Sound Investments Inc.

Kenneth A. Gilpin CFP

Third Quarter 2012

DJIA 13447.13 S&P 500 1440.67 NASDAQ 3136.60

This September I moved my practice to 8801 Long St in Lenexa KS. I share an office with another investment advisor, Dr. Ron Seltzer, who is retiring over the next 2 to 3 years. I've known Ron for 15 years and it is a pleasure to work with him. See attached a map and directions.

Quarterly Report

The third quarter was a risk-on period as markets reacted positively to central bank moves to stimulate the economy. U.S. large-cap stocks were up 6% while core investment-grade bonds gained 1.5%. From the stock market low on June 1, large-cap stocks were up 10.7% versus 1.6% for core bonds. European stocks rose dramatically on the heels of major policy action from the European Central Bank and were up nearly 9% for the quarter and 17% from the June low. Emerging-markets stocks gained 6.5% in the third quarter and also posted double-digit gains from the June low.

Why the Markets Went Up

The key driver was a change in the World's Central Banks monetary policy. The European Central Bank committed to potential unlimited purchases of distressed euro zone government bonds (i.e. from Spain or Italy) with maturities up to three years. This program is significant because it is the first time the European central bank has made an open ended commitment in terms of the amount and the time frame; it had the desired effect of sharply reducing interest rates in both Spanish and Italian government bonds. The chart on back of this page shows interest rates going down which spurred equity prices.

Not to be outdone our own Fed Chairman, Ben Bernanke on Sept 13th announced quantitative easing (QE3) to buy $40 billion per month of government backed mortgages. What this does is keep interest rates lower and in fact the Fed wants to keep short term interest rates at 0 to ¼ of 1% till mid 2015. Previously, the expectations were through 2014.

Low interest rates are good news but it is all about monetary policy or political developments. It has nothing to do with the actual state of the economy, which according to a variety of indicators, remains worrisome.

Summary

The S&P 500 rallied 15% from a June low amid unprecedented monetary stimulus from the Federal Reserve to boost economic growth. Since peaking at its highest level since Dec. 2007 the index has been struck in a 37 point range.

While we've had a slow but steady economic recovery here in the U.S. Many parts of the world are in worse shape. Southern European nations are in outright recession and China can no longer be counted on to provide robust demand for raw materials. Clearly the U.S. Federal Reserve is trying to get ahead of the recession by acting now.

As I write this on Oct 17th one hundred of the S&P 500 companies have reported their quarter results. Earnings are holding up but sales in 6 out of 10 companies have declined. Profit and revenue at U.S. companies have been expanding since the 3rd quarter of 2009, a bright spot in what has been a lackluster recovery. This run may be coming to an end and reflects a slowing world economy. Since equities are trading relative low we will maintain our existing asset allocation and will continue to monitor the situation.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Kenneth Gilpin CFP 913 908 4366

The United States continues to grow at an abnormally slow pace, with 2nd quarter growth rate revised downward to 1.3%. Europe is stuck in no-growth territory as it struggles with its debt crisis. As for China, the world's main growth engine, no one knows exactly how hard a landing it is currently experiencing – but it's most recent manufacturing data signals a greater slowdown than previously anticipated.

The stock markets mindset seems to be bad news is actual good news because the Central Banks will step in with even more aggressive intervention, which will be a further boost to risk taking. While we've had a slow but steady economic recovery here in the U.S. Many parts of the world are in worse shape. Southern European nations are in outright recession and China can no longer be counted on to provide robust demand for raw materials. Clearly the U.S. Federal Reserve is trying to get ahead of the recession by acting now.

Changing Gears: The Real Economy.

There are a lot of positives outlined as follows: A) Based on price / earnings ratios and dividend yields, stocks haven't been this cheap since the 1950's. B) Corporate balance sheets are strong with a high level of cash on hand. C) U.S. companies are making money at home despite a volatile global economy (See chart on back page 1) D) Confident consumers are stepping up spending. (See chart on back of this page)

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Conclusion

A 79 year old Blackstone Partner, Byron Wien, recently wrote "The world usually ends up better than the pessimistic think. We wouldn't have got this far if the pessimists had always been right." But that doesn't mean disasters don't happen. It means by and larger we work our way out of problems such as:

1. Government expenditures are 24% of GNP and tax revenues are 17% and we are running an annual deficit of a Trillion dollars. The blended interest rate of our national debt is around 2%. If it goes to 3% and we keep accumulating annual debts of more than trillion a year, by the year 2020 it will take 20% of total tax revenue to service the debt. It takes 9% now. Regardless of who wins the presidency, we are a democracy and there will be some agreement on raising revenue, cutting expenses and bringing the budget into line.
2. The U.S. economy is stronger than it appears. Ninety-Two per cent of the people who want a job are working and they are going to spend money at Christmas. Retail sales have been good all year and housing is going to turn up next year. Agricultural exports are helping. Everybody complains about job creation but the private sector has created quite a few jobs while the public sector has cut back.

We appreciate your continued confidence and trust.

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