

## Newsletter – October 2012

### Third Quarter Market Recap

After experiencing a 10% correction in the second quarter, equity markets rebounded sharply and largely ignored a multitude of concerns such as the global economic slowdown, the European sovereign debt crisis and growing tension in the Middle East. The resilience in equity markets was evident as international stocks outpaced domestic stocks with developed markets +6.9% and emerging markets +7.7% - both up over 10% year-to-date. In the U.S., large caps led the way with the S&P 500 Index +6.4% while mid caps and small caps were +5.4%. For the first three quarters, domestic equity markets have outpaced international equities with the S&P 500 Index +16.4%, S&P Mid Cap Index and S&P Small Cap Index +13.8%. Even with double-digit equity returns so far in 2012, retail investors continued to redeem \$77 billion from domestic equity mutual funds. Since 2007, investors have poured \$1.29 billion into bond mutual funds and ETFs (Exchange Traded Funds) while only \$209 million was invested in stock mutual funds and equity ETFs.

Domestic bonds produced positive returns in the quarter and again continued to receive the vast majority of cash flow into mutual funds, even as yields remain at multi-decade lows. Money market mutual funds, with a yield close to zero, continued to experience significant outflows – likely to bond mutual funds. Municipal bonds eked out positive returns for the quarter. For 2012, Barclays Intermediate Govt./Credit Bond Index is +3.5% and the Barclays Capital Municipal Bond 3 Year Index is up 1.9%. Of the main investment alternatives, real estate was +1.4% for the quarter and +16.6% for year. Gold benefited from global unrest and rebounded sharply with an 11% return in the quarter and 12.5% for the first three quarters. The broader commodity basket was +11.5% in the quarter buoyed by higher oil prices but only +3.5% for the year.

### Commentary

#### Icarus and Hubris Revisited

On page three of last quarter's commentary, we referenced the rising fascination that more and more investment firms have for short term trading. As an example, we mentioned that Goldman Sachs had made a call that their clients should consider shorting the market in anticipation of a 5% correction. You can see our last newsletter for why we think this approach is unhelpful to most individual clients and the antithesis of our long term approach to building enduring portfolios.

Obviously this short call would have been quite a loser for investors in the third quarter as the S&P 500 Index gained 6.4%. Perhaps it won't surprise you that as we write this newsletter in early October, Goldman has tripled down on their call and are now suggesting a 15% decline may be in the offing. But they feel certain that the market will then have a good chance at recovering to new highs after the

#### MARKET TRENDS 9/30/12

<u>US Stock Markets</u>	<u>YTD</u>	<u>Q3</u>
S&P 500 Index	16.44%	6.35%
S&P MidCap 400 Index	13.77%	5.44%
S&P SmallCap 600 Index	13.80%	5.40%

<u>Int'l Stock Markets</u>		
EAFE Index	10.08%	6.92%
Emerging Mkts Index	11.98%	7.74%

<u>Fixed Income</u>		
Barclays Intermediate Gov't/Credit Bond Index	3.53%	1.40%
Barclays Capital Muni Bond 3 Year Index	1.88%	0.59%

<u>Commodities</u>		
SPDR Gold Shares (NAV)	12.47%	11.00%
Goldman Sachs Commodities	3.47%	11.54%

<u>Real Estate</u>		
Dow Jones US REIT Index	16.62%	1.39%

<u>Yields</u>	<u>9/30/2012</u>	<u>12/31/2011</u>
T-Bills	0.09%	0.01%
10 Yr UST	1.63%	1.88%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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*“We don’t think these market calls do much to help clients because they are not actionable.”*

*“...various QEs...do not represent the “usual” and favor rising prices in bonds, stocks, and real estate!”*

*“...a methodical, common sense approach can be very successful- and without multiple decisions and major shifts in strategy.”*

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correction. Recall “unhelpful”! Morgan Stanley goes further and suggests via David Darst that as much as 15 to 25% declines are likely by year end. The ancient Greeks warned of hubris, our tendency toward prideful self-aggrandizing, like Icarus flying too close to the sun only to have his wax wings melt and plunge him into the sea.

We don’t mean to criticize the accuracy of these short term market calls, but at Shorepoint we wonder out loud: what is the point? How does this help clients? We don’t think these market calls do much to help clients because they are not actionable. For us there is a difference between being active managers, which we are, versus trading speculatively on the direction of broad indices which is usually fruitless. If you look back over the last few years of our newsletters, which are all available on our website, you can see that we have had a bias toward tactically overweighting clients toward equities. That means simply that if a client who has a moderate tolerance for risk and an implied exposure of 50% in stocks, we would add 5-10% more than in “normal” times. You might ask what normal times are? And that would be an astute query, with our answer being that the active position of the Federal Reserve (“FED”) and the various QEs (quantitative easings) do not represent “the usual” and favor rising prices in bonds, stocks and real estate!

Three years ago we published a list of dividend paying stocks that looked reasonably valued during a correction. We thought it would be useful to revisit those positions now to prove the point that a methodical, common sense approach can be very successful—and without multiple decisions and major shifts in strategy. As a basket of stocks, they outperformed the S&P 500 Index with lower volatility. Even today, their indicated yield is significantly higher than the S&P 500 Index yield and the 10 Year US Treasury yield.

	Dividend Yield	Price/Earnings 2010 (est.)	Dividend Yield	Price/Earnings FY1 (est.)	Total Return
Abbott Laboratories	3.65%	11.6	3.10%	13.0	55.7%
Altria Group Inc	7.03%	10.6	5.46%	14.6	84.6%
Chevron Corp.	3.83%	8.7	3.26%	8.6	82.3%
IBM Corp.	2.00%	11.5	1.78%	12.6	73.4%
Kraft Foods Inc.	3.90%	14.6	4.30%	16.2	57.0%
McDonald’s Corp.	3.13%	15.7	3.52%	16.4	48.1%
Merck & Co. Inc.	4.22%	10.7	3.65%	12.1	39.2%
Procter & Gamble Co.	3.11%	12.1	3.29%	17.5	23.4%
United Technologies Corp.	2.48%	14.7	2.74%	14.7	27.1%
VF Corporation	3.00%	13.4	2.23%	16.3	132.3%
Vodafone Group Plc.	7.46%	8.0	7.13%	11.1	55.2%
Waste Management Inc	3.75%	15.9	4.40%	15.2	12.3%
	<b>3.96%</b>	<b>12.3x</b>	<b>3.74%</b>	<b>14.0x</b>	<b>57.5%</b>
S&P 500 Index	<b>2.03%</b>	<b>13.9x</b>	<b>2.27%</b>	<b>13.9x</b>	<b>45.2%</b>
10 Year US Treasury	<b>3.30%</b>	<b>30.3x</b>	<b>1.63%</b>	<b>61.3x</b>	<b>49.4%</b>

**Source:** Telemet, Yahoo Finance

**Note:** The above list is for illustrative purposes only and does not represent a portfolio recommendation and should not be considered or relied upon as investment advice.

***“...perform careful planning and analysis to identify a level of return that meets client goals and take as little risk as possible to achieve the clients’ objectives...”***

***“Overall earnings in the third quarter so far seem mixed with cautious guidance on future growth.”***

***“The positive forces within our economy seem less prevalent in the media but may be no less significant than the hand wringing headlines...”***

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We are focused on the small, daily work and choices of managing risk as best we can while not giving up too much of the upside. We are somewhat boring and deliberate by design, trying not to fly into the sun. In an age when many clients are planning for concrete goals like building an income for retirement or for education costs of the next generation, we think more like a pension fund than a manager with a hot hand. We would rather perform careful planning and analysis to identify a level of return that meets client goals and take as little risk as possible to achieve the clients’ objectives, preferably with the income of the portfolio covering the majority of the goal’s expense.

### A Muddled Moment

Overall earnings in the third quarter seem mixed with cautious guidance on future growth. With the strength of the U.S. dollar, U.S. multi-nationals have found their profitability impinged by the relative strength of our currency. With the continued intervention of the FED with QE3 (quantitative easing’s third iteration), Bernanke has elongated his prediction for how long he will keep rates low—probably until 2015??? In addition, the FED has also agreed to buy \$40 billion of mortgage securities per month to keep interest rates low, in its attempt to fight unemployment by availing consumers and businesses to attractive lending rates. The argument against these tactics suggests that the money being printed and pushed out by the FED isn’t accomplishing its intended objective. Critics of the FED believe the problem is not credit availability but end demand; people and companies are buying less compared to years past.

The known negatives facing our economy remain: uncertainty in Europe, China growth slowing, Mideast tensions, the US election, how politicians will deal or not deal with the fiscal cliff. Besides the domestic Presidential Election, how the impending fiscal cliff is “resolved” will dominate the media (Google has over 74 million references) which may heighten investor anxiety at a time when investors are still wary about equities, even as equities are up almost 100% from the March 2009 low. The impact of the fiscal cliff is significant with \$600 billion in expiring tax cuts, new taxes and automatic spending cuts to take effect in 2013. It impacts everything from the across the board increase in tax brackets, higher taxes for dividends, capital gains, estates, AMT, etc. to substantial defense spending as a result of the failure of the deficit super committee last year. Obviously, the impact to the economy would be severe if nothing is done, which is unlikely. The real question is whether another “patch” is implemented in the short term while a more protracted but less volatile solution is worked out over many years (more likely).

The positive forces within our economy seem less prevalent in the media but may be no less significant than the hand wringing headlines: foreclosures down, housing turning up, consumer confidence increasing even as gas prices rise, small gains in employment, no runaway winners in elections (which is conservative for markets), billions flowing out of stocks and cash into bonds, which takes risk from equity but shifts it to fixed income securities, especially the longer dated maturities where the FED is feeding as well.

### What It Means for You and What is Shorepoint Doing

***“...expect that volatility will return to markets in the fourth quarter...”***

***“...‘big’ difference between market corrections, periodic 10% pullbacks, and a bear market in stocks...”***

***“...markets go up when worries are plentiful and not the reverse.”***

***“Our focus on income generation will lower portfolio risk as well as address a key cash flow need for many clients.”***

Although the market rallied in almost a straight line for the third quarter, we at Shorepoint expect that volatility will return to markets in the fourth quarter (experiencing it as we write this!). While the market may be due for a technical correction a la the speculations of firms like Goldman Sachs, we still think stocks remain attractive based on valuation - especially in comparison to most other asset classes (bonds and cash). The FED’s implementation of QE3, with 4, 5 and 6 to follow if needed, does further enhance the attractiveness of stocks. There is a “big” difference between market corrections, periodic 10% pullbacks, and a bear market in stocks, although it might feel the same at the moment it is happening. After all, the market climbs “a wall of worry” – in other words – markets go up when worries are plentiful and not the reverse. Think back to 2000 or 2007 – the media and investors were all bullish and the result was a bear market. In 1982 or 1987 or 2009 – investors were bearish and the equity market had significant increases. As Warren Buffett said,

***“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”***

However, Shorepoint is mindful of the prevalent macro issues in the markets which we consider when composing and managing client portfolios. Overall, we are defensively positioned although we have higher equity weightings than our target. First, our emphasis on dividends actually lowers the volatility of the equities in your accounts. Second, these stocks are attractively valued although we anticipate increased volatility and a more challenging growth environment. Third, these companies have excellent balance sheets and produce significant cash flow which can be used to raise dividends, buy back its stock and make strategic acquisitions. Fourth, stocks are hated (see our last Newsletter)! Also, as we look at risk, we are mindful of the risk in bonds and have reduced the allocation to lower yielding, higher valued bonds such as US Treasuries. Our focus on income generation will lower portfolio risk as well as address a key cash flow need for many clients.

We will be disciplined and use opportunities to position your portfolio for the future with consideration of your individual goals and objectives. As we have written previously, generally, our clients that ignored near-term market gyrations and stuck to their plan are ahead of where they were at the market peak in 2007 and those clients who either systematically or on pullbacks added to their portfolios are well above their previous peak. As always, we will continue to communicate our viewpoint, which will generally be contrarian in nature, and we are here to discuss your concerns.

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