Marathon Investment Management

"The taxpayer – that's someone who works for the federal government but doesn't have to take a civil-service exam."
-President Ronald Reagan at the Republican National Convention, October 27, 1964

April 2011

Dear Friends,

Wow! Another year and another quarter with gains and worries galore. As is always the case, the first quarter of 2011 was more than eventful – both on a national and global basis.

Domestic Equity Markets

At year-end the Standard and Poors 500 (S&P 500) closed at 1257 showing a gain of 12.8% for 2010. As of March 31st the S&P 500 stood at 1325 with a 5.4% gain. Other notable indices reported the following returns[1]:

Index	1st Quarter 2011
Dow Jones Industrial Average (DJIA)	6.4%
Russell 5000 (total stock market)	5.6%
NASDAQ Composite	4.8%
Standard & Poors 500	5.4%
Russell 2000 (small companies)	7.6%
Morgan Stanley EAFE (international)	2.7%

As mentioned in our year-end letter, the bears lost out – and so it continues so far this year. According to Mark Hulbert, there have been 33 bull markets prior to the current one since the beginning of 1900. Of those, only 14 have lasted for two years or longer. Of these 14 bull markets that followed the average DJIA gain over 2 years was 61.7%[2]. The DJIA return for 2 years of the current market rally is 86.7%[3]. Mr. Hubert points out that since 1900 there have been only 2 other bull markets that have out-performed the current market for a 24 month period.

On a daily basis we track most major market indices but focus on the broader S&P 500. From the intra-day low March 6, 2009 to April 1, 2011 the S&P 500 has recovered 98.94% - from 666 to 1325. As of the quarter end the S&P 500 is still 15.92% below its all-time intra-day high of 1576 reached October 11, 2007.

The domestic market overcame the two major shocks of the first quarter – namely the Japanese earthquake and tsunami as well as the growing political turmoil and violence in the Middle East. The DJIA rose 742 points (6.4%) making this last quarter its best in percentage terms in 12 years. Due to the Mideast turmoil, obviously energy has been one of the best stock sectors for the quarter. Other sectors that led the market were primarily commodity–based or energy related including (as measured by their respective non-leveraged ETF):

Industry (reported by respective ETF)	1st Quarter 2011 Return[4]
Cotton (BAL)	42.72%
Internet (BHH)	39.78%
SC energy (PSCE)	25.01%
Silver (PSLV)	24.80%
Brent oil (BNO)	24.60%
Solar energy (KWT)	23.11%
Oil & gas exploration (XOP)	22.37%

On March 31st the price of oil rose to a 30-month high as the tide turned in Col. Gadhafi's favor against rebel forces in Libya. Benchmark West-Texas Intermediate crude closed at $106.72 a barrel[5]. The jump in oil prices is continuing despite the promise and follow-through by Saudi Arabia making up the 1.6 million barrels, or 2% of global consumption, of exports primarily to Europe from Libya.

In general, commodity prices are breaking multi-year highs worldwide. As of the beginning of April the S&P/GSCI index (measuring 24 raw materials) has risen 16% in 2011[6]. As of April 5, gold prices rose to an all-time high above $1,450/ounce as new peaks in crude oil and grains fueled inflation fears[7]. A downgrade of Portugal's credit rating, as well as other debt concerns in Europe added to inflation fears as well.

Stocks that benefit from rising commodity prices, i.e. energy, led among gains for the quarter. Technology issues also did well – especially those that capitalized on 'cloud' computing. Among sector mutual funds the quarter leaders were as follows[8]:

Sector Mutual Funds	1st Quarter 2011 Leaders
Natural Resources	12.7%
Health/Biotechnology	7.3%
Real Estate	6.2%
Science & Technology	6.1%

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Among the DJIA issues, construction and mining-equipment maker Caterpillar was the Dow's top performer for the quarter, climbing 19%[9]. Energy companies Chevron and Exxon Mobil were close behind returning 18% and 15% respectively.

Bulls are encouraged that U.S. corporations are in reasonably good financial shape. S&P 500 company earnings, although down from the previous quarter, are expected to be up 14% year over year according to Thomson Reuters[10]. Standard and Poors is anticipating a rise of 12.9% for the 500 largest U.S. corporations[11]. Investors plowed more than $29 billion into stock mutual funds in the first quarter[12]. This is still a small fraction of what was withdrawn during the 2007-2009 market crash.

International Markets

Based in U.S. dollars, international markets had a mixed performance so far this year. Some markets that led the charge last year are falling back while others have rebounded from 2010. Many of the east European markets that made significant gains last year have continued their climbs. Consider the following country-by-country (in U.S. dollars)[13]:

Strongest (1st Qtr 2011)	Return	Weakest (1st Qtr 2011)	Return
Bulgaria	35.1%	Egypt	-23.0%
Romania	29.1%	Kuwait	-10.1%
Hungary	19.6%	Oman	-9.9%
Czech Republic	15.3%	Peru	-9.7
Russia	14.8%	Chile	-8.4%
Greece	14.0%	Jordan	-7.8%
Spain	13.5%	Argentina	-7.7%
Italy	13.5%	India	-6.9%
Estoria	11.4%	Malta	-5.6%
Slovakia	10.9%	Japan	-5.3%
France	10.6%	UAE	-5.1%
Iceland	10.4%	Taiwan	-4.2%
Netherlands	10.0%	S. Africa	-3.5%
Portugal	8.3%	Turkey	-2.7%
Canada	7.0%	Israel	-4.1%
China	4.7%	Qatar	-2.0%
Indonesia	4.3%	Singapore	-1.4%
Malaysia	4.3%	Hong Kong	-0.9%
United Kingdom	2.8%	Mexico	-0.1%

Geopolitical troubles and natural disasters explain the declines in the Middle East and the Far East. Global food prices negatively impacted Asian markets which moderated the high economic growth outlook in India, China and other related markets. Although severe debt issues

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remain, much of the gains among the "PIIG" European markets seem to be technical recoveries after deep losses for 2010. For most of Latin America political uncertainties, high inflation and a technical correction have put a damper on their stock markets.

Debt Markets

Short-term rates, due to continued Federal Reserve intervention along with relatively tight lending, have remained historically low. Inflation concerns have had an effect on longer term obligations. Consider the following:

Treasury Obligation	Rate as of 1/3/11[14]	Rate as of 4/1/11[15]
3 month T-bill	0.12%	0.09%
6 month T-bill	0.18%	0.17%
2 year T-note	0.60%	0.82%
5 year T-note	2.01%	2.26%
10 year T-bond	3.33%	3.46%
30 year T-bond	4.37%	4.50%

According to the Wall Street Journal, for the quarter, junk bonds returned 3.9% while investment grade corporate bonds returned 0.8%[16]. With turmoil overseas as well as economic uncertainty at home, demand remains strong in search for yield. Investors poured a net $37.7 billion into taxable bond funds through March 23 this year[17]. As we discussed regarding the fourth quarter of 2010 corporations continued to take advantage of the low interest rate environment and raised $77 billion in bond offerings[18].

Analysts are uncertain regarding the effect on the bond market when the Federal Reserve ceases its bond buying spree – expected to end by mid year. Some feel that rates will rise, perhaps dramatically due to more supply than demand. Others feel rates may fall due to the certainty of the market process without the artificial support of the Fed. Of course there are many influences on interest rates despite the Federal Reserve including housing, labor markets, international events including foreign currency supports and global crises such as we have seen this last quarter.

Out Thoughts Going Forward

We have prepared clients for a rising inflation scenario. Rising oil prices effects everything in an economy. Ethylene, widely used in plastic resin, is up 75% from 2009[19]. Due to the loss of Libyan light sweet crude to Europe, U.S. refineries have been shipping diesel

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across the Atlantic, which further puts upward support on our energy prices. Note that the producer price index rose 1.6% in March, the most since June 2009. Prices climbed 5.6% versus a year earlier, the most since late 2008[20].

We anticipate the continuation of slow economic growth as realized in 2010. For the October – December 2010 quarter, the Commerce Department reported 3.1% gross domestic product (GDP)[21].

The most recent employment numbers are improving. Non-farm payrolls grew 216,000 in March, the fastest pace since last May according to the Labor Department[22]. The nation's unemployment rate fell to 8.8% in March from 8.9% in February.

As we enter the summer season we see that Congress and the White House are beginning to debate the outstanding issues that have been described in recent Marathon quarterly letters – namely the national debt and deficit spending. With solutions to these most serious issues being considered by representatives of both major political parties, we are hopeful that some consensus will be established including entitlement reforms. Expressing growing confidence, we see that according to the Business Roundtable quarterly CEO Outlook, 52% of the nations top CEOs plan to add staff over the next six months[23]. Faster hiring could fuel consumer spending and provide some floor for the still – slumping home sales and prices.

Retail sales rose in February by 1%, the most since last October, according to the Commerce Department[24]. U.S. consumer spending (which represents about two thirds of GDP) rose 0.7% in February – the largest increase since October 2010. This was the eighth straight month of gains, according to the Commerce Department[25]. Personal income rose by 0.3%. Finally U.S. auto sales rose 17% in March led by Chrysler, Nissan and Ford Motors[26]. U.S. demand for autos seems to be moving steadily higher – a significant indicator of improving GDP.

As we outlined in the year-end letter we feel that the bulls, despite on-going market volatility – remain in charge. Investors are aware that year over year earnings are slowing, but remain positive. Many analysts believe that unless crude oil prices rise and remain $120-$150/barrel for an extended period of time global economies will make the necessary adjustments.

We see continuing opportunities overseas, especially in developing markets. Europe is still challenged with very high debt and pending bailouts of Ireland, Portugal and perhaps Spain or Italy. We see the opposite with emerging markets where lower private and public sector debt levels allow the consumer, business and government sectors to grow at a healthy pace. From

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what we read, analysts anticipate real GDP growth rates of economies such as Brazil, Russia, India, Mexico and China to grow at 5.5% to 8.5% this year[27].

Investor Behavior Issues

Our hopes are the next three quarters, and more, will be as rewarding as this first one of this year. But in reality markets don't move in a straight upward trajectory and 'safe havens' aren't always as dependable as they are perceived - creating significant challenges for investors. Investment and financial planning success, as we see it, need to be objective and long term. There are a few investment management lapses that we want to highlight and suggest remedies for.

The 'New' Bonds

Currently, over $36 trillion are invested in government and corporate bonds - with interest rates remaining low and inflation rising. Standard and Poors tracks over 7,000 publicly owned companies that report their dividend activity. For the first quarter of 2011 they reported the average dividend rate rose 6.7% which included 510 companies that resumed their dividend payouts or boosted payouts versus 399 companies a year earlier – a 27.8% increase[28]. On a dollar basis, dividends fell by $43.8 billion in the first quarter of 2009, but rose by $6.4 billion in 2010's first quarter and $19 billion for this year's first quarter[29].

We have read numerous articles that have shown that the total return of dividend paying stocks offer not only growth of income but superior total return over non-payers. Studies have found that 90% of U.S. equity returns over the past century have been delivered by dividends and dividend growth[30]. At Marathon we maintain and update a list, based on our research, of the most promising dividend paying stocks among the S&P 500. We anticipate additional dividend payout increases from profitable companies for the remainder of 2011.

Bonds and Inflation

Bill Gross, who manages the world's biggest bond fund, and who has spent months warning about the dangers of inflation on bonds and our national debt, has sold out of his billions of U.S. Treasuries. Over the last decade clients know that, unlike the equity market suffering through two historic crashes, the bond markets have offered steady and often superior returns. Now Mr. Gross, well known for his expertise in fixed income has actually gone 'short' in several of his managed portfolios. In his PIMCO funds, he has placed over $7 billion betting against Treasury bonds - I believe other prominent money managers have followed suit[31].

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For Marathon discretionary clients we have been proactive to protect clients with bond allocations. We have adopted several strategies including those of PIMCO, to protect these clients going forward.

Equities and the Long View

A friend of mine gave me a copy of a CNNmoney.com article last year titled "How She Turned $5,000 into $22 million (and how you might too…)"[32]. This lady who put herself through college and law school started investing when she was 38 years old worked for the IRS. She invested on a regular basis always using a portion of her modest paycheck – she "paid herself" first. Here is what she did not do:

- She did not act out of emotion
- She did not switch investment strategies based on the domestic and international news
- She did not invest in stocks that seemed 'trendy' – staying only with leading brands with growing earnings
- She did not make huge bets on one investment but rather stayed diversified
- She did not make withdrawals from her account but instead reinvested her dividends
- She never sold, but she did stay informed by attending shareholder meetings, reading financial publications and collaborated with her broker at Merrill Lynch

If you would like to read her story please contact our office. We found it interesting and relevant reading.

In the fall, Forbes magazine comes out with its "Mutual Fund Honor Roll." We usually keep it in the office for several months. Many of the funds listed have made the 'honor roll' multiple times. A key factor to be placed on this select list is outstanding performance over a 'business cycle.'

One of the outstanding money managers that we invest with is Don Yacktman who recently was interviewed by Barrons. In response to the question of why his funds lagged the S&P 500 in 2010 he responded… "We tend to look at our record on a 10-year basis. It does require patience. It does require a long-term focus. Usually, once people go through a full cycle, they are comfortable. But that's the challenge: getting them through the first cycle.[33]"

Conclusion

After a decade-plus of sub-par equity market performance, many investors are tempted to strike out in a 'new' strategy – either a conservative "safe haven" insured or guaranteed return with minimized growth potential or an alternative aggressive and possibly untested or misunderstood strategy based on recent but impressive performance. Our record, which we are

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proud of, for over a decade is based on some of the fundamentals written above and in previous letters. A few last reminders to take with you:

- Economic expansions have lasted longer than recessions
- Longer time horizons may lower chances of loss
- Dividend-growing stocks (and funds of such) have outperformed over time
- Broaden investment horizon into global markets
- Regular investing (such as dollar cost averaging) can smooth the ride
- Diversification may help lower risk
- Past performance is not a guarantee of the future (including the results of the past decade)
- Be objective and take advantage of our resources - We feel they are worth it!

Enjoy the summer!

George Gumbiner
President

Footnotes:

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