PATIENT INVESTORS TO BENEFIT MOST OVER THE NEXT 10 YEARS

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Focused Asset Management

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Our view is that while things remain rather uncertain for the next year, publicly traded businesses (i.e. stocks) will perform in the 8%-10% range ~ on average ~ over the next several years.

Stock returns can be broken mathematically down into three components: 1) earnings growth, 2) dividends, and 3) changes in the price-to-earnings ratio (valuation changes). This can be proved for any individual stock or the market as a whole. As a result, projecting market returns along these lines is one fairly simple but valid approach out of several.

In our view, businesses will continue to grow earnings and sales in the 6-8% range which is consistent with the long-term average. Second, dividends are yielding 2% give-or-take. If anything, we expect dividend payout ratios to increase; thus are comfortable with current yields. Finally, how will prices adjust based on valuations? Valuations are historically normal right now as we will demonstrate later. As a result, it's a toss-up. However, prices are not biased downward or upward based on current valuation abnormalities (i.e. in 1999 most agree we were in a bubble, today most agree stock prices are far from bubble levels).

As a result, our base case is that returns for the stock market as a whole will be more impacted by growth and dividend factors and less so on valuation adjustments. Thus, adding 6%-8% growth to 2% dividend yields puts us in an 8%-10% total return range over the next 5 to 10 years. This would be historically normal.

Currently, however, several market concerns exist that threaten market performance over the next year. They can be summarized as follows:

1. European Crisis. Much concern centers on Europe's collective willingness to fund member countries that are having fiscal shortfalls and banking crises.
2. The U.S.'s "fiscal cliff" which essentially amounts to automatic tax hikes and mandatory spending cuts. While on the surface this is prudent, the speed and degree by which this happens has many concerned economic growth will be penalized by 2%-3%.
3. China. China is slowing down with further deceleration assumed to be on the horizon. Historically, their growth has done wonders to prop up the global economy (i.e. 2009). With no Chinese flotation device, softness here and in Europe could negatively impact U.S. growth.
4. Finally, the ultimate backstop to falling asset prices has laid with the Federal Reserve's ability to adjust the plumbing. However, given the current zero interest rate policy and loss in impact from the various asset buying & twisting programs, many are concerned the Fed has run out of bullets.

Despite these threats, basic economic gauges seem to be muted but positive. Specifically:

- The economy is still growing and only a slim minority are actually calling for recession despite the concerns listed above.
- Inflation has been positive and mild and consensus calls for a continuation of this.

- Home prices are expected to increase in 2012 for the first time in six years.
- Unemployment is still high, but has been trending down and consensus calls for more of the same.

What's an investor to do?

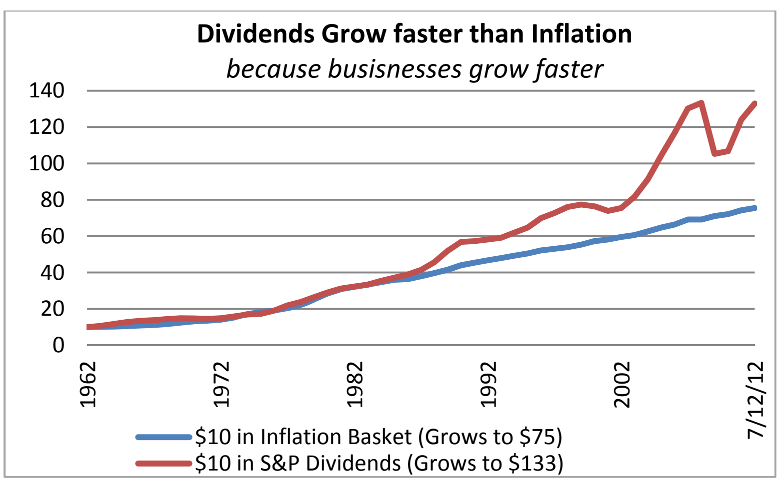
We recommend a strategically neutral weight for investors with a bias towards stock accumulation (during future periods of market stress).

We do not know how Europe will solve its periphery challenges or how our politicians will dampen the consequences of the Fiscal Cliff domestically. However, usually in markets where the challenges are this well understood, asset prices have already done a good bit of adjusting. As a result, risks to economic and corporate earnings growth remain, but we expect risks to stock prices to be shorter term in nature. As these issues flare up over the next 12 months (and we expect they will), asset price volatility will likely be more opportunistic than a valid reason to make any longer-term risk reducing decisions.

> Most importantly, a well thought out customized strategic (i.e. longer term) asset allocation is always going to be good baseline for the "what should I do" question. When investors do not operate out of a strategic asset allocation framework, it can become quite tempting to make excessively large moves, sell too late, or buy too late – whether it is stocks, bonds, gold, cash or igloos. In fact, if you Google the term "behavioral finance," you'll see an entire school of Nobel awarded thinking that is all about why investors make mistakes. After conquering much of this body of knowledge, you may likely conclude that a good long-term strategy will help avoid most of the mistakes.

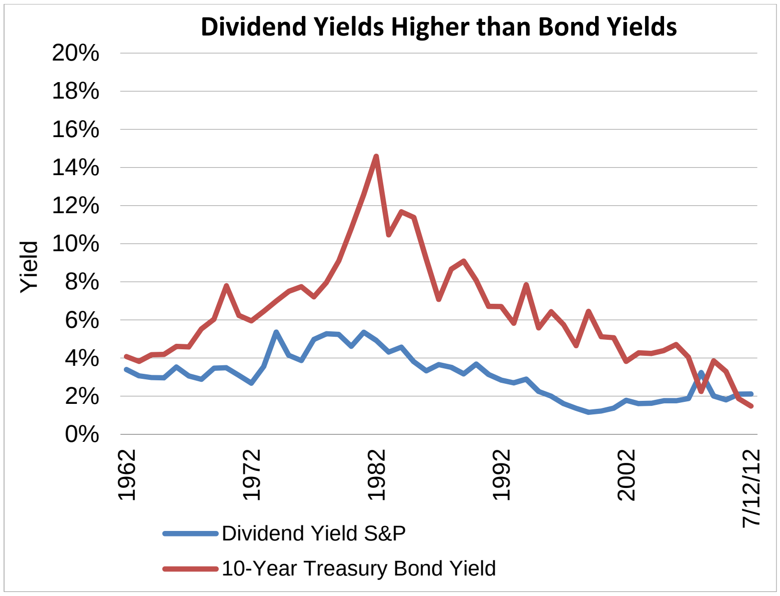
The following charts demonstrate why our base case for stocks is favorable over the next 5 to 10 years.

Exhibit 1: As can be seen in the chart below, companies increase dividends at a faster rate than inflation.



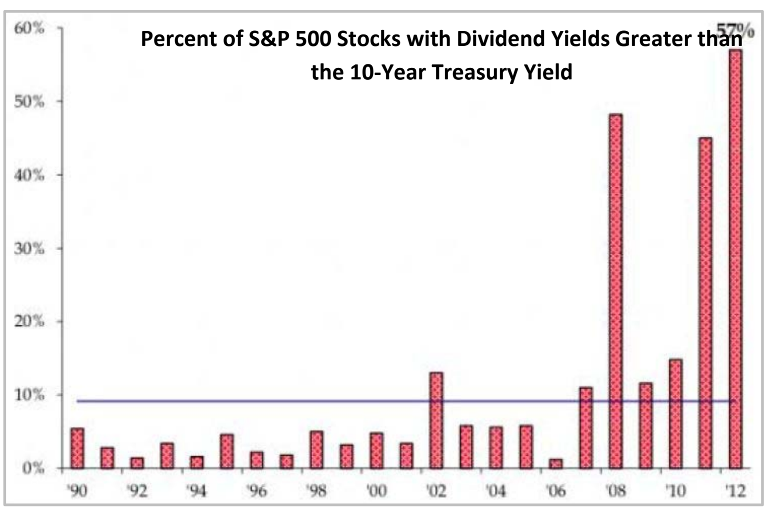
Source: Robert Shiller, Bls.gov.

Exhibit 2: The broad stock market is providing a dividend yield greater than Treasury bonds. Dollar for Dollar, yields are higher today for stocks. This hasn't been the case since the late 1950's (and briefly in 2009). As a result of higher yields and with growing income streams, the incentives clearly bode well for stocks over longer periods of time. As investors are drawn to stocks based on incentives, prices should appreciate (and companies in turn, incentivized to increase dividend payouts).



Source: Robert Shiller.

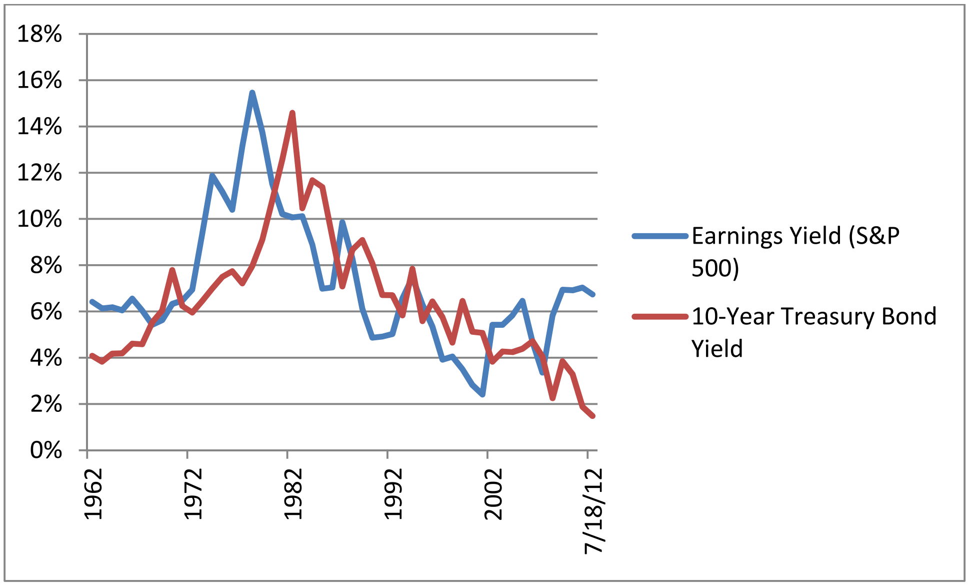
Exhibit 3: Finally, consider that 57% of the individual members of the S&P 500 today have higher yields than Treasury bonds. In a similar analysis, we identify 38% of S&P 500 companies have a higher yield than the broad bond market as measured by the Barclay's US Aggregate Bond Index (currently yielding 2.44% as of 7/14/12).



Source: Strategas.

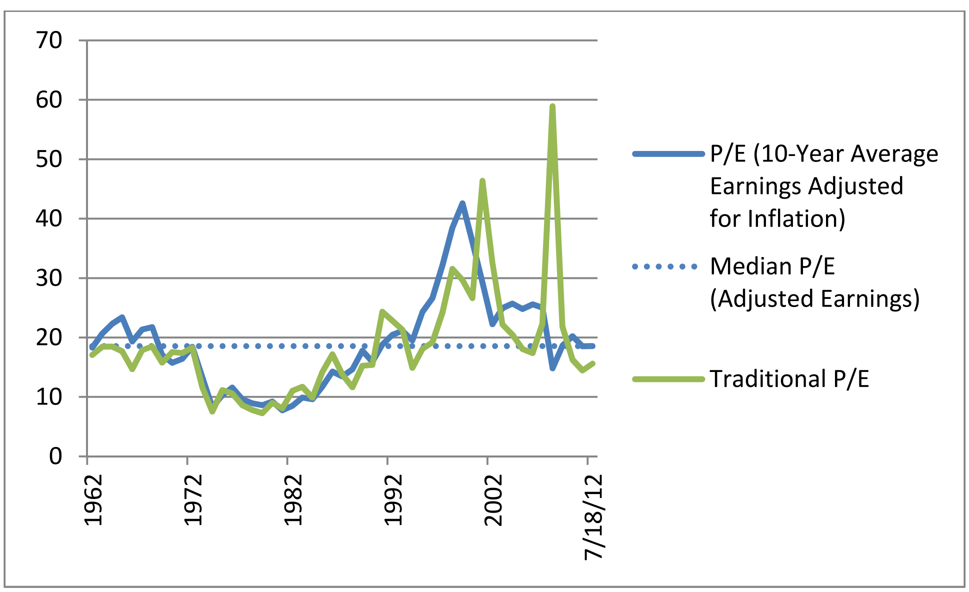
Exhibit 4: Yield Analysis: Stocks Attractive
$100 Invested in Stocks equates to $7.0 in annual earnings.
$100 Invested in Bonds equates to $1.5 in annual coupons.

This analysis, also referred to as the Fed Model for no great reason, is essentially arguing that stocks are cheap relative to bonds. With bond yields at historic lows, over the next few years many bonds will likely have negative returns when adjusted for inflation.



Source: Robert Shiller.

Exhibit 5: Market Multiple is Normal-to-Below Normal
The good old fashioned Price-to-Earnings ratios, whether looked at in the traditional sense or a conservative approach using "average earnings" indicates that stocks are reasonably priced. This *also* means there is a good supply of stocks that are individually quite attractive.



Source: Robert Shiller.

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