BCM
Growth | Preservation | Partnership
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"There are no great limits to growth because there are no limits of human intelligence, imagination, and wonder."
Ronald Reagan

One of the biggest questions surrounding the aftermath of the Great Recession has been how the government was going to pay back our debt burden. We have several choices: raise taxes, lower spending, spur growth and inflation. From the monetary perspective, the Federal Reserve has been very clear in their position to help support growth with low interest rates and quantitative easing. From the fiscal perspective, we continue to have unclear messages. While we avoided the worst of the fiscal cliff, taxes have gone up. But, we also kicked the can down the road on spending cuts. This sets us up for additional ugly, nail biting battles down the road, including the real potential for further downgrades by the rating agencies. All that said, until we are comfortably underway with a clear debt reduction strategy, we continue to believe that our economy will be in a tug of war between monetary stimulus and fiscal austerity. While this will likely create volatility in the equity markets, we plan to remain nimble and to use price swings to our advantage by taking some profit when stocks reach our price targets, or by adding on weakness.

As we said last quarter, the decisions made by the European Central Bank during the second half of 2012 significantly reduced the tail risk of a liquidity crisis. Therefore, we believe that we can be less macro driven in our investment approach and spend more time focusing on specific secular growth themes. Even in times of economic uncertainty there are growth sectors. Last quarter we spoke about how we have been investing in the US housing recovery. This quarter we want to spend time talking about the US energy boom.

One of the areas of strong growth potential in the United States is energy. In the last two decades technology advances enabled companies in the US to extract natural gas from shale deposits. As a result, production of oil and gas has increased significantly and is up 32% in the past 6 years. Production costs for natural gas have decreased, and the price of natural gas has fallen from over $10 to under $4.

The high availability of natural gas and its low price has the potential to be a huge benefit to our consumers, our manufacturers and our national interests. The low price of natural gas is holding down spending on electricity. This is not only a benefit to consumers but also to many chemical companies. The energy boom is helping to increase employment. According to ISI, employment in oil and gas extraction is up 25% over the past three years and those jobs pay almost 22% more than the national average. Furthermore, for every direct job created in the energy industry, on average three or more indirect jobs are also created, according to HIS. Increased energy production has the potential to be very long term, since the US holds natural gas reserves roughly equivalent to 100 years of US demand. Finally, according to the International Energy Agency, there is a real possibility that the US could be a net energy exporter by 2030, making our nation energy independent. The biggest concern on shale gas production is the potential negative impact on our environment and water supply. We are watching to see how regulation and technology move to limit this risk.

We are playing the long term theme of growth in energy throughout our portfolios in several different ways, owning a mixture of both defensive and growth-at-a-reasonable price investments. First we own some oil and gas producers: Second, we own several Master Limited Partnerships. These are companies building the pipelines that transport natural gas from the producers to the consumers. The great thing about this business is that it is primarily a toll road with take-or-pay contracts so that profitability is fairly steady. A concern about MLPs is that since they are required to pay out a significant portion of the profit to their shareholders, they have to grow through debt and stock issuance, so the companies tend to be highly levered. Overall we believe that they offer decent growth with strong dividend yields (usually over 5%). Finally we like the suppliers to the shale gas producers.

The year 2012 was another year of the two-step forward, one-step back variety, similar to what we have seen since the end of the Great Recession. We continue to believe that we will encounter this for the upcoming year or so, and that our current equity strategy remains relevant. We own some defensive, high-yielding stocks for when the economy is stepping back, and we own some GARP stocks for when the economy is stepping forward. We still have a constructive view on equities for the long-term, but recognize there are near-term risks, especially as Europe is in recession and the US still has to resolve its debt reduction plan. Fortunately the news out of China has started to improve. Since 2009 we have increased the allocation to equities every year, and most of our clients are near their benchmark allocations.

Bonds continue to provide safety with little (or negative) real return. To compensate, our focus continues to be on corporate bonds over government bonds, keeping the ladder of maturity relatively short (under 5 years), and/or buying higher yielding stocks. With unemployment still over 6.5% we are not overly concerned about inflation in the near term. It is a wonderful time to buy a house, as the Fed continues to focus on keeping mortgage rates low to support a housing recovery.

While we have only spoken generically about asset allocation in this report, we believe that it is a very individual decision. We do our best work for you when we are up-to-date on changes that may be occurring in your lives. If your situation changes at any time, please reach out to us and let us know.

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

Laura K. Drynan, CFA
Partner