TFC Financial Management

October 7, 2011

QUARTERLY INVESTMENT LETTER – Q3 2011

Investing for the Long Term in Free-Market Economies (Is the Risk Worth the Pain?)

The quarter just ended and this year have been a difficult period for all—investors, money managers, anyone whose personal net worth is importantly tied to the equity markets. Year-to-date through September 30th, U.S. stocks (S&P 500 Index) have declined 16% from their peak values in April; worldwide the MSCI All Country World Index slid 20.5%; Emerging Market equities are down 25.8%. Globally, equity market volatility is moving back toward levels experienced in late 2008, early 2009 (see attached chart).

Investment market psychology continues dour. The Euro-debt and bank capitalization drama deepens. Questions abound about China's ability to sustain its strong GDP growth rate and continue to expand consumer spending. In the U.S., economists are busy revising their assessments of this year's output of goods and services (GDP). Although most such prognostications are being tempered downward, the majority of macro economists still expect slow growth in the U.S. and internationally this year and next. At the moment, a double-dip recession economic scenario seems not to be a prospect. But U.S. equity markets teeter on the edge between a mere "correction" (i.e., a decline of 20% or less from previous peak) and a Bear Market call (i.e., off more than 20%).

Since the domestic equity stock market is one of the leading components in the macro-economic equation, the question of how accurate it is in anticipating recessions is relevant. The oft-quoted retort is that the stock market has predicted nine of the last seven recessions. In fact, history reveals that since WWII equity bear markets have preceded recessions in all but two instances (1969 and 1990). So the behavior of the U.S. equity markets during the next few weeks requires close scrutiny. But even if a Bear Stock Market call seems warranted, the lesson from history indicates an economic recession doesn't necessarily follow.

The Key Driver: U.S. Corporate Earnings

In today's disappointing economic environment, the big question becomes whether U.S. corporate earnings projections will need to be revised downward? Without, we suspect, any really in-depth fact-checking, some media pundits are beginning to quote "analysts" who are supposedly dramatically reducing their 2011 and 2012 earnings forecasts. To begin with, there is always at best a certain amount of windage in such forecasts. But since the case for equities hangs so heavily on the ability of U.S. corporations to weather this economic storm and emerge with profitability still intact, careful attention needs to be paid to the corporate earnings outlook.

Our sense is that some moderation is called for. Decision Economics, one of our sources for the macro-economic outlook, has dropped its S&P 500 Index company earnings projection from $98 to $95 for this year, and from $110 to $105 for 2012; not a severe departure from its established outlook--but the media beat will continue to question this assumption. Our portfolio strategy presumption is that the recent disconnect between GDP growth and corporate earnings improvement will persist (i.e., GDP will expand slowly and corporate earnings will continue to rise at a slightly greater rate).

Piled onto all this evident financial market pessimism is the ever-present vulnerability of our economy to more policy misdirection inflicted by our bloviating political class (e.g., the current proposed Senate bill imposing tariffs on Chinese imports). The self-serving maneuvering in Washington these past few months has done little to reassure the average voter (investor) that the country's best interests, first and foremost, are driving the political process. Difficult political-economic decisions remain to be taken. In many ways, for the U.S. economy, the 2012 elections are perhaps the most important in decades.

But it goes without saying that the global financial markets are aware of all this. In their information-discounting mode, the investment markets may have become so sensitized to the continual outpouring of negative news that they could be vulnerable to unanticipated positive surprise data or information. Even if 2011 earnings for the S&P 500 Index should fall short of current expectations, today's market multiples value the average company at very reasonable price-earnings levels.

As we discussed in our last quarterly letter, throughout our interconnected global financial markets, computerized, high-frequency trading fans the flames of volatility and responds to the constant menu of concern served up by the media. With every institutional trading desk worldwide tuned to CNBC and all sharing data through ubiquitous Bloomberg terminals, and hedge funds speculating in a dizzying assortment of financial instruments, increased volatility will continue to be the result well into the future.

In this week's *Wall Street Journal*, we learned that Black Robe Capital Partners is raising capital to securitize participation in the outcomes of high stakes litigation. Your friendly broker may soon be calling upon you, offering a pre-packaged chance to speculate on the outcome of a trial before TV Judge Judy? Financial engineering in the extreme . . . is the stock in trade from Wall Street. Hopefully, interest in such investment vehicles will be confined to "sophisticated" investors.

Your (Our) Investment Goal: An Inflation-Adjusted Annuity Throughout Retirement

At times like the present, it's often useful to re-examine long-term personal objectives and plans and reaffirm portfolio strategies decided upon previously in times of less stress. The temptation is always to adjust one's approach in light of current market circumstances, or perhaps is prompted by the out-performance of some flavor-of-the-month asset class or newly discovered Wall Street conventional wisdom. Such discussions are usually motivated by the feeling that "it's different this time," so it's probably useful to examine just how the current situation differs from those more traditional slow growth economic settings and drivers of past decades.

Of course, *it is different this time*. The investment markets, and to a great extent our economy today, are hostage to a weakened banking system and financial services sectors, as well as burdened by public and personal balance sheet deleveraging requirements, perceived income and wealth disparities, and unemployment levels which threaten political stability. As pointed out in previous letters, much of this over the past decade has been priced into the equity markets as participants (investors and speculators) adjusted expectations and voted with their capital funds. For the aggregate of average investors, the result of this has been a gradual capital migration from equities to fixed income securities, a reduction in stock market valuations from 26x earnings in 1999-2000 downward to today's 11x prospective earnings, and a decline in 10-year U.S. Treasury bond coupon rates from 6.5% to 2.0% today; (i.e., as U.S. corporate earnings grew, equity P/E's declined, as reflected in a flat market in stocks, and the bull market in bonds seems to be concluding).

During the past 12 years, for bonds the decline in short rates to virtually zero coupon levels (in some instances presently short U.S. Treasuries offer a *negative* real rate of return) has meant the end of the 30-year bull market for bonds. In such fixed income market circumstances, one might be tempted to shop for improved assured rates offered by insured fixed or variable annuities. But for some of the same reasons that bonds today appear to offer sub-par total return prospects, fixed annuities are unattractive, not the least of which is their internal cost structure.

Today, for the first time in perhaps 30-50 years, one can say there is a high probability that in the future stocks will out-perform bonds. Only rarely have the odds so favored equities. With 10-Year U.S. Treasury bonds at present providing only a 2.0% coupon, U.S. large company stocks (paying out average dividend returns of 2.3%, and providing earnings yields of 8%) offer the prospect of variable annuity-like inflation-adjusted future payment streams not available for decades. To be sure, there is added risk (volatility) in shifting portfolio strategy back toward greater equity participation. But as Charley Ellis* suggests in his recent book, *The Elements of Investing*, . . . "Rebalance to the asset mix that's right for you . . . and stay the course and ignore market fluctuations; they are likely to lead to serious and costly investment mistakes. Focus on the long-term."

*Charley has agreed to speak at our mid-June 2012 client reception and book-signing. *The Elements of Investing* is co-authored with Princeton Professor Burton G. Malkiel.

A Recap of TFC's Portfolio Strategy for Third Quarter 2011

"It is clear that, overall, the recovery from the crisis has been much less robust than we had hoped. We have also recently seen bouts of elevated volatility and risk aversion in financial markets, partly in reaction to fiscal concerns both here and abroad." *Chairman Ben S. Bernanke before the Joint Economic Committee, U.S. Congress on October 4, 2011.*

During this past quarter, heightened fears, extreme risk aversion and pessimism once again took hold, and investors sold off equities in favor of U.S. government bonds. The yield for a 10-Year U.S. Treasury bond fell to a record low of 1.7% in August and equities were down across the board. Unfortunately, during crisis periods and down markets, equity correlations tend to increase and there are no safe havens except for cash and U.S. government bonds.

Fixed Income:

Our short duration, high quality fixed income structure continues to provide principal stability, liquidity, and modest income, which has helped to offset the volatility and recent decline of global equity fund values in portfolios. The Barclays Intermediate Government/Credit Index gained 2.5% during the quarter.

In tax-deferred and tax-exempt accounts, we recently reduced clients' holdings in Treasury Inflation Protected Securities (TIPS) and reinvested the proceeds in shorter duration global bond funds. This change was made since the current real yield of the Vanguard TIPS Fund has turned negative despite the fact that total return is over 10% this year. Current yield on the reinvested funds, as a result, will improve slightly.

Please note that our fixed income portfolios have no direct sovereign debt exposure in Greece, Spain, Portugal, Ireland, or Eurozone bank paper, nor do any of our short-term money market funds.

Equities:

Perhaps surprisingly longer term, despite the sharp global market declines of recent weeks, the MSCI All Country World (Equity) Index has rebounded by over 70% since its trough in March 2009. At present price levels, global stock markets are selling at price-to-earnings valuation multiples of 11x prospective earnings and only at 12.4x trailing (past/actual) earnings. Both measures are low and very attractive in absolute terms and relative to long-term averages, particularly in a low interest rate environment.

The latest economic forecast from the IMF in September projects global growth at 4% for 2012 (reduced from 4.5% in June 2011), with advanced/developed economies expected to grow at 1.6% and emerging economies at 6.4%. Therefore, global corporate earnings should increase also, albeit unevenly among countries and regions.

Despite solid corporate fundamentals (strong balance sheets, large cash reserves and high profit margins) and low valuation multiples, negative investor psychology (often irrational and emotional) can override logic and rational behavior. When there is further clarity, if not a resolution to the European sovereign debt crisis, and other less dire economic news in the U.S. and worldwide, we expect stock prices to begin to stabilize, then recover and rise again.

The top panel of the attached chart reflects performance of the MSCI All Country World (Equity) Index over the past four years since the previous market peak of October 2007. The bottom panel reflects the daily returns of the Index during the same time period. These charts illustrate a few important lessons: attempting to time market peaks and troughs is very difficult; market volatility is likely to remain elevated during the initial rebound period (as it was in 2009); and missing several critical up-market days could significantly prolong a portfolio's recovery period and reduce long-term returns.

In uncertain times and for the long term, we believe the most effective and optimal strategy continues to be investing in globally-diversified (economic, currency and market), multi-asset class portfolios and maintaining a disciplined rebalancing strategy in rising and declining markets.

As always, we welcome your comments and questions.

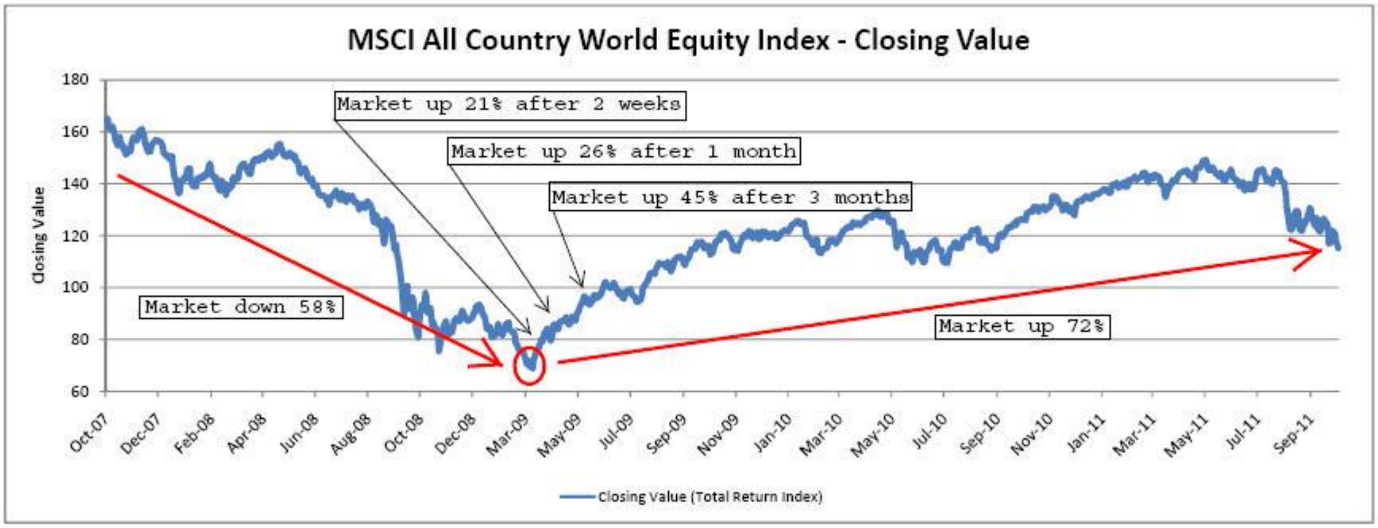
Sincerely,

Jim

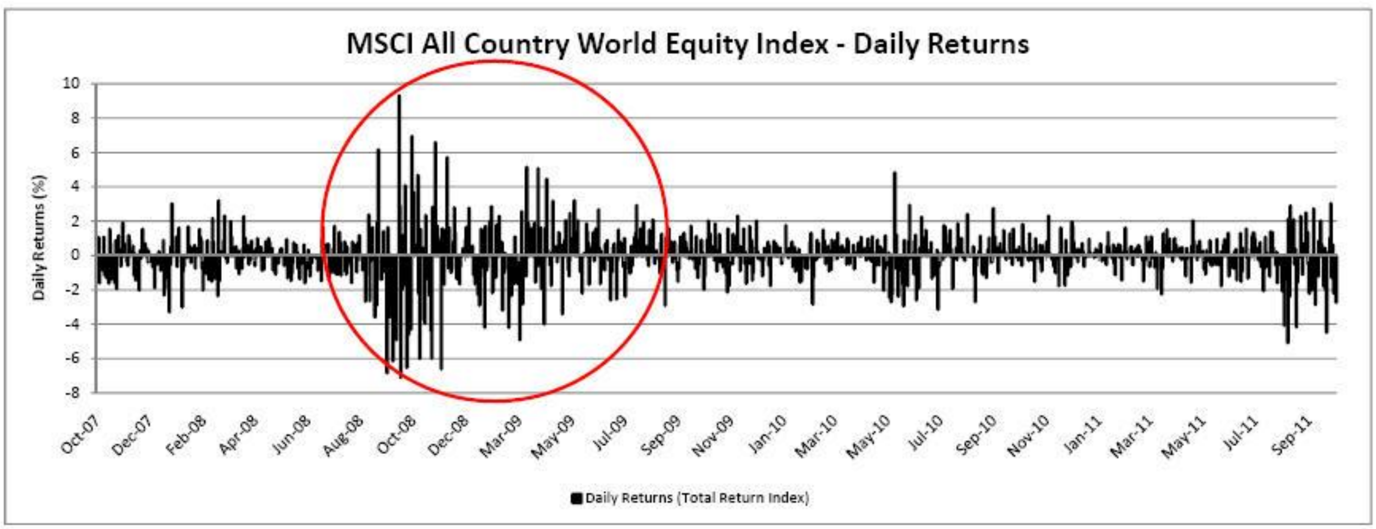
James L. Joslin
Chairman, CEO & CCO

Renée

Renée Kwok
President



MSCI All Country World Equity Index - Closing Value
Market up 21% after 2 weeks
Market up 26% after 1 month
Market up 45% after 3 months
Market down 58%
Market up 72%
Closing Value
Closing Value (Total Return Index)



MSCI All Country World Equity Index - Daily Returns
Daily Returns (%)
Daily Returns (Total Return Index)