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Outlook and Strategic Discipline

I recently shared the following synopsis of our current thinking with a client. Now I want to share it with all of you, with a few changes to broaden its relevance.

- Economic outlook continues to improve as businesses and consumers emerge from their bunker mentality, but weakness in employment and housing markets won't go away anytime soon.
- Fiscal woes at the state and municipal levels will dampen the recovery.
- Accordingly, central bank policy will stay accommodating to keep recovery from stumbling; short-term interest rates remain low.
- Longer-term interest rates will continue to drift higher so long as US Federal Reserve pursues loose money policy to pump up the stock market.
- Inflation at the commodity level threatens further instability abroad (particularly in emerging markets, where food/fuel comprise a greater proportion of household budgets), and compounds hardship at home.
- Input-cost inflation threatens corporate profit margins as companies have trouble passing along costs to still cash-strapped and credit-shy consumers.
- Credit excesses of prior decade will play out increasingly on government balance sheets in the Eurozone, UK and USA; this is a fundamental, systemic risk factor which has the potential to shock values across all asset classes.

In keeping with the above, we aim to:

- Scour equity markets for high quality stocks with 1) free cash flow patterns that remain robust across the business cycle, 2) low reliance on the debt and equity markets for new capital, 3) sustainable competitive advantages that afford margin protection, and 4) track records of increasing dividends at a rate greater than inflation.
- Scour bond markets for significant mispricing that can result from indiscriminate reallocation away from bonds toward stocks; this may entail investing to the areas worst-hit, including Treasuries and municipals.
- Build inflation resistance into portfolios via increased exposure to energy stocks, Treasury Inflation Protected Securities (TIPS), and precious metals and mining positions.
- Increase foreign allocations on weakness (equity and fixed income alike) to diversify against deterioration of the US dollar's status as global reserve currency.
- Hold fast to our discipline of not overpaying for assets just for activity's sake (i.e. deploying cash just to be "doing something").
- Be willing to forgo speculative gains that risk permanent destruction of client capital.

And a final thought:

- The last few years have delivered some nasty black swans (unanticipated, low probability/high consequence events); are we on the verge of a *positive* black swan in the Middle East? It's tempting if premature to ponder how a changing power structure in the Arab world could transform major geopolitical and macroeconomic forces for the better.