OCTOBER 2012

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"He who knows not and knows that he knows not is a wise man."

SUMMARY:

Stocks are up over 16% in 2012 despite a long list of worries.

Many investors are missing out on these gains. They are selling stocks and buying bonds. We analyze why.

What is the likelihood that stocks will see another 20% or more decline? We lay out the reasons for prior bear markets.

In this low interest rate environment, it is more challenging to produce income. We are leveraging our research on equities to find opportunities in the corporate bond market.

We have found lower volatility equity alternatives appropriate to use in some portfolios.

In This Letter

Dear Clients and Friends,

The market climbs a wall of worry.

This is one of many investment sayings, and the first nine months of 2012 will have to go down in the history books as one of the best examples of the stock market climbing a wall of worry. We began this year with concern that Greece would default, and in fact they technically did default on some of their bonds. However, it was not wholesale default, and there was little to no effect on the Euro. The equity markets actually staged a strong rally in January. Additionally, we have had the following concerns to deal with this year (in no particular order):

- GDP growth slowed from 3% in 4Q11 to 2% in the 1Q12 and to 1.3% in 2Q12.
- Employment growth has stalled and unemployment is stuck at 8%.
- Europe is in recession.
- The Euro crisis is never ending. There are periodic spikes in interest rates as the markets worry about whether the countries will hold the common currency together, and whether certain countries can pay their debts.
- U.S. manufacturing has slowed, in part as a result of weakness with many of our trading partners.
- China, now the world's second largest economy, has had a slowdown in economic growth.
- There has been no progress on U.S. debt or deficit levels.
- There is a looming fiscal cliff – now only 3 months away. Many areas of government spending will be cut, and tax rates are scheduled to rise.
- Political inaction has reached new levels of absurdity this year. Over $1 billion will be wasted in advertising on the Presidential election alone. They haven't approved a farm bill, a highway bill, or even a law to deal with the post office.
- Oil rose above $100 a barrel in the spring and again recently. Gasoline has approached a $4.00 national average twice this year.
- The Middle East powder keg continues to blow periodically: Syria, Iran & Israel, and Egypt.

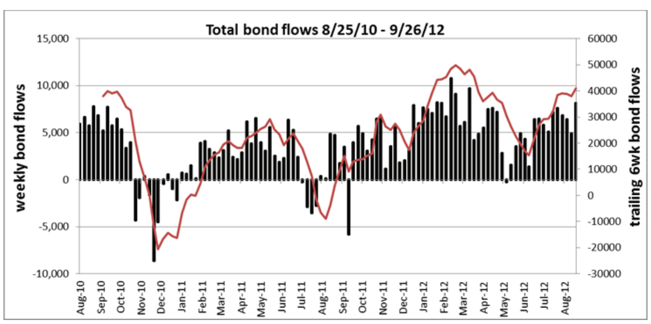
And yet, the stock market is up over 16% this year. The table on the next page summarizes the returns of the major asset classes.

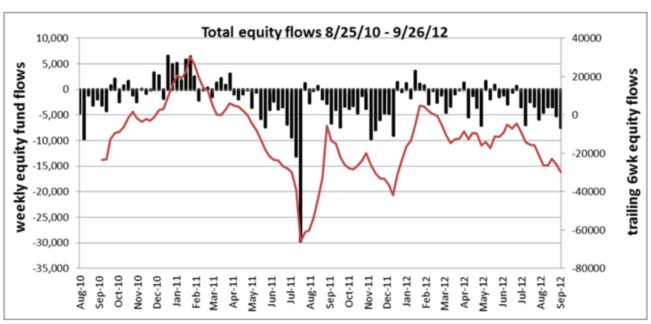
Returns as of September 30, 2012	3rd Qtr 2012	YTD 2012	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative
Large Cap U.S. Stocks	6.3	16.3	36.6	111.6
Mid Cap U.S. Stocks	5.3	13.7	52.1	168.5
Small Cap U.S. Stocks	5.5	13.9	45.9	174.0
Nasdaq 100	7.2	23.7	84.6	238.6
Foreign Stocks - Developed	6.1	9.6	12.8	111.3
Foreign Stocks - Emerging	5.6	10.3	68.3	392.0
U.S. Bonds – Taxable	1.6	3.8	19.2	67.0
U.S. Bonds – Tax-Free Municipals	2.5	5.5	17.5	55.8
REITs	1.5	13.9	64.9	158.3
High Yield Bonds	3.7	9.6	37.7	123.0
Commodities	7.6	1.9	29.6	155.5
Hedge Fund Index	1.3	1.6	18.0	95.7
Gold	10.8	13.1	77.1	454.9
60/40 Balanced Index	4.4	11.2	35.1	106.6

We think investors are unaware of this performance. We often hear about the lost decade, or how poor equity investments have been. In a recent poll of 1,000 investors who were asked whether the S&P 500 was up or down during each of the past three years, 66% said was down in 2009 (it was up 26%); 48% said was down in 2010 (it was up 15%); and 53% said it was down last year (it was up 2%). Even the 10 year record is now in line with historical averages – 10% or better average annual returns for most equity indexes.

We know that many investors are missing out on this performance too. Look at the two charts below. The first one shows flows of dollars into bond funds over the last two years, and the second in equity funds. You can see that investors have been adding to bond funds and selling stock funds despite the much better returns from equities.

Why is this so? We suspect it is a hangover from the two major bear markets we have seen over the last decade. So what are the chances we will experience something like that again?





There are two ways to approach this question. First, we can look at history for details on how often bear markets occur, and we can also study the causes of major bear markets. We have often advised clients to be prepared for 10% corrections in the stock market at any time. We cannot anticipate them nor react quickly enough to sidestep them. But, we will attempt to make adjustments if we are worried about true bear markets – typically defined as declines of 20% or more.

Historical stock market data can be found going back to the 1600s in England, but the data is not terribly reliable as stock markets did not become truly active until the late 1800s. The most widely cited market data on the United States was compiled by Roger Ibbotson and dates to 1926. Some would argue that the “modern era” really began after World War II, but for a more complete data set let us look at the entire 86 year period. Since 1926, there have been six calendar year declines greater than 20%: 1930, 1931, 1937, 1974, 2002, and 2008. As a beginning point, we can say that these declines happen only 7% of the time.

If we look at rolling annual periods using quarterly data, there were 327 annual time frames from 1926 to 2008 (a study by the Leuthold Group). Of these 327 observations, there were 22 periods of -20% or greater, which is 6.7%

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of the time. We can therefore conclude that it is rare (only 7% of the time) for 20% or greater drops in the market. However, as Boulderites learn about the 100 year flood, it doesn't mean the flood will happen every 100 years. It means there is a 1% chance of it occurring every year. If you flip a coin four times in a row and it comes up heads, it is still a 50% probability of heads or tails on the fifth flip of the coin.

What then were the causes of these -20% declines in stock prices? Most bear markets are the result of declining economic activity. The worst of all was the Great Depression when unemployment reached 25% and lasted from August 1929 to March 1933. GDP declined by -26.7% from its peak to trough. Unemployment was still 17% in 1936 and rose again to 19% in 1938. This extreme period of terrible economic activity is when half of the bear market periods occurred.

During the 1973 – 1975 years there was a quadrupling of oil prices and high government spending because of Vietnam, which resulted in "stagflation" – a stagnant economy and rising inflation. Unemployment peaked at 9% in May 1975 and GDP fell by -3.2% peak to trough.

The 1990s were the longest period of economic growth in U.S. history. During the 1980s and 1990s the stock market averaged +18% per year. The 2001 recession from March through November was only a drop of 0.3% in GDP and unemployment rose to 6.3% - a very mild recession. Without the September 11 attacks, the economy may have avoided a recession altogether. In this case, the -22% decline in the stock market was caused by significant over valuation from the dot-com era.

The most recent decline of -37% in 2008 was accompanied by the Great Recession of December 2007 to June 2009. Unemployment spiked to 10% and GDP fell -5.1% from peak to trough. The recession was caused by a financial crisis, in turn caused by over-leveraged institutions and excesses in the real estate market.

The causes that can be identified through this analysis of bear markets can be combined into a few signs that we need to watch for:

1. A drop in GDP that leads to rising unemployment.
2. A significant shock to the economy such as quickly rising oil prices.
3. A significant rise in inflation.
4. Over-valuation.
5. Excessive leverage / financial risks.

This is the history that has led to our Six Pillars. We attempt through this analysis to identify the signs that might lead to another 20% or greater bear market. Our current view on the Six Pillars is as follows:

The Pillars

<u>The Economy</u>: Growing (but more slowly): +1% to 2% this year in the U.S.; China +7%; Europe -0.3%; Japan +2%. Interestingly, through the first 7 months of 2012, U.S. exports to Mexico were $17.6 billion, double the $8.6 billion to China.

<u>Earnings growth:</u> Growing, but at a slower pace than expected. Estimates for 2012 have been falling, but are still projected to be +10% vs. 2011. See the table below:

Year	Operating	Change
2007	$83	-6%
2008	$50	-40%
2009	$57	+14%
2010	$84	+46%
2011	$92	+10%
2012	$101	+10%

<u>Interest Rates:</u> No change. Rates will remain low through 2013 and maybe much longer. The Fed has indicated they will keep short term rates low through mid 2015. Inflation, broadly measured, is not a concern for the next year or more. People are too concerned about this as an imminent problem. Yes, longer term we are unsure about the implications of quantitative easing (money printing). But, for the next year or two, we do not see inflation rising beyond 2% to 3%.

<u>Valuation:</u> Fair. Current P/E is 14.4x, still well below historical averages, but not as cheap as earlier this year. We think some discount to historical P/E ratios (long term average is 16x) is justified by greater risks.

<u>Financial Stress:</u> Lower. We saw a spike in some financial stress indicators in July; and we made some moves to raise cash. This turned out to be a false alarm, and we re-invested as quickly as we could to normal equity targets. More on this in the Strategy & Performance Section.

<u>Political Policies:</u> Earlier this year we wrote: "Neutral but worsening. Nothing of substance is going to happen before November. However, many tax rates are scheduled to rise in 2013 and budget cuts are also scheduled (more

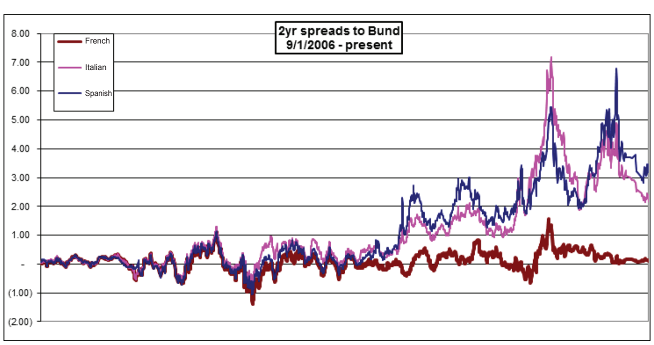
on this later). This concern will rise as the year goes along. Plus, the election rhetoric is likely to be negative and distracting." This is still true. Based on current polling (before the debates, so this could change), we could end up with the same stalemate in Washington that we have now.

We add some thoughts in the Financial Planning section, but it seems inevitable there will be some increase in taxes and decrease in government spending. There is an outside chance for real tax and budget reform after the election – in the first half of next year. If this happens, it could be a real stimulus to economic activity. We believe there is significant pent up activity due to uncertainty regarding tax policy, health care reform, and other government policies.

Performance Review

Like everyone, we are wary of this bull market and the weak economic growth we have had since the end of the recession. The risks are clear and were listed earlier. We have added tools to our toolkit to monitor financial stress levels. Many of you have seen these charts and the one below shows the spread between the French, Italian, and Spanish government bond yields and the German government bond yield. The difference between yields is called the spread, and a widening signals the market is concerned about the creditworthiness of the more risky countries.

You can see on the chart that spikes occurred in the spreads in the summer of each of the last three years (2010 actually had two spikes). These corresponded with drops in our stock market. In 2010 the market dropped -15%, and it fell -18% in 2011. This summer it appeared to be setting up for the same type of drop, so we entered the 3rd quarter with a more defensive posture holding 5% or more in cash. However, it turned out to be a shallower and shorter drop, about 8.7% over only six weeks or so. In



July, we reversed our defensive posture and re-invested closer to our normal equity targets. Once again, we are reminded of the difficulty of market timing.

Our performance for the quarter and this year has been good. On average, balanced accounts were up around 4% during the 3rd quarter, and are up by about 9% for the year. If we had not held cash at the beginning of the year, or in the summer the results would have been slightly better. International investments and small / mid capitalization equities have been a drag on performance this year, but not as significantly as last year. Our stock picking has been solid, but we trail the S&P slightly through the first three quarters. Our Model Equity portfolio is up 15.1% vs. 16.4% for the S&P 500. We believe we are well positioned to outperform going forward with a slightly less risky portfolio and a few stocks that we think were unjustly punished in the 3rd quarter. In the next section, Kreighton will discuss the asset classes in more detail and our strategies going forward.

In sum, while we wish we had better sidestepped the 2008 debacle (who doesn't?), we are pleased with performance generally over the last three years. Returns have averaged over 10% per year for most balanced portfolios. The biggest obstacle has been fear of another crisis. As shown earlier, too many investors have been too conservative. Our goal is prudent risk management, but to also make hay while the sun is shining.

Strategy & Analysis (4th Quarter and into 2013)

By Kreighton Bieger, CFA

U.S. Stocks: This year stocks around the world, to turn a political phrase, have done a lot of 'flip-flopping'. In the first quarter, the switch was set to risk on, and most domestic and international equity markets rose 12-20%. Wow! In the second quarter, weakening global economic data, increasingly noisy news flow from Europe, a slowing Chinese economy and talk of the 'fiscal cliff' drove stocks lower, with most indices declining 3-5%. Some markets plunged – Greece fell nearly 23% in the second quarter; Brazil dropped more than 18%, and Italy fell 11%, while Portugal folded down 13%.

We now know that Europe is officially in a recession, the Chinese economy is taking a breather, and global manufacturing and trade data indicate that economies are mostly slowing. We continue to see a concomitant rise in sovereign debt issuance as central banks try to prop up and rescue their economic systems. Obviously, we should avoid these risky trades, right? Not so fast. Mr. Market, for all his flaws, is pretty good at looking around corners and out into the distant future. Around the time our investment committee was asking "How much lower can these European stocks go?", the market decided enough was enough. In the third quarter, Greek markets rose 21% vs. 6% for the S&P 500. Portugal tacked on nearly 12%. European markets in general rose 10.5%. We have cautiously begun to add to positions in international developed (generally, Europe, Japan and the UK), and to a lesser extent emerging markets dominated by China, which may in fact be in for a prolonged period of weak returns.

U.S. equities have now returned 37% since January 1, 2010 and 116% over the 10 years ended September 30, 2012. However, while recent corrections were marked by overvaluation (2000, when the market traded at nearly 26x earnings) or a global financial crisis (2007), right now the market continues to trade at a forward P/E of around 14 compared to a long-term average of 16. The stocks we favor most in our individual picks are large-cap growth, and within U.S. equities this segment is the most attractively priced, recently trading at 72% of its 20 year average, compared to the broader market at about 81%.

While we are way up high on a wall of worry right now, and an upside catalyst is not immediately apparent, within equities we continue to favor large-cap U.S., with a cautiously improving stance on international positions. We will add opportunistically to our positions where appropriate.

Fixed Income: If you haven't had a chance to go get some cheap borrowed money, this is a pretty good time to do that. With another nod to the politicians and all their hot air, one way to assess how well off you are is to look at access to credit, such as a 0% car loan, a 2.7% 15 year mortgage, or a 3.5% home equity line of credit. Issuance of corporate debt at these staggeringly low interest rates recently hit an all-time high. Even high yield "junk" debt is being issued at 6-7%, approximately where 10 year Treasury bonds were in the summer of 2000, compared to 1.65% today. Now, would you rather lend money to the government at 1.65% or to a "junk" company at 6%? Almost feels like a Hobson's choice, doesn't it?

For better or worse, we know that the Fed intends to keep interest rates low into 2015, until the labor market improves substantially, and just this week the Fed indicated perhaps even longer than that. The signal from the Fed here is that there is far more risk of deflation than inflation. In fact, Fed inflation hawk Narayan Kocherlakota of the Minneapolis Fed recently capitulated and threw his support behind the Fed's easing. Kocherlakota has been concerned with the Fed's 'credibility problem' should easing be promised to 2015 then withdrawn before, or inflation not be tamed. So I interpret his shift in stance as endorsing the view that continued Fed accommodation is increasingly necessary to stave off deflation.

For most of our portfolios we include a little to a lot of fixed income, which we buy intending to hold to maturity with a focus on the following: safety of principal, income and lastly, relative performance. The first is not too hard to come by, what with bucketloads of Treasury bonds being issued, but income is a bit trickier. We have continued to leverage our equity research to purchase corporate bonds with 3-7 year maturities that are rated BB+ to A-, and generally can earn 1-1.5% more in yield this way. We also continue to find limited opportunities in municipal debt, both in Colorado and beyond. Our trader and junior analyst, Trace Welch, continues to improve our municipal credit research capability and add to our team's depth of knowledge here.

We have not been buyers of mortgage backed bonds this year, with returns lagging the broader index, at only 2.8% YTD, but with the Fed committing to purchase $40 billion of these per month, we may seek some opportunistic selling as we see opportunities.

We are pulling levers and working on our fixed income strategy daily. We could easily earn yield by extending maturity dates out 20 years or more, but when interest rates rise (and they will), we would subject portfolios to meaningful price declines. We can buy safety owning shorter Treasury bonds, but at yields that are 1-2% less than inflation. As such, we continue to be somewhat underweight our fixed income targets in favor of aggressive income alternative strategies. However, know that as we invest fixed income dollars we are thoughtfully considering each trade in the context of our pillars of safety, income and performance.

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Alternative Strategies: Our alternative strategies have done well in 2012. Aggressive income has generally returned 7-10% vs. the aggregate bond market at 4%, and our low-volatility investments have returned 9-11% as well. This compares to the hedge fund indices at 2-4%.

Earlier, Brad discussed several reasons for investors avoiding equities. Another explanation is investor reluctance to accept the wild swings of the stock market, also termed volatility. The more volatile an investment, the more the price will swing around.

A recent paper by the CFA Institute looked at the volatility of the S&P 500 since 1950. And in fact, compared to the last 61 years, volatility has increased by nearly fivefold since 2000. And 2008 alone accounted for nearly half of all the major stock market swings in 61 years. Investors can understandably be forgiven for looking at ways to avoid this bumpy ride.

So how can we dampen some of this volatility in our portfolios? We are especially concerned with this given that we find U.S. equities the most attractive asset class right now, yet it offers us the bumpiest (scariest?) ride of all. We could simply avoid volatility and park our investments in treasury bonds and let inflation slowly gnaw away at our real returns, much like the proverbial frog in a pot of water brought to boil. But that strategy would hardly maximize returns.

We have recently done quite a bit of research on a few exchange traded funds that offer exposure to stocks but also seek to minimize volatility. There are several ways to skin this particular cat, and after quite a bit of research, including calls to grill product teams in detail, we decided on a product that seeks to build a minimized volatility portfolio that does not aggressively tilt toward the typical 'safe' sectors of the market – namely consumer staples (think P&G, Heinz) and utilities. This investment seeks to offer the same stock sector exposure as the S&P 500 while producing a return that has 60-65% of the S&P's volatility over time. So as we look at markets and are faced with the attractiveness of equities in a world of increasing volatility, where appropriate, we are keeping our equity targets at their full weight, while dampening volatility with this opportunistic tool. Please give us a call to discuss if you have any questions about this or our process.

We have limited insight into where the equity markets will finish the year (and start 2013), but we are fairly certain that it will be a bumpy ride. Rest assured we are doing our very best, as always, to protect your portfolios, and continue to provide investment management with diligence, integrity and care.

Company News

By Patty Meneley, COO

We are happy to update you on some changes at Sargent | Bickham | Lagudis. Eileen has decided to pursue other goals, and we are excited to introduce two new team members. Lindsay Markin will be replacing Eileen as Client Service Manager for Brad, Kreighton, Bill and Meagan. Her background includes experience at Key Bank, UBS Financial Services, and Smith Barney. (Be sure to ask her about her MA in Forensic Psychology.)

Jordan Kunz has joined us as an Advisor Associate. Jordan is both a Chartered Financial Analyst and Certified Financial Planner. He will be helping us with everything including security analysis, portfolio management, financial planning, and supporting our Non-Profit / Institutional clients.

We look forward to introducing you to both of them.

Brad and Meagan were selected once again by 5280 as Five Star Wealth Managers. This award is achieved by fewer than 7% of the wealth managers in Colorado. We were also ranked 23rd in the March issue of the Denver Business Journal in assets under management for Colorado asset managers.

We wrap up our softball season next week with the Greenbacks' final game of the year. It's been a great season with one epic win and lots of fun in the dugout. Our desk jobs don't seem to prepare us for the local competition as much as we might hope but, boy, we have lots of fun!

You should have recently received your SBL Report for the third quarter either by email or by mail. If you received your report by mail and would like to change that to email, please contact me at patty@sblfinancial.com and I'll be happy to make that change. It's fast and password protected.

Financial Planning

The fiscal cliff gets ever closer. We wrote last April about the estimates by some economists that economic growth could drop by 3% to 4% if all the tax cuts expire as scheduled, and the spending cuts are implemented. We said before, and still believe, that this makes it likely there may be some action by Congress before year end (but it might spill into early January).

Any predictions about the changes that might come are less likely to be accurate than a Florida weatherman in hurricane season. Nonetheless, here are our best guesses based on the research we reviewed and our interpretations:

- The payroll tax will likely expire and not be extended. That means an increase in social security taxes on earned income of 2%.

- We think the odds favor a short term extension of the current tax law (excluding the payroll tax cut(?)) into 2013 – probably for six months to a year. This would give Congress and the President time to tackle tax reform.

- Tax Reform predictions:

  - On estate taxes, Obama has proposed an exclusion amount of $3.5 million per person. Romney has said he would leave it at $5.0 million where it is today. One of these is more likely than reverting back to a $1 million exemption.

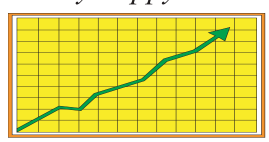
  - Back door tax increases on people with higher incomes are likely to come from more limited deductions. This may include limits on itemized deductions such as charitable deductions, mortgage interest, and even municipal bond income. Romney's latest idea, is to limit deductions to a single number such as $17,000. That way no single group is targeted – making it easier to pass through Congress.

- There is already an increase in taxes on unearned income (meaning interest, dividends, annuities, and capital gains) for Obamacare on incomes greater than $250,000. This begins in 2013 and is probably going to stick unless Obamacare is repealed, which is unlikely because the Senate is currently predicted to remain closely divided. It would take 60 votes in the Senate to overturn the law.

There are a few strategies our clients are considering before year end. These include making gifts to children for estates greater than $5 million for individuals and $10 million for couples; Roth conversions for people with incomes less than $70,000 for couples; and taking capital gains or gifting to charity on highly appreciated property.

As we say in every letter, all of our growth over the years has come from referrals from clients and other professionals. We have grown to be one of the largest independent registered investment advisors in Colorado, and we thank those of you who have referred your friends and colleagues. We ask the rest of you to remember us when your friends or colleagues might be looking for wealth management services. Have them give us a call or check us out at www.sargentbickham.com. We would also be happy to put them on our mailing list for the newsletter, and feel free to share this with them.

Many happy returns,



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