Marathon Investment Management

JULY 2012

Apples, Oranges, and Yield

Dear Clients,

I know this is a strange title, but it seems to us that we are living in extraordinary times and the temptation is to give up the apples for oranges. I will explain later; first a review of the second quarter 2012 and year-to-date.

Domestic Equity

The DJIA closed at 12,880, down 2.5% in the second quarter; the S&P 500 finished at 1362 off 3.3%, and the NASDAQ Composite, down 5.1% closed at 2,935 while the Russell 2000 (small-cap) decreased almost 4% for the quarter closing at 798. Please review the following[1]:

Index	2Q 2012	1st Half 2012
DJIA	-2.5%	5.4%
S&P 500	-3.3%	8.3%
NASDAQ Composite	-5.1%	12.7%
Russell 2000 (Small-Cap)	-3.8%	7.8%

After a powerful first quarter, the April through June period saw the various domestic markets go back to the kind of volatility experienced in 2011, with a S&P 500 performance in May of -6.27% and the EAFE (large cap international) index fell 11.48%. In June the S&P 500 recovered 3.96% with the index jumping 33.12 points or 2.5% on the last day of the month – its largest single day percentage increase since December[2].

International Equity

Broad market conditions remained unstable across the globe due to the credit crisis in Europe, mounting concern that growth is slowing in China, and signs that the U.S. recovery is losing steam. According to the Dow Jones Global indices on a country-by country basis only a handful actually made gains during the second quarter.

The following table will give some perspective on the challenges globally (U.S. dollar based)[3]

2nd Quarter BEST Performances		2nd Quarter WORST Performances	
Kenya	8.2%	Cyprus	-46.3%
Iceland	5.9%	Ukraine	-31.8%
Philippines	4.9%	Argentina	-24.8%
Nigeria	2.5%	Serbia	-24.8%
Oman	-0.5%	Finland	-21.3%

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2nd Quarter BEST Performances		2nd Quarter WORST Performances	
Vietnam	-0.9%	Brazil	-20.9%
Turkey	-1.8%	Portugal	-20.8%
Mexico	-2.0%	Romania	-20.1%
Colombia	-2.1%	Bulgaria	-19.8%
Tunisia	-2.9%	Slovenia	-18.7%
Belgium	-3.3%	Greece	-18.6%
Bahrain	-3.4%	Russia	-17.7%

Among the major stock exchanges worldwide, those that were ascendant last year are falling this year and vice versa. For example[4]:

Exchange or Index	Closing Value*	Year-to-Date*
Sao Paulo Bovespa (Brazil)	54,354	-4.2%
TSX Composite (Canada)	11,596	-3.0%
Santiago IPSA (Chile)	4,400	5.3%
DAX (Germany)	6,416	8.8%
FTSE MIB (Italy)	14,274	-5.4%
IBEX 35 (Spain)	7,102	-17.1%
FTSE 100 (U.K)	5,571	0.1%
Shanghai Composite (China)	2,225	1.2%
Hang Seng (Hong Kong)	19,441	5.5%
Bombay Sensex (India)	17,429	12.9%
Nikkei (Japan)	9,006	6.5%

**As of June 30, 2012*

Many of the analysts we read express optimism for an Asian recovery. They point to a combination of a fresh stimulus package, a cut in interest rates, and moves to boost bank lending in China which would create the "soft landing" investors seek. In general, we are taking a more cautious approach for clients using funds and individual issues with wide "moats" – companies that show consistent profitability in an adverse business environment.

Debt Markets

The Federal Reserve's strategy of maintaining exceptionally low borrowing rates was maintained as stated by Chairman Bernanke last year. When one considers where rates were even a few years ago, what we are witnessing today is exceptionally rare and record-breaking. Rates worldwide by those nations that are considered fiscally solvent i.e. Germany, China etc. have followed suit as well. The People's Bank of China has cut its benchmark lending rate for the second time in four weeks while the European Central Bank reduced its main policy rate to an all-time low of 0.75%. Consider the following[5]:

U.S Interest Rates as of June 30, 2012

Issue	Current Rate	One-Year Ago
3-Month T Bill	0.08%	0.01%
1-Year T Bill	0.13%	0.14%
2-Year T Bill	0.30%	0.42%
5-Year T Note	0.72%	1.66%
10-Year T Note	1.64%	3.11%
30-Year T Bond	2.75%	4.36%

Commodities

Commodity prices in various categories generally lost value throughout the second quarter, until June. Corn, soybeans, and wheat prices rallied during the latter days of June. Corn prices (per futures contract) rose over 20% from June 15 through quarter end. Other agricultural and consumer commodities had similar rallies. On Friday, June 29th oil prices rocketed 9% due to the latest agreed upon "debt deal" in Europe. For the quarter, the Thomson Reuters-Jeffries CRB index for commodities, showed an 8% drop – its sharpest decline since the third quarter of 2011[6].

After a strong 2011, gold seems to have lost its luster closing at $1,603.50/troy oz. on June 29, 2012, an increase of 2.41% since January 1, 2012[7]. This shows that gold, unlike U.S. Treasuries, are no longer the safe haven of choice for investors and institutions. The strengthening of the U.S. dollar partly explains the gradual drop in most commodities that are dollar denominated. Natural gas finished the quarter at $2.824/MM BTU – down 5.52% year to date. Crude oil finished at $84.96/barrel, off 14.03% so far this year[8]. The other major factor for falling prices is of course, less demand by Europe, China, and the U.S. as their economies continue to sputter.

Macro-Economic Thoughts

As of today, Barclays, Goldman Sachs, and Macroeconomic Advisors all slashed their second-quarter GDP estimates. Barclays, which now forecasts 1.5% growth, is down from a prior estimate of 2.5% as trade seems to be easing and slower inventory building looks to have subtracted from growth[9]. Goldman Sachs cut its estimate to 1.3% from 1.4% while Macroeconomic Advisors made a revision to 1.2% from 1.4% due to recent trade data.

U.S. manufacturing activity fell in June for the first time in three years according to the Institute of Supply Management (ISM)[10]. This was the first reading of contraction since July 2009.

Finally, consumer spending stalled in June with sales at stores open at least a year climbing 0.3%, the smallest annual gain since August 2009[11]. There were exceptions with off-branded goods retailers, Ross Stores and TJX enjoying 7% same-store gains.

The big story of the week was the June unemployment report as released by the U.S. Labor Department. With June's weak payroll gain of 80,000 combined with three straight months below 100,000, the unemployment rate held at 8.2%[12]. The broader measure of underemployment, part-timers desiring full-time work, ticked up to 14.9%. The labor force participation rate held at 63.8%, close to a generation low[13].

On the positive side we are seeing more upbeat news regarding real estate. The rate for a 30-year, fixed-rate loan, the most popular mortgage product, dropped to 3.62% as of July 5[14]. The 15-year fixed rate fell to 2.89%, from 2.94%[15]. One-year ago, the same 30-year loan would have carried a 4.6% rate. Real estate construction has also picked up, as well as sales.

Further progress is seen regarding consumer debt – not national debt. The percentage of consumer loans at least 30 days overdue dropped to 2.35% in the January – March period, down from 2.49% in the last quarter at 2011[16]. This is the best performance since second quarter 2007 putting consumer delinquencies below the 15-year average of 2.4%, according to the American Bankers Association[17].

The U.S. remains the largest, richest, most secure market globally. It continues to lead in foreign direct investment (non-treasury obligations), which rose to $194.5 billion from $135 billion in 2009, and stood at $155 billion through the first three quarters of 2011[18]. This year for the first quarter the U.S. attracted $28.7 billion in FDI, the 12th consecutive quarter of positive flows according to the Commerce Department[19]. In free markets, money will flow towards where investors – both individuals and institutions – believe they will get the best return on their investments. Despite our challenges the world remains optimistic about America's financial future, and so do we.

<u>Apples, Oranges and Yield</u>

Mark Hulbert of the Hulbert Financial Digest tracks the performance of perhaps 100 advisors and advisory newsletters. It's common knowledge that as interest rates rise bond values fall. With the 10-year Treasury yielding 1.64% at quarter-end investors anticipate that at some time in the near future rates will rise. The challenge will be to exit those bonds before rates rise and values fall. Hulbert has tracked several dozen bond market timers over the last decade and determined that none beat a buy-and-hold strategy and furthermore, no one has been able to consistently time the market's gyrations[20].

There are alternatives to money-market funds, Treasuries and CDs all of which are at-or-near record low yields. Following are some alternatives to consider or to diversify with:

1. **Dividend paying stocks.** In past letters we have often made the argument for investing in companies, or funds that own companies that have consistent profits and ongoing increases in dividend payout. Last year I mentioned McDonald's as an example – a company that has increased its dividend by more than 1,100% since 2001, or 28% annualized[21]. If one had purchased

McDonald's in 2001 the yield today would be nearly 10%. Currently the yield is about 2.5% and therefore the stock value had risen about four times since 2001.

During the past 40 years, dividend yield and dividend growth combined have contributed about 78% of total returns for U.S. equities and nearly 100% in Europe[22]. During the past 25 years, a basket of global high-yield equities has returned 11% per year, outperforming global equities by 3.2%[23]. Currently the S&P 500's yield is greater than that of the 10-year Treasury for just the second time since 1947.

2. **Master Limited Partnerships.** Master limited partnerships (MLPs) according to Barron's, have been one of the best investments over the past 10 years, generating an annualized total return close to 16%, versus 4- to-5% for the DJIA and the S&P 500[24]. MLPs mainly transport and store oil, natural gas and other refined petroleum products. The majority of MLP revenues come from government-regulated fees and royalties. MLP dividends are actually up to 95% of the total distributions of the fees earned and are mostly tax-deferred. The dividends reduce investors' cost basis of the shares and are subject to taxes when those shares are sold. Additionally, investors receive a more cumbersome K-1 tax form rather than a 1099. The high yields are mandated by federal laws and are taxed only on the partner levels.

3. **Real Estate Investment Trusts.** Real Estate Investment Trusts (REITs) are also tax-advantaged and provide attractive income based on investments in real estate, rental payments, and gains from property sales and from mortgages. As with MLPs valuations are high in this historically low interest rate environment. However, REITs that use leverage can be more volatile than other forms of equity.

4. **International Bonds.** Not all international debt offer attractive yields, such as Danish sovereign debt which currently has a negative yield. Of course there are lower quality debt such as Spanish and Italian obligations that can pay over 6% if the bonds do not default. Finding the right combination of risk and return is getting trickier. Among the factors that determine the credit-worthiness of sovereign debt are how much they owe, the size and growth rates of the economies they oversee and the inflation rate. As of quarter-end, the most attractive foreign sovereign debt investors consider include the following[25]:

10-Year Government Obligation	**Current Yield***
Australia	3.04%
New Zeeland	3.29%
Mexico	5.48%
Indonesia	6.51%
Turkey	8.57%

As of June 30, 2012

Other possible alternatives for relatively attractive yield include preferred stock and exchange-traded funds (ETFs) which can hold bonds from “junk” quality through investment-grade and often pay monthly dividends.

The concern investment advisory firms such as ours face is when interest rates fall, investors can be persuaded to adjust their risk levels higher to compensate for the lower returns. In other words, the investment environment influences investors to consider investments that normally would not fit their risk/reward parameters. Our responsibility is to anticipate these contingencies and design and implement an investment strategy that is broad and flexible enough to create sufficient return even during challenging times. Establishing this investment strategy for each of our clients is our highest priority. Please call us if you have any questions.

We wish you a pleasant and enjoyable summer.

Yours,

George Gumbiner

[1] Value Line Selection & Opinion, pg.1482, 7/13/12
[2] Wall Street Journal, “This June Was a Boon, Not a Swoon,” pg.134, 6/30/12
[3] Wall Street Journal, “Country-by-Country Derby,” pg. C8, 7/2/12
[4] Wall Street Journal, “International Stock Indexes,” pg. C4, 7/2/12
[5] Wells Fargo Securities, “Economic Groups,” pg. 8, 7/6/12
[6] Investors Business Daily, “Copper Jumps, Crude Rises 9% After EU Deal,” pg. 1316, 7/2/12
[7] The Wall Street Journal, “Commodities,” pg. B5, 6/30/12
[8] ibid.
[9] www.marketwatch.com, “Q2 Growth Estimates Slashed by Economists,” 7/11/12
[10] Investors Business Daily, “U.S. Manufacturing Retreats in June,” pg. A1, 7/3/12
[11] Investors Business Daily, “Retail Sales Stall on Jobs, Storms, but Some Winners,” pg. A1, 7/6/12
[12] Investors Business Daily, “Just 80,000 Jobs Added As Economy Downshifts,” pg. A1, 7/9/12
[13] Ibid.
[14] www.cnnmoney.com, “Mortgage Rates Smash Old Record,” 7/5/12
[15] Ibid.
[16] Denver Post, “Consumer Debt t Lowest Level Since 2007,” pg. 14A, 7/4/12
[17] Ibid.
[18] www.thedailybeast.com, “Myth of Decline,” 4/30/12
[19] Wall Street Journal, “Foreign Investment Surges,” pg. A3, 6/15/12
[20] www.marketwatch.com, “Bond-market Investors’ Delusions,” 5/11/12
[21] Kiplinger’s Investing for Income, “Where to Invest Now for Safety and Income,” pg. 2, 5/12
[22] www.investmentnews.com, “Dividend Yield Vital Amid Low Growth,” 6/3/12
[23] Ibid.
[24] Barrons, “Pipelines to Profits,” pg. 21, 6/4/12
[25] Wall Street Journal, “Even Cautious Bond Investors Should Look Overseas,” pg. B7, 6/30/12