ValueWorks
quality assets. compelling valuations.

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Financial markets opened 2012 with a strong advance. By-and-large, the degree to which investors participated was tightly tied to how willing they were to accept risk. This pattern makes sense coming off the market trauma of last summer. Because the US economy continues it's long healing process, and because Europe is now poised to head in the same direction, this rally is likely to be just the most recent stage of a prolonged and extended advance.

The mid-point of investor returns in the quarter was the Dow Jones Industrials, which produced a total gain of 8.7%. Cash once again earned negative real returns – now having lost 7% of its purchasing power since the market bottom (as measured by the CPI). Bonds provided a total return of 0.3%. The Dow Utilities Index posted a total return of 1%. The S&P 500 added 12.6%, sandwiched by the Russell Large Value and Large Growth at 10% and 14%. The more aggressive Nasdaq Composite added almost 20%. Our portfolios posted a satisfying advance for the quarter, but it was an advance closer to the Dow than the Nasdaq; our Capital Appreciation group of accounts was up 9.63% through March. Given that our portfolio is anchored by higher-quality, larger, more stable companies – names like Boeing, American Express, Eli Lilly, Pfizer, Cisco, Dow Chemical, and 3M, and given that it is designed to be appropriate for nest-egg assets, I consider it a solid quarter.

The correlation of returns over the past nine months is a result of investor focus on big-picture, macro concerns. The third quarter was a mini-bear market driven by fear that Europe's tight monetary policy would ignite another global meltdown. In that context, virtually all investments sold-off, the primary difference being a question of degree. The most volatile sold-off the most, and the most stable sold-off the least. It was a sharp, broad, lock-step move down. Once policy makers loosened the monetary spigot, liquidity returned, reducing the risk of melt-down, and markets recovered. Given that the decline has been erased, the scale of the rally was just as striking. With moves of this size, the nuances of better-or-worse-valuations get swamped by the overall market dynamic. (That said, these periods can offer opportunity to reposition the portfolio by degrees, for example buying Cree and Paccar last July and August, and selling Teco Electric in January.)

Top 10 holdings*:

1. American Express Co.
2. Calpine Corp.
3. Williams Companies
4. Paccar Inc.
5. Boeing Company
6. Dow Chemical Company
7. Pfizer Inc.
8. Cisco Systems Inc.
9. 3M Company
10. Zimmer Holdings Inc.

—as of 03/31/12—

*see notes on p4 for additional Information

In my last quarterly letter I argued that Europe's "crisis" was largely a reflection of a liquidity crisis that was being used as a tool to force fiscal discipline and greater fiscal control across Europe. Liquidity had been withheld from the system to limit access to borrowing and the capital markets by the more leveraged counties in the Euro Zone. In that letter I suggested that there was evidence that this policy had changed – that the ECB was providing significant liquidity through the LTRO -- and that such a change could actually represent a "solution" to that "problem." There has been significant stabilization across Europe over the past four months. There are those that contend that this simply reflects "kicking-the-can-down-the-road," and that the underlying problems will shortly re-emerge. While such a risk should not be ignored completely, I would offer the US experience over the past three years as potentially informative. The provision of ample liquidity does not automatically heal the economy in one fell swoop. But it does seem to provide the conditions for healing and growth to begin.

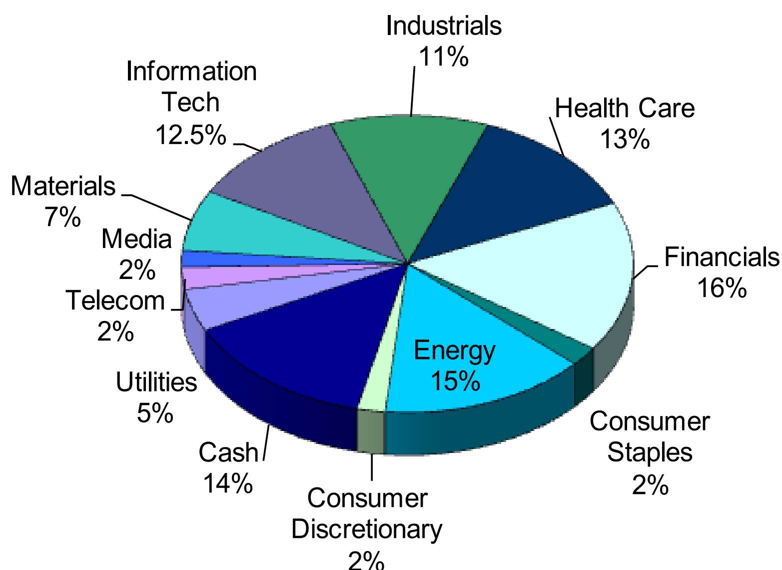
Through this turmoil, the US healing process has continued. Roughly 250 thousand jobs have been created per month since the middle of the fourth quarter. The rebound in auto and truck sales continues. There may be a real sign of a turn coming in residential real estate. It is true that home sales have failed to increase over the past several months. But what is different in the data is that the number of contracts signed to purchase houses is up nicely. The purchases have not been closing, translating to a spike in cancellations.

This recent trend of cancellations may be a result of borrowers being turned down for financing because the homes are not being appraised at the level that the buyer is willing to pay. That is important because the great bulk of those cancellations would represent a family that is not simply actively looking to buy a house, but also has evidenced the financial confidence to write a deposit check and commit to a purchase. They haven't bought a house yet, but they are ready and willing. That suggests there may be a growing "shadow inventory" of buyers. If that is the case, and if a logjam being created by low appraisals is cleared, there could be a significant jump in home purchases in any given month. Such a jump could change the tone of the economic discussion. Such a change could provide a nice lift for equity markets across the board.

As various equity indexes start to approach their old highs, mostly set in March of 2000 , investors question how much more room there is to run. If the economy continues on its current growth path – which seems the most likely outcome given current economic policies – it would not be surprising to start seeing headlines with major indexes touching new all-time highs in the reasonably near-term. Historically, those highs provide a base for continued advances, rather than a ceiling. That is especially true after a twelve year consolidation process.

— Charles Lemonides, CFA

Sector Diversification--
Capital Appreciation Composite



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