capital markets review

HAMILTON CAPITAL MANAGEMENT
REGISTERED INVESTMENT ADVISER

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Economic Outlook

Significant Volatility Triggers Fear, But Reality Is Better

Executive Summary

Volatility has been the hallmark of recent months. Rising commodity prices through early 2011 and the March Japanese tsunami had a real, slowing impact on the economy. This, of course, was greatly exaggerated by concerns of fiscal crisis in Europe and the U.S., as politicians failed to provide leadership.

Economic data continue to suggest a moderate rate of growth rather than falling back into recession. And, the crux of the matter is not so much economic as political, both in the U.S. and Europe. Significantly, European leaders may now be showing resolve about fixing the fiscal problems of several member countries, as the crisis may have reached a pitch that makes unpalatable decisions politically feasible.

Fear seems to have become the prevailing sentiment. Are we falling off a cliff?

Economic data have indeed pulled back from the strong pace of early this year. Yet, as we categorize the numerous indicators we follow, the picture that emerges at this point is one of slow growth. So the answer would seem to be no, we're not seeing evidence of falling back into recession in the U.S.

Further, the traditional *driving or causal* factors of economic shifts are largely supportive. This is not unlike March 2009 (just as the economy and financial markets were bottoming), when economic indicators were uniformly much weaker than today, yet the *driving forces* of economic growth had become noticeably positive. These factors currently include low interest rates, a relatively low dollar (which helps exports) and falling commodity prices. Fiscal policy in the U.S. has shifted from a positive to a neutral, and it's still not clear whether it will become a negative. It depends on what Congress and the administration do with numerous proposals for a "near-term stimulus."

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How reliable are those causal factors that you follow so regularly?

Every cycle is different, as these causal factors are always present in different doses. But they've worked quite well historically and

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The Interviewees

Matt Hamilton, CFP®
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Tony Caxide, CFA®
Chief Investment
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Eric Shisler, CFA®
Vice President
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The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Vice President & Portfolio Manager Eric Shisler shortly after the end of the third quarter of 2011.

Equity Portfolios

STOCKS ROCKED BY VOLATILITY, WHILE EARNINGS SHINE

Executive Summary

The economy and financial markets often march to different drummers. Last quarter they shared strong volatility. Equities experienced weak performance (much of it offset in early October on improved perceptions) while profits were at very high levels.

The riskier part of the market – emerging markets, small-cap U.S. stocks, Europe – tended to underperform. These are sectors that we have either avoided or under-weighed relative to our "neutral" allocations for some time. We do feel that stocks overall (and large-cap companies with global franchises and strong balance sheets in particular) are priced at a discount to their current as well as their sustainable earnings.

I know that the portion of my portfolio allocated to stocks should experience much higher volatility than what I have in bonds or cash, but this quarter felt much worse than usual. Was it?

You're right. This was a difficult quarter by any standard. Of note we would point to two particular characteristics. First, in late July/early August, the S&P 500 dropped nearly 17% in a few trading days! As if that weren't enough, stock indexes then proceeded to yo-yo up and down violently, with numerous, multi-percent, daily shifts.

One other thought is relevant. We tend to measure interim results in these convenient periods (quarterly, annually). A perfectly reasonable approach much of the time, it can create misconceptions, particularly in the hands of revenue-hungry media who seem to live by the credo "if it bleeds, it leads." For instance, if we shift the end of the measurement period from September 30 to the middle of October (as this is being written), after the market experienced a 12% gain in just a few days, then the performance becomes much more typical. In fact, year-to-date stock indexes are down about 1% in total return terms through mid October -- an outcome not noteworthy after 2010, when the S&P 500 returned over +15%. But the ride has been awful.

Since profits are such an important part of your work, what is the latest read?

This might sound like a broken record, but second-quarter profits have reached yet another record level.

This divergence between modest economic results and strong profits is not unheard of, as the two can drift apart for quarters, even years. We've talked before about the successful steps taken by corporate America, ranging from disciplined cost management to sourcing revenue abroad (in higher-growth markets). But it's particularly striking given how the uncertainty surrounding this recovery has played out in the news.

Although profits do not correlate with stock prices on a daily basis, we feel that profits are the "stock" (so to speak) in the soup of equity prices and ultimately define its taste (i.e., the level of prices). And the level of profits is quite good for now.

So how do you reconcile this frightening volatility with one's effort to invest longer term?

We feel, as you mention in your question, that investing is for the long term. Investors are well served, particularly during difficult market environments, if they have the foundation of having worked closely with an advisor to develop the right long-term plan. We call it "selecting the right ship to sail in," and it differs from investor to investor. But when you pick the right long-term or "neutral" allocation of asset classes (like U.S. large-cap stocks, non-U.S. emerging market stocks, U.S. high-yield bonds or cash), and you understand how that portfolio of assets has fluctuated in the past, you're much more likely to face market volatility with patience and wisdom, and avoid the mistake that research has shown most individual investors make (to their portfolio's significant detriment): getting out when things are gloomy and coming back when they're sunny.

This is a key, but it's not the only step. Even with the right long-term plan, one can still face market environments that transcend past experience, or one can try to do a little better that "the market" in terms of return and/or volatility. That's where disciplined, active management comes in. By carefully assessing how different asset classes are priced relative to their fundamental value, and emphasizing the ones that are undervalued (while avoiding the expensive ones), one can make a positive impact on portfolio characteristics and, equally important, in the mindset of investors.

Let us re-emphasize that we're not talking about sentiment-driven investing nor about market timing. Research shows that gut-driven decisions detract from portfolios, and waiting for sunny days typically causes investors to miss sharp market rebounds (like the one we just experienced in early October), which may define a year's return and constitute a meaningful part of one's long-term return as well.

In Agreement

"If you're saving for retirement or preserving assets in retirement, you may be better off looking beyond the current headlines to consider a market's historical performance and how current market performance appears to be part of a pattern the market has repeated on a fairly regular basis throughout history.

"In the sense of 'big picture' or macro events, the 1980s and 1990s were historically the exception rather than the rule. There were recessions, but there were fewer than any other two-decade period in U.S. history. There were wars, but they were shorter and had fewer casualties than any other two-decade period.… As a result, it may have been easy to fall into the misleading conclusions that investing is only about balance sheets, earnings and ratios."

— *Spotting Opportunity Amid Uncertainty*,
Wells Fargo Advisors:
Gary Thayer,
Chief Macro Strategist;
Stuart Freeman, CFA®,
Chief Equity Strategist; et. al.,
September 2011

Fixed Income Portfolios

A Volatile Quarter For The Bond Market

Executive Summary

The bond market experienced its share of volatility as investors tried to reconcile numerous issues facing the economy and markets. Ongoing uncertainty about a Greek default, signs the global economy is slowing, and a downgrade of the U.S. government debt all gave bond investors plenty to analyze.

Concern about slower economic growth led some investors to reduce their risk level over the quarter. Operation Twist helped longer rates move lower. Currently we're emphasizing bond portfolios with a core of high-quality and relatively shorter-maturity bonds. Augmenting this core with a dynamic allocation in more risky high-yield bonds can, we believe, generate the long-term returns and portfolio characteristics we seek for our clients.

We've heard about Greece's sovereign debt issues for some time. Where do things stand currently?

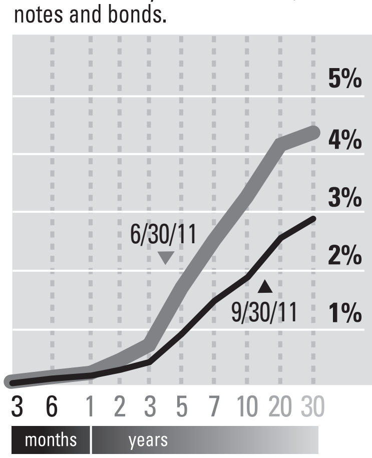
The Euro-zone and IMF continue to assess whether Greece has passed the tighter fiscal policies that will merit additional aid payments. Most recently, leaders in the EU (led by Germany and France) obtained agreement from member countries to increase the flexibility of the sovereign debt assistance program – the European Financial Stability Facility (EFSF) – and are working to require greater contributions from the private sector (such as banks), which owns large swaths of Greek sovereign debt.

The Greek economy represents a relatively small portion of the Euro-zone's economy. Why not just bail them out and put this issue behind us?

Leaders of the Euro-zone must strike a balance. On one side, they need to help Greece by making funds available to help the country emerge more competitive. On the other hand, a simple bail-out poses numerous risks, as it would remove pressure on Greece (and other countries in similar straights) to enact austerity measures, which will ultimately help them resolve their debt issues. These worries, along with reports of slowing economic growth, caused investors to move out of riskier assets over the past few months. And investors' concerns are not limited to Europe. The securities markets of many countries that have seen their debt-to-GDP ratio increase since the credit crisis are impacted as well – including the United States.

Treasury Yield Curve

Yield to maturity of current bills, notes and bonds.



Speaking of which, we noticed Standard & Poor's reduced the credit rating of U.S. debt. How has that impacted the U.S. Treasury bond market?

S&P's rationale for reducing the U.S. credit rating one notch, from AAA to AA+, was partly based on the country's growing government debt burden. Interestingly, the market responded contrary to what one would expect when an issuer is downgraded – prices of Treasury bonds rallied. This illustrates both the fear that pervaded markets recently and the fact that investors continue to believe that U.S. government debt is one of the safest investments in the world. The silver lining is that the downgrade served as a shot across the government's bow, calling them to action on managing the debt load.

The Federal Reserve started another form of stimulus called Operation Twist. What is it?

In order to reduce longer-term rates, the Fed intends to sell short-term bonds it already owns and buy longer-term bonds instead. By creating demand in the longer end of the market, the Fed hopes to bring down longer-term interest rates. These rates are typically used as benchmarks for many types of loans: mortgages, corporate bonds, and others. The plan was successful even before it started, as markets anticipated it by driving ten-year government bonds sharply lower. Commensurately, mortgage rates dropped to levels home buyers and owners haven't seen for decades.

How are you managing bond portfolios in this market?

In terms of maturity strategy, we continue to remain short of the duration of our benchmarks. Given historically low interest rates, a more normal level of inflation and extreme negative sentiment on economic growth, we believe the risk is tilted toward higher rates rather than lower. Should that occur, our position would preserve principal while continuing to generate some interest income. This may play out over time, but we have hints of it early in the fourth quarter.

Whether in taxable accounts (emphasizing corporate over government bonds) or municipal bond portfolios, high-quality bonds remain the largest percentage of our bond strategies. However, we believe the sell-off of riskier assets over the past quarter has created an interesting opportunity over the coming 18-24 months in high-yield bonds. As a result, we continue to hold an overweight position in high-yield bonds where prices, in our view, are too low relatively to our expectations for defaults.

Economic Outlook

(Continued)

globally, and we feel that we understand how they impact each other. This is the real key to having confidence that we can anticipate how they will interact in the future and the impact they are likely to generate – not every time, but more often than not.

That said, we're not stopping there. Beyond economic indicators and causal factors, we always assess the political setting, as both monetary and fiscal policies have strong political elements. Although we often share our distaste for the ugly "sausage-making" aspect of the political process, it's an integral part of our work and, believe it or not, politics can help.

Wait – politics can help? You have to explain that. It goes against our every instinct.

We know, injecting politics into our future seems hopeless, and we certainly have a love-hate relationship with our elected leaders. Typically, the inefficiency of the process and cynical public displays drive us to despair at an emotional and moral level.

However, intellectually we recognize that this is a necessary part of the process of creating consensus among the voting public. Our founding fathers never intended the process to be efficient – we feel that they designed it to be broadly participatory and dilutive. They were less concerned with the messiness of it and more with avoiding a concentration of power.

In Europe we feel that the crisis may have finally reached a stage where a more lasting solution is within reach – one that includes things seemingly impossible just a few short weeks ago, including greater fiscal integration (with its implied loss of sovereignty for individual nations) and greater financial commitments from the rich countries like Germany to the weaker ones and even to the "black hats" of the recent economic crisis, the banks.

Most importantly, in our view, is that although the details can and will change, sometimes on the fly, key political leaders have reached a conclusion that they must help fix the fiscal problems of the weaker EU countries, and that they will seek to avoid a collapse of the Euro at nearly all costs (as they would all lose if that occurred, including Germany). In other words, they may be about to pick up the can rather than kick it down the road endlessly. Of course, this process is ripe for disappointment, so we expect it will be a halting process with many setbacks.

Can you apply that political screen to the U.S.?

We feel that we're going through a similar process here. Although Republicans and Democrats remain at each other's throats (nothing ever changes), there is a detectable shift in their platforms and a growing consensus that we must reduce our large government budget deficits and debt levels (but not too rapidly) while providing an environment that facilitates growth. Further, the more sober political voices seemingly recognize that although the party philosophies may be different, both they and the nation will lose (for the politicians, literally their jobs) if they fail to find a solution.

We don't want to convey that it's all neatly wrapped up in a bow. We're also closely monitoring a slowdown in emerging markets growth that we've anticipated for some time. But the key political decisions are the building blocks that we incorporate, along with earnings, in our assessment of valuations and our portfolio design decisions.

Shifting the focus a little, is there anything to worry about with inflation?

The essence of the story is that prices are taking a path close to our expectations. Overall inflation has begun to slow, to some extent driven by slowing commodity prices (the principal factor that drove inflation higher to begin with).

If you exclude the volatile commodity elements (e.g., food and energy), so-called "core" inflation is likely to peak near the Federal Reserve's preferred range of 1.5 – 2%.

THE HCM ADVANTAGE

The largest investors often have the benefit of sophisticated internal investment departments led by a qualified Chief Investment Officer to design and manage their investment portfolios.

Unfortunately, most investors can't maintain an internal team of that caliber. But if having an external investment team of that sophistication is something you could gain from, then we're here to serve.

We function in a fiduciary capacity as an external Chief Investment Officer for our clients. Our structure is similar to the investment departments of large, sophisticated institutional investors, and our team has extensive global investment experience. In fact, several of our team members have received national recognition for their abilities and accomplishments.

Each day, we diligently apply our disciplined investment process to the design and continuous, forward-looking supervision of your portfolio. Our goal: To build a complete investment solution for you.

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Form ADV: If you would like to receive a copy of our current Form ADV, Part II, please contact us.