

From: Warner A. Henderson, ChFC

Subject: Investing Amid Political Dysfunction

Here we are once again; being subjected to extreme political polarization and dysfunction by our representatives in Washington. While the impact of the government shutdown is being immediately felt by some 800,000 federal workers (about 30% of the workforce), the ripple effect will likely impact US economic growth more and more with each passing day. Economists estimate that the nation's GDP growth rate, already limping along at an anemic 1.6%, will lose about 0.1% to 0.2% for each week the government remains in shutdown mode. At that rate, a five week shutdown might shave between 0.5% and 1% from the GDP's annualized growth rate just at the time when the economy was picking up steam. While the shutdown is bad enough, the much bigger problem is the Debt Limit which must be raised within a few weeks lest the Treasury Department find itself in the unprecedented position of having insufficient funds to pay for all of our nation's obligations.

I will not go into a lengthy rehashing of how we ended up in this predicament which has been brewing over the past few years; from an investment perspective, however, we should consider how this may all play out. The *somewhat* pessimistic view from political observers in Washington is that the shutdown may last for another few weeks and an agreement to raise the Debt Limit might not occur until just before or within a few days after reaching the technical Debt Limit; sometime between October 17th and 30th (one reason the deadline might extend beyond the earlier date is due to the fact that the shutdown is "saving" the government about \$200 million per day by not paying the 800,000 federal workers). While it now appears there are sufficient votes in the House from Democrats and moderate Republicans to pass a "clean" Debt Limit expansion, it's more likely the Republicans will push for some spending or tax reduction compromises as a precondition; for example, the repeal of the health care tax on

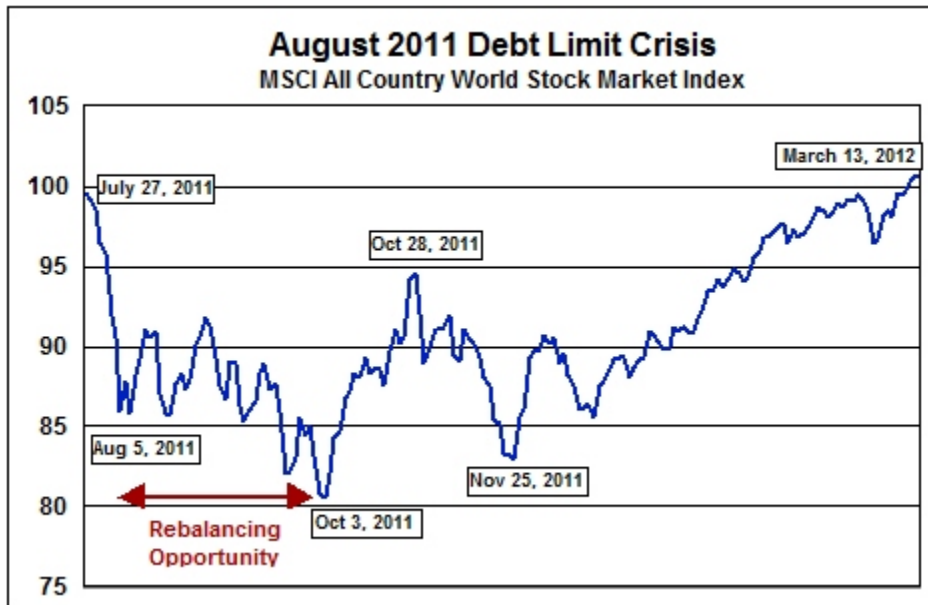
certain medical equipment which is part of the Affordable Care Act. There's even the remote possibility of conditioning the approval to raise the Debt Limit on an agreement to reopen negotiations for putting together a major budget deal to address our nation's longer term fiscal challenges (Speaker Boehner and President Obama were reportedly close to such a "Grand Bargain" deal before the last Debt Limit crisis in August of 2011 and there is currently growing support for this idea in the Senate).

While we believe there will be a resolution before the deadline, what if we breach the Debt Limit deadline without an agreement? In that situation, the US Treasury Department (in collaboration with the Federal Reserve) will have to determine which obligations would be paid first (there would only be about \$2 of revenue coming in for every \$3 of government obligations). Fortunately, the US Treasury and Federal Reserve are led by two very bright and *rational* individuals, Messrs Jack Lew and Ben Bernanke, respectively. The Treasury's first priority would be to retain our nation's creditworthiness and pay any interest and principal due on our nation's debt; in other words, *there will be no default on our nation's debt* (contrary to the media's sensationalistic hype). *However*, after dealing with the first priority, the options become more complicated as the Treasury Department would then have to determine which other obligations would be paid or delayed (including Social Security payments). By that point, however, the political pressures on members of Congress would be so great that some sort of deal would be struck to end the standoff.



How might the investment markets react to all of this political dysfunction and fiscal uncertainty? Up to this point, the markets have been relatively calm given the general consensus that a deal will ultimately be reached (we've gone through this before, haven't we?). Globally, stocks are down by about 3% since the government shutdown drama began. And while the probability of defaulting on our nation's *debt* is practically zero, investor anxiety will undoubtedly rise as each

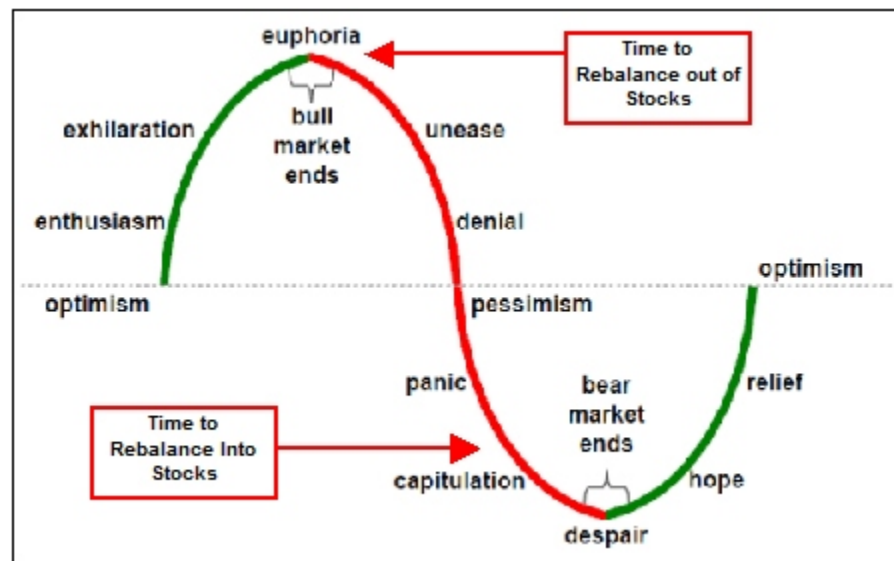
day passes without a resolution. In looking at stock market behavior during the last Debt Limit crisis in August of 2011 for guidance, stocks fell by about 14% leading up to the August 5th deadline and then another 6% following our credit downgrade. Once fear subsided, stocks regained their lost ground over the ensuing five months (and went on to record new record highs). The lesson we seem to be *relearning* too often is that fear and uncertainty can drive stock prices significantly lower, but for long-term investors, fear can also create an opportunity to buy stocks at relatively depressed prices through portfolio rebalancing (i.e., buying low). In the chart below, note that during the two month period between August 5th and October 3rd of 2011, investor fear enabled investors to buy stocks at a 15% to 20% discount. (Remember Warren Buffett's guidance, "Be fearful when others are greedy, and greedy when others are fearful.")



Using Fear and Exuberance to Our Advantage

Alan Greenspan coined the phrase "Irrational Exuberance" to describe excessively high stock prices during the Tech Stock Bubble of the late 90's. Given a relatively peaceful world and the promise of a technology-led economic revolution at the time, investor enthusiasm drove stock prices to record high levels. As measured by its Price-to-Earnings Ratio, stocks in the S&P 500 Index

were more than 100% over-valued. Stock prices were inflated by overly optimistic expectations rather than sound economics; clearly a time when Buffett's "be fearful when others are greedy" advice was sounding the alarm for investors to take stock gains off the table. In the familiar looking chart below, human psychology inexorably creates an emotional roller coaster where optimism can drive stock prices to excessive levels and, conversely, pessimism and fear can drive prices to depressed levels. While it seems perfectly rational to sell (or trim) stocks when prices are high and buy (or add to) stocks when they are low, human psychology typically moves investors in the opposite direction and is one of the primary reasons why the average investor fails to beat the broad stock market indices (most active managers fail to beat the indices as well, but that's another story). Just



where are we on the emotional roller coaster today? We're clearly not at the euphoric level which is positive from a stock valuation perspective (although euphoria would feel a lot better) and we're not at a level of despair (that was in the fall of 2008 and early 2009). Before the government shutdown and Debt Limit crisis, I would have put us somewhere at the right of the roller coaster cycle between relief and optimism. Reasons to be optimistic include an improving US economy, a brighter employment picture and stimulative interest rates; even Europe has settled down and appears to be coming out of recession. Higher stock prices this year are reflective of investor sentiment turning positive toward the economy and stocks for the first time in more than five years (up until this year, investors were moving more money into bonds than stocks). As of this writing,

however, the political fiasco in Washington has begun to dampen investor optimism and sentiment could turn sharply negative depending on how the events unfold over the next few weeks. We should be prepared for heightened volatility in the days and weeks ahead and if the current Debt Limit episode turns out to be anything like the one experienced in August of 2011, we should also be prepared to consider rebalancing opportunities in weeks and months afterwards.

Asset Class Performance

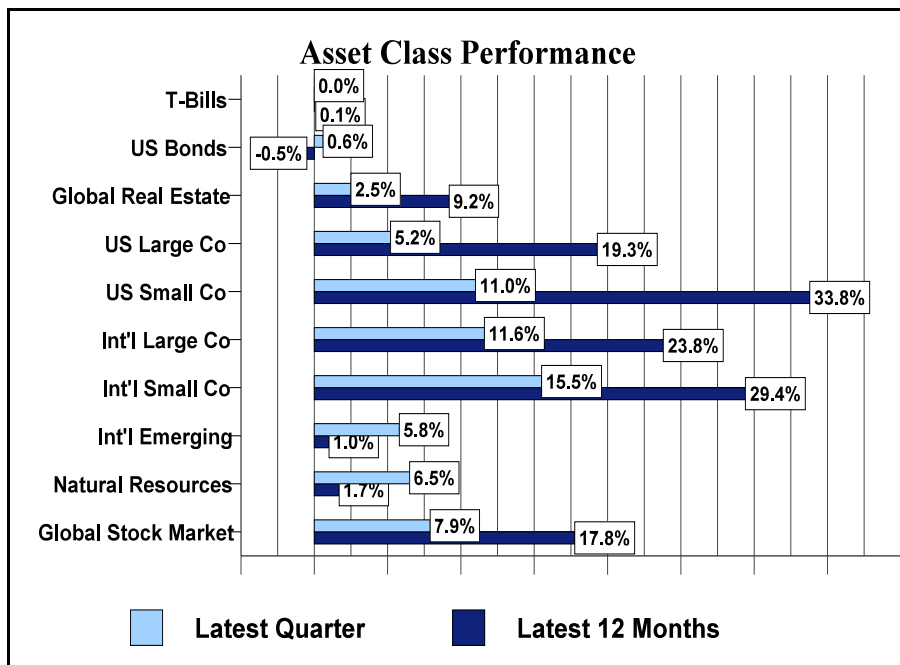
Obviously, the bulk of this letter has been devoted to our dysfunction in Washington and the potential outcome and opportunity resulting from the Debt Limit crisis. While it seems like we're moving from one crisis to another in the US, the global economy has been making progress despite all of the turmoil and challenges we face around the world. Reflective of this economic growth story, the average return for stocks around the globe was close to 18% over the past

particularly attractive opportunity for long-term investors). Within Fixed Assets, US T-Bills (+0.1%) provided a near-zero return and US Bonds posted a modest loss reflecting the effect of rising interest rates. All in all, a terrific twelve months for stocks.

For the quarter, the returns were likewise robust for most of the stock asset classes with the Global Stock Market gaining 7.9%. Leading the charge were Int'l Small Co's (+15.5%), Int'l Large Co's (+11.6%), US Small Co's (+11.0%), Natural Resources (+6.5%), Emerging Markets (+5.8%), US Large Co's (+5.2%) and, lastly, Global Real Estate (+2.5%). US Bonds (0.6%) recovered somewhat as tapering fears subsided and US T-Bills were flat (0.0%).

Closing Comment

While we're discouraged about the current dysfunction in Washington, we understand there are difficult choices to be made in order to create a more sustainable economy for ourselves and future generations. Comprehensive and sensible *bi-partisan* plans already exist to address our government's long term fiscal challenges (e.g., the Bowles-Simpson Plan and the so called Gang of Six Plan). While it now seems like there's an enormous divide between the current dysfunction and a comprehensive bi-partisan solution, perhaps the current crisis will enable the moderates from both sides to jettison the extremists and steer us in that direction. Winston Churchill once said, "Americans can always be counted on to do the right thing....after they've exhausted all other possibilities." Perhaps we're getting closer to that moment.



twelve months. Leading the way were US Small Co's (+33.8%), Int'l Small Co's (29.4%), Int'l Large Co's (+23.8%) and US Large Co's (+19.3%). Global Real Estate (+9.2%) was next with Natural Resources (+1.7%) and Emerging Markets (+1.0%) following far behind (we believe Emerging Markets stocks present a