



MCM News

Please note that required minimum IRA distributions will resume for the 2010 tax year. The Worker, Retiree, and Employee Recovery Act of 2008 suspended RMDs for the 2009 tax year only.

Please also note rules affecting Roth IRA conversions were implemented in 2010. Consider taking advantage of them.

Please do not hesitate to contact our office if you have any questions.



Much has changed since our last quarterly letter. Greece nearly defaulted on its sovereign debt and was downgraded to junk bond status. Hungary also announced near term debt troubles and Portugal, Spain and Ireland may not be far behind. As a result of these problems, the Euro has fallen, the dollar has soared, and austerity has become the new mantra for countries around the world. We even had a new term - Flash Crash - enter the financial lexicon after the Greek budget riots prompted stocks to fall nearly 9% and then rally back over the course of just a few hours on May 6th. The Deepwater Horizon oil spill has savaged the economy of the Gulf coast. Hundreds of billions of dollars have been taken off the value of the companies involved in the spill and the full extent of the economic and environmental damage may not be known for years.

In a broader scope, violence is escalating in Afghanistan and Iraq; tensions are increasing with Iran, in the Middle East and with North Korea. Governments around the globe are raising taxes and cutting spending and re-regulation has replaced deregulation as the focal point of most legislative agendas. These events, which are healthy reminders that good old-fashioned geo-political risk still exists, are collectively weighing on investor psychology.

It is little wonder the second quarter was a disappointing one for stocks. Virtually every major index fell during the period. Domestic stocks, as measured by the S&P 500, fell 11.5% and were down 6.66% for the first half of the year. International stocks continued to underperform with the MSCI EAFE index losing 13.97% and 13.23% for the same periods. Bonds put in the only positive performance during the quarter with the Barclays Intermediate Index returning 2.92% in the quarter, led higher by Treasuries. For the year, bonds have produced a total return of 4.78%.

We do not believe the decline of the past few months is an indication the economy is about to relapse into recession. As we noted in our last letter, the initial phase of the recovery has been strong and we expect economic growth to continue despite the headwinds buffeting the markets. While this growth may not be robust, we do not see a double dip recession.

Despite this outlook, we note the economy and markets often do not move in tandem, or even in the same direction at this stage of the cycle. We will see more backing and filling before markets fully stabilize. This divergence between economic performance and market performance should be expected. Market bubbles take a long time to correct and the declines we have seen this year are a necessary part of the process. As Charts 1 and 2 show, the correction phase can last for years, with many ups and downs.

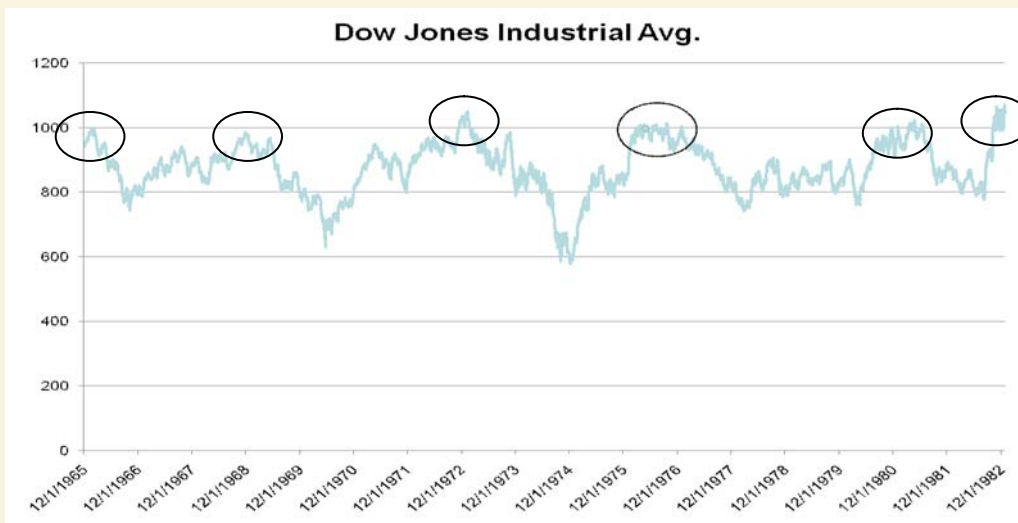
There are several reasons for the long duration of post-bubble recoveries. Consumer psychology does not change overnight. The so called "wealth effect" makes consumers feel poor long after a bubble bursts. Slow economic growth and additional losses prolong this anxiety. Nervous people are not good consumers and growth remains tepid. Employers are afraid to expand without demand so unemployment can remain high. This "vicious cycle" may go on for years. Unfortunately, ballooning budget deficits and the rising risk of a policy mistake are not helping to sooth the nerves of the private sector in the current market.

Market mechanics also take time to adjust. This refers to the process of how investors factor in their expectations for growth, perceived risks and investment options into the price they are willing to pay for an asset. When investors expect earnings to grow faster, they are happy to pay more for stocks. Earnings multiples then rise and risk premiums are said to fall. Conversely, when investors expect slower growth, price multiples fall and risk premiums rise. In the 1990's, for example, inflated expectations for technology company earnings took stock prices to ridiculous levels. The same could be said of the real estate

bubble of this decade when expectations for price appreciation and very low interest rates lured many into confidently over-paying for homes as an investment. It takes time and pain to change such widely held expectations. We spent a great deal of time in our last letter talking about the inevitable impact of rising interest rates on securities prices and the economy. The events of the past three months serve as a reminder of how escalating geo-political risks also need to be factored into investor decision making. In this environment, investors are likely to demand greater returns from their stock investments, or, in the parlance of the industry, higher risk premiums over the returns offered by lower risk investment options such as Treasury bonds. This is manifested in lower earnings multiples even as the underlying earnings may continue to recover. This is the phase we are going through now.

One of the best examples of a low return market can be seen in the sideways move of the late 1960's and 1970's. After the strong bull market of the 1950's and early 1960's, the market essentially went sideways for nearly 17 years. Chart 1, below, shows the Dow famously coming within pennies of the 1,000 level in early December, 1965 and then failing at multiple attempts to break that level before permanently crossing it in November of 1982.

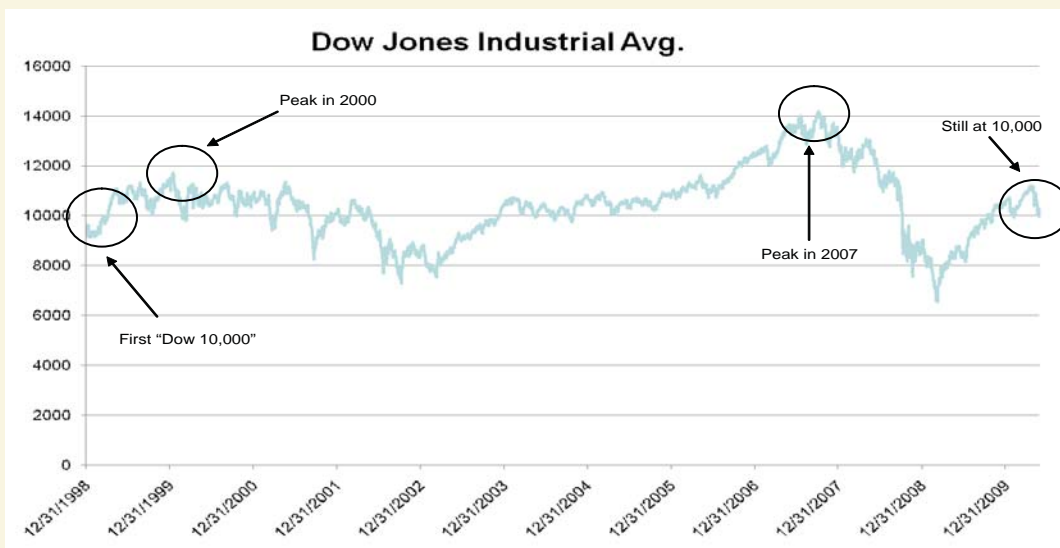
Chart 1.



Source: Bloomberg

There are many more examples of sustained periods of low return in the financial history books. The Great Depression and the Japanese stock bubble of the 1980's are two of the better known periods of sustained low returns. The current market certainly fits the description of a low return environment. As we can see in Chart 2, below, stock prices today are little changed from eleven years ago. The Dow Industrial average peaked at 11,750 just before the "Dot Com" bubble popped in early 2000. The Dow is just barely above 10,000 today, more than eleven years after crossing it for the first time in March of 1999. We would suggest the sell off in the winter of 2008 was part of a much bigger event.

Chart 2.



Source: Bloomberg

Although U.S. stock market indices hit record high levels in October of 2007, this chart shows the price gyrations of the past few years have been part of a longer term correction process that began in early 2000. A strong case can be made that markets only reached the levels of 2007 due to flawed monetary and regulatory policy. The plunge in 2008 and early 2009 was simply the laws of economics being enforced after more than a decade of bad policy.

While some may see this chart as depressing, we view it as quite encouraging. Placing the market, especially the past two years, in a longer term context implies stocks are well into the correction process and not just starting it. Stepping back even further reminds us that this is not new territory. Markets have gone through these very same gyrations in the past and will continue to do so in the future. This is simply how the excesses are shaken out of the system. Fortunately, it is also how many great opportunities are created for those with long term views.

It is hard to keep a long term perspective in this day and age, especially given the ever shortening time horizons used in the financial media. Where publications used to report on the long term business models of companies, business shows now tout predictions about where the markets will close at the end of the day. Each new release or news event is treated as the reason to trade now. While great for brokerage firm revenues, this hype does not make for sound investing or sound sleeping. One should not lose sight of the basics.

Benjamin Graham once noted “the underlying principles of sound investing do not change from decade to decade, but the application of the principles must be adapted to changes in financial mechanisms and climate”. While the market is adapting to the evolving climate, it may help to look at Chart 1 and remember Warren Buffet bought Berkshire Hathaway in 1965 and famously made his best investments during the late 1960’s and ‘70’s under circumstances similar to those we see today. We will probably see more turmoil over the next few years, but it is a great time to be an investor.

Investment Strategy

As the world begins to look more like the 1970’s and less like the 80’s or 90’s, markets will change to reflect the new environment. We expect the next few years to bring slower global growth rates, continued high government budget deficits and curtailed consumer spending as households pare down debt. There is already an increased hostility towards capital and those who hold it. These developments are generally not good for investors.

We are seeing many market metrics and practices change. For example, the concept of “normal” or fair value for the stock market has come down but is still above what was accepted as “normal” twenty-five years ago. It is likely many such metrics will see further adjustment in the years ahead. Many of the higher risk strategies and tools developed in recent years to control risk often help one side of a trade while increasing risk for the other. These products may help to stabilize markets but also risk hurting aggressive buyers. Some have since been regulated while the use of others has fallen.

Yet many time tested principals that were discarded as “old-fashioned” are now being rediscovered. In this new world, Ben Graham’s principles of sound investing are being embraced again. Companies must be evaluated on their ability to create profits for investors, not just on their ability to grow revenues. Companies that tout new products to change the world but do not earn economic profits may do well in the short term but they often fail in the long run. In the emerging world that we foresee, the chance of success for these “profitless” companies goes down considerably.

One of the biggest changes in investor thinking will be to once again think of stocks as companies, rather than a homogenous asset class. This has been out of vogue for many years. Companies can survive and profit even during periods of market turmoil, should we see one in future years. While the prices of these shares may go down, most of these high quality stocks will not go out of business. We (and as a matter of public record Warren Buffet) view such price disruptions as buying opportunities and not a reason to panic.

What may be even greater heresy in the financial world is our view that we should be increasing equity exposure even as market participants see risks rising. When compared with other asset classes, including bonds, the stocks of many individual companies look very attractive. These companies have defendable franchises, solid balance sheets and usually pay dividends. Most of these dividends are higher than those on the 10-year Treasury note, in some cases substantially higher. We have not seen this happen in several decades, especially with such a high degree of dividend coverage. There are clearly some compelling opportunities, especially for income oriented investors.

Risk-averse investors are probably having the hardest time with the current market environment. Income has been hard to generate as yields fall. Maturing investments can only be reinvested at sharply lower rates. When similar conditions prevailed a few years ago, investors found alternatives in bonds backed by sub-prime loans and Alt-A mortgages. Chasing those higher yields proved to be disastrous for many.

Matters are even worse if you think, as we do, that interest rates will eventually head higher. Bond prices fall as interest rates rise. Locking in a 10-year Treasury bond at 3% may avoid default risk but it locks in a low interest rate and puts capital at risk should liquidity be needed.

Fortunately, turmoil creates opportunities in bonds as well as in stocks. In many instances, tax free municipal bonds now yield more than Treasuries. Fears of towns and cities defaulting are legitimate, but a bit of homework can turn up some very rewarding bonds. As State and local government funding issues mount, we suspect more opportunities will be created.

As always, we welcome your questions and comments.