

“Certainty is the mother of quiet and repose, and uncertainty the cause of variance and contentions.”

Edward Coke (1552-1634)

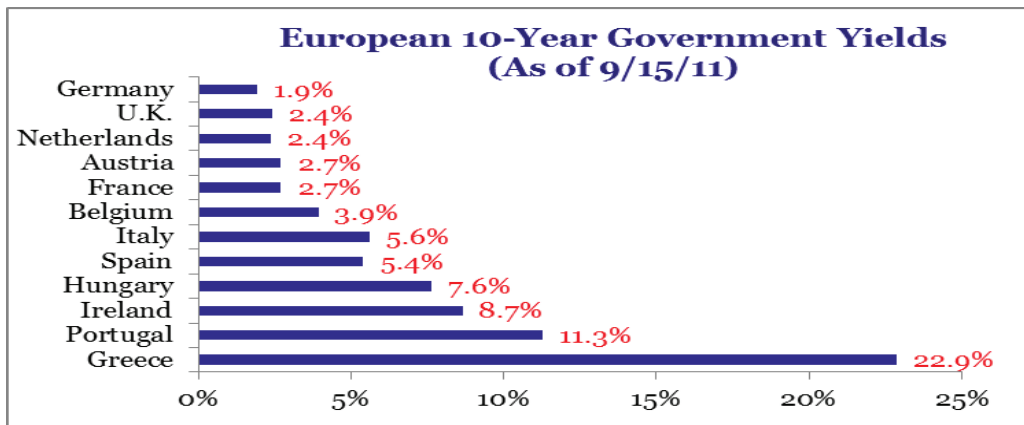
“A man in debt is so far a slave.”

Ralph Waldo Emerson (1803-1882)



- **Hurricanes, floods, and earthquakes (Oh my!)...** While such natural events might not have a direct influence on investing, per se, they did nothing to sooth the already fragile psyche of the population.
- **Man-made disaster:** Oblivious to the country’s angst, our elected “knuckleheads” sent the country into the fetal position with the harangue over the debt-ceiling and the resulting downgrade of our country’s credit rating. Is it any wonder the economy lost what little momentum it had?
- **From the 1976 movie Network,**
“I’m as mad as hell and I’m not going to take it anymore!”
So busy with their own political futures, we wonder if our political leadership (an oxymoron) realizes that we’re angry with *all of them*.
- As for the partisanship demonstrated in DC ... in a word, **disgraceful.**
- **The genie is out of the bottle...** While most of the developed world focused on the debt crisis and natural disasters, perhaps the most profound global event occurred in the Middle East. Technology has not only allowed the world’s population to see how the other half lives, but now, via cell phones and social media, the oppressed can organize against their oppressors. Our own politicians should take heed.
- **Pay-back:** Borrow from the future and it has to be paid back. That’s where we and others (i.e. Greece) find ourselves. Since no one willingly reduces their standard of living, the process will be slow and trying for all.

- **Absolutely!...**is the cry. “The debt must be paid down!”...*so long as it doesn’t hurt me*. While the process is wrenching, fiscal conservatism is coming. Either we will exercise the political will to put the “house” in order or our lenders will do it for us. Witness what is happening overseas...



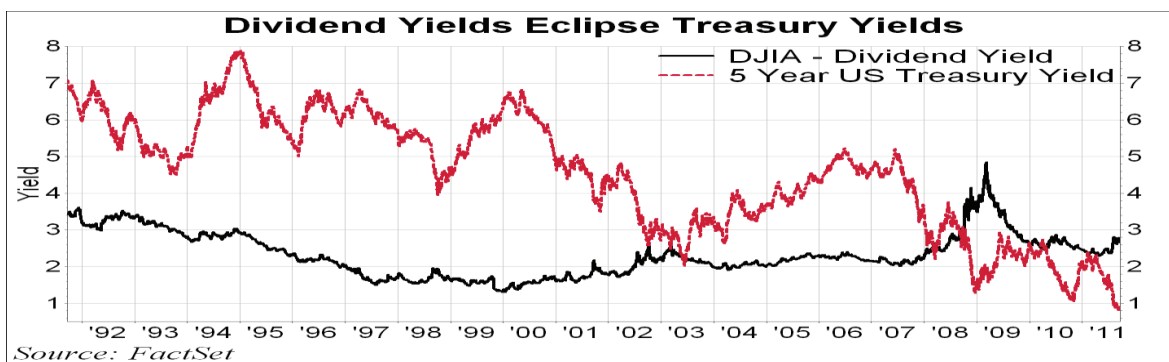
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- **The EU: Well-intentioned, but structurally fragile...** While the seventeen countries in the European Union share the same currency, the members have limited oversight over each other’s fiscal behavior. As a result, a profligate nation can undermine the trust in the currency shared by the other sixteen.
- **Greece...** The prevailing opinion is that Greece cannot avoid default and that its failure could lead to a contagion of sovereign defaults and bank failures.
- **Recency bias....**Behavioral studies have shown that investors are highly influenced by their recent experience. Thus, if Lehman Brothers’ failure led to a contagion amongst US banks, then Greece’s failure would lead to..... *You get the picture.*
- **Formula for a stock market swoon...**Add equal parts (1) muddling, “pay-back” economy, (2) fragile investor psyche, and (3) recency bias. Add a dollop of Euro crisis, a dash of knucklehead and whip vigorously into a panic.
- **Bipolar...** we think we’re witnessing the mirror-equivalent of the late 1990’s greed in today’s bias toward caution. We give you, “*...but how do we know when irrational exuberance has unduly escalated asset values...?*” and by contrast, “*...even taking into account the many financial pressures they face, households seem exceptionally cautious.*” The first was infamously offered by Alan Greenspan in December 1996, while the latter was observed just days ago by Ben Bernanke.
- **Pessimism = low valuations = opportunity...**We were recently rereading one of the “bibles” of investing, William Bernstein’s The Four Pillars of Investing. To quote:

“As this book is being written [Copyright 2002...just months after the tech bubble burst], most readers should have no trouble believing that irrational exuberance happens. It is less obvious, but equally true, that the sort of pessimism seen in the markets 25 and 70 years ago is a near certainty at some point in the future as well.”
- **Bernstein continues...**

“...the most profitable thing we can learn from the history of booms and busts is that at times of great optimism, future returns are lowest; when things look bleakest, future returns are the highest. Since risk and return are just different sides of the same coin, it cannot be any other way.”

- **Are we headed for recession?** While the chances have increased significantly, the most probable outcome remains “no”. Presently, companies are holding only enough inventory to meet near-term demand. Typically, it isn’t until there is excess inventory that businesses begin to cut back. Absent a spike in oil prices, we should continue to muddle along until real estate has repaired itself (2014?).
- **Still**, “pay-back” and the wrenching policy process that will accompany it means the country’s growth will be slower and sloppier than anyone would prefer.
- **Uncertainty prevails...**New and uncertain regulations as well as potential tax code revisions have left the “rules of the game” in limbo-land. As a result, investment capital has gone to the sidelines.....leaving our economic engine in idle at the very moment we would most want it in full gear. Policy-makers need to focus on stimulating business activity. The best elixir for the pain of pay-back is the “top line”. If business activity accelerates and GDP grows faster than our debt grows, the debt crisis will abate much more quickly than by spending cuts alone.
- **Chicken-and-egg....** Simplify the playing field for everyone in a fashion that is obviously long-term in scope (the tax code, government regulation, and entitlements) and call upon everyone to participate in the cure. We are reminded of John F. Kennedy’s “ask not” quote as the kind of leadership required to unify the country toward a single goal.
- **Patriotism is alive and well...**While noting JFK, we would also observe it would be the perfect moment for such leadership to challenge the country to something grand....Today’s equivalent of going to the moon? How about declaring war on the national debt? Is there anything more threatening to our future?
- **Dividends!** Conventional wisdom suggests that stocks are for younger investors building for retirement, while bonds are more suitable for retirees. We would – at this moment in time – challenge that perception.
- **Safety is over-priced...**While it is certainly true that the market value of stocks tends to be much more volatile than that of bonds, the perceived safety of bonds has never been more highly priced. For that “safety and security” today’s investor can capture a scintillating 0.90% on a 5-year US Treasury or 1.85% if willing to lend to the Treasury for 10 years. Importantly, these rates of return are lower than the current rate of inflation. Buying bonds is all but assured to produce a negative “real” return.
- **By comparison**, one can earn 2.75% from owning the stocks of the country’s thirty largest companies (which, by the way, have far superior balance sheets to that of the US Treasury).



- **Choose one...** A ten-year US Treasury (recently down-graded) paying 1.85% or Proctor & Gamble’s common stock yielding 3.30%. The interest rate on the bond is fixed for ten years. Proctor & Gamble’s dividend has been raised every year for the past twenty-six years. This is not a trick question.

- **Inflation!...** As further evidence that stocks are important to retirees, our own Jon Morris recently found that the *dividend growth rate* of the S&P 500 has consistently exceeded the rate of inflation over ten year periods.

Average Annual Growth Rate			
	30 Years 1980-2010	20 Years 1990-2010	10 Years 2000-2010
Core US CPI	3.25%	2.38%	0.97%
S&P Dividend	4.54%	3.36%	1.99%

Source: Bloomberg, Palladium

- **Income trumps volatility...**In today's near-zero interest rate environment, stocks provide not only a higher level of income, but an income that is likely to grow. Investors need to focus less on the market value of their monthly brokerage statement and more upon the stream of income their investments provide. Over-time, a rising level of income will result in a higher market value. (It's that tortoise thing!)
- **Discipline!** We fully appreciate that people are worried and uncertain about the future. We feel the same way. However, investment success requires one to divorce emotion. Seen as a natural part of the process of a democratic and capitalistic nation (and we wouldn't trade with anybody), the country is in one of those ugly places through which it has navigated in its past and will undoubtedly face again in its future. While it may be endemic to our profession, we remain optimistic and know – as a result - that our unwavering commitment to our investment discipline will prevail.
- **Behavior is everything...** Investment success is not about what you know, it's about what you do. And, while it is true that knowledge, like experience, can be helpful, too much information can negatively influence one's behavior. A landmark Harvard study revealed that investors who consumed no financial news earned better returns than those who were fed a constant stream of it (Why Smart People Make Big Money Mistakes and How to Correct Them, Belsky and Gilovich, 1999).
- **What about gold?...** We hear this a lot. While perceived as calamity insurance, gold is, by its nature, speculative. Its principal use (in jewelry) has seen demand fall, so the recent rise in price is purely the result of fear, as people seek what they perceive as "safe". However, investors should keep in mind that not only is gold costly to own (must be safe-kept and insured) and it provides no income, but any profit from investing in gold is subject to a 28% tax rather than the maximum capital gain tax rate of 15%. For our part, we think we may well be witnessing the next bubble.
- **Beware the purveyors of doom...**We recall the highly publicized prediction of Meredith Whitney about the coming demise of municipal bonds via "hundreds of billions" in defaults. In 2010, municipal defaults totaled some \$3.6 billion, about 1/8th of 1% of the current municipal issuance (Bloomberg) and roughly equal to the historical norm. Year-to-date, Distressed Debt Securities reports that defaults total \$946 million....So much for municipal Armageddon. As we've said before, when it comes to investing, the media is not your friend.
- **God Bless the USA...**Having recently passed the tenth anniversary of 9/11, we will close by offering our most sincere appreciation to all those who put themselves in harm's way to protect our way of life. As troubling as the political and economic climate may be, there is no place we would rather live.

September 2011