



Value Equity Perspective

Just Because Europe Gets a Cold Doesn't Mean That the U.S. Will Contract Pneumonia

By David Anderson

As the third quarter of 2011 draws to a close there is no clear evidence of a recession in the United States. However, there are fears of a worsening financial crisis in Europe, slowdowns in business activity in key emerging markets and the probability of collateral damage to the U.S. Every major stock market in the world (except New Zealand) has declined by close to 20% (or more) from late-spring peaks. Broadly speaking, September monthly market declines (6 to 7%) were about as bad as the experience of the third quarter's first two months (July and August) combined. Therefore, the major U.S. stock market indexes fell by 12% to 14% for the third quarter.

Within this overall third-quarter market decline, there were very few places where a conservative investor could hide. 1) The utility stocks were stalwarts as they actually rose slightly, and 2) healthcare and 3) consumer staples stocks were down only modestly. However, financial stocks were lower by 23%. The cyclical stocks in the material and industrial sectors were down by 25% and 22%, respectively. Small-cap stocks, represented by the Russell 2000 index, fell nearly 22% and foreign markets were almost all below S&P 500 results by about double (again the main exception was New Zealand).

S&P 500 earnings will certainly be below current projections *if* we experience a global recession. However, the contrarian, longer-term signals that we have come to rely on are suggesting that

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Asset Allocation Perspective

Handcuffed by Events in Europe

By Brian Perott, CFA

Markets around the world obsess daily over the headlines about the European debt crisis, especially as it relates to Greece. Although the risk may begin with Greece, the primary concern is a domino effect: if Greece defaults and backstops are not in place, bank exposure to Greek debt and the related counter-party risk could ripple through the entire financial system.

In this scenario European banks could run into problems with exposure not only to the sovereign debt of Greece and other European countries, but also to private loans extended to businesses and citizens in those countries. The uncertainty surrounding this issue is the primary driver of the increased volatility of the global stock markets. Until some meaningful solutions and actions by the various leaders appear to be close at hand, riskier asset classes (stocks and corporate bonds) may continue to struggle. Leaders need to lead. The longer the European countries debate how to reconcile their various national interests with their need to achieve a common economic goal, the more likely the world will feel the additional stress of another recession.

On top of the European crisis, the U.S. economic environment continues to be sluggish and provide little relief.

At FCI, we strive to not get caught up in the headlines of the moment; we try to take a longer-term approach. In times like these we step back and take a deeper look at valuations, investor

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the U.S. stock market should not be reacting as poorly as it has been (note: it is just *real* hard to believe in the signals when your emotions are flying high). Sentiment measures are heavily tilted toward the bearish camp. The CBOE-VIX indicator has skyrocketed up to 2008 levels. Various put/call ratios are elevated to excess and insiders have noticeably moved back to the buy side. In summary, if the U.S. doesn't suffer a severe recession that damages both profit margins and earnings and produces dividend cuts, then stocks are very cheap (particularly compared to alternative yield instruments). In the 2008 credit crisis, the U.S. caught a cold and Europe merely sneezed. Now, in 2011, we expect Europe's cold to produce a slight sneeze from the U.S. However, **investors have driven stock prices to a level suggesting that we will suffer a severe case of pneumonia – which we doubt very much!** 🌪️

Equity Income Perspective

Earning Income Through The Storm

By Benjamin Hill, CFA

Like me, I'm sure many of our readers were happy to see the third quarter of 2011 come to a close. The third quarter was an all-too-perfect representation of the last couple years for equity investors – short periods of stability interrupted by erratic equity market volatility and inconsistent stock market returns. Volatile equity markets, which are often accompanied by varying returns across asset classes, equity styles, market capitalization and geographies, serve to reinforce the importance of maintaining a disciplined, risk-appropriate asset allocation strategy.

So where can investors position themselves to ride out the volatility storm? In short, in an allocation to high quality dividend-focused stocks. Companies with stable dividend policies often generate substantial cash flows and have demonstrated a firm commitment to returning capital to shareholders via cash dividends. Given the stark historical underperformance of dividend-cutting companies, company managements are effectively signaling to shareholders a commitment to prudent capital allocation and balance sheet strength by maintaining a strong dividend policy. Investors have clearly rewarded this commitment, as over the last nearly 40 years companies growing dividends have outpaced companies cutting dividends. What's more, the outlook for dividend-focused investing may

be stronger now than at any point in recent history. After years of a downward-trending S&P 500 yield, investors are starting to re-emphasize the importance of dividends at a point when the stage may be set for above-average dividend growth. The current yield on the S&P 500 is approximately 2.23%, nearly 40% below the 50-year average yield of 3.05%, and at a time when S&P 500 operating earnings are at record highs and the dividend payout ratio is near record lows. Companies are clearly responding to investor demand as 287 companies have initiated or raised dividends over the past 12 months compared with just 8 who have cut or eliminated them, a positive trend that we expect will continue.

When investing in dividend payers, too many investors tend to focus their efforts incorrectly, emphasizing nominal yield levels rather than high quality cash flows and dividend growth. At FCI, our dividend-focused strategy goes beyond the mere objective of "booking yield". FCI's Equity Income investment strategy separates itself by focusing on sustainable dividend growth, balance sheet strength, and total return rather than just yield, while striving to maintain broad-based sector diversification. In order to maintain real purchasing power into the future, income-oriented investors must demand increasing cash flows to combat the negative long-term effects of inflation. FCI's Equity Income strategy is well suited to meet this demand as current strategy holdings have increased dividends an average of 13.9% over the last year. With strong profitability and cash flows, healthy balance sheets and a renewed focus on returning capital to shareholders, we may very well be entering a new era of the dividend. 🌪️

Core Equity Perspective

Saving Private Sector

By Bill Courtney

The economy is burdened by heavy government debt, European fiscal austerity, more government regulations, low consumer confidence and inept political leaders. We argue that we might be heading into another recession, but in some areas it seems we are already in one! Look at the housing market, shadow home inventories, underemployed, and shadow unemployment.

We need to create jobs to revive our economy and the private sector is the only solution. Embrace and



promote capitalism, strive to make the private sector stronger. The U.S. corporate economy is much stronger than the consumer economy and the government economy. Corporate earnings are at record highs. Corporate balance sheets are strong with modest debt levels and large cash levels. The corporate economy is what drives the stock market and if the corporate economy is the solution then equities are the solution.

Equities are relatively attractive versus all other liquid investment choices. In 2009 we hit a generational low in the S&P 500 index and, sadly, we probably lost a generation of equity investors at this low. Great companies at reasonable prices, what we call Core Equity holdings, are a preferred investment choice right now! 🌱

Economic Perspective

Recession or Not?

By Val Schaff, CFA

The National Bureau of Economic Research defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production and wholesale-retail sales.” Historically, the rule of thumb has been “two quarters of down GDP”. Given this definition, has the U.S. economy slipped back into a recession? It may feel like it in various parts and segments of the economy, but technically we are not in a recession.

This is not to say there aren't risks in the economy that may lead to a recession in the future. Following the last Federal Open Market Committee meeting, the statement released by the Fed made note that “there

are significant downside risks to the economic outlook, including strains in global financial markets.” While not a direct impact on our economy, the problems with economies overseas have an indirect impact due to the global nature of trade and finance. These problems also have an impact on the psychology of the consumer, and the consumer remains the dominant influence on the U.S. economy.

In addition to the problems overseas, the consumer has been impacted by the situation in the labor market. Continued high unemployment and the accompanying weak job market have had an impact on consumer attitudes and expectations and ultimately on the amount of consumer spending. While spending has slowed, there remains some growth. The recent decline in some commodity prices, such as energy, should have a beneficial impact on discretionary spending. As spending improves, the manufacturing sector should also benefit, as greater production is needed to satisfy the increase in demand.

The Fed has made a commitment to keep interest rates low into 2013 as well as announced “Operation Twist”, as described in our Fixed Income article. Washington, D.C. is also attempting to help the labor market by encouraging job creation legislation. These actions help provide a foundation and support to guide the economy through difficult times. The consumer has not reduced spending, they have just slowed the rate of growth to reflect their concerns. All of these factors indicate a slow and uninspiring economy, but not necessarily a recession. Unfortunately, growth will probably continue to be slow and below average while the many problems are addressed and worked through. However, the signs are not all disastrous and neither the world nor the economy is coming to an end. 🌱

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sentiment, insider buying and corporate guidance – all of which point to a rebound. Currently, we see much more value and opportunity in various equity asset classes than we do in a lot of the fixed income market. We favor U.S. high quality large-cap stocks with an emphasis on dividend payers and growers. Emerging market stocks should also provide some growth over time as they continue to see positive economic and demographic characteristics. Our asset allocation committee is considering increasing the low weighting

in developed international equities. Valuations are becoming compelling, especially in Europe where the U.S. is trading at nearly a 65% price-earnings ratio premium. The historical average is closer to 15%.

We remain conservative in our asset class structure (underweighting developed international and small-cap stocks) until we see further developments in Europe and improved economic numbers in the U.S. 🌱



Fixed Income Perspective

Can I Squeeze the Fixed Income Market Into This Article?

By Peter Greig, CFA

In the limited space a newsletter provides, is it possible to write a concise analysis of current events in the bond market? Any discussion should dissect the factors leading to this past quarter's significant drop in Treasury bond yields and corresponding rally in prices. It should also analyze the major forces affecting rates going forward. But these are book-worthy subjects involving global economics and international relations. Dissertations will be written about the forces compelling the world's central bankers to take intrepid actions with dramatic effects on the investment markets. So how should I begin?

Do I begin with Europe's epic struggle with its debt crisis? Greece continues to do just enough to receive its next round of emergency funding; few involved expect they will avoid a restructuring (read: bankruptcy), but they must keep the hope alive. Why? If Greece defaults, then the entire undercapitalized European banking system may fracture.

Europe needs to recapitalize its banks, allow for an orderly default of Greece and firebreak the fallout to prevent other sovereign defaults. But these objectives are joined at the hip: solving one moves the target for the others. Any solution must achieve the above, establish acceptable budget projections in each country, and avoid a depression. Not an easy task when dealing with limited funds and 17 independent nations, some more fiscally responsible than others. Each time the picture gets cloudier and the path to resolution less certain, European bank stock prices take a hit, leading their entire market down.

The follow-through thinking is that European economies as a whole will slip into a prolonged and painful recession, damaging U.S. company earnings that are dependent on foreign sales, followed by a drop in the U.S. stock market and a slowing economy. Lastly, the solvency of U.S. banks is questioned by their exposure to European banks and sovereign debt. What do investors do in this situation? They buy the safety and liquidity of U.S. Treasury notes, regardless of yield.

But perhaps that's too complicated for the limited space I have. Since this is the 30th anniversary of the great bond bull market, maybe I should discuss the sputtering U.S. economy and Federal Reserve's steps to revive it.

All indications are that the U.S. economy is on life support. Finding a bright spot of activity is difficult and the metrics indicate that a second recession seems, though not probable, increasingly possible. Given the anemic level of economic activity and employment, the Fed has taken action. With few arrows left in its quiver, in late July the Fed made the unprecedented announcement that they would likely hold the fed funds rate at nearly zero for the next two years. Giving a green light to bond investors, yields dropped sharply across the curve.

In late September, still observing worsening economic data, the Fed introduced "Operation Twist" whereby they would sell up to \$400 billion of shorter maturity debt and swap into longer dated securities. Intraday, the 10-year note dropped to a yield of 1.67%, a level not seen in more than 40 years. But how much space would a proper treatment of this convoluted topic require? Much more than I have, unfortunately.

Unable to decide which of these two topics to write about, I'll simply summarize our outlook: Interest rates will remain low longer than most of us care to think. For the foreseeable future, new savers will likely be punished by receiving a yield level that is below the prevailing rate of inflation. In accordance with the Fed's wishes, investors will be urged to take greater risks through either credit risk or by increasing allocations to asset classes that have traditionally had more volatile returns, such as equities. Corporate bonds, both investment grade and high yield, should perform relatively better given that their yields did not decline as much as Treasury yields. 🍷

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