Market Commentary

Third Quarter 2011

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we'll get there together

The third quarter of 2011 will not be remembered fondly by investors. The summer months saw a sharp increase in volatility, rapid declines in interest rates, and negative financial headlines on a seemingly daily basis. The benchmark S&P 500 index declined by 13.87% on a total return basis. This brings the year-to-date decline to 8.68%. The bulk of the decline in the quarter occurred in a two week stretch beginning in late July. Catalysts for the sharp sell-off were concerns over the European debt crisis, fears of a US government shutdown, and Standard & Poor's first ever downgrade of the US credit rating. Over 11 trading days, the S&P 500 declined by an astounding 16.8% – one of the most rapid declines in many years – before stabilizing and moving higher.

Fixed income markets continued to rally as investors continued pouring money into bonds of all types. US Government bonds moved dramatically higher in price during the quarter (yields move inversely to price). The benchmark 10-year U.S. Treasury note saw its yield decline from 3.18% at the beginning of the quarter to an astounding 1.93% on September 30. Bond investors are showing no signs of deserting fixed income securities despite the fears of European default, US budget problems, and economic uncertainty. We continue to concentrate on shorter-term, higher quality debt instruments to help protect against principal fluctuations. Interest rates over the longer-term are much more likely to move higher from here than lower, and we will not sacrifice principal risk in search of a slightly higher yield.

Our Outlook

Although volatility is not a welcome addition to the investing equation, we remind investors of the specific role that equities play in their portfolio. Equities are not purchased to ensure a good night's sleep each day. Rather, they provide investors with one of the best forms of protection from long-term inflation. Although we haven't faced significant inflation in the past two decades, inflation remains a much larger threat to long-term financial gains than volatility will ever pose. It is clear there is a noticeably high level of investor "frustration" over the past few months. Those that did not raise cash at the yearly highs are upset. Those that raised some cash are upset they didn't raise enough. Lastly, those that panicked and sold it all near the bottom are frustrated they have missed the recent move upwards. We do not believe in market timing and feel that a well-designed portfolio with proper asset allocation and periodic rebalancing will lead to better returns with less emotional decision-making.

While we had predicted the President and Congress would agree to increase the debt limit and thus prevent the US government from entering default, we did not foresee how ugly the process would become. The squabbles between the legislative and executive branches have been detrimental to nearly all involved, including citizens and investors. This current fiscal crisis in the US was avoidable and was brought to us by incompetent and cowardly leaders on both sides of the political aisle. Unless, and until there are meaningful policy shifts, and the leaders of our country begin to act as elected leaders rather than partisan bickerers, there will be no real improvement in the economy or the financial system of our nation. We would note that many European countries have been able to implement economic reforms that would have been unheard of even two or three years ago. These reforms, while very painful, will help secure and improve the potential for long-term economic growth. Ireland is the furthest along in these actions and we hope other nations will follow.

Warren Buffett has made significant news during the past few months claiming again that he paid taxes at a lower rate than his secretary. While we acknowledge Mr. Buffett's investing acumen, we take issue with his "sound bite" mathematics. Mr. Buffet says he paid only $6.9 million in taxes last year. But Berkshire Hathaway, of which Mr. Buffett owns 30%, paid $5.6 billion in corporate income taxes. Were Berkshire Hathaway a Subchapter S corporation as are many small businesses; and thus exempt from corporate income taxes, Mr. Buffett's personal tax bill would have been 231 times higher, at $1.6 billion. We don't believe he would be asking to pay more taxes were so much of his current income not in taxadvantaged capital gains and municipal bond interest.

While the financial system of both the United States and the broader global economies are under scrutiny, we continue to see a vast improvement versus late 2008 when the financial system almost broke under tremendous and unanticipated stresses. The current focus is Greece, and while we believe Greece has significant financial issues to deal with, we do not see this becoming a global contagion. There are hopes for a possible near-term resolution to the Greek crisis, although this has been discussed for several months now with no solution. Those who compare Greece to Lehman Brothers in 2008 are missing an important point. Greece has been in serious trouble for years and a number of governments and institutions are working daily to resolve the problems involved. Conversely, Lehman's potential bankruptcy was not even discussed until a few days before it ultimately happened. This unexpected event caused significant and widespread disruptions through the global financial system primarily because it was so unexpected.

Portfolio Positioning

Client equity portfolios continue to move towards higher-quality companies. We continue to believe that a second recession will be avoided, although growth may remain quite muted into 2013. To best protect against negative growth surprises; larger, high-quality companies with strong balance sheets and proven business models have been added to client portfolios. Fixed income portfolios remain very short in duration and highly concentrated in the strongest credits due to the paucity of yield increases available in longer or lower-quality offerings. As we head into the last quarter of 2011, political headlines will increase and remain with us through the November 2012 elections. We believe markets will begin to be affected by political polls as we move through 2012.

Conclusion

This is not the first time we have heard news stories bemoaning the negative issues facing America. It has occurred more than once in the past quarter-century alone. Through each instance, the American spirit has rallied and brought the country and the US economy to even greater heights. Human desire, potential and ability are the greatest assets we have. The US system – with few exceptions – is the greatest in the world for harnessing these capabilities. We admit the future does not look particularly promising currently, but we believe in the American dream today as much as we did 10, 20 and 30 years ago.

It currently looks like the last quarter of 2011 will see volatility and shifting economic winds continuing.

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The political rhetoric will also increase as we move towards the 2012 election. Our early look into 2012 is cautiously optimistic based on our belief that some of the current headwinds facing investors may be resolved. Yields on fixed income securities should remain extremely low at least into 2013. Equities remain undervalued based on earnings multiples, cash flow yields and compared to almost every other asset class. Our current forecast is for forward 12 month returns approximating the long-term average for equities of about 10%.

In closing, we thank you for the trust you place in us at Tandem Wealth Advisors. We strive to earn your trust and loyalty every day. We are here to help you and encourage dialogue between us. If you have any questions or comments, please do not hesitate to contact us.

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