

Investing is about making choices in a framework that often lacks full transparency and during periods when uncertainty abounds. Current market volatility is extreme; correlations are very high, which means that traditional diversification methods do not work well. Professional investors are unlikely to take on risk for long periods of time, which results in periods of manic euphoria and paranoia. However, we think that a fair evaluation of likely corporate profits suggests that it is worthwhile to own stocks and non-traditional bonds in this next market cycle, even while this takes some fortitude in the short term.

### Outlook and Analysis

In our analysis, we'll review some issues that concern us on the periphery and then address the proverbial 800-pound gorilla, the European debt situation. We are concerned that retail investor emotions are close to abandoning equity markets as a whole. In the past, this has been a reliable contrarian indicator that an investment class has exhausted its downside pressure and that the future return potential is positive. But as we have communicated to clients these past several weeks, we think that the U.S. economy has been in a recession for the past several quarters, even while government headline statistics do not state this. We think of recession as economic growth (measured by broad metrics such as GDP) below the rate of demographic growth. In practical terms, if there are not enough jobs to provide for new people entering the workforce, coupled with an existing large unemployment rate, this is a recession. If the domestic and global developed economies go into further recession, corporate earnings projections are clearly too high and will need to be aggressively adjusted downward. On the other hand, corporate profits are undeniably healthy across large sections of the economy. (In the first quarter of 2011, after-tax corporate profits in this country are at 8.4% of GDP, compared with a 50-year average of 6.1%.) In the past, robust corporate profits have led to more hiring and additional spending on growth. We are not completely convinced that this past will repeat itself this time, and, even if it does, the timing is uncertain. Thus, we are reducing investments in sectors which are most correlated with industrial growth and shifting into sectors which we feel will benefit from cheap valuations and other factors which will support their success in the long-term. (See *Client Portfolios* section of this commentary.)

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There is an ominous reality lurking beneath these profits, a reality that exists for the private sector and the public sector alike – entitlement spending. For the public sector in this country, the unfunded and undisclosed healthcare and Social Security liabilities are in the tens of trillions during the next several decades. Mainstream politicians are not discussing this. For the private sector, even though wage growth has been flat (high unemployment tends to do this), pension obligations have soared. Politicians and regulators have always been willing to compromise and punish savers in times of duress, and this time it is no different. Low interest rates and commensurate low discount rates for

pension liabilities are an enormous burden for private-sector pension liabilities. In most investment sectors, pension liabilities are not funded above 75%, and even that is generous given the rather optimistic assumed expected return on assets and the high liability discount rates used in previous years. We think investments in sectors that rely less heavily on defined benefit pension plans, and more self-directed retirement plans, are likely to mitigate some of this risk.

Inflation risks and deflation risks are fighting for dominance. The destruction of capital that took place in the 2008 financial crisis is, of course, very deflationary. On the other hand, the actions of America's Federal Reserve (and central banks around the world) would appear to stimulate inflationary tendencies. But at low levels of interest rates, there is no catalyst to promote bank lending. As has been happening in Japan for decades, banks are much more willing to buy government bonds at an artificially high spread (between short-term rates and long-term rates) than to lend to the private sector. We commend the recent Federal Reserve desire to reduce this spread and promote bank lending to the private sector, but we would commend a reduction in central bank interference in the interest markets even more.

Now for the acute problem, the European situation. We are still at risk of an explosive banking crisis. There is no way around the reality that all European economies have been dishonest in reporting their debt burdens and inaccurate in forecasting growth projections. While the bulk of the political and popular emphasis is now on what to do about the debt loads of Greece, Italy, Portugal and Spain, the real emphasis should be on realizing that the only long-term solution is to focus on economic growth. There is absolutely no way that growth can be achieved in the framework of massive debt burdens relative to GDP. This is why personal, corporate and sovereign bankruptcies have been so critical in the past. Europe and European debt investors will have to recognize that haircuts much larger than is comfortable for creditors, in the range of 90%, will be the only long-term solution to re-orient these economies to growth, rather than debt payback. There will have to be a massive transfer of wealth from creditors to borrowers in Europe – most likely in the two trillion euro range (about 400 billion Euros to provide operating capital for Greece for the next several years, about 800 billion Euros to re-capitalize banks, and about 800 billion Euros to provide for massive support to Italy for the next several years). *Trillion* has replaced *billion* as the new baseline of normality. Ultimately, Europeans will realize that their history with a common currency will have to end. There is no possibility for a common currency without a common fiscal framework, and that is just not going to happen. The countries that realize this will move through a difficult transition period, but will then be able to compete again in the global marketplace for production, consumption, tourism, etc.

Our research and outlook suggests that the process of credit accumulation, borrowing and spending is likely to result in continued periods of crises and intervention. There is not much that austerity and fiscal discipline can do to help weak countries recover; the time for this has passed. The only practical path will have to be a massive transfer of wealth from creditors to borrowers in Europe. And this is when we think the inflation risks will win the fight for dominance. Countries will compete to quantitatively ease (that is, print more currency). Gold may hold up as a store of wealth, but there is no certainty on this either.

### **Client Portfolios**

Capital markets continue to vacillate wildly between periods of euphoria and periods of stress, and we have been using and will continue to use this cyclicity to rebalance portfolios. We are ready to “sell” the economy, but less willing to massively sell equities just yet for several reasons. First, revenues and profit margins are high, and although we cited a lack of future demand clarity, high revenues and profit margins produce healthy balance sheets from which to

positively exploit the next cycle of growth. Second, healthy balance sheets for dividend paying companies provide an attractive alternative to low-yielding Treasury bonds. Even if the capital markets exhibit intense volatility, shareholders are likely to receive dividend payments on a regular basis from cash-flow generating sectors (such as Energy and Healthcare). Third, the reality is that valuation metrics and many investment sectors are historically cheap compared to their book value (as opposed to earnings-per-share, which is more subjective). Fourth, mergers and acquisitions and corporate share buybacks are on the rise. These healthy balance sheets, bolstered by record profit margins, are creating a currency for sector consolidation (particularly valuable in the Energy sector) and share price support.

Practically speaking, we have been reducing exposure to equities on the recent run-up in capital markets – not completely, but certainly around the edges. The deterioration of the financial system throughout Europe is disturbing and seems to be leading to new massive financial flows out of Europe, hence our desire to increase protection by reducing equity exposure. In yield-oriented portfolios, we continue to maintain an exposure to non-traditional investments in emerging debt and higher yielding domestic debt. As we rebalance client portfolios, we are taking into account a number of unusual factors that are driving this market.

We eliminated our exposure to **yield-oriented equity** investments this quarter, which had provided a prudent tradeoff between yield and equity risk. While we value the 4% yield, the equity risk overwhelmed any yield advantage over Treasuries.

We eliminated our exposure to **taxable municipal bonds** this quarter, back in July. Although we do not believe there will be major municipal bankruptcies, we are not convinced that municipalities will be able to fund their obligations without severe (perhaps externally imposed) fiscal discipline and significantly higher local tax rates (property taxes and all sorts of new and increased use revenues).

For client portfolios with both equity and yield exposures, we committed some cash to medium duration (7-10 year maturity) **Treasuries**, currently yielding around 2%. Although this may run counter to our opinion that Treasuries are an unproductive investment, we view this as a prudent hedge against equity volatility.

For clients with investment policies that permit it, we continue to maintain an exposure to local and US-dollar denominated **emerging market bonds**. This includes exposure to debt issued by Brazil, Malaysia, Mexico, Indonesia, Turkey, and Poland, among other countries. Yields are now in the 5.5% range with a duration of about 4.5 years. We think that economic malaise in developed economies has created particularly positive dynamics for growing emerging economies, where debt levels are significantly lower than in the developed economies. In the short-term, these bonds have been adversely impacted by a flight to Treasuries, but this short-term phenomenon is not sustainable, particularly as the central banks back off interventionist interest rate policies.

We continue to maintain an exposure to **preferred securities**, a security that exhibits characteristics of both bonds and stocks. This investment has a current yield of around 7%. A large component of the exposure here is in financially-oriented companies. In 2013, under the Dodd-Frank Act and Basel III requirements, current preferred securities will no longer be allowed to maintain Tier 1 capital for banks. We expect that most preferred will be redeemed in lieu of this new type of hybrid security around \$150 billion in face value. About 35% of the current portfolio investment contains preferreds trading below their par value, so this provides a solid price floor, in spite of what is likely to be interim volatility.

For clients with investment policies that permit high-yield bond exposure, we maintain a **high-yield corporate bond** investment. The current yield is at 8.3% with a modified adjusted duration of about 4.6 years. As we have seen these past two months, any macro fears have had a significant impact on the high-yield market, although these have come back strongly in October, along with the equity markets in general.

We eliminated our exposure to the **capital markets** investment this quarter, primarily on concerns that the uncertainty in Europe can adversely impact the financial market stocks more so than other sectors. Of course, if the European debt situation is resolved and economies do not dip more, financial stocks are likely to do very well.

We continue to maintain an exposure to the **oil/gas equipment services** sub-sector. These are the companies that provide the specialized labor and equipment for oil and gas exploration and extraction. The world is addicted to oil. Independent of the price level of oil, there is the need for exploration and extraction, which provides the profit stream for these companies.

In fact, the **Energy** sector is our highest conviction idea, and we are using market volatility to increase exposure to this sector. Along this thinking, many client portfolios also have an investment in a group of **master limited partnerships** (MLPs) that focus on oil and natural gas transport in the United States. The majority of MLPs currently operate in the energy infrastructure industry, owning assets such as pipelines that transport crude oil, natural gas and other refined-petroleum products.

We also have energy and commodities exposure through the investment in **Indonesia** although we have reduced this during the quarter on macro-economic concerns. This is one of the few petroleum-based energy-independent nations in the world. This is a solid investment in a world that is still highly dependent on petroleum-based energy. About a third of the investment exposure is in financial services, with another third split about evenly between consumer discretionary, materials and energy.

We invested in the country of **India** this quarter, which has a large carbon-based energy supply and demand footprint (along with an enormously productive and growing middle class). Credit growth is growing and industrial production is increasing, although the central bank remains concerned about the inflationary pressures that correspond to this growth. The debt crisis in Europe is a concern for India's trade and growth prospects, although it may serve to reduce local inflationary pressures.

Continuing with the energy/commodities theme, we also have an investment in **strategic/rare earth metals**, although we have reduced this significantly during the quarter on macro-economic concerns. The investment thesis is based upon the increased use of modern technology in both the developed and developing world. About a quarter of the exposure is in Australia, about 40% divided equally between Canada and the United States, and 15% in China. The remainder is scattered among Japan, Mexico, Ireland and Brazil.

We also maintain an investment in the country of **Chile**, although we have reduced this during the quarter on macro-economic concerns. The political and economic climate in this country is reasonably well-balanced and generally conducive to capital growth. Half of this exposure is in local Utilities, with the remainder in Basic Materials (mainly copper extraction in mining) and Financials. The key risk is from global demand for copper, a large export.

The **Industrial** sector has been a strong driver of broader market performance. Sales and earnings-per-share have been robust and margins are very healthy, and these factors have been reflected in stock prices. During the past two months, the strength of recovery has moderated, and we have used opportunities to reduce exposure.

We are maintaining the investment in the **Consumer Discretionary** sector, although we have reduced this during the quarter on macro-economic concerns. Although sales and margins are healthy, stock prices are reflecting this, so the risk is that consumers will focus on savings in lieu of spending (a very real risk in the developed world, but very much the opposite expectation in the developing world).

We continue to maintain exposure to **real-estate investment trusts**. Single-home residential property prices continue to decline, as high unemployment and a high inventory of distressed properties continue to pressure the market. We are not invested in single-family housing, but in the portion of the residential real-estate market that invests in senior-living facilities, self-storage and multi-unit apartment buildings. There is adequate cash flow from operations to justify an investment in this specific sub-sector of real-estate, even while the timing of a recovery in single-family residences is uncertain.

We continue to maintain exposure to **Healthcare**, although we have reduced this during the quarter. We are excited by the consumption opportunities in the developing world, as access to modern healthcare by populations that are growing relatively wealthier is an enormous market-penetration opportunity.

We continue to maintain an exposure to the **Technology** sector, one of the few sectors where we have not reduced exposure during this quarter. Sales, earnings and profits are all in record territory for this sector, although sales growth is expected to slow down next year. Our thesis continues to be that corporate spending will continue to focus on capital expenditures to increase competitiveness and reduce costs. As the economy recovers, this should serve to spur and broaden corporate spending on additional technology.

To summarize, we remain cautious, but are sticking with an allocation to equities and non-traditional yield investments. We are using market volatility to re-orient portfolios away from relatively expensive investments to relatively inexpensive investments.

### **Concluding Thoughts**

During this uncertain period, we remain ever vigilant. In light of a great deal of uncertainty, the one certainty is that capital markets will continue to be volatile. Patience does pay off, but sometimes not every month or every quarter.

On a productive and positive note, we have been working on a union with another Chicago-based investment firm. We complement each other with a deeper bench of investment professionals and a wider array of investment strategies. We will keep you posted on what this means for our business, but do expect some exciting news in the near future.

We thank you for your support and confidence in Advocate. Please contact us with your questions, comments or suggestions.

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