PERKINS
INVESTMENT MANAGEMENT

# FOURTH QUARTER CIO UPDATE

**Jeff Kautz, CFA**
Chief Investment Officer,
Portfolio Manager

## Playing Strong Defense

The economic rough patch that has driven market volatility throughout most of 2011 intensified during the third quarter. Double-dip recession fears continued to mount, due to consistently high jobless claims, further housing price declines, weaker manufacturing activity and the government fiscal dysfunction constantly emerging out of Europe and the U.S. Collectively, these problems painted an incredibly uncertain and potentially negative economic picture – and the fact is markets simply don't act well in that situation.

Severe stock swings remained the norm, most notably when the S&P 500 Index fell 15.1% mid-quarter. The index also tumbled nearly 7% in the last half of September based on growing anxiety about the recent global economic malaise. Despite several short, sporadic periods of impressive gains, the index was unable to overcome these steep declines and ended the quarter 13.87% lower, with an 8.68% decline year to date. We expect there may be further downside to the market with the current economic and political challenges. Consequently, we continue to maintain a somewhat defensive portfolio stance, as we have for quite some time.

## Caution Ahead

Given these persistent economic headwinds, a double-dip scenario seems more likely than it did a few months ago, and we are now factoring in this increased probability into our downside price targets. Recent consensus gross domestic product (GDP) estimates have been consistently lowered and now hover in the 1.5-2% range, compared to the 3.5-4% range at the beginning of the year. We think the most probable outcome in this environment is a multi-year period of subpar 1-2% GDP growth that borders on stall speed as consumers and sovereigns continue to work through the deleveraging process. This type of tepid expansion could be easily derailed with the steady stream of market shocks that seems to occur with increasing frequency. Macroeconomic factors and rumors continue to dominate market moves, and investors should, at the very least, be prepared for a bumpy path ahead, since there is little indication of any data that might lift the economy to its much-needed escape velocity anytime soon.

Indeed, the opposite has proven true, with a growing risk of a negative feedback loop that could make a further slowdown unavoidable as more and more investors continue to finally acknowledge that the structural problems that plagued the financial crisis remain fundamentally unresolved. Consider the stubbornly poor employment data. Without marked improvement in this key area the chance for any recovery turnaround appears dim. Modest recent improvement notwithstanding, current headline unemployment is still 9.1%, only slightly lower than the 9.6% figure from August 2010. Even more troubling, the broader U6 unemployment rate, which includes marginally attached workers and those forced to work part-time for economic reasons, is closer to 16%. The employment outlook also remains bleak. The Congressional Budget Office projects the unemployment rate will only decrease to 8.5% by the fourth quarter of 2012 and not hit 5.3% until the fourth quarter of 2021.

This coupled with persistently slow housing sales and huge foreclosure and underwater mortgage overhangs could continue to restrict consumer spending levels, which in turn would likely call into question the sustainability of corporate earnings, as well as manufacturing and firms' reluctance to hire and invest in their businesses. While earnings have remained strong so far, the positive impact of corporate restructurings and cost cuts are waning, and comparisons get tougher in the quarters ahead without real revenue growth. It is unclear where this may come from unless consumers start to open up their wallets or companies are able to regain some degree of pricing power, both of which seem doubtful to us in the near term.

There's also growing awareness that the Federal Reserve (the Fed) has few, if any, tools left to lift the economy out of its doldrums. Interest rates can't go lower, and two rounds of quantitative easing (QE) have ballooned the Fed's balance sheet, with future expansion problematic in today's political climate. The recent "Operation Twist" (OT) may help reduce mortgage rates by flattening the yield curve, but a flatter yield curve doesn't solve the current underlying economic problems, in our opinion. In fact, OT may actually end up impeding short-term growth if it discourages banks from lending by moving long-term rates too low or prompts consumers to save more and spend less as short-term deposit rates start to rise. On the other hand, as financial institutions stretch for yield they might take inappropriate risk. And low interest rates are a considerable penalty to the retired generation. The Fed has understandably taken the philosophy that some sort of tinkering is probably better than nothing, but the reality is that each of its actions has had less and less impact. At this point, even Ben Bernanke is pointing to Washington and telling investors that monetary policy alone isn't going to fix this mess and that sound fiscal policy is also required.

Unfortunately, leadership out of Washington seems almost nonexistent at the moment. In addition to the political paralysis around the floundering economy, there's the very real issue that our country's debt level is simply too high. The U.S. government missed a real opportunity in the recent debt ceiling debates and chose political posturing rather than focusing on realistically addressing the country's tremendous fiscal problems. Even the loss of the coveted AAA credit rating failed to break the extreme partisan fighting, and the final agreed upon $1.2 trillion in budget cuts over the next ten years is almost meaningless as annual deficits exceed $1 trillion. At some point our elected leaders are going to have to make painful political and deleveraging decisions, and until that happens they are just kicking the proverbial can farther down the road. Hopefully, the problem won't be insurmountable by the time they decide to address it in a meaningful way. In the meantime, business activity is also impeded by the added uncertainty of an evolving regulatory environment.

The situation in Europe is even more concerning, with the crisis in Greece and the other PIIGS nations (Portugal, Italy, Ireland, Greece and Spain) at risk of spiraling out of control. European Union (EU) leaders have thus far been unable or unwilling to address the crisis head on in a unified and comprehensive manner. The outcome becomes very bleak if financially strong countries such as Germany get fed up and decide they don't want to be on the hook for their neighbors' past irresponsible fiscal decisions. Concerns also continue to revolve around the thinly capitalised European banking system, given the sizable number of European banks carrying the debt of these financially strapped sovereignties as well as the expanding volume of bad loans being uncovered. Layered on the problems of the U.S. and Europe is a slowing global economy and the risk of contagion. All in all, it just feels that some major event has yet to play out in this already bad situation, which just increases the general angst in the market.

## Near-term Uncertainty, Long-term Opportunity

With such a high level of uncertainty, it is hard to predict what may be in store short term for the markets. Long term, however, we remain extremely confident about our portfolios' reward/risk potential. The current volatility has helped us do what we believe we do best: invest in well-run companies, with strong balance sheets and attractive free cash flows, trading at attractive reward/ risk valuations. Too often we think investors ignore the risk side of this equation until it is too late and they are reminded how quickly the reward component can vanish. In the current climate, we believe assessing downside exposure and limiting absolute risk is more crucial than ever. There was a time not too long ago when a 1% daily stock market move was somewhat unusual. Now it happens fairly frequently, and it isn't unusual to see a 3-4% movement either up or down. With this level of volatility, we think there are certainly opportunities, but investors need to remain intensely aware of how much money they might lose if things continue to go awry.

The good news is that equity valuations continue to appear reasonable to us, even more so after the recent dislocation. In general, corporate balance sheets remain healthy, with many cash balances at over 6% of total assets, the highest levels since the 1960s. Merger and acquisition activity was increasing until the recent market disruption. The S&P 500 is trading at 12x forward earnings (and less than 15x S&P if earnings decline from the current $95 level to $80). For the first time in over 50 years the dividend yield of the S&P 500 is greater than the 10-year U.S. Treasury, and the likelihood is that the dividend will grow. Many stocks are now yielding in excess of 4%, offering an important return source even if appreciation remains muted. Still, we think it could be some time before the current down market reaches its bottom. While we have been selective net buyers, principally through smaller, incremental investments in higher-quality, lower-beta securities, we also now hold more than 10% in cash across portfolios as we patiently wait for greater clarity in the economic environment or an extreme negative market reaction to offer more compelling reward-to-risk opportunities.

Despite a more highly correlated market in which stock selection is more difficult, Perkins continued to deliver value to our clients in the recent quarter when our portfolios once again outperformed. Seeking to preserve capital in difficult stock environments is nothing new for us. Extensive risk analysis has been embedded into our disciplined research methodology for more than 30 years. In fact, we focus on downside risk and how far a stock price might fall before considering its upside potential. This distinctive investment process has helped our portfolios deliver stronger risk-adjusted performance over the long term. By seeking to protect against losses in market declines and capture solid absolute returns during market rallies, we believe we have been able to maximise the effects of compounding and deliver attractive performance across full market cycles relative to our portfolio benchmarks and peers.

As we move through this turbulent period, we want to thank you for the confidence you have placed in Perkins Investment Management. Our investment team is firmly committed to our value discipline and remains heavily invested in our strategies. We look forward to providing strong performance on all of our behalf for many years to come.

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