FOR YOUR INFORMATION

*An Investment Newsletter from*
*Monticello Associates*

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# "Friends, Romans, Countrymen"

He was an unlikely author and playwright. The son of an itinerant glove maker from rural England, he would ultimately proceed to craft almost forty plays and over 150 sonnets, many of which are still produced by theater companies throughout the world.

William Shakespeare was born in 1564 in the town of Stratford-upon-Avon. His youth is a bit of a mystery and by the early 1590's he arrived in London becoming an actor -- notably at the famed Globe Theatre. Over the next twenty years, he steadily wrote the plays that made him the most famed writer in the English language today. Shakespeare wrote comedies, histories and tragedies, but the tragedies were responsible for the strength of his reputation. After all, who hasn't seen or read *Hamlet*, *King Lear*, *Othello*, *Macbeth* or *Romeo and Juliet*.

Shakespeare died in 1616 and was respected during his lifetime, but he really catapulted to the list of the world's greatest writers during the 19th Century – a full two hundred years after his death. His plays are performed and published in every country in the world and virtually anybody you know can recite a line or two.

The historically stunning thing about Shakespeare is we are not sure if he actually wrote the plays. A massive conspiracy theory has developed over the past one hundred years concerning William Shakespeare's suitability as an eminent author.

However, the evidence is mostly circumstantial and has never been proven. The conspiracy theorists, who break into many divisions dependent upon whom they believe authored the plays, have based their theory upon the fact that Shakespeare; did not attend college, never left England, had illiterate parents, had two daughters who also could not read or write and began his stage career as a relatively insignificant actor.

I admit I find it pretty strong evidence that the world's greatest author had children who signed their name with an 'X', but so be it. The equally interesting question is who may have written the plays if they were not authored by Shakespeare. Francis Bacon, Christopher Marlowe, the Earl of Oxford and the Earl of Derby are all candidates. A recently released movie *Anonymous* focused exclusively on Edward de Vere, the 17th Earl of Oxford. I should note that **all** of the historical evidence points to William Shakespeare as the author, but it is fascinating to think someone may have pulled off one of history's greatest hoaxes.

Well, regardless who wrote these plays, they are exceptional. Everybody probably has their favorites, but mine is *Julius Caesar*. I first saw *Julius Caesar* in Junior High School and I've seen it many times since – it is a pure gem. *Julius Caesar* has always been one of Shakespeare's more popular plays, and it is said that even Abraham Lincoln consoled himself nightly by reading *Julius Caesar* during the difficult years of the Civil War.

*Julius Caesar* has many great scenes, but Mark Antony's Funeral Oration can't be beat for drama. After all, when you begin a speech, *"Friends, Romans, countrymen, lend me your ears; I come to bury Caesar, not to praise him,"* you've certainly grabbed the audience's attention!

What is great about the funeral oration is that after telling the mob assembled in Rome at the burial of Julius Caesar that he was there to quickly bury Caesar and not to praise him, Mark Antony spends five minutes doing nothing but praising Caesar and whipping the crowd into a pro-Caesar fury.

For some reason during the turbulent months of August and September, I began to think about Mark Antony's Funeral Oration and stock market volatility. To state the obvious, investors have not had it easy the past four years.

The horrific year of 2008 stands out as a monument to portfolio destruction and frazzled nerves. 2008 was the single most difficult year for investors in over seventy-five years, as virtually nothing was left standing in its wake. Every single stock market index plummeted between 30% and 70%. The Dow Jones Commodity Index fell almost 60% in the last six months of the year alone. Emerging markets suffered the most as Russia tumbled 78%, China fell over 60% and India dropped 59%.

Equally disturbing, was the amount of volatility that accompanied these losses. Market volatility reached its highest levels in modern market history as days with 500 point drops on the Dow became commonplace. As volatility soared, margin calls increased dramatically forcing mass liquidations across every asset class.

Consequently, investors became frightened of volatility and fled equities and many have never returned. In the *aftermath* of the crisis, "clever" Chief Investment Officers explored tail risk hedging strategies in an attempt to isolate only the upside and eliminate the downside.

Unfortunately, August and September of this past year hit the replay button on all of 2008's fearful and sordid investor emotions. Stocks plummeted as the S&P 500 fell 17.8%, emerging markets lost 25% and the EAFE index declined 20.6%. Losses were even greater among individual countries as India and Brazil fell more than 20%, Austria dropped 38% and Greece plunged almost 50%. Commodities once again failed to offer much desired and meaningful diversification, declining over 20% from their late spring highs.

As with the financial crisis of 2008, it was the volatility that really stung investors. The months of August and September saw the greatest levels of equity volatility, other than 2008, in the past fifty years. The VIX soared, almost tripling during this period. Importantly, just as in 2008, the intra-day volatility reached levels that were brain-numbing. For example, over the past twenty years, 72.9% of the daily moves of the S&P 500 have been plus or minus one percent or less. From July onward this number, which has been fairly constant over stock market history, dropped to 45.2%. Not surprisingly, if lower volatility days were substantially reduced, then higher volatility days were much more frequent. In fact, the number of trading days during the second and third quarter in 2011 that were up or down 2% to 3% went up more than 3 times (5.0% to 19.2%). Additionally, the number of days that moved plus or minus 3% or greater escalated more than 5 times the historical average. In August, the Dow Jones went up or down more than 400 points four consecutive days in a row!

These jarring days were, just like in 2008, accompanied by soaring correlations. The correlations between company stock prices reached an all-time record high (even eclipsing those of 2008) of almost 90%. This statistic is very harmful for investors as it indicates that company fundamentals didn't matter as almost every stock in the Standard & Poor's 500 was moving in the exact same direction on each and every trading day.

It now seems individual investors continue to flee the stock market, having been net-redeemers of equity mutual funds since 2004 and having just survived two of the most volatile periods in stock market history during the past four years. It would be a very simple exercise to *"bury volatility"* as Mark Antony attempted to bury Caesar. Who wants volatility? Who would be a witness for the defense of volatility if volatility were on trial? Who would want more volatility at this point in time?

But is it so easy to avoid volatility? And should investors avoid volatility? I don't think so and actually believe volatility should be praised.

**Volatility is a primary driver of excess returns.** In the table below, you can see the historical annualized returns and volatility levels, as measured by standard deviation of the three primary U.S. asset classes:

| U.S. Asset Class Returns 1926 - 2010 | | |
|---|---|---|
| | Return | Volatility/Risk |
| Treasury Bills | 3.6% | 3.1% |
| U.S. Fixed Income | 5.7% | 7.0% |
| U.S. Large Cap Stocks | 9.9% | 20.4% |

As you can see, bonds have had higher returns and higher volatility than treasuries, a risk-free asset, and stocks have had higher returns and more volatility than bonds. Furthermore, if we were to add higher returning assets this relationship remains intact.

| Asset Class Returns Inception - 2010 | | |
|---|---|---|
| | Return | Volatility/Risk |
| Large Cap U.S. Stocks | 9.9% | 20.4% |
| International Stocks | 10.9% | 27.1% |
| Small Cap U.S. Stocks | 12.1% | 32.6% |
| Emerging Markets Stocks | 12.5% | 33.9% |

Inception is defined as the longest time period for which results are available.

As historical returns rise so does volatility. **The reason for this is that volatility drives returns. Generally speaking, without volatility there are no excess returns. The reason for this is that markets actually go up much more frequently than they go down. Over the past 90 years stocks have appreciated in 72% of the calendar years. Therefore, because there is such a positive skew to the data, the more volatility you have over time the better your investment results should be.**

Consequently, the question shouldn't be whether the long-term investor should avoid volatility because they clearly shouldn't, but whether the long-term investor should be avoiding volatility *in the near-term*.

Fortunately, the answer to this question is relatively simple. While markets in the very near-term tend to be excessively driven by sentiment that is propelled by a myriad of factors including politics, the global macro environment and random corporate events, the most important factor when projecting future returns is current valuations.

If I have learned one thing in three decades of investing it is that the most common determinant of investment success is valuation levels. If you have an opportunity to purchase a security or asset class at historically low valuations your probability of success increases dramatically. Alternatively, if your entry point valuation level is high your probability of failure rises and your likelihood of a much lower future return becomes almost a certainty.

If investors had to have one factor on their side in making investments it should be valuation. Low valuations create a cushion that generally results in lower volatility and greater investment success.

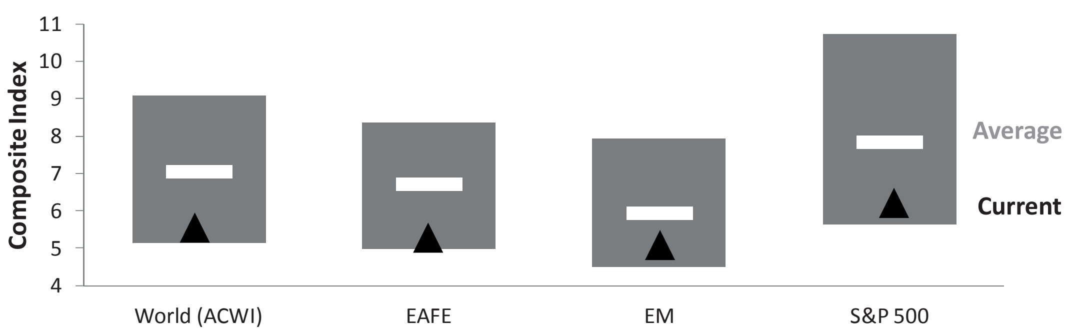
Famed Columbia Business School Professor, Benjamin Graham authored much of the original work in the investment field on the subject of valuation. In addition to creating the term *"Margin of Safety"* Graham was the author of two legendary investment textbooks that dealt primarily with the subject of valuation: *Security Analysis*, co-written with David Dodd in 1934, and *The Intelligent Investor* published in 1949. Both books are still in print and remain mandatory reading for any serious student of finance. Graham was a popular professor at Columbia and his classes became legendary, baptizing many formidable investors including Warren Buffett.

Graham believed in investment, not speculation. He also loved free-cash flow and dividend yields. However, he mostly coveted the chance to buy stocks cheaply as that was instrumental to investment success in the long-term. *"Operations for profit should be based not on optimism but on arithmetic"* summarizes his views on this subject.

Well, if investment arithmetic matters, and it's my opinion that it certainly does, then investors should be relatively optimistic as it's been almost three decades since equity valuations have been this attractive.

The following graph depicts a current valuation matrix for each of the four major stock market indices. The valuation criteria are an equally weighted composite of four fundamental metrics: price to forward earnings, price to current book, the last twelve months cash flow and price to last twelve months' dividends. Once these variables are calculated we've created a bar graph outlining the last ten years worth of these valuation statistics.

## Global Equity Valuations




| | Current Composite Index | Current | | | | 10-Year Average | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Fwd. P/E | P/B | P/CF | Div. Yld. | Fwd. P/E | P/B | P/CF | Div. Yld. |
| World (ACWI) | **5.7** | 10.6 | 1.6 | 7.8 | 2.9% | 13.8 | 2.1 | 9.8 | 2.4% |
| EAFE | **5.5** | 10.3 | 1.3 | 6.8 | 3.8% | 13.5 | 1.8 | 8.6 | 3.0% |
| EM | **5.2** | 9.4 | 1.6 | 6.9 | 2.9% | 10.8 | 1.9 | 8.6 | 2.5% |
| S&P 500 | **6.2** | 11.3 | 2.0 | 9.1 | 2.2% | 14.6 | 2.6 | 12.2 | 2.0% |

*Data as of 12/31/2011*

• Current Composite Index: Each valuation index shows an equally weighted composite of four metrics: price to forward earnings, price to current book, price to last 12 months' cash flow and price to last 12 months' dividends.
•The grey bars represent valuation index variability over time.

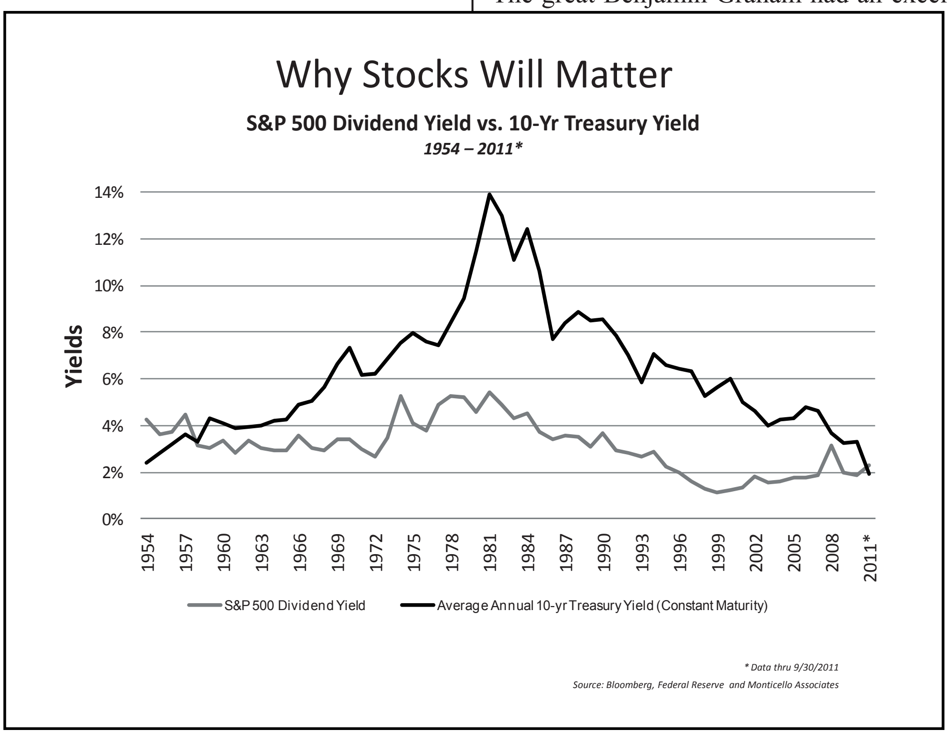
*Source: Bloomberg, MSCI, BofA Merrill Lynch and Monticello Associates*

Clearly, stocks are as inexpensive as they've been in over ten years and by a considerable margin. This is even more stunning when you reflect back that ten years ago the forward price earnings multiple for the Standard & Poor's 500 was over 30 times earnings. History would suggest that when you initiate an investment at 30 times earnings your probability of success, defined in this case as future returns, goes down dramatically. Thus, it comes as no surprise that the ten-year compounded return for the S&P 500 from the third quarter of 2001 through the third quarter of 2011 is only 2.81%, well below the historical average of 10%.

Today, however, the opposite situation has developed. As the previous graph illustrates, every single one of the world's four primary indices are selling at a substantial discount to historical valuations. The S&P 500 is selling at 11 times earnings, emerging markets are selling at 9 times earnings and the EAFE Index is selling at a little over 9 times. Benjamin Graham would be thrilled as these clear-cut cheap valuations offer investors his famed *"Margin of Safety"* at a level that has not existed since the 1979 – 1982 period.

Having established stocks offer today's investor a compelling opportunity based upon historical valuations, it's also worth examining the historical relationship between equities and fixed income. It's a fact that there is a finite amount of capital in the world available for investing. To have an asset class appreciate there simply needs to be more demand than supply. There has been plenty of demand for fixed income during the past decade as interest rates plummeted and stocks wallowed. Not surprisingly, bond returns have been robust as cash has flooded the fixed income markets.

The following graph displays the historical relationship between the yield of the ten-year Treasury and the dividend yield of the S&P 500. As you can see, stocks currently have a slightly higher yield than the ten-year bond. The last time this happened was 1958! For over fifty years investors could place money in bonds, knowing that the annual cash income they would receive was much higher than the dividend yields offered by equities.




The recent underperformance by equities has allowed equity yields to rise, once again allowing investors another dollop of Graham's *"Margin of Safety."* After all, given the chance to purchase equities at the same yield as bonds allows investors to transfer assets from a stunningly over-valued asset to historically undervalued equities. Moreover, fixed income offers investors little protection from the future threat of inflation at these yield levels, while equities have historically provided an attractive return after subtracting inflation.

Importantly, investors are now being offered the opportunity to invest in equities at a valuation level that hasn't been seen in many years and at a point in time where many of the world's leading businesses offer a combination of free cash flow, dividend yields and profit margins that are very impressive.

Yet, many investors today have little or no interest. Individual investors have once again been net redeemers of equities. In fact, since 2007 investors have pulled more than $300 billion from equity funds while placing almost $800 billion in fixed income funds – a shocking differential of over $1 trillion. Hedge funds are hunkered down with historically low exposures, demanded more often than not by their risk-averse institutional clients. Cash levels remain at or near record highs and fixed income mutual fund sales remain at or near record highs. The volatility of the past four years clearly has terrified investors. Clever Chief Investment Officers are seeking to hedge entire portfolios by buying extravagantly expensive put protection, in some cases spending 3% - 5% annually to "hedge" the portfolio. As I am writing, our local paper, *The Denver Post*, has just released its investment outlook for 2012. Predictably, the headline reads *"Investors Brace for Rocky 2012."*

The great Benjamin Graham had an excellent analogy for this type of situation. Graham created a mythical character named *Mr. Market* in an attempt to deal with the emotional swings of investors.

According to Graham, *Mr. Market* shows up every day at an investor's office offering a different price than the previous day's offer. Some days *Mr. Market* is wildly optimistic and bears little relation to the facts (think 1999). Other days *Mr. Market* pops up in your office and is depressed -- very, very depressed (think 2012). *Mr. Market*, in the down state of his volatile manic existence, has little or no interest in your shares. He may, reluctantly, provide you with a quote for your company, but due to his actually depressed state it has little to do with reality and will be dramatically lower than the facts would suggest.

Graham loved *Mr. Market*, because it offered investors the opportunity to profit from these wide discrepancies by buying shares much lower than they should be priced in a rational world. Graham urged investors to focus exclusively on fundamentals, not on sentiment. He frequently stated that, *"In the short-term the market is a voting mechanism and in the long-term it is a weighing mechanism."* In other words, for a long-term investor, valuations, dividend yields and free cash flow are all that matters – short-term volatility should be ignored unless you have an opportunity to profit from it by buying shares at low prices – i.e. embracing volatility. I suppose it should come as no surprise that Berkshire Hathaway was gobbling up shares in the fourth quarter of 2011, purchasing over $24 billion in stocks, an all-time record high. Unfortunately, buying low, which is crucial to long-term investment success, is very difficult. Today's market sentiment is terrible, mostly due to the ongoing saga with the European Monetary Union.

Let me be the first to say, the concerns within Europe are real. While it isn't much interest to me whether Greece stays in the Euro-Zone or leaves, the effect this may have on Europe's banking system is of primary importance. If a run on bank deposits occurs and a sweeping global financial contagion develops as a result it will not be pleasant for investors.

There is always a reason investors have the chance to buy securities cheaply. In the late 1970's the combination of 14% interest rates, 12% inflation and 20% money market yields were the reason *Mr. Market* was depressed. In fact, I find the combination of hyper-inflation and soaring interest rates much more damning than the current Euro-Zone crisis, but investors are currently fixated on Europe.

The fact of the matter is that, at some point, the stock market will go up and it will likely go up a lot. 40% of a bull market's return happens in the first six months of the market's move. The reason for this is obvious as many investors were frightened to maintain exposure and entered the bull cycle under-invested; they have to play catch-up by putting vast quantities of cash to work. Historically speaking, moves off of market bottoms from low valuations are explosive and there is little chance to quickly get on board as the market moves up 30% - 50% before investors know what is happening.

**Thus, I believe investors should do everything they can to embrace the amount of market volatility they are most comfortable with. This very well may be a different level for each individual investor. Given volatility drives equity investment returns and valuations are at the very low-end of the historical range, investors are being paid handsomely to accept market volatility and should be compensated by competitive investment results over the next decade.**

What I am not suggesting is take a trip to the bank or pawn shop and borrow as much as you can and put it in the market because you'll make a fortune in the next twelve months. I am simply stating that equity returns have a substantially above average probability of generating their historical average returns of roughly 10% per annum over the next decade due to the current high quality of earnings coupled with very low current valuations. After all, that's all an investor can ask for – a low entrance point from a pricing perspective and a quality cash flow environment.

In fact, the longer the free stock market languishes at these valuation levels and does not move higher, the greater the next upward move will be. Over the past year, as the earnings on the S&P 500 appreciated 19%, the P/E multiple on the market contracted an additional 20%, from 14x to 11x. If corporate earnings continue to remain historically average and the market's multiple keeps declining, then, when the market begins a new up phase it will be a strong and powerful surge, probably making up for a few mediocre years with a single great year, which is a pattern that has been present repeatedly throughout the past century of equity investing. Moreover, one of the least known facts about equity investing is that the entire return premium differential between stocks and treasury bills, roughly five percent, happens in less than five percent of the total trading days. Thus, if you miss the big up days, up months, up quarters and up years, then your overall portfolio returns are dramatically reduced.

In conclusion, investors should look to accept -- even embrace -- volatility and to persevere through this difficult period. The same tough macroeconomic issues of the day (which have heightened market volatility and lowered valuations) have also provided an entry point with a high probability of generating excellent long term equity returns. Equity investors have never failed to be rewarded from valuation levels at current prices and "risk" by definition always encompasses a greater list of negative events than that which will actually occur. Thus, strategies need to be developed to participate in the more than likely attractive returns over the next decade.

At Monticello Associates, we've spent much of the past year reviewing a variety of strategies that will benefit investors in this realm and we look forward to sharing our ideas with you in upcoming meetings.

*Come I to speak in Caesar's funeral.*
*He was my friend, faithful and just to me:*
*But Brutus says he was ambitious;*
*And Brutus is an honourable man.*
*He hath brought many captives home to Rome*
*Whose ransoms did the general coffers fill:*
*Did this in Caesar seem ambitious?*
*When that the poor have cried, Caesar hath wept:*
***Ambition should be made of sterner stuff . . .***

***B. Grady***

*I am pleased to announce that Teng Huang joined the firm in 2011 as Director of Quantitative Analysis. Teng, originally from China, will be focusing on all the quantitative aspects of Monticello Associates investment consulting practice including asset allocation, investment manager performance attribution and overall historical market performance trends.*

*Teng graduated from the top technical college in China, Tsinghua University, with degrees in Civil Engineering and Economics. While at Tsinghua, Teng graduated with honors, received a Government of China Fellowship and a first prize for Academic Excellence. Additionally, he was a first prize winner in the prestigious Chinese Mathematical Olympiad.*

*Teng also received a Masters of Science from the Massachusetts Institute of Technology (MIT). While at MIT, Teng graduated with a perfect GPA and received the prestigious Schoettler Fellowship.*

*Teng is fluent in Mandarin and English and enjoys hiking in the Colorado mountains. He loves basketball and has become a passionate Denver Nuggets fan.*

# We've Moved

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