Sound Investments Inc.

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Third Quarter 2011

DJIA 10913.38 S&P 500 1131.42 NSDAQ 2491.58

Quarterly Report

At the beginning of the year the Dow-Jones average started at 11,577and as I write this on Oct 18th it closed at 11,578 which is where we started. We had a great run to 12600 on the Dow - Jones then a collapse down to 10800 - as we had an onslaught of news about the challenges facing the global economy that sent stocks tumbling beginning in late July, then zig-zagged through September. This volility reflects the tremendous indecision that abounds. Over the course of this report we will review some of the factors and attempt to evaluate the risk in the market.

Housing Job Engine Falters

Over the past decade the housing market has been a powerful engine: it helped the economy out of recessions and created jobs as construction firms took on workers and new homeowners hired contractors to decorate rooms and maintain lawns or purchase new furniture. From 2000 to 2008 the whole US economy was built on housing and the services that come with it.

But, today the housing sector endures a prolonged slump, (i.e. see chart on the back of this page) many of the jobs it created are gone. It is a measure of the depth of the U.S. economy's current weakness that despite the lowest mortgage rates in 40 years, the housing market has not revived. Housing has become what many economists see as a vicious cycle that has left the wider economy struggling to gain altitude. For example, "People are losing their jobs and not getting equivalent jobs - So people are not in a mood to expand." says Yale economist Robert Shiller. This affects other businesses from flower shops to daycare providers and auto sales.

Other Issues: Unemployment and Europe

In this recovery companies are increasing their payrolls while state, local and federal governments are trimming theirs. This, trend would be much more pronounced if not for the tens of billions of dollars in stimulus funds given to states to patch their budgets.

So, in Sept the private sector added 137,000 jobs – decent but nothing to write home about - while the government sector cut 34,000 jobs. Taking a longer view the U.S. economy has added 1.78 million private sector jobs in the last year. It sounds like a lot

We upgraded based upon the observation, that few, if any money managers consistently excel. Instead, we observed a wide range of performance returns, with only a small percentage of professional money managers investing in the right sectors of the equity markets at any given time.

This is because each money manager has a particular style that works well in some, but not in all market environments. Market leadership rotates between large-caps and small-caps, growth and value styles, and international and domestic areas. Leadership changes because economic conditions change. However, most fund managers do not change their particular styles when the market leadership changes.

Since market leadership is forever changing, we move incrementally towards the top ranked funds by progressively selling the lower ranked funds and investing in the new leaders. **This continuous process provides an effective way to invest in a broad range of investment opportunities as they develop.**

We use no load funds, exchange traded funds and some stocks as they provide access to the talents and research of the country's leading money managers, while they are at the top of their game.

of jobs but, there are 14 million unemployed so at this rate it going to take at least 4 or 5 years to get the unemployment rate down to a more manageable level

There is trouble in Europe as well. The European Union has thrown billions of Euros to keep Greece afloat, so far without noticeable effect. There is talk of downgrades for the sovereign debt of France, Spain, Italy, Ireland and Portugal as well. It is going to be hard for all the member countries to agree to whom will shoulder the debt and you can't blame the German people for be reluctant to carry it. This story will play out over the next year or two.

A Little More Upbeat Please

In the last 5 paragraphs I presented a gloomy picture but a lot of it is already priced into the market. Equity analysts are gradually coming to terms with the economic slowdown, as earnings estimates slowly but surely drop from robust to merely adequate levels. In past client letters we have talked about estimates for the S&P operating earnings. We estimated at $95 in our last report. Some economists had it as high $100 in 2011 and 110 in 2012. An article in Barrons, entitled 'Puffed up Profit Projections", estimated it to be $94 for 2011, and $81 to $104 for 2012. Even using the lower figure of $81 with the S&P 500 index currently at 1100, this gives a Price / Earnings ratio of 13.9 which is low compared to the long term average of 15 to 16. Dividend yields are now higher at about 2.5% for the S&P 500 and 2.4% for the Russell 3000 ---Yields on 10 year bonds are now around 2%, and the last time dividend yields were higher was in 1958. On a valuation basis the market is inexpensive. There is no doubt that the memories of the 2008 collapse and subsequent financial crisis are still fresh in peoples mind. A lot of progress has been made with the banks and I think it is very unlikely that it will break support at the 1000 level on the S&P 500. (See chart on the back of this page). I do not believe we will see a replay of 2008.

Markets are forward looking and they often surprise. There have been 10 quarters as bad as the last quarter since WWII, and 89% of the time was followed by positive quarters, up an average of 5.3%, according to Ned Davis Research. There is a tidal wave of money sitting on the sidelines ready to go work at the slightest uptick in sentiment.

Recent Data Brightens Economic Views

Economist are doing an about face from just a month ago, when they were fretting that the county was on the cusp of a recession. For example, in mid-Sept a weekly poll of forecaster expected the GNP to grow at 1.7% for the year as that same group anticipates a much improved rate of 2.7%. What has happened to change their views? During the summer, Europe's financial troubles and the rancorous debt-ceiling debate in Washington badly damage the confidence of many consumers and investors in the recovery footing. So far it hasn't led to a tigthing of the purse strings. The charts on back of page 1 show increased retail sales and higher shipments of manufactured goods. The bottom line is businesses and investors continued their spending.

To put the 2.7% into focus this only brings down the unemployment rate by ½% over the course of one year. The economy could still stall if government spending slows, or there is fallout from Europe region. A number cruncher with J. P. Morgan commented "the chances of a recession have diminished quite a bit."

Conclusion

We are wary of the market yet recognize the values it holds. In many ways I feel more comfortable with this market since it has the earnings and dividend yields to support it. We will continue to monitor the situation and be in touch.

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