Marathon Investment Management

Plan, Patience and Two Great Indicators

November 1, 2011

The Third Quarter

The stock markets ended September 30, 2011 with all the macro-economic challenges as unresolved as they have been all year. The DJIA (Dow Jones Industrials) closed down 12.1% at 10,913; the S&P 500 fell 14.3% to 1131 while the small-cap Russell 2000 stalled out at a miserable 644 dropping 22.1%. The Dow Jones Global index, even with the European debt crisis, did slightly better than the Russell 2000 with a slide of -20.2%. Note the following:

Index	3rd Quarter[1]	Year to Date[3]
DJIA	-12.1%	-5.7%
Total Stock Market i.e. Russell 5000	-15.7%	-11.4%
DJ Global (ex US)	-20.2%	-18.6%
NASDAQ Composite (high tech)	-12.9%	-9.0%
S&P 500	-14.3%	-10.0%
Russell 2000 (small cap)	-22.1%	-17.8%

The third quarter 2011 resulted in the biggest quarterly drop since the financial crisis in 2008. As seen in the above, the big issues of the European sovereign-debt crisis, a U.S. economy flirting with a double-dip recession, and mounting signs of the fast-growing Chinese economy slowing down with mounting inflation are taking its toll on return.

On 18 separate occasions during the quarter, the DJIA fell more than 200 points, but the index stayed in the range of 10,600 to 11,500. Market volatility, which continues to unnerve investors, seemed to reach record levels this quarter with reversals even on an hourly basis. In August through September, the DJIA rose or fell by more than 1% on 29 days, and there were 15 days with final moves of more than 2%[4]. At least 7 of those days were moves of more than 3%.

Among the DJIA (large cap) issues, McDonalds Corp. performed the best with a 4.15% gain while Bank of America had the biggest fall with a drop of 44.16%[2]. Those companies involved with manufacturing, refining and processing raw materials, and financial institutions led the fall. Defensive stocks such as utilities and consumer staples held up the best. A major index we usually do not report on, the Dow Jones Utility average, finished the quarter unchanged.

International Markets

International stock indices complemented our domestic markets. The European market average, as represented by the Stoxx Europe 600 fell 17.1%[5]. Please note the following:

Best 3rd Quarter by Country (US$)		Worst 3rd Quarter by Country (US$)[6]	
Peru	-0.4%	Greece	-45.3%
Quten	-0.8%	Cyprus	-44.9%
Iceland	-3.0%	Hungary	-43.7%
Sri Lanka	-3.2%	Poland	-35.5%
Jordan	-4.8%	Austria	-34.3%
Oman	-5.2%	Italy	-31.2%
Japan	-5.99	Germany	-30.9%
Morocco	-6.4%	Romania	-30.2%
Pakistan	-7.7%	France	-30.0%
Kuwait	-7.8%	Russia	-28.5%
Philippines	-8.3%	Finland	-28.0%
Slovakia	-8.3%	Brazil	-27.2%
Buhrain	-8.5%	Chile	-27.0%

Among the major exchanges we follow, performance compares with ours:

Stock Market	3rd Quarter (US $)[7]
London FT-SE100	-13.7%
Tokyo Nikkei	-11.4%
Toronto TSE 300	-13.5%

As with our domestic markets, the European financials led the downward spiral. Beginning in late July major European banks holding Greek, Italian, Portuguese, and Spanish sovereign debt collapsed. Shares of Societe Generale SA plunged more than 40% in 13 trading days[8]. BNP Paribas (which owns US Bank of the West), Credit Agricole, Royal Bank of Scotland, and many others saw their values plunge and their ratings cut.

The MSCI Emerging Markets index fell over 23% for the third quarter, with eastern European and Asian exchanges suffering the worst of the rout[9]. Growth rates (GDP) in emerging markets have slowed from roughly 6.6% on average to 4.6% this year – still much higher than the developed economies of Japan, US, and western Europe. Due to decreasing demand in the western countries for retail, electronics, components, and durables, we saw a drop in demand for commodities by China and other eastern economies with their equity markets dropping in a complementary fashion.

Until the latter part of the third quarter Middle Eastern markets held up well because of stable but high crude oil prices. Crude closed the quarter at 79.20/barrel off 13.33% year-to-date. Mid-year prices were as high as 95.42 before demand decreased.

Commodities

The DJ-UBS Commodity index finished the quarter down 11.3% as demand from China and other emerging-market nations eased. Copper, which China imports more than any other nation, fell 26%. Soybeans, exported by the US to China and others, fell 9.7%[10]. If demand for finished goods by western nations continues to drop, demand by developing markets in east Asia for raw materials can drop further, and price will follow.

Gold, after hitting an August high of $1,888/troy oz., closed the quarter at $1,656/troy oz., up 16.53% for 9 months of 2011. This rise continues to reflect ongoing concern about US and European paper currency stability while central banks continue to pump more cash into their respective economies.

Fixed Income

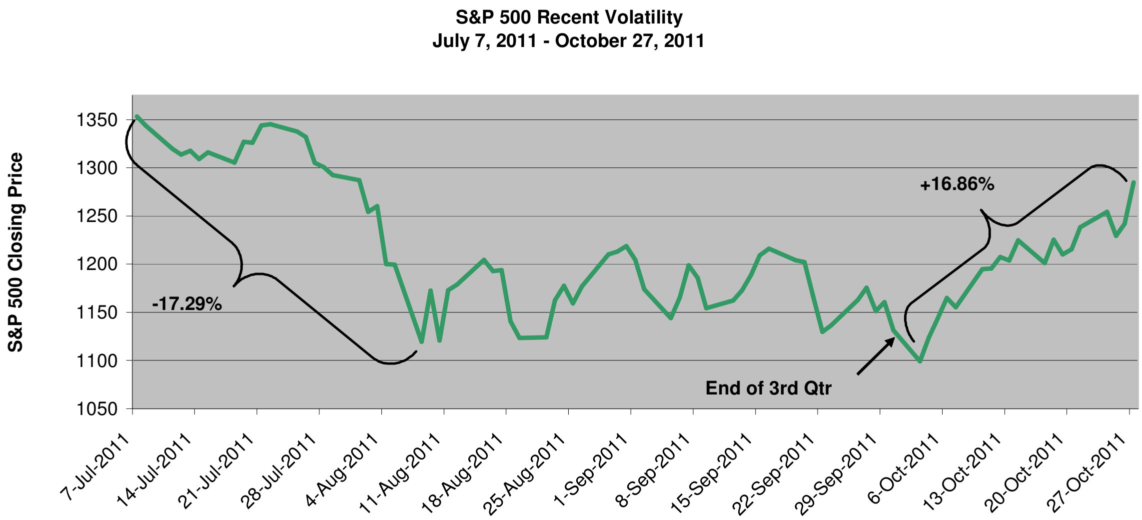
Naturally, high quality bonds, particularly US treasuries, held and gained value as global challenges mount. Note the following:

Bond	September 30, 2011 yield[11]
2-year T-bill	0.26%
5-year CD	1.66%
10-year T-note	1.92%

The downgrading of US sovereign debt from AAA to AA+ had no observable effect on interest rates. The trend of falling yields and subsequent rising bond values has been a decade-long trend – way outperforming equities. For the last 10 years the total return of the S&P 500 has been 32% while the Barclays Capital US Aggregate Bond index returned roughly 73%[12]. Will rates drop to zero, hold where they are, or reverse direction and rise?

Two Key Bullish Indicators

The S&P 500 closed the third quarter at 1131.42. On Monday, October 3 this index fell to 1,099.23. Eighteen trading days later on Thursday October 27th, the index closed at 1,284.59 up 16.86%.



As seen in the chart above, we have witnessed two serious corrections this year. Who could have predicted that, and furthermore, who predicted the current rally? Despite the market volatility investors (and some of our clients) attempt to predict corrections and rallies – with at best, minimal success.

We base investment strategies for discretionary clients first on financial needs and goals, and then on risk/reward attitudes. For us, a successful working relationship is based on the above; following an investment discipline throughout "bull" and "bear" markets alike, allowing us to rebalance and adjust accordingly based on opportunity and relative value. This has brought about clients' investment success as compared to other respective indices over time.

Currently, we are seeing corporate third quarter earnings growth of 12.6% compared to a year earlier. We are also observing US corporations hoarding about $2 trillion of earnings accumulated over the past two years waiting for signs of economic certainty and stability.

Over only a few days in October several companies announced major acquisitions. First, Kinder Morgan and El Paso Corp agreed to merge in a $38 billion deal creating the largest natural-gas pipeline system in the US[13]. A few days later Cigna Corp agreed to acquire Health-Spring for about $3.8 billion. The same day Oracle Corp struck a deal to pick up Right Now, for about $1.5 billion, while JM Smucker agreed to acquire a majority position of the North American food, coffee and beverage service of Sara Lee Corp worth about $400 million. As the day wore on Statoil of Norway bought out Texas-based Brighton Exploration Co for about $4.4 billion[14]. Finally, we read that the giant Swiss pharmaceutical, Roche Holding AG will acquire San Diego based Anadys Pharmaceuticals for $230 million[15]. This is one indicator we look for, and all this happened in one day!

Stock buy-backs are another bullish indicator we consider. Last month Berkshire Hathaway authorized the repurchase of its own stock for the first time in four decades[16]. This investment holding company owns stakes in 27 companies including purchases made in General Electric and Goldman Sachs during the credit crisis of 2007-2009. Last year Burlington Northern Santa Fe was purchased for $26.5 billion. Mr. Buffett recently stated that he expects economic growth to continue and will “bet very heavily” against a second recession in three years[17].

As we go forward in the fourth quarter and later into an election year, also positive indicators historically, we maintain our constructive approach.

Truly yours,

George Gumbiner
President

Footnotes

1. Wall Street Journal, Market Boxscores, 10/3/2011, pg. C8
2. Wall Street Journal, "How the 30 Dow Jones Industrials Performed", 10/3/2011, pg. C8
3. Value Line Stock Market Review: Third Quarter, 2011, 10/24/2011, pg. 1962,
4. Wall Street Journal, "Spooked Investors Seek Safety," 10/3/2011, pg. C1
5. www.marketwatch.com, "Stocks dive for worst quarter since crisis," 10/3/2011
6. Wall Street Journal, "Country-by-Country Derby," 10/3/2011, pg. C10
7. Value Line Investment Survey, Third Quarter, 10/14/2011, pg. 1962
8. Wall Street Journal, "Greek Ills Infect the Neighbors," 10/3/2011, pg. C10
9. Wall Street Journal, "Investors Sour on Developing World," 10/3/2011, pg. C10
10. Wall Street Journal, "As the Chinese Take Breather, Markets Gasp," 10/3/2011, pg. C7
11. Wall Street Journal, "Corporate Borrowing Rates and Yields," 10/1/2011, pg. B4
12. Wall Street Journal, "The Stampede Into Debt Continues," 10/3/2011, pg. C7
13. www.marketwatch.com, "Kinder Morgan buying El Paso in $38 billion deal" 10/17/2011
14. www.marketwatch.com, "Statoil buys U.S. Company in $4.4 billion deal," 10/17/2011
15. www.marketwatch.com, "Roche to buy Anadys, to boost hepatitis therapies," 10/17/2011
16. www.investmentnews.com, "What Buffets rare buyback says about large-caps," 10/17/2011, pg. 1