



TEALWOOD E-DIGEST

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We Are Making A Strategic Adjustment:

Rebalancing to opportunity with increased international diversification, commodities and a bit of cash.

There are a dozen issues that merit discussion amidst the current market volatility and recent downdraft. We will address several of the most important of these, but let's cut to the chase on the really big questions first.

#1. THE MOST IMPORTANT THING: IT'S NOT THE MARKET, IT'S YOUR STRATEGY. In this environment, none of us are going to draw *obvious* confidence from the marketplace; hence, you must be able to derive confidence from your strategy. Below are our broad recommended asset allocation strategies for various investment objectives:

<u>Objective</u>	<u>Equities (Offense)</u>	<u>Fixed Income (Defense)</u>
Capital Appreciation	80%	20%
Moderate	50%	50%
Conservative	20%	80%

#2. Equity Strategy (*Large Cap Value and Value Growth* portfolios). While everyone prefers the proverbial level playing field, for equity investors, the last three months have felt like running the hurdles. Starting with the Greek Debt "sticky situation," then sequentially: round one of the debt ceiling negotiation, the revised first half GDP data (showing 1.3% growth in the first half), the (predictably) make no one happy round two debt ceiling negotiation, the S&P credit downgrade and the Federal Reserve's accommodative announcement. While we always favor a steady hand on the wheel, running this gauntlet requires recognition that an adjustment is sensible.

We used to believe there was one all important question when investing in equities. This most important inquiry is captured in two parts:

- a) what is the business worth? and
- b) what is the relationship of the market price to the business value?

Our objective is to invest in high quality, profitable, growing companies at discounted prices, and to capture appreciation by the movement from discount to fair value. We still believe this is the most critical point. However, we have added another question to the "most important" category: Is the economy expanding or contracting?

Post 2008, we added this additional question to our checklist from our “acquired wisdom.” That painful episode drove home the insight of just how much equity results are correlated to expansions and contractions in the economy. We adapted a new resolve to focus on offense in expansions and defense in contractions in order to add meaningfully to risk management and effective investing. So here are today’s updates on these two questions:

Q. Are we invested in high quality companies at discounted prices?

A. Yes

Q. Is the economy expanding or contracting?

A. The U.S. economy is likely to continue in modest expansion, but a) “likely” is a VERY underwhelming answer, and b) international diversification (markets excluding Europe) holds the potential for both lesser risks and greater rewards via investing in creditor nations with expanding economies.

- **We are making an opportunistic adjustment.** This adjustment has three components:
 - 1) give more emphasis to global and developing markets;
 - 2) give more emphasis to basic materials and commodities as a defense against dollar weakness today and the risks of a monetary bubble “down the road;” and
 - 3) we are modestly increasing our cash position.
- **We believe the recent sell-off represents the market discounting another recession.** It is not obvious to us that another recession is imminent. However, it is obvious that the bigger issues causing market dislocation, such as deficits, debt, Eurozonia, et al, are structural issues that go beyond short-term fixes or band aids. A clever maneuver out of these problems is not in the cards. These issues can be fixed, and our long-term faith in American values and market resiliency give us cause for hope, but let’s not delude ourselves. Potential solutions require a level of resolve and leadership that are not currently visible.
- **Over the past several years, Fed accommodation has correlated with higher prices in commodities and precious metals.** We expect more of the same from this new chapter in accommodation. The same policies that make us concerned about a monetary bubble and inflation down the road also result in dollar weakness today. The August sell-off has had a “throw the baby out with the bath water” character with indiscriminate selling across sectors. We expect over the next year that opportunities will be discriminate, not indiscriminate, and we intend to be opportunistic about using this “panic” to allocate to strategic advantage.
- **Despite lackluster GDP growth, we believe profits will continue to be healthy and stocks will go where profits lead.** At the same time, we expect a modest multiple (12X to 14X for the S&P 500 Index), and this valuation appropriately discounts the issues and complications in the marketplace. So what do we mean by “healthy” profits? The current consensus earnings estimates for the S&P 500 Index for 2011 and 2012 are \$100 and \$112* respectively. We give these estimates a “margin of safety” haircut to \$90 and \$97. So over the next year and a half, this math (that is the math of the price-to-earnings (PE) multiple times the projected earnings) projects to potential range of returns

from -4% to +19%. **We are not attempting to forecast short-term market gyrations; we are working to think about fair value over a longer period of time.** We see this as a positive risk/reward relationship for equity investors.

- **For Clients invested in the *Strategic Income* and *Defensive Fixed Income* portfolios:** Year-to-date we are pleased these more conservative strategies have defended in this volatile environment. We see a “yield panic” breaking out and we expect your portfolio to benefit from being positioned for both quality and yield.

* Source: Bloomberg