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October 10, 2012

Dear Client,

We hope this letter finds you well. Enclosed, please find your Third quarter performance report.

As we enter October, we're now three quarters through a very eventful 2012. We're writing to provide perspective on what's happened this year and to share our thoughts on what we are looking at and how this will shape strategy as we continue to move forward. To help do that, we've tapped into insights from Barton Biggs (who we have mentioned from time to time), a legendary observer of the investment scene who passed away earlier this year, after 40 years in the investment industry. Before we get to this, however, here is a quick summary of 2012 to date. This year has been a tale of three quarters, with returns to the end of September of 16% in the U.S. and 13% globally (calculated in U.S. dollars.)

Market performance for first three quarters of 2012
The first quarter saw the strongest start for the U.S. stock market since 1998, driven by a reduction of fears about Europe and stronger economic data in the U.S. The second quarter gave some of those gains back, due to escalating concerns about the European currency union and slowing global growth, accompanied by discouraging data on employment. We also saw a slowdown in China and India, putting downward pressure on the prices of oil and commodities and stocks in general.

The last quarter saw markets bounce back, as the U.S. Federal Reserve Board and the European Central Bank (ECB) put measures in place to stabilize economies and to boost growth prospects. In particular, European confidence was boosted by the ECB's announcement that it would backstop Greece, Spain and other countries whose economies are struggling. Here's a summary of global market performance in 2012 to date, all in U.S. dollars:

	US	International	Fixed Income
4/01/2012 to 6/30/2012	(3.19%)	(7.13%)	2.06%
1/01/2012 to 6/30/2012	9.18%	2.96%	2.37%

Sources: Wilshire, MSCI, Barclay's Capital – US Dollars

Guidance from a Wall Street legend
Looking back is the easy part of investing – looking forward is more challenging. To help us do that, one of the sources we've always looked to and has been referred to in past correspondence, has been legendary Wall Street veteran Barton Biggs. Given that our philosophy aligns itself with Mr. Biggs, we thought it worthwhile to share his views with you.

Barton Biggs entered the investment industry in 1961, and in 1973 joined Morgan Stanley, where he served as chief global strategist from 1985 until his retirement in 2003. He was named 10 times to the All-America research team and was voted Wall Street's top global strategist each year from 1996 to 2000. Among his claims to fame:

- He predicted the bull market that began in 1982 and warned investors about Japanese stocks prior to their collapse in 1989;
- In an interview in July of 1999, he identified a bubble in the US market and advised investors to sell tech stocks;
- He correctly called the bottom in US stocks in March 2009.

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Biggs wrote extensively on how investors can prosper in volatile markets. Three of his themes are especially relevant today:

- Owning stocks is essential for most investors
- The challenges of investing rationally in an irrational world
- The psychological makeup of successful investors

Why owning stocks is essential
One insight from Biggs relates to why investors need to own equities at some point in their investing lives:

> "*The history of the world is one of progress and as a congenital optimist, I believe in equities. Fundamentally, in the long run you want to be an owner, not a lender"*

Biggs also discussed the trap of making short-term safety your only investment consideration and sacrificing higher returns for lower volatility:

> ***"****Warren Buffett put it best when he said he would always pick an investment strategy that over five years would give him a 12% compounded annual return, but that was volatile over one that promised a stable 8% return annually."*

Rational investing in an irrational world
Biggs also wrote widely on the challenges of being caught up in the emotions of the market and the tendency to root our investment outlook in what happened in the immediate past, rather in than what's happening today and what will happen tomorrow. This is no different than military officers who attempt to prepare for the next war by applying the lessons from the last one, without recognizing that the context is entirely different. Biggs' comment helps explain peculiarities such as massive inflows into government bonds during a period of all-time low rates, leading to the virtual certainty of capital losses when interest rates rise:

> "*As investors, we always have to be aware of our innate and very human tendency to be fighting the last war. We forget that Mr. Market is an ingenious sadist and that the delights in torturing us in different ways …. Mr. Market is a manic depressive with huge mood swings and you should bet against him, not with him, particularly when he is raving."*

Biggs went on to refer to a comment by Warren Buffett about investing – that it is like being in business with a partner who has a bipolar disorder:

> "*When your partner (with a bi-polar personality) is deeply distressed, depressed and in a dark mood and offers to sell his share of the business at a huge discount, you should buy it. When he is ebullient and optimistic and wants to buy your share from you at an exorbitant premium, you should oblige him. As usual, Buffett makes it sound easier than it is because measuring the level of intensity of the mood swings of your bi-polar partner is far from an exact science."*

The psychological makeup of successful investors
As a result of the strong emotions at play, many money managers find it hard to stick to their strategies. Here's what Biggs had to say about the importance of immunizing yourself against the psychological effects of the swings of the market:

> *"The investment process is only half the battle. The other weighty component is struggling with yourself and immunizing yourself from the psychological effects of the swings of the market, career risk, the pressure of benchmarks, competition and the loneliness of the long distance runner."*

And Biggs offered one final piece of advice about knowing yourself and your foibles, which will particularly resonate for those of you who remember the tech boom in the late 1990s. While this advice is oriented to investment professionals, it applies to individual investors as well:

> *"At the extreme moments of fear and greed, the power of the daily price momentum and the mood and passions of "the crowd" are tremendously important psychological influences on you. It takes a strong, self-confident, emotionally mature person to stand firm against disdain, mockery and repudiation when the market itself seems to be absolutely confirming that you are both mad and wrong."*

What this means for your portfolio
In my email at the end of last quarter, we outlined some guiding principles in our approach to building client portfolios, five of which I repeat here. We will also touching on these in portfolio reviews as we go forward as we feel Should you be interested in doing so, I'd be pleased to discuss these guidelines at our next meeting.

1. Taking the right level of risk: My starting point with clients is to identify the rate-of-return they need in order to achieve their retirement goals, and then to construct a portfolio based on that return objective. My goal is to take the right level of risk for each client – enough that we can be fairly confident that over time you'll achieve your objectives, without taking more risk than is necessary.

In fact, it's our view that one of the biggest mistakes is to focus on how much risk investors **want** to take (which in markets we've seen of late is as little as possible) rather than the more important and fundamental question of how much risk investors can afford an/or **need** to take in order to hit their long-term goals. Taking excessive risk increases the psychological stresses that Biggs describes, but taking insufficient risk, while comfortable in the short term, is a sure route to a long- run failure to achieve your objectives.

2. A buffer for retired client: All that being said, for retired clients, we believe in maintaining secure, liquid funds to cover three years of expenses. Having that buffer means that we reduce the risk of having to sell holdings at depressed levels; this also lessens the stress and anxiety which Biggs referenced.

3. Adhering to your plan: Regardless of what happens to markets in the short term, barring a significant change in your circumstances, we should stick to our agreed-upon investment parameters. Biggs pointed out that this is easier said than done. Some of you may recall my advice in early 2009, as we faced what appeared to be an end-of-the-world scenario and some stocks hit lows they hadn't seen in 20 years. At that time, we urged clients to maintain a core level of equity exposure. Given strong stock performance in the first quarter, some clients asked about increasing equity weighting above the maximum boundary in their portfolio guidelines. And then in May, in the face of significant declines, I got questions about selling stocks that would have taken equity weights below the minimum range (in a couple of cases from the same clients.) In both instances, I strongly recommended against making changes. While I am always happy to discuss adjusting portfolios on a case-by-case basis, I advise against deviating from the range that we established going into 2012 unless there has been a significant change in personal circumstances. In light of stock valuations and the risk in bonds, for some clients earlier this year we increased equity weights to the upper end of their range. Given strong stock performance in the last quarter, for some clients at the top of their range last spring we recently rebalanced holdings to bring the equity weight back down within portfolio guidelines.

Of course market reversals from current levels are always possible; however, taking a long-term view, at current levels there is a strong case for stocks over bonds and I continue to believe that clients will prosper from taking Barton Biggs' advice to be an owner rather than a lender.

4. Diversifying portfolios
When building equity portfolios, I've always advocated strong diversification outside the U.S. This helped our clients through most of the 2000's and has hurt them in other periods such as the past year. Going forward, we have no idea whether the dollar and the U.S. market will do better or worse than global

markets, but do know that we represent less than half of investing opportunities around the world and need to stay geographically diversified as a result.

5. Focus on cash flow

The final principle relates to the role of cash flow from investments. In an uncertain environment for immediate economic growth and equity returns, I continue to place priority on the cash yield from investments; having a steady cash flow reduces the psychological tensions described by Biggs.
In my view, the returns on some REITs, investment-grade corporate bonds, the better rated high-yield bonds and dividend stocks in selective sectors continue to be more attractive than the alternatives. We do have to be increasingly selective, however, as some stocks that pay steady dividends now look expensive by historical standards and appear to have stretched valuations – this is because investor appetite for yield had bid up prices of those dividend-paying stocks. Should you have questions about anything in this note or about any other issue, please feel free to give me or one of the members of my team a call.

And as always, thank you for the opportunity to serve as your financial advisor.

Sincerely,

Doug Babcock

Bob Frey