Argent Wealth Management
QUARTERLY
Investment Outlook
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Third Quarter 2012 Investment Outlook

Second Quarter and Mid-Year Review: Another Flare-Up In Europe

The past quarter marked yet another flare-up in the European debt crisis, with this latest chapter focused upon surging bond yields in Spain and Italy. As bond yields touched 7%, there was a real risk that these economies (much larger and more significant than Greece) could not continue to pay the costs of huge debt burdens and that the European Union did not have the firepower this time to come to the rescue. Compounding the government debt problem was the increasing risk of insolvency within the Spanish banking system. Spanish banks have been burdened with a housing crisis that has been more severe and later to arrive than the U.S. housing crisis.

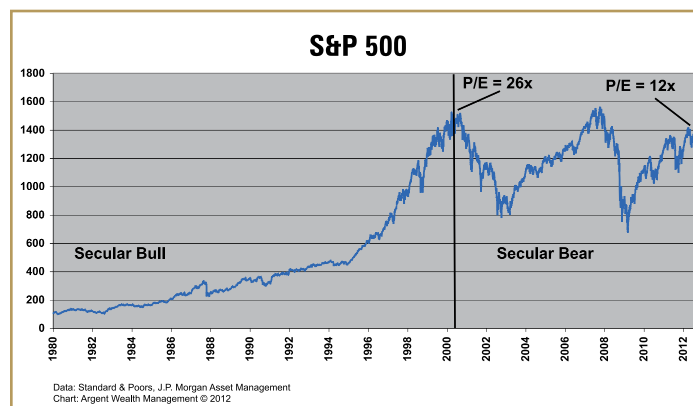
Around the globe markets languished, and the European Union was forced into another round of emergency meetings. After intense negotiations and a number of false starts, the European Union coalesced around an agreement to provide support for government debt in Italy and Spain, as well as for the Spanish banking system. Equity markets rallied sharply as news of an agreement broke, making the quarter much less painful than would otherwise have been the case.

While the immediate risks of insolvency have diminished, we believe that this is just another step in a long and painful process of restoring fiscal prudence. We fully expect additional flare-ups. With fiscal policy severely constrained, growth will remain uneven and below long term potential and unemployment rates stubbornly high.

Fortunately for our clients, we were able to exploit the market's volatility, as we had trimmed risk, in a measured way, just prior to the beginning of the quarter. As discussed in our prior Outlook, we did not claim any unique or profound insight to the market's direction; only the view that equity markets had rallied more than 30% in a virtual straight line and investor sentiment had become extremely complacent. Markets corrected sharply to the downside, and we were able to find a number of compelling opportunities to invest the higher than normal amount of cash.

Perception vs. Reality

We're finding a common theme in recent client meetings that perceptions of market returns are far worse than the reality of actual returns. Perhaps this is a natural and understandable reaction to the overwhelmingly negative tenor of recent economic news. More importantly, we believe that our clients, as well as most investors, are conditioned by a "secular" bear market in equities that is now more than a decade long. More about this later.

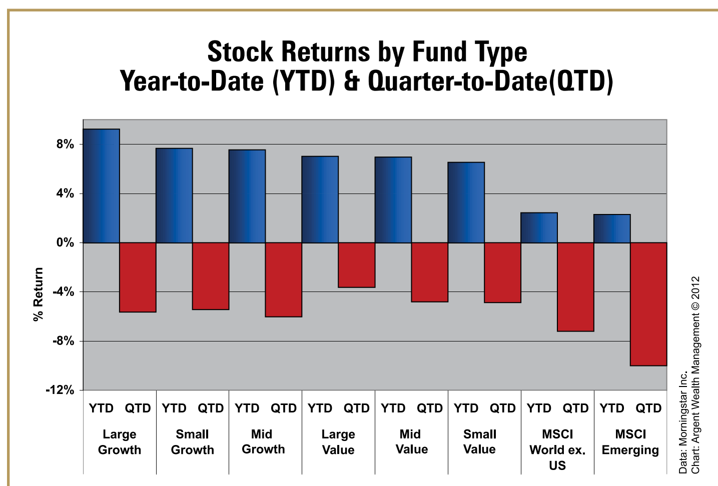


Secular markets: *Markets driven by long-term forces (generally 10 to 20 years) that cause an asset class to rise or fall. In a secular bull market, there is buying pressure over an extended period of time. In a secular bear market, there is selling pressure over an extended period of time. Within a secular bull*

market there are often short-term or cyclical bear markets, and within secular bear markets there are often short-term or cyclical bull markets.

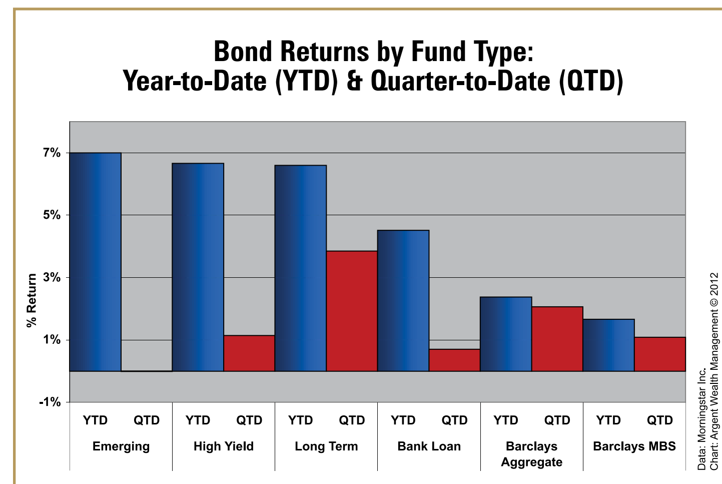
For the quarter, equity prices declined an average of about 5%, with relatively small dispersion across categories. Such a correction is actually quite modest and normal, even healthy, within the context of a well intact cyclical rally that started last October. Year-to-date returns are still handsomely positive, averaging about 8% with Larger Capitalization and Growth sectors leading the way. We remain significantly overweight in many of the leading areas of the equity markets and our best managers have materially beaten their respective benchmarks.

While International markets declined more sharply, it was only by a modest amount. Emerging Markets, typically more sensitive to changes in economic growth, declined the most. However, year-to-date returns remain positive across the board. Even European focused equity funds are positive 4.5% year-to-date.



Fixed Income returns continued to be excellent for the quarter and year-to-date. Normally we would expect underwhelming fixed income returns, and potentially losses, during a period of significantly advancing equity prices. However, exceptionally accommodating central bank policy around the globe has resulted in additional yield declines and higher prices.

Here too, actual portfolio returns are significantly better than index returns. The Barclay's Aggregate Index return looks modest at 2.06% for the quarter and 2.37% year-to-date. However, the average High Yield fund was up an impressive 6.66% year-to-date. Bank Loans and Multi-sector bonds were close behind. Selective Closed End Funds and other aggressive credit strategies did even better.



The first half of 2012 was a solid period for a well built, well diversified portfolio.

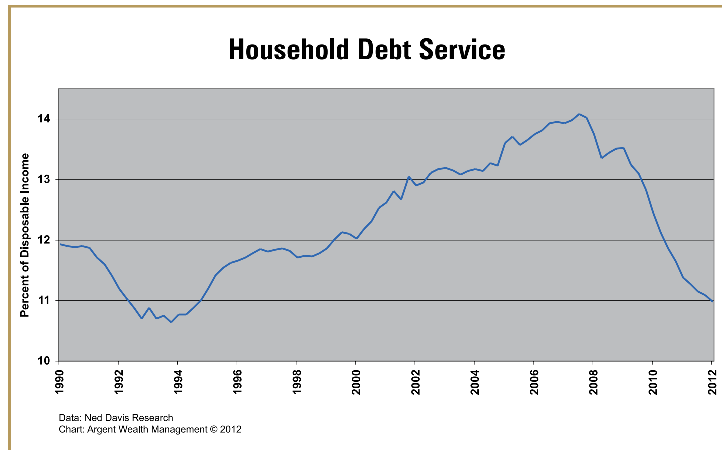
The Bigger Picture; Have Investors Lost Faith and Confidence In Markets?

We believe that this past quarter is reflective of a much broader and more significant issue. Investors have been traumatized by more than a decade of poor investment markets. Numerous scandals and an increasingly toxic political environment have certainly contributed to this despair. Even the past quarter has dealt some major body blows to investor confidence with the European crisis, as well as, other confidence losing issues; J.P. Morgan's trading debacle, Facebook's IPO flop and the unfolding LIBOR manipulation scandal. It is no wonder that investors question the fundamental structure and fairness of markets.

However, it is critical to understand that all "secular" bear markets feel this way and markets have survived periods as long and as dire as this one. The last secular bear market in equities ended in 1980, with single digit price earnings ratios on major equity market indices, double digit inflation and a Fed Funds rate that maxed out at 21.5%.

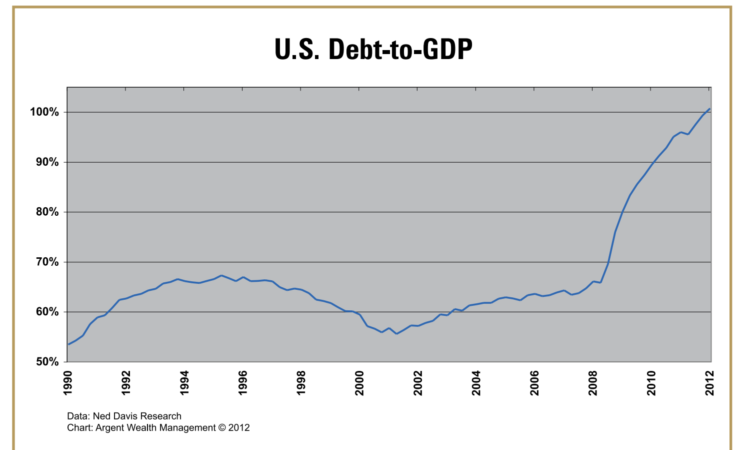
While secular bear markets have similarities, there are also critical differences. This secular bear market is fundamentally driven by a collapse of financial leverage that had fueled a significant part of the 20 year period of exceptional investment returns that began as the last secular bear market ended. As inflation and interest rates fell, leverage was added to all parts of the economy. Corporations leveraged their balance sheets and turbo charged earnings growth as interest rates declined. Consumers reacted by over spending, over investing in housing

and viewing appreciating real and financial assets as an ATM machine. Governments took on debt burdens that obviously cannot be paid for without severe adjustments to both revenues and expenditures.



The collapse of financial leverage will clearly take a long period of adjustment before it is complete. Fortunately, while it may feel as if this process is only beginning, very significant adjustments have occurred or are in advanced stages. U.S. housing prices are now at the most affordable levels versus income since World War II and a much underappreciated housing recovery has begun. Corporations have largely weaned balance sheets from leverage (particularly Financial firms) and are hoarding record amounts of cash.

The adjustment process of government debt is the last and most problematic. These adjustments will be painful and will require real sacrifice from all sectors of the economy. One way or another, these debt burdens will be "right sized" versus revenues. There are only five ways to align revenues with expenditures and the ultimate solution will likely involve all of these tools. The most desirable and hardest to accomplish strategy is to accelerate economic growth. Government expenditures clearly need to be trimmed and taxes raised. Currently, taxes are at the lowest share of GDP since 1950, and regardless of one's political affiliation, it is common sense that raising taxes must be part of the solution. The remaining two strategies are clearly less desirable and painful; to "repress" government bond yields at super low levels and essentially confiscate wealth from investors in bonds or alternatively raise the level of inflation. Ultimately it comes down to simple budget math, and nominal GDP must be rising at a faster rate than government expenditures.



Finally and most importantly, all secular bear markets do indeed end. Typically this ending point is when investors have completely lost confidence in the asset class in question and valuation is washed out and cheap. All secular bear markets are associated with scandals of one form or another and regulators routinely over-tighten the screws, paradoxically restraining recovery. Just when it seems impossible to imagine respectable returns, a new secular bull market begins.

The critical question for investors is how long does the remaining secular bear market last and how should assets be positioned for the next period?

A Disciplined Framework

While it is impossible to perfectly predict the transition to the next secular bull market in equities, it is entirely possible to construct a disciplined and rational investment framework. All asset categories' returns are fundamentally linked to the starting valuation of the asset class, growth of earnings (yields for bonds) and assumptions about future valuation.

We have incorporated a conservative set of assumptions to forecast equity returns for the next decade. Real GDP growth is assumed to average only 2%, reflecting the restraint coming from the massive government debt burdens and the limitations of fiscal policy. Inflation is assumed to average 3%, although it is likely to be lower in the early years of the next decade and potentially higher later on. Dividends are simply assumed at the current level and growing at the level of profit growth. Profit growth is conservatively assumed to be just 1% above nominal GDP growth (less than historical averages). Ending Price-to-Earnings ratios are assumed to be the average of the past 15 years (16.8 times).

Using the S&P 500 as a proxy, and reinvesting dividends, average annual returns would be about 9.5% or alternatively about 2.5 multiples of capital over the decade! Even if the ending P/E ratio was a modest 15 times (roughly 2 points below historical averages), average annual returns would be about 8.35%, or close to 2.25 times invested capital. This compares extremely favorably to 10 year Treasury bonds, with a starting yield of 1.5%. An investor holding a 10-year Treasury bond to maturity, would be left with only 1.15 times original capital and lose a significant 15% of purchasing power versus our assumed 3% annual inflation.

Of course, our assumptions could be well off the mark. It is possible that the economy (and profit growth) could be much worse than even the conservative estimates that we use (or much better if you are an optimist). However, if earnings only grew at the rate of GDP, the ending Price/Earnings Ratio would need to fall to about 7 times to have stock and bond returns equal. While theoretically possible, the historical odds are extremely low.

The truly frustrating part of all of this for investors is that secular markets and financial bubbles can last an astonishingly long time. This analysis says nothing about when the transition to the next market cycle will begin, only that the odds are stacked heavily in favor of equities versus bonds at current valuations.

Building a Portfolio Using This Framework

The challenge is to now put this framework into action. To do this most effectively requires investors to think about the long-term and to ignore the bombardment of current news…a very challenging assignment for most investors.

While admittedly challenging, this framework can be effectively utilized as an anchor for constructing a portfolio. Clearly, equities have much more impressive long term potential than high grade fixed income and should be adequately overweight. An overweight in equities will likely be mandatory for investors that require appreciation over the next decade.

Higher grade fixed income should be minimized, within the context of a broadly diversified portfolio. Fortunately, not all fixed income is created equal. As we have discussed in prior reports, there remain a number of attractive "credit" strategies such as Mortgages, Corporate bonds and High Yield. While these sectors certainly involve taking on credit risk of one type or another, a carefully researched and constructed basket of these assets is attractive.

Alternative assets can also be skillfully utilized to substitute for higher grade fixed income allocation. Admittedly, these areas are complex and require careful analysis in order to be utilized effectively. However, return potential, diversification advantages and the potential for loss are all preferable for certain carefully researched and carefully vetted strategies.

The resultant portfolio has the potential for substantial appreciation but has very reasonable levels of volatility and downside risk. We expect that the next decade of investment returns will be more rewarding than the past decade, even though it does not feel that way now. However, we don't think that this will be a return to the 90's with dramatically above average investment returns of both stocks and bonds. The successful investor in this next period will need to more carefully construct a portfolio and will exploit a broader and more creative set of assets.

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