February 2012 Volume 2

"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance."

- Cicero , 55 BC

To kick off this year's string of newsletters the partners at Clearview agreed it would be a good idea to give our clients and friends a good idea of what shapes our process and outlook for the coming year. It is important to recognize that many of our clients' portfolios are invested with money mangers or mutual funds that take a fully invested approach to investing clients' money. What this means is that most of them do not make cash or bond allocations or vary their mix of assets as the overall macro (or big) picture changes. They tend to be what we'd call bottom up; first finding the best stocks or bonds to buy, then looking at the industry or sector's health, then finally looking at the broad economy. Contrary to what many investors think, asset allocation makes up the bulk of the return any investment pool achieves (about 90%) versus about 10% which comes directly from stock or bond selection. For this reason we spend a lot of time trying to get the big picture correct so that we can help our clients properly reallocate (moving to more cash and bonds strategically in times of high risk and more towards stock and alternatives in a time of lowered risk).

The graphic on the following page illustrates the basic framework we have in coming to our 12-month forecast. We review this four times a year and at mid-year may revise our forecast depending on developing data. Though not presented here, the inputs that drive us to our numbers within the matrix come from a myriad of sources. We use a mosaic of available data depending on the data type. Sources include the Bureau of Labor Statistics, Federal Reserve statistical tables, Bureau of Economic Analysis, research from major Wall Street firms and even some arcane data sources like the Port of Long Beach and The International Swaps and Derivatives Association. Through research and analysis we arrive at the numbers which you see presented here. There is a very large component that is only captured here in nuance, however. That is the behavior element of the consumer. Of course consumer sentiment measures do exist, but they often tell the story of what consumers plan to do when asked, but as we all know, talking about doing something and actually doing it may be two separate things. The measurable things eventually do make it into the data, but the problem is that it is often with a lag that makes forecasting difficult at best. Although not perfect, the procedure is valuable because a close approximation of expected outcomes will often illustrate the areas with greatest risk and also generate ideas for risk reward tradeoffs that appear compelling (or overrated). In this way we have one more tool at our disposal to help folks navigate to a successful investment outcome. This allows us to better frame expectations for our clients as we move forward in time.

On closer inspection you will find that our Current Forecast (in the lower block) is the summation of the 'Base', 'Best', and 'Worst' cases multiplied by their respective probabilities. It may seem dire that we are expecting an 8% decline in stock values over the next twelve months, but that masks the fact that we expect about a 6% total return from stocks with a likelihood of 70%(the Base case of –1.43% X .50 plus the Best case 24.52% X .20 plus about 2% dividend yield). It's the renewed risk of recession and its heightened probability that weigh down our prediction and make the likely outcomes for 2012 disparate.

12 Month Forecast 2/7/2012 0:00

Probability	BASE CASE							
0.50	Inflation	2.00%	S & P Earnings	$92.00	S & P Target	1297.2		Trsy Bonds
	GDP	1.20%	P/E Multiple	14.1	S & P %	-1.43%		1.82%
	10 yr. Tsry	2.10%	Dollar	Trading Range	Oil	$90	$105	
				77-88	Gold	$1,400	$1,800	
	BEST CASE							
0.20	Inflation	2.80%	S & P Earnings	$102.42	S & P Target	1638.72		Trsy Bonds
	GDP	2.60%	P/E Multiple	16	S & P %	24.52%		-10.07%
	10 yr. Tsry	3.55%	Dollar	Trading Range	Oil	$95	$125	
				73-85	Gold	$1,400	$1,700	
	WORST CASE							
0.30	Inflation	0.32%	S & P Earnings	$58.83	S & P Target	779.4975		Trsy Bonds
	GDP	-2.00%	P/E Multiple	13.25	S & P %	-40.77%		10.35%
	10 yr. Tsry	1.06%	Dollar	Strengthens	Oil	$75	$120	
				80-90	Gold	$1,000	$1,800	
	CURRENT FORECAST							
	Inflation	1.66%	S & P Earnings	$84.13	S & P Target	1210.193		Trsy Bonds
	GDP	0.52%	P/E Multiple	14.225	S & P %	-8.04%		2.00%
	10 yr. Tsry	2.08%	Dollar	Trading Range	Oil	$86.50	$113.50	
				77.10-88.00	Gold	$1,280.00	$1,780.00	

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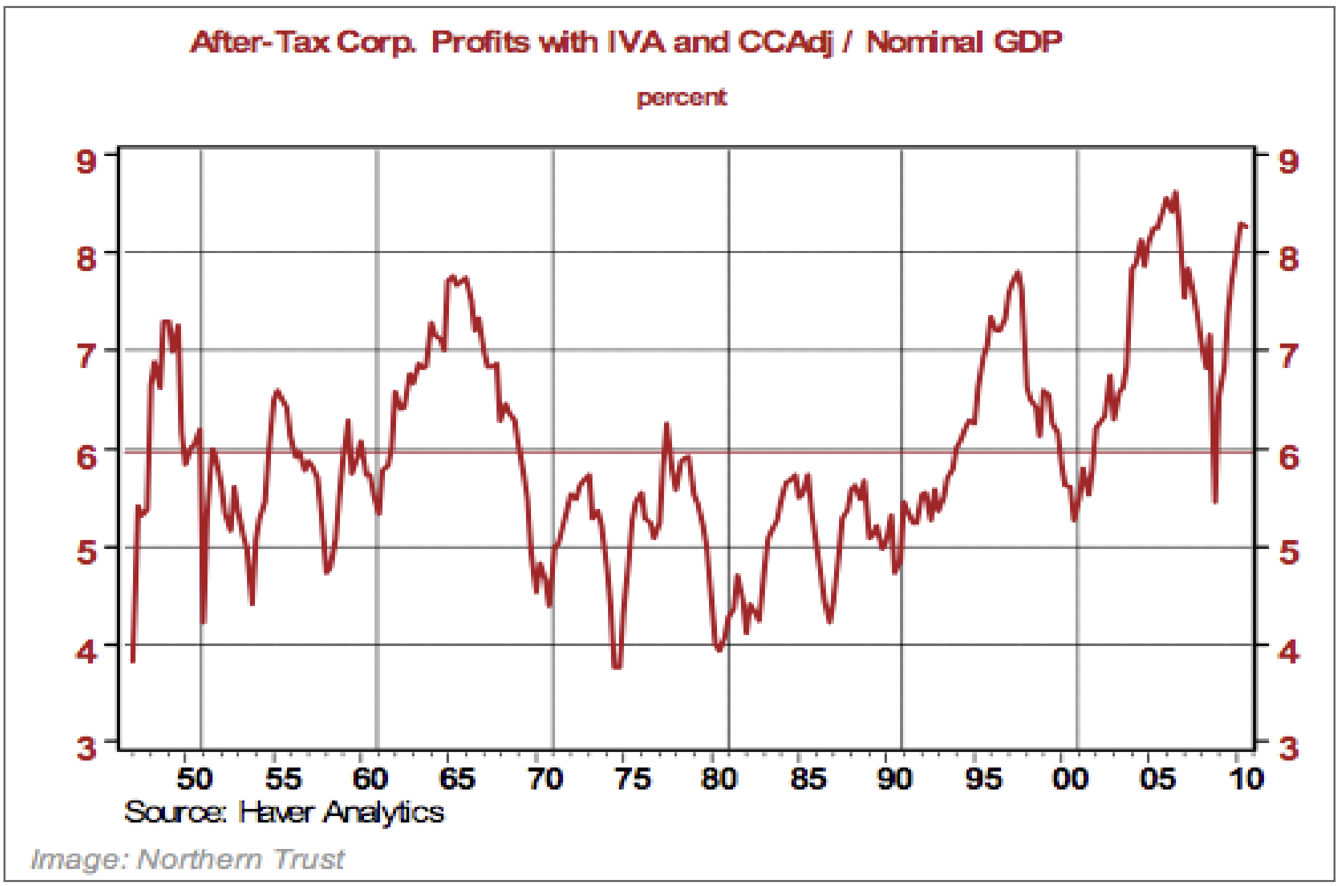
A Word On P/E (price/earnings) Ratios

Price to earnings ratios (P/Es) are one of the most often used stock valuation metrics used in the media and financial circles to validate the level of a particular stock or the stock market as a whole. Over time P/Es have cycled between a level in the high single digits to a level in the low 20's. The stock market's average P/E over a very long time period has been about 15. Today the stock market's P/E is just about average, that is to say very near 15. Interestingly, two levels of earnings (the E in P/E) have emerged over the last 20 years; 'Operating Earnings' and 'As Reported Earnings'. Without getting into a much deeper discussion, suffice it to say the difference between the two can be very large. So which is an investor suppose to use? There are arguments for each, but the growing divide between the two suggests a lower P/E is warranted because of the uncertainty of which is the proper measure to use.

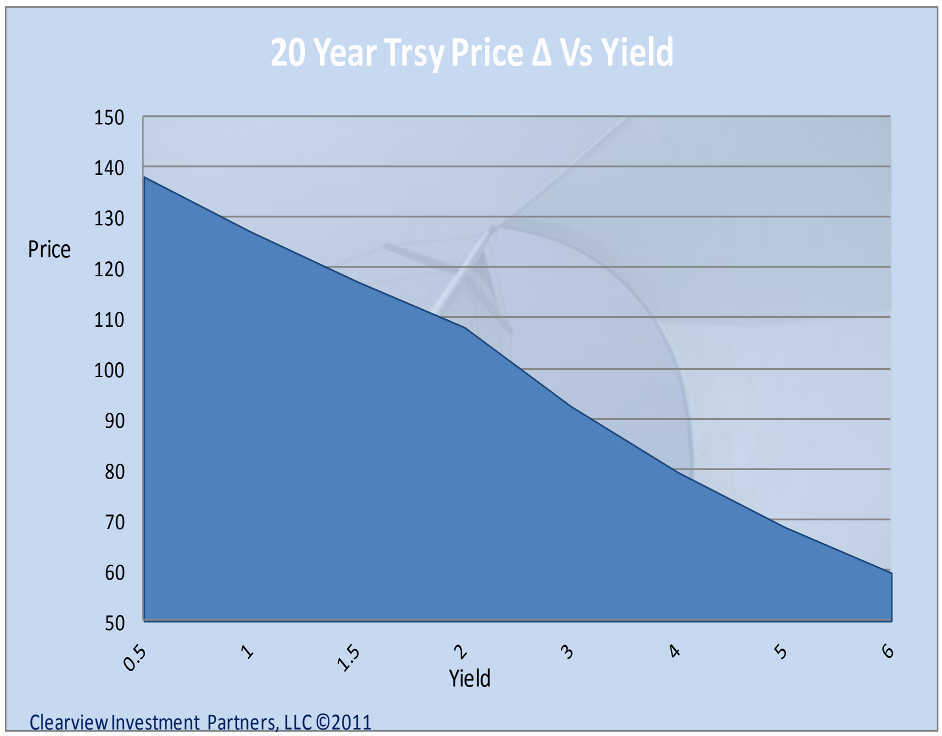


A second factor affecting earnings is the current high level of profit margins. Profit margins tend to mean revert over time and, as they do, earnings will fall along with them. As you can see in the chart above, corporate profit margins are at historically high levels. Again this would argue for a more suppressed P/E in anticipation of such mean reversion.

Our conclusion is that stocks are neither overpriced nor underpriced at the current level. However, the ***trend*** in P/Es is currently lower so we would err on the side of a more conservative stock weighting at this time. In addition, the overall macro economic backdrop that we discussed earlier in our 12-month forecast raises a yellow flag for caution.

Sensitivity of Bonds to Rate Rises

The very low yields on bonds, or any fixed income (i.e. CDs, bank loans, mortgages) has lead investors to hunt for higher yields. That hunt often leads to a yield grab that forces investors into longer-dated bonds. As you can see from the accompanying chart, a small change in rates rising for this 20-year bond reduces the price by a fair amount. For example, a 20-year Treasury bond with a 2.5% yield/coupon will fall by about **-7.5%** with just a 1/2% rise in interest rates and nearly **-30%** with a 2% rise in rates! Just 1/2% rise in rates would wipe out nearly three years of coupon income. For this reason, we are advising clients to keep maturities shorter than normal. Unfortunately, this posture results in low returns, but ***protects principal.***



As always, our charge is to, first, do no harm and second to grow our clients capital in a prudent, risk tolerable manner. On this front we continue to scour the landscape for those opportunities that will allow us to achieve these goals for our clients and at the same time be sensitive to their specific needs.

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