

October 26<sup>th</sup>, 2012

## **A Look Back**

All three major indices rebounded from losses in the second quarter by posting quarterly gains ranging from 4% to 6% propelled by the generosity of global central bankers. In September the Federal Reserve moved markets when it announced a third round of bond buying, referred to as quantitative easing, or QE3 in an effort to bolster the economy and spark job creation. A week earlier, the European Central Bank also said it would initiate an aggressive bond purchasing program aimed at keeping borrowing costs subdued in indebted countries like Spain and Italy and reduce financial stress in the system.

With central banks throughout the world green lighting an aggressive purchase of virtually all asset classes: investors, particularly hedge funds took the bait and drove the price of these assets higher. While the new stimulus packages from central bankers won't translate into peppier economic growth anytime soon it did reduce a worst case scenario for the global markets.

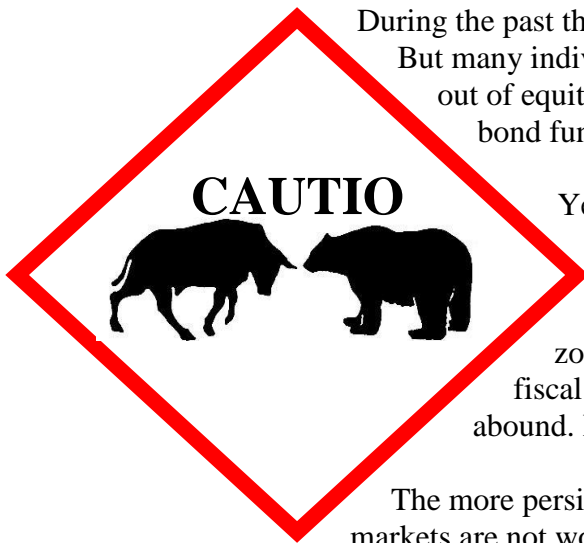


## **A Look Ahead**

The stock market does not like uncertainty, and as I write to you there are a myriad of problems confronting it.

Internationally, there is Iran, Syria, and Egypt to name just three. But I would be remiss if I did not also mention Iraq, Afghanistan and Pakistan. Here at home we have presidential and congressional elections. There is a \$16 trillion debt problem facing us which can no longer be kicked down the road. We have Social Security and Medicare issues to contend with. And then we have tax increases and federal spending cuts at the end of 2012 which could lop off nearly four percentage points of annual economic growth, according to both government and private estimates. In an economy expanding at less than a 2 percent annual rate, this fiscal cliff, as the potential dilemma is referred to is a concern for us all. With all of these potential headwinds confronting the markets, as well as valuations not nearly as compelling as they were during the past few years, in our opinion, a more defensive posture makes sense.

## Are Bonds Today a Much Riskier Bet Than Stocks?



During the past three years the S&P 500 has compounded by roughly 13% per year. But many individual investors are not participating. Some \$300 billion has flowed out of equity mutual funds during that time frame into the perceived safety of bond funds, which captured approximately \$1 trillion of inflows.

Yet, I believe that investors who pull their money out of the stock market today to invest in bonds are making a huge mistake.

Granted, the litany of uncertainties worrying investors is a long one. Europe is in recession, and it is far from clear that the euro zone will hold together. China is slowing. The U.S. risks falling off a "fiscal cliff" and, of course, election-year and tax policy uncertainty abound. But there are always economic uncertainties.

The more persistent uncertainty plaguing individual investors is the fear that our markets are not working properly. Quantitative high-frequency trading, driven by computer algorithms, has harmed our stock markets.

And the recent fiasco concerning Knight Capital and its errant computer that kept feeding incorrect orders into the market with no "stop button" is the latest strand in a long string of market meltdowns from the "crash of 1987" to the "flash crash" of 2010. Such "Knightmares" have convinced many individuals that our stock markets are broken and that they are at a huge disadvantage relative to the pros. Neither of these propositions is true.

The Knight mishap actually provides a wonderful example of how well our stock markets work. When Knight's flawed sell orders hit the market, legions of floor traders and other market participants were happy to buy. Market prices quickly returned to normal, and the result was a transfer of \$400 million from Knight to the savvy investors who were willing to take the other side of the trades. Knight's common stock lost more than two-thirds of its value. That's just the way markets are supposed to work.

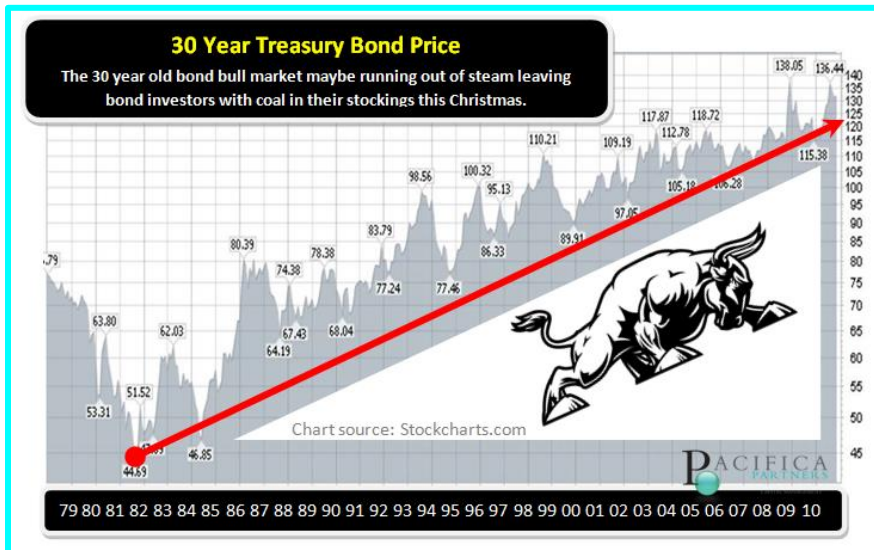
The logo for Knight, featuring the word "Knight" in a blue, sans-serif font with a registered trademark symbol (®) to the upper right.

Should individual investors abandon the stock market because of the increased volatility rapid-fire trading can cause? Not at all, investors saving for retirement have no reason to fear day-to-day or week-to-week volatility. Remember, market corrections, whether swift or of long duration are an integral part of the investment process. They allow an investor the opportunity to purchase a new position at a bargain basement price, or purchase additional shares in a business already owned at a lower valuation.

Volatility is not the same as risk. Investors should be less concerned with moment to moment price changes and more concerned about the permanent loss of capital in any given investment. In our opinion, equities today on a relative basis are more attractive than any asset class we can think of; perhaps single family homes in certain parts of the country are equally attractive.

Individual investors are wary of taking on any type of risk, and who can blame them. After all during the past twelve years or so they were the victims of three financial tsunamis. First, you had the Internet bubble, followed by a real-estate debacle of epoch proportion and finally a financial collapse that a number of economists have likened to the Great Depression.

For almost two decades bonds have been in an incredible bull market. Interest rates for awhile reached double digits compared to the roughly 3.3 % yield currently available on a 30 year Treasury bond. One can make the case that today stocks offer significantly less risk than bonds. Individual investors, particularly, in the last couple of years have dramatically increased their exposure to bonds, as yields have plummeted.



One can argue that bonds were a reasonably good investment alternative to stocks when yields were significantly higher. Naturally, the amount of money flowing into that asset class at that moment in time by individual investors was paltry when compared to today's fund flows. Unfortunately, investors have this uncanny ability to invest at or near market peaks, without fully comprehending the inherent risk they are taking.

Purchasing a single family home was a good idea any time prior to 2000. Homes were relatively inexpensive and affordable. Price increases on average were about 2% per annum. During the housing bubble home prices were advancing by 10% per year and were very expensive and unaffordable; and yet at or near their peak more and more people piled into this inflated asset class without analyzing the potential downside.

So let's get back to bonds. Just like other bubbles in the making investors do not realize how speculative of an investment they are making. Money market funds for example, yield virtually zero percent, and the Federal Reserve has indicated these rates will stay anemic until at least 2015. So, investors are forced to make more speculative purchases, and in the case of bonds extend their duration, in an effort to get as high a yield as possible.

Make no mistake about it, this bubble will pop just like all the others. The timing of the inevitable collapse is anybody's guess. Manias tend to last much longer than they should. Quite frankly, the bull market in bonds should have already ended, however, with an incredibly accommodative federal reserve the duration has been extended for another 3 years.

Even if I am wrong and the bond market does not implode: by purchasing a 30 year Treasury and accepting a 3.3% return your purchasing power over that period of time will be significantly diminished. After paying your taxes your return on capital will be well below the current rate of inflation. If I am right and the debt market's multi- year bull market does end, it will be far worse for bondholders. So how much money can a bond investor expect to lose if interest rates rise? Today, the 30 year Treasury currently yields 3.3%. Ten years ago it yielded roughly 5.8% and the average for the past 25 years was 7.5%. If interest rates just go back to the ten year ago level during the next five years an investor would lose 40% of their capital. If you added back the interest they would receive on those bonds your loss would be a mere 29%.

Inflated valuations historically have only looked inflated with the help of a rear view mirror. Bond buyers beware.

*Partial attribution to a Wall Street Journal article dated August 14, 2012 and written by Burton S. Malkiel entitled "Even amid the Current Turmoil, Stocks Still Beat Bonds." Also Boyar's Intrinsic Value Research.*

## **Buttonwood — The Secret's of Buffett's Success**

If investors had access to a time machine and could take themselves back to 1976, which stock should they buy? For Americans, the answer is clear: the best risk-adjusted return came not from a technology stock, but from Berkshire Hathaway, the conglomerate run by Warren Buffett. Berkshire also has a better record than all the mutual funds that have survived over that long period.

Some academics have discounted Mr. Buffett as a statistical outlier. Others have simply stood in awe of his stock-picking skills, which they view as unrepeatable. But a new paper from researchers at New York University and AQR Capital Management, an investment manager, seems to have identified the main factors that have driven the extraordinary record of the sage of Omaha...

Mr. Buffett has been able to exploit the anomaly of [low beta stocks outperforming high beta stocks] overtime. He is well-known for buying shares in high-quality companies when they are temporarily down on their luck (Coca-Cola in the 1980s after the New Coke debacle and General Electric during the financial crisis in 2008). "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price," he once said...

Without leverage, however, Mr. Buffett's returns would have been unspectacular. The researchers estimate that Berkshire, on average, leveraged its capital by 60%, significantly boosting the company's return. Better still, the firm has been able to borrow at a low cost; its debt was AAA-rated from 1989 to 2009.

Yet the underappreciated elements of Berkshire's leverage are its insurance and reinsurance operations, which provide more than a third of its funding. An insurance company takes in premiums upfront and pays out claims later on; it is, in effect, borrowing from its policyholders. This would be an expensive strategy if the company undercharged for the risks it was taking. But thanks to the profitability of its insurance operations, Berkshire's borrowing costs from this source have averaged 2.2%, more than three percentage points below the average short-term financing cost of the American government over the same period.

A further advantage has been the stability of Berkshire's funding. As many property developers have discovered in the past, relying on borrowed money to enhance returns can be fatal when lenders lose confidence. But the long-term nature of the insurance funding has protected Mr. Buffett during periods (such as the late 1990s) when Berkshire shares have underperformed the market.

These two factors—the low-beta nature of the portfolio and leverage—pretty much explain all of Mr. Buffett's superior returns, the authors find. Of course, that is quite a different thing from saying that such a long-term performance could be easily replicated. As the authors admit, Mr. Buffett recognized these principles, and started applying them, half a century before they wrote their paper.

*Excerpt from The Economist September 29, 2012*

## **Banks Reap Rewards of QE3 as Move Boosts Profits on Mortgages.**

Bank profits from new mortgages have soared since the Federal Reserve began its third round of bond purchases a number of weeks ago, fueling the debate over the fallout over the latest dose of quantitative easing.

The extent to which QE3 drives down new mortgage rates and helps homeowners or is pocketed by banks will be crucial to the success of the policy and the prospects for growth. The average rate on a fixed 30-year mortgage reached 3.4% recently- a record low- but mortgage rates could be lower if banks passed on the full drop in their funding costs.

The interest banks pay on mortgage bonds has dropped from 2.36 percent on September 12, the day before the Fed announced its program to around 1.75 percent recently.



That means the profit, or spread, banks earn from creating new mortgages from homeowners paying around 3.40% and selling them into the secondary market has risen to about 1.60%. That is higher than the 1.44% spread they pocketed before QE3 and greater than the 0.5% they earned on average in the decade 2000-2010.

The Fed plans to buy about \$40 billion a month of mortgage backed securities from investors until there is a significant improvement in the economy. That has sent prices for the bundled loans soaring in the secondary market.

As expensive as homes were in most parts of the country, just a few short years ago that is how inexpensive they are today in the vast majority of cities and states. By lowering mortgage rates it will make homes more affordable, which should spur demand. Ultimately, this should drive home prices higher. The Fed believes if this occurs homeowners will feel wealthier, thus accelerating consumer spending which in turn will grow GDP at a faster clip, lowering the stubbornly high unemployment rate... So goes the Fed's theory... Whether it works or not we will have to wait and see. What we do feel quite confident about, however, is that it will have a positive effect on many banks income statements and balance sheets.

*Condensed from an article written by Tracy Alloway, Stephen Foley, and Robin Harding  
That appeared in the October 2, 2012 edition of the Financial Times.*

## **Investors Must be Wary of the 'Central Bank Put' Bubble.**

The recent release of the minutes of the last Fed policy meeting leaves little doubt; the Fed intends to keep its foot on the policy accelerator well into an economic recovery.

Essentially, the Fed is inserting a sizable policy wedge between market values and underlying fundamentals. And investors in virtually every market segment- including bonds, commodities, equities, foreign exchange and volatility - have benefitted handsomely. In the process, many asset prices have been taken close to what would normally be regarded as bubble territory, with some already there.

Central bank action, both real and perceived, rules the investment day, and will continue to do so for now. This is also the case in Europe.



The Federal Reserve remains the best friend of many investors. It is among several key western banks that are supporting asset prices not as an end itself but as a means to promote growth and jobs.

If the critical hand-off to fundamentals does not materialize, the reaction of markets will not be pleasant. Positioning on the basis of the "central banks" put is a particularly crowded trade. Also, it involves some investors being over-confident in the powerful omnipresence of these institutions, some believing in immaculate economic recoveries, and some feeling they can wait for markets to peak decisively and then exit smoothly.

The summary takeaways for investors are straightforward and important for both generating returns and managing risk.

Investors must pay attention to western central banks and respect the market influence of unconventional policies but they should do so with a wary eye on how far, and how long, valuations can be divorced from fundamentals.

Risk exposures should evolve accordingly. Differentiation, both within and between asset classes, should increasingly underpin portfolio construction-with emphasis on companies and countries with strong balance sheets-and positive cash flow. And this need not crowd out exposure to other parts of the world, where central banks are less active but markets are better supported by solid economic and financial fundamentals.

Investors can take with a pinch of salt the operational feasibility of maintaining a maximum "risk-on" position until the markets turn, then making a quick exit. It is an idea that risks sounding better in theory than it works in practice.

*Condensed from an article written by Mohamed El-Erian ,Chief executive and co-chief investment officer of PIMCO  
That appeared in The October 11, 2012 edition of the Financial Times.*

### **Masters of the Universe Play the Long Game in Search for Profits**

Profit-starved hedge fund managers, best known as masters of the financial universe, are turning to an unlikely place for their next windfall: the unglamorous world of long-only asset management.

Amid volatile markets, constraints on the capacity of their main trading strategies and an ever more conservative investor base, some of the industry's biggest names are focusing on raising money for pared-back versions of their main portfolios, eschewing leverage and short selling in pursuit of assets and stability.

Hedge fund managers see big opportunities in bringing their skills – and the higher fees they charge – to an increasingly passive long-only investment world...

While several firms have run long-only products for the past few years, serious interest is only now beginning to be taken by large institutional clients such as pension funds. Hedge fund firms with growing long-only businesses include Winton Capital Management, Lansdowne Partners, Egerton, Odey, Renaissance Technologies, CQS, Citadel, Two Sigma and GLG Partners – all leading names in the industry.

“We’re starting to have a lot of conversations with people in the pension fund world about hedge fund managers being used in traditional equity allocations,” says Peter Harrison, chief executive of the \$5bn London-based hedge fund RWC Partners. Last Tuesday, RWC acquired three long-only activist funds from pension fund giant Hermes. The deal means that half of RWC’s assets are now in traditional long-only strategies...



“Most hedge funds launching long-only strategies have targeted funds of \$500m-\$1bn, but are really looking to expand that further,” said Mr. Caplan. “It’s definitely the right time to be doing it.”

For many, opening long-only funds makes good sense and takes little effort: managers already have teams generating long investment ideas for their hedge funds and the infrastructure to manage large client bases.

But there are challenges. Hedge funds’ abilities to raise money for new long-only products have hitherto been stymied by high charges that traditional long-only investors are unwilling to pay. Typical hedge fund-run long-only funds charge fees of between 1 and 1.5 per cent annually and sometimes performance-related fees as well.

*Excerpt from the Financial Times September 24, 2012*

### **A Decade on, Another Tech Bubble is Set to Deflate**

After the dotcom bubble popped so spectacularly in 2000-2001, a few glum years for the technology industry have been followed by an equally spectacular run. Apple has roared back from near extinction and this week became the most valuable company in history. Facebook amassed users and mesmerized investors for years before Wall Street staged what now seems a wildly overpriced initial public offering. Predicting the demise of social media has turned out to be a mug’s game. Companies may have risen (Facebook) and fallen (MySpace) but the sector has grown and morphed in endlessly surprising ways. The habits of at least one generation, and significant parts of others, are now irreversibly changed when it comes to sharing, recommending and locating each other in real time. Cloud computing has compounded the speed of technological change. Even while the rest of the US has wallowed in recession, Silicon Valley and other high-tech pockets have thrived.

But bubbles can pop with a bang or deflate with a long, slow hiss...

David Sacks served as chief operating officer of PayPal before it was sold to eBay for \$1.5bn in 2002. This year he sold his latest start-up, Yammer, which provides social networks to businesses, to Microsoft for \$1.2bn. He is one of the Valley’s most influential business people. Last weekend he posted on his Facebook page that he thought “Silicon Valley as we know it may be coming to an end.” To create a successful tech company, he wrote, “you have to find an idea that 1) has escaped the attention of the major internet companies, which are better run than ever before; 2) is capable of being launched and proven out for ~\$5m, the typical seed plus series A investment; and 3) is protectable from the onslaught of those big companies once they figure out what you’re on to. How many ideas like that are left?”

The most vigorous response to his comments came from Marc Andreessen, one of the Valley’s most powerful venture capitalists. The big companies feared by Mr. Sacks, he argued, are incapable of successful innovation. The better run they become, the more they have to lose, so the less likely they are to accept change. Innovation, he wrote, would remain the preserve of nimble, disruptive start-ups. It is possible that both Mr. Andreessen and Mr. Sacks are right. The Valley of today is baffling, for those who live there as much as for those who gaze from afar.

Even after the 50 percent drop in its share price since its IPO in May, Facebook remains an extraordinary entrepreneurial story. But it can also seem like a shell game. Advertisers love the idea of Facebook but they cannot figure out how to use it to sell their products. Those who know the company best seem unduly eager to sell its stock. Peter Thiel, who invested \$500,000 in 2004, has sold almost his entire holding for close to \$1bn. He has earned a huge return but this is not the action of a Facebook believer.

Apple continues to churn out cash like a broken slot machine and may yet become the world's first trillion-dollar company by market capitalization. But it is undoubtedly a less exciting company without its late founder, Steve Jobs. The new retina displays are lovely, but they are no iPhone or iPod.

This points to a deeper problem, hinted at by both Mr. Andreessen and Mr. Sacks. To build a significant tech company in a new space, you cannot be trivial. Yet this is exactly how many start-ups and some big tech companies now feel.

Ten of the top 15 paid apps on iTunes this week are games. For all of Apple's commercials showing people doing clever, scientific-looking things with their devices, most people are using them to play *Angry Birds* rather than solve the world's problems...

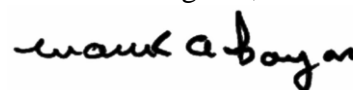
In theory it has never been easier to start a tech company. Global markets are accessible at a keystroke and technology infrastructure costs are a fraction of what they were a decade ago. But great, well-executed ideas remain as scarce as ever. Entrepreneurship may have been democratized but still very few can make a serious go of it. If the markets for Facebook games, daily deals on designer clothes or apps to locate our friends in bars collapsed, few would mourn them or their ever more esoteric derivations. This bubble has addressed the margins of our lives, not the core.

Mr. Sacks is right: an era in Silicon Valley is ending, quietly leaching away rather than imploding. But, equally, Mr. Andreessen is right to keep the faith in innovators and start-ups. There is no point being part of the tech industry, whether in London, New York or San Francisco, unless you grasp that bubbles are inevitable yet trust that the next one will always be better than the last.

*Excerpt from the Financial Times August 23, 2012*

If you have any questions or comments, please do not hesitate to call.

Best regards,

A handwritten signature in black ink that reads "Mark A. Boyar". The signature is written in a cursive, slightly slanted style.

Mark A. Boyar