Investment Commentary
March 31, 2012

Don't Move The Ball, Lucy

I have long been a fan of the Peanuts Gang, Charlie Brown and the rest of the group. In fact, I sometimes sport my Peanuts themed sweater that has a large image of Snoopy and Woodstock playing football. But the football image from the Peanuts gang that has been on my mind these days is Lucy holding the ball for Charlie Brown to kick. To refresh your memory, that is the scene where Charlie Brown worries that Lucy will pull the ball away at the last moment as Charlie Brown goes to kick it. Lucy insists that she won't move that ball, but she always does, and Charlie Brown goes flying in the air landing on his back in a painful thump. "Good Grief"!

It feels like the markets have been subject to their own version of the Lucy & Charlie Brown scene. Since mid-year we have experienced tumbles as the market reacted to global financial and political news on top of shifting expectations for corporate earnings and economic growth. The market regroups and gets set for another move back up when it appears that political leaders are finally coming to grips with Europe's grave systemic problems, only to fall again when the measures taken prove to be inadequate.

The market suffered a major decline in early August when concerns about financial stability in Europe triggered a decline of more than 12% on the S&P 500. Troubles had been brewing for a while, but events at that time truly raised concerns about the possibility of sovereign defaults and economic contagion not just in the Euro zone, but on a global scale. The stock market recovered, and then lost more than 6% as investors became concerned that European leaders were not doing enough to confront the systemic problems of slow growth and excessive borrowing by peripheral Eurozone countries. The stock market rallied back, recovering almost half of the total decline from mid-year until concerns that a "voluntary" restructuring of Greek debt would force losses on investors in sovereign bonds, circumventing the protection of credit default swaps that many investors had used to hedge their risk.

During this time the markets were also subject to inter-day volatility, and sharp day-to-day swings as each new pronouncement from European leaders gave investors hope that a solution was at hand, only to be disappointed when the details were vague or the potential for any realistic change was limited. Just like Lucy, they said that they would do what they need to do, only to pull away at every critical juncture.

Despite this frustration, the markets and investors seem to be learning a valuable lesson, albeit slowly. There seems to be less euphoria over every pronouncement from European banking and political leaders and more of a "show me" mentality. The market swings are clearly less pronounced, and there is a greater focus on the details and realistic potential of any new proposal. Since the problems in the Eurozone are critical and complex, with far reaching implications for members within the union and global trading partners, any potential solution is fraught with uncertainty. A more patient and skeptical approach by our markets regarding potential European solutions is not only healthy, but provides the opportunity for investors to focus some attention on domestic news flow on business, the economy and political developments here at home.

Charlie Brown keeps trying because he knows that Lucy could really hold the ball, and if she does he could kick it through the uprights. Investors know the same thing. There are a number of factors that could work in our favor, and it might not take much to trigger a move that could generate a decent return in the stock market. The market continues to trade at inexpensive valuations. Earnings growth has declined over the past year, and earnings expectations from analysts and corporate management indicate that the trend could continue, but that could change quickly. Corporations have become more efficient over the past several years and management seems much better equipped to navigate in a slow growth economy. Since the Fed has pledged to support economic growth by keeping short-term rates close to zero and purchasing higher-risk long maturity securities, the risks for a double-dip recession here should be reduced; and if central bankers in Europe are able to avoid the disaster of failed sovereign refinancings they might buy enough time to allow their economies to begin to recover. Just a little unexpected good news on Europe, corporate earnings, or the economy could be all that it takes.

And, of course, domestic politics could play a role. The presidential election year is generally good for the economy and markets. The potential for a change in leadership in the White House could be viewed as a positive by the markets. While that may be difficult to predict at this point, the markets will be watching carefully. Keep in mind, however, that over the longer-term the financial markets have prospered

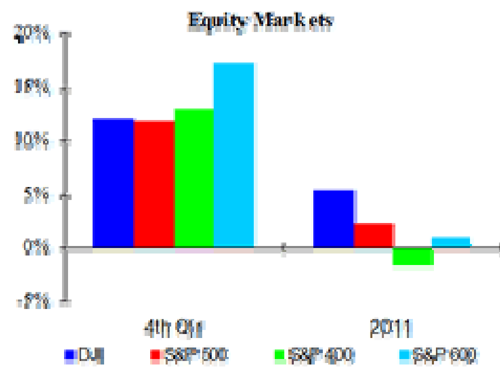
more when control of the White House and Congress is split between the two major parties. Investors seem to like “gridlock” and if that is the outcome of this election it could also be viewed as a positive.

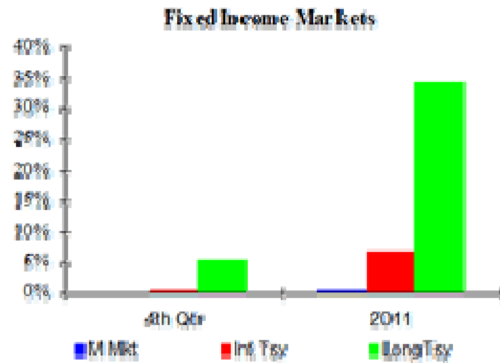
Our investment approach will continue to balance the risks of financial problems in Europe and weak economic growth here at home with the potential for some workable solution and the benefits of reasonable valuations in the market. We will continue to focus on investing in companies with attractive valuations relative to their growth potential and financial stability. In addition to that valuation criteria, we will look for company management that has a clear vision and ability to execute in this challenging economy.

Sincerely,

Daniel A. Morris

Market Summary: December 31, 2011





Stocks rebounded during the quarter, recovering much of what they lost in the previous quarter. The rebound was impressive given the fact that the European crisis continued to dominate the headlines, and earnings estimates for the major market averages experienced negative revisions for the first time since 2009. The market chose to focus on indicators of US economic activity and employment, which prove to be slightly better than many had feared, and raised hopes that the domestic economy might be able to weather a worrisome international situation. Cyclical stocks showed considerable strength, and small cap stocks outperformed their larger cap brethren.

Prices of Treasury securities traded in a narrow range during the quarter, largely retaining the appreciation achieved during the previous quarter. Steady Fed buying of longer dated maturities, as well as a continued flight to quality as the European crisis dragged on, served to offset inflationary concerns caused by rebounding oil prices and a stabilizing US economy. Fixed income total returns as a result were subdued across the yield curve, but longer-term assets continued to outperform.