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"Every object persists in its state of rest or uniform motion unless it is compelled to change that state by forces impressed upon it."
Newton's first law of motion

Unfortunately, the state of motion of the stock market during the third quarter of 2011 was down, and unfortunately there were no forces that compelled it to change direction.

During the third quarter of 2011, the total return of the S&P 500 was negative 14%. Sovereign debt levels were the focus. What started with the downgrade of Greek debt several months ago has snowballed into a cascade of sovereign debt downgrades, including Ireland, Italy, Japan, New Zealand, Portugal Spain, and the United States. And as recently as October 4, 2011 Moodys believed the "Euro area credit pressures had yet to peak." A Greek default (or whatever they plan to call it) now appears a foregone conclusion, and since European banks are the primary holders of Greek debt, many major European banks were next to be downgraded. UK and Portuguese banks have followed. Fed Chairman Ben Bernanke says that direct exposure to Greece by US banks is minimal. But the stock market continues to be concerned about the indirect exposure. To quote Greenspan "The situation in Europe is very dangerous...and the notion that US banks are isolated is…unrealistic." Visions of the 2008 liquidity crisis enter investors' minds. Unless something is "done," the spillover into economic growth is inevitable. Headlines about the potential of a slowing economy or recession are above the fold on every newspaper. In the latest FOMC release, the committee believed that "there are significant downside risks to the economic outlook, including strains in global financial markets." The market was definitely in a risk off mode.

What are the potential forces that could change the direction? **Bold** steps in monetary and fiscal policy are needed. So far in 2011, it appears that the US and Europe have done too little too late. However, there are some plans underway that could be catalysts for positive change. For example, the latest plan from the European Financial Stability Facility could be approved (we are almost there), and then quickly followed by a MUCH LARGER rescue fund. Central banks could loosen monetary policy globally (several countries have announced stimulus, rate cuts, and QE during the past few weeks). Further G-20 coordination with action to maintain the liquidity in the global financial markets. The Super Committee is 'successful', and confidence in our leadership edges up a notch. Aside from the macro pictures, there is the potential that quarterly earnings could positively surprise.

It appears to us that the stock market expects these forces to fail, and this has led to the selloff and one of the highest equity risk premiums since the 1930s. Therein is the potential opportunity. The one event that we believe is not priced into the market adequately is a 2008-type liquidity event. At this stage we do not believe that this will occur. US bank capital ratios are twice as high as in 2008, and credit risk levels, while elevated, remain at under 10% of the levels achieved in 2008. But we also believe that the stock market won't stage a sustained upside rally until some of these issues are resolved, and bank stocks rally. Discussion and endless meetings with lip service to ideals aren't what we need. We need forceful action. We do not know when this will occur, or what ultimate form it will take, but we do believe that it will occur eventually. Until resolved, this uncertainty is likely to support high volatility in the stock market.

We have been busy during the past several quarters raising cash, repositioning the stock portfolio, and bringing the bond portfolio back up to benchmark levels. This has helped shield us from the worst effects of the recent stock market decline. Given the uncertainties surrounding Europe we believed a slightly more defensive positioning was prudent.

We began by raising cash back in March and April of this year, with the idea of sell high in mind, and this continued in Q3.

When we added stocks to the portfolio, we focused on a few themes. First, we believe that the barbell strategy that we have been following continues to be relevant. We hold a combination of GARP (growth-at-a-reasonable-price) stocks for when the economy is moving forward, and high dividend yielding defensive stocks to help support the portfolio during times of weakness. Second, we are looking for strong companies with good dividends and/or strong balance sheets that have secular growth stories whether or not the economy grows. We are looking at stocks that have been beaten down in this selloff.

As for the bond portfolio, we were aggressive in building up the bond portfolio in early September ahead of "Operation Twist." With this policy the Fed is trying to lower long-term rates in order to help support the economy. While the subsequent decline in yields certainly did help balance portfolio performance on the margin, the yield-to-maturity on bonds remains at historic low levels. For example, the 2-year US Treasury yields a pathetic 0.3% and the 5-year yields only 1.1%. This is completely distressing and frustrating for those who live off the income from their portfolio. On the flip side, the very low yields can help give some additional support to economic growth overall, and especially to the mortgage market. (As an aside, for those of you with home mortgages, you should explore the benefits of refinancing with 30-year mortgages falling below 4%).

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

John A. Zaro III, CFA
Managing Partner

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Partner