of the market's risk and 60% of its upside over longer periods of time, and indeed we have achieved that relative to both the bond and stock indices, and also outperformed the CSFB hedge fund index. We continue to allocate a portion of our fixed income holdings here, as well as a small portion of the stock exposure we trimmed from international in the early part of the year.

Alternative Strategies, An Interpretation: We include in Alternative Strategies a wide variety of assets, some of which are obviously "alternative", such as gold and commodities, and others which might look like fixed income or equity in disguise. For example, we are sometimes asked why we consider junk bonds "alternatives" rather than simply "bonds". A junk bond is in fact a bond, just a very low quality bond where the probability of repayment is quite a bit lower than a bond we would usually purchase for your fixed income portfolio. But functionally it has risk and return characteristics that make it perform differently from a high quality municipal, corporate, Treasury or mortgage backed security. We buy bonds for safety and income and expect only those two things. Junk bonds can guarantee us little safety and high income, but that comes with a price: volatility and uncorrelated returns as summarized in the following table:

	Correlation to Stocks	Correlation to Bonds	Beta vs. S&P 500
Junk Bonds	48%	36%	.35
Investment Grade Bonds	-5.1%	100%	.01
REITs	82%	-15%	1.5

What this shows is that junk bonds have a greater correlation to stocks than to bonds, and they have 35 times more volatility. Bonds have been negatively correlated to stocks, but junk bonds have not. REITs are highly correlated to stocks and are more volatile.

This kind of analysis goes into all of our Alternative Strategy positions, and we also regularly look at the overall portfolio for volatility, correlation and assess whether the mix is appropriate to achieve our target of 40% of the market's risk and 60% of the upside. We can tilt this basket toward or away from income, and have achieved returns similar to hedge fund returns, only with daily liquidity, dramatically lower cost, and complete transparency.

Financial Planning

By Gary Powell, CPA [1]

As we enter the fall season, the Washington political movie will contend for the public screens of various media when Congress returns from its August recess. As they wiped their collective brows over a last-minute debt ceiling compromise, the stock markets did not applaud their efforts and a corner of the credit markets, Standard and Poor's, followed the decline of the stock market with a downgrade of the US credit rating from AAA to AA+. Some of the quotes from S&P are …" the plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics… The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."

So where do we go from here? Moody's first assigned the United States a AAA rating in 1917. Fact is, we have never been is this financial circumstance for history to be our guide. Just like the financial crisis of 2008, unintended consequences often result. We will have to wait out the uncertainty and see. However, even after the downgrade, the United States will likely still be able to pay its bills for years to come.

Back to the Washington polarizing events that have been developing over the last 15 to 20 years and seems to be focused today on the "super committee". The "super committee" is charged with finding an additional $1.2

[1] Inactive license *("recovering")*

trillion of spending cuts over the debt ceiling compromise of $917 billion which is spread over 10 years. Its is due to report by November 23rd and have a "up or down" Congressional vote by December 23. However, the debt ceiling compromise did nothing about allocating the $917 billion spending cuts to the various government agencies. Compounding the polarization is the federal budget for the 2012 fiscal year that starts October 1st . Given the political rancor over the debt ceiling, the federal budget will be delayed by a series of continuing resolutions (we have had 7 over the last 6 months) to continue funding the federal government.

The word for the current situation is "uncertainty". This "uncertainty" will prevail through the 2012 elections and whoever wins will be challenged by the 2001 tax cuts expiring, the estate tax rules expiring, implementing last year's health care legislation, addressing needed changes to our tax code, budget deficits etc., etc., etc. Uncertainty creates indecision and indecision creates caution.

On to the things that we can control. We are very excited about the improvements to our financial planning software. We have added more versatility, functionality and analytical options to our financial planning process. We invite you to challenge us with your questions about modeling your financial plan.

Coming soon will be new estate planning software. We are currently evaluating two estate planning software packages that will enable us to add significant planning options and provide you with the future financial effects of those options through various graphs, charts and calculations. We look forward to improving our services to you.

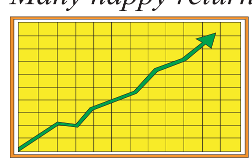
Company News

By Patty Meneley, COO

Much has been happening at Sargent Bickham Lagudis this summer. Many of you already know that Jenny (Trindel) Ostrow is going to be leaving us and moving to Philadelphia soon. Replacing her as Brad's Client Service Manager is Eileen Evans. Eileen has many years of experience in financial services and we are pleased with the skills and knowledge she brings with her to Sargent Bickham Lagudis. She and Jenny will be working together through the summer during the transition. Also, very exciting news, Luke Daniel and his wife, Lisa, welcomed their new baby daughter, Javanna Lucia, this week. And, lastly, you may have noticed a new friendly voice when you call SBL. We have a new receptionist, Anne Kimmell, who joined us in June. Anne is a recent transplant from Maryland and is enjoying her new position. Luke passed the CFA Level I exam and Trace passed CFA Level II. SBL has recently formed a softball team. Yes, this hard-working bunch of desk jockeys has extraordinary athletic skills (who knew?) and will be showing them off against other highly skilled (not!) corporate teams on Thursday nights through the fall. If you want a laugh, come by the Mapleton Fields on Thursday nights and cheer on the SBL Greenbacks.

As we say in every letter, all of our growth over the years has come from referrals from clients and other professionals. We thank those of you who have referred your friends and colleagues, remind the rest of you that if you know of anyone who might be interested in our services have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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