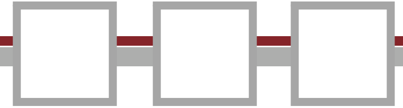
CLEARY GULL

PERSPECTIVES

ON INVESTING AND OTHER OBSERVATIONS



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A LITTLE HISTORY

Since I began my career 43 years ago, the financial markets and how they operate have changed significantly, reflecting the impact of technology on communication, information dissemination and its analysis.

In 1969, most stocks traded on the New York Stock Exchange. Commission rates were fixed and could be found in the back of the Stock Guide, a small, monthly publication that contained information on companies, their revenues and earnings and trading. Bonds were usually bought and held to maturity. There was a ticker tape machine that spit out news and trading information located in the bank lobby. Until 1973 when The Depository Trust Company was founded to maintain shareholder records and facilitate trade settlement, investors held physical certificates. About three-quarters of trading activity was conducted by individuals then, while today institutions dominate. DTC settled more than $300T of security transactions in 2010. According to the Investment Company Institute, in 1970 total net assets in mutual funds approximated $47.6B; there were 361 funds and about 10.7 million shareholders. By the end of 2010, mutual fund total net assets exceeded $11.8T invested in 7,581 fund portfolios with over 292 million shareholders.

The Dow Jones Industrial Average grazed 1000 in 1966 with a closing high of 995.

NASDAQ, the first electronic securities market, was not launched until 1971, replacing most OTC trading. In early 1973, major growth stocks, known as the "Nifty 50," made new highs. Other stocks had been in decline since 1968; according to Ibbotson, small cap stocks declined 25% in the four years ended December 1972, while large cap stocks gained 29%. With President Nixon's visit in 1972, China's opening to the West began. In response to import controls imposed by Nixon and the Yom Kippur War, OPEC placed an embargo on oil sales to the U.S. in October 1973.

From the 1051 peak in January 1973, the Dow declined 45% to a low of 577 in December 1974. Many stocks declined considerably more. Some sold at share prices below net cash on the balance sheet. Such cheapness was recognized and stocks began to recover. Negotiated commissions began on May Day 1975 and the cost of trading dropped. With the passage of the Employee Retirement Income Security Act (ERISA) in 1974, institutional investors grew rapidly in importance.

During the 1970s, inflation soared, the result of spending on social programs and the Vietnam War and policies to spur job growth in an attempt to accommodate the surging labor force, caused by the demographic group known as the "Baby Boomers" coming of age. The female labor participation rate rose from one of the lowest in the developed world to one of the highest. Now, the nation faces the retirement of the "Baby Boomers."

In the 1970s, the average annual rate of inflation was 7.4%. According to Ibbotson, in the 70s none of the major asset classes of the time earned returns that equaled, much less exceeded the rate of inflation: 6.3% annualized for Treasury Bills; Intermediate Treasury Bonds, 7.0%; large cap stocks, 5.9%. In 1979, President Carter appointed Paul Volcker Chairman of the Federal Reserve. At that time the federal funds rate was 11.2%. Under Volcker the Federal Reserve raised the federal funds rate steadily to a high of 20% in June 1981. Inflation peaked then, at 13.5% and declined to 3.5% in two years, as the inflationary psychology was broken. The great bull market began in 1982.

The Dow Jones Industrials reached 1000 in 1983.

Valuations (Price/Earnings ratios) were low and expanded as interest rates fell. Under President Reagan, the economy grew as regulations were eased and tax rates were lowered. With the end of the Cold War and the fall of the Berlin Wall in 1989, globalization began in earnest. However, Japan had long been expanding overseas, not just selling to consumers in the U.S. and Europe but also investing globally. In 1989, the market capitalization of Japanese stocks constituted about 70% of the total value of the Europe, Australia and the Far East Index (EAFE). In-

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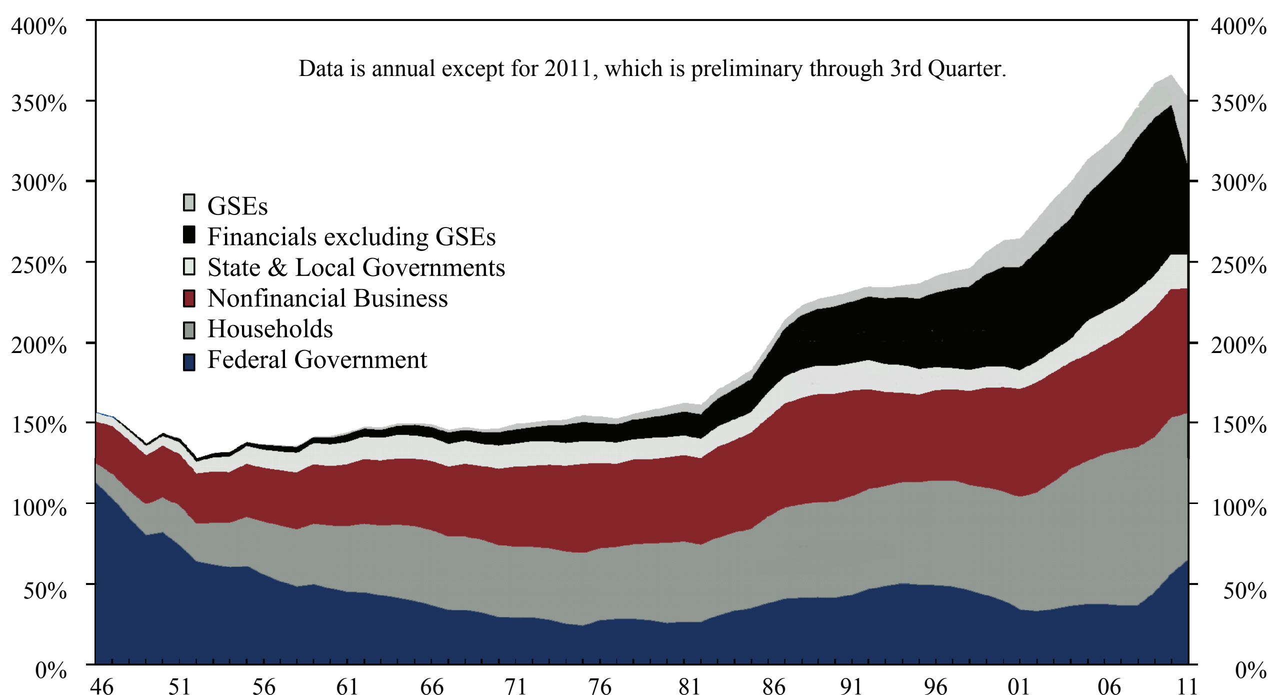
ternational investing was taking hold with institutional investors. Hedge funds were the purview of a small group, investing primarily for themselves and other wealthy individuals in privately offered funds. In 1990, there were as few as 300 hedge funds. Today, there are about 2,000, fewer than at their peak in 2007. Total managed assets now approximate $639B. Other private funds that became more widely used by institutions in the 1990s were private equity and real estate funds. All of these investment vehicles have limited liquidity and generally higher fees than mutual funds. Many of the best hedge and private equity funds stopped accepting new investors long ago.

Remarkable Innovation Followed

In addition to the demographic changes that began in the late 1960s, a period of remarkable innovation ensued. In 1969, Advanced Research Project Agency Network (ARPANET), the precursor to the Internet, made its first connection between computers at Stanford and UCLA. Use was limited to government, education and research until the early 1990s when commercialization of the Internet began. The Internet stock bubble busted in 2000. NASDAQ, home to myriad Internet related stocks, peaked at 5000, dropped to a low of 1165 in 2002 and is now about 2545. The Standard & Poor's 500 (S&P) hit 1499 in 2000, dropped to 777 in '02, then rose to its all-time high of 1549 in October '07, dropping to 677 in March 2009 and is now about 1250. The Dow Jones Industrials also made its all-time high of 14,087 in October '07, dropped 50% and has since recovered to about 12,100.

In 1968, almost all mutual funds were sold by brokers with a sales load. The first money market fund was introduced in 1971. The no-load fund industry began to grow in the 1970s and took off with the advent of the 12b-1 fee in 1980. 12b-1 fees allow mutual funds to use these fees to help compensate for sales and administration. Fidelity's hiring of a Proctor & Gamble marketing executive further spurred the industry's proliferation of funds and growth. According to the Investment Company Institute's latest annual report, there are 90.2 million individual owners of mutual funds. 80% own equity funds; 61% made their first mutual fund purchase through an employer retirement savings plan; 93% of owners invest in mutual funds for retirement. In 1990, only 8% of defined contribution plans' assets were invested in mutual funds compared to over 54% now; other investments are primarily stable value accounts and company stock. Institutional investors constitute 13% of mutual fund assets and 35% of money market fund investments. Mutual funds also affect investment markets. About 45% of commercial paper is owned by funds. Recently, U.S. money market funds have been sellers of their short-term investments in European banks, aggravating the liquidity crisis in Europe but protecting their own investors. Because saving for retirement is woefully inadequate and primarily the responsibility of individuals, we expect mutual funds and other investment companies to continue to grow and influence investment markets.

Saving and investing are critical for the well-being of all people and nations. As has been widely discussed, the growth of the developed world economies over the last 30 years was fostered by a growing mountain of debt, borrowing by individuals, businesses and governments. The sobering graph below shows the Post WWII history of Total U.S. Debt as a % of Gross Domestic Product and its components. In order to bring debt down to a more manageable level, we must do one or more of the following: spend less and save more, renegotiate debt to reduce its cost, depreciate the value of the money used to repay debt (inflation), grow incomes faster. The global challenge is that every nation cannot depreciate its currency to gain competitive advantage and repay debts with less valuable money. But, we can take personal responsibility for our own finances.



Sources: Federal Reserve Board; Bureau of Economic Analysis

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Thoughts On The Future

The biggest challenges are the unwinding of global leverage, the demographic shifts as the populations of the developed world age and the continuing development of the digital economy. In December, the Boston Consulting Group published a thoughtful paper entitled, "What Next? Where Next?" This paper considers the potential impact of global deleveraging on businesses, but applies equally to investors.

> Key conclusions are the importance of innovation, a focus on new growth opportunities, attention to pricing/costs and being decisive.

There are two basic ways to reduce the impact of the debt overhang: repay debt with depreciated currency/inflation or reduce growth in order to repay debt/deflation. Neither is very good for debtors or creditors. Government efforts to stimulate inflation have so far been unsuccessful. Continuing to reduce debt through restructuring and gradual repayment will inhibit growth. And yet, economic growth is the best way to generate the means to pay-down debt.

Recently, McKinsey published an article by W. Brian Arthur, a visiting researcher with the Intelligent System Lab at the Palo Alto Research Center, an external professor at the Santa Fe Institute and author of books and research papers, on the effects of technology on society. Arthur considers the impact of the Industrial Revolution and the railroads on the physical economy as the muscles of our nation. Then, he hypothesizes on the impact of digitization on the "second economy," the neural system or brains of the economy. He wrote, "Physical jobs are disappearing into the second economy, and I believe that this effect is dwarfing the much more publicized effect of the jobs disappearing to places like India and China." Middle management jobs and many types of service jobs have disappeared as technological advances in information processing affect how the service economy operates. Consider checking in for an airline flight, cashing a check or searching for information on-line rather than in the library. Arthur believes that the skills needed in the digitized economy are sound human judgment and effective human interaction. Finding ways to continue to engage retirees in the economy will be important on many levels: less demand for support in retirement and retention of the wisdom that experience brings.

Lessons Learned

Inflation rose during the 1970s. Only small cap stocks earned returns in excess of inflation, but that was because small cap stocks had declined steadily from 1968 to 1975 and then rebounded sharply in the following four years. In the 1980s, all financial assets earned strongly positive inflation adjusted returns. The key was not economic growth; real GDP grew about 3.2% annually in both decades. The level of interest rates and equity valuations (P/Es) at the beginning and end of each decade were more important determinants of returns. It is hard to imagine U.S. interest rates going lower. So returns on domestic bonds will likely not exceed current yields without astute trading and credit analysis. With P/Es at about 14 times trailing reported earnings, over time equity returns ought to exceed bond returns if they just track earnings growth but, again, astute analysis and selection are likely to make meaningful differences in returns. While a P/E of 14 is not very low it is not high either. So, if earnings grow at 5-7% and dividend yields are about 2%, the average potential total return of 7-9% (before fees and expenses) would exceed current bond yields of 2-5%, depending on credit quality.

The first column in Table I provides **hypothetical** historic returns for an institutional investor covering the period from December 1968 through December 2010. These returns are estimates only and were calculated by Cleary Gull using the respective asset class market index returns (during periods available) blended at 60% in equity and 40% in fixed income, with certain new asset class indexes added as they became widely available, such as small caps, international, and high yield bonds.

Table I	Hypothetical Returns	
	Institutional Investor	Individual
20 Years to 12/88	9.8%	9.3%
20 Years to 12/98	14.5%	14.9%
20 Years to 12/08	8.4%	8.8%
Best Year (1985)	28.0%	29.3%
Worst Year (2008)	-21.8%	-21.8%
42 Years	10.0%	9.5%

Before fees and expenses which would reduce results by 1.5%-2% depending upon the amount of fictional cash, management fees, trading and custody costs. Methodology available on request.

Sources: Ibbotson SBBI Classic Yearbook and Zephyr

The second column in Table I provides **hypothetical** historic returns for an individual investor for the same periods. These returns are estimates only and were calculated by Cleary Gull using the respective asset class market index returns (during periods available) with and based on investing $500 annually for the 11 years ended 12/1979 and $1,000 for the next 10 years ended 12/1989 in a 20/80

bond/stock portfolio; $1,000 for the subsequent 10 years ended 12/1999 in a 30/70 bond/stock portfolio; and $10,000 for the final 11 years ended 12/2010 in a 60/40 stock/bond portfolio, adding certain new asset class indexes as they became widely available to individual investors. In both cases, the allocations were rebalanced to the blended target at the beginning of each year. The results are remarkably similar! *Details on the allocations and methodology used for calculating these returns are available on request by emailing clearygullresearch@clearygull.com.* Based on our estimates and assumptions, an individual's total investment of $159,500 could have grown to exceed $670,000 over the 42 year period. Of course, these results have no real world fees or transaction costs, which would reduce returns by about 2% annualized. The last decade has not been kind to equity investors, but as the data show, over time a hefty allocation to stocks has rewarded investors. I learned early in my career that disciplined saving and investing produces results.

I have had the opportunity to work with many accomplished investors and business people. Highly successful investors invest in what they know and understand and, as a result, often have concentrated portfolios. They are passionate but discipline their emotions and are willing to be different, have a different time horizon or consider how problems may be opportunities. Good analysts do not necessarily make good portfolio managers; good portfolio managers are often not good business people. Successful portfolio managers take calculated risks, but make mistakes, recognize them, learn from them and move forward. Successful business people understand their clients.

As I evaluate my personal investments, I realize that my best investment has been in my own continuing education, my business, and, as a result, the investment in our clients. In the '90s, my credo was "we will measure our success by the success and satisfaction of our clients." That is still true. Going forward, Brian Andrew will lead the investment communication with you each month, delivered primarily electronically over the Internet, covering the investment considerations of the time and the strategies being employed to yield results. I am confident that our clients will be well advised by the team of investment professionals and their service team colleagues within the Cleary Gull organization.

Thank you for the opportunity to work with you in the pursuit of your investment goals.

By Maureen Busby Oster, CFA
Cleary Gull Advisors Inc.

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