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In this quarterly commentary we discuss how we deal with the constant challenge of uncertainty in determining our investment strategy.

In assessing risk, we differentiate between temporary factors (such as corporate governance scandals) and those which are likely to have a long-term impact on the investment environment (such as high debt levels). We also try to differentiate between cyclical and secular trends.

Some risks are material but difficult to assess. If we can protect our portfolios from such risks with little or no opportunity cost, we will do so.

Stock valuations are reasonable, helped by strong earnings growth, and our return expectation for stocks over the next three to five years is decent: in the high single-digit to low double-digit range.

Inflation and deflation are interrelated, and we think in coming years we could be in for a balancing act as policy makers try to protect against too much inflation without creating deflationary forces (such as high debt levels leading to decreasing spending).

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.

Quarterly Investment Commentary:

Stocks hit the mid-point with little to show for the last six months. After a slight increase in the First Quarter, the broad market retreated in April to Mid-May before rebounding through June. Year to date the Dow gained just 0.09 % and the S&P 500 3.4%. Small cap stocks represented by the Russell 2000 ended the first half up 6.2%. International markets were up about 1%.

Financial markets didn't flinch from the long anticipated interest rate hike because the market is already doing the job for the Fed. The yield on the benchmark 10 year Treasury Bond had already moved up a 100 bias points, so there were no surprises. For months pundits had focused on the strength of the economic expansion and the Fed's eventually tighting of monetary policy. It was only a matter of time before interest rates would head higher and that time arrived at the end of June when fed funds rose a quarter point. This is likely the first step in a series of interest rate increases from a 46 year low of 1%.

Even after a series of interest rate hikes, interest rates will still be at historically low levels. The short term cost of money sits well below the rate of inflation. If inflation rekindles, the Fed may move aggressively, but for now they decided the pace will be slow.

With business profits flourishing, the environment is positive for stocks, even with interest rates rising; Corporate earnings were up over 28% year over year bias in the first quarter while the market was essentially flat. Second quarter earnings could also produce a 20% increase. Keep in mind the average earnings growth of the S&P 500 over the past 20 years is only 8.3%

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On average, Large–cap funds, both in the US and right around the world, were essentially flat in the second quarter, while small and mid-cap funds brought in slight gains although experts have been anticipating the rotation into large cap funds it did not materialize.

As is typical of small company funds have been more volatile this year than large funds this year. When the broad market declined from April to mid May, small caps lost twice as much as large caps. Thinking that a leadership change from small caps was overdue market forecasters were quick to call an end to the five year small cap trend. However, when stocks rebounded from mid May through June small caps gained twice as much as large caps. This is why it is important to have a longer term view and make changes incrementally.

Value investment styles continue to outperform growth funds in all size categories. Mid-Cap funds finished up 2.2% for the quarter, topping all diversified categories, while their growth counterparts gained 0.7%. Growth strategies fared particularly poorly among small cap funds, perhaps reflecting investor's reduced appetite for risk. Small cap value funds were up 2% but their growth peers lost 0.3%.

International funds particularly small caps and Japan remain prominent among our top ranked funds. Europe was the dark horse among international funds last quarter rising 1.5% on average. Meanwhile, emerging markets funds dropped sharply, as did Latin America and Asia/Pacific funds that exclude Japan.

Its being difficult market track but our positions in Oakmark International, Dodge and Cox International American Century Small Cap Value etc. have tracked these trends the small cap value and international trends very well. In some ways it's been like threading a needle. What I try to do is follow the long term trends of the market and invest in quality mutual funds. Since we are a registered investment advisor the transaction fees are very low, no commissions are paid (usually this is 5%) only a 1% management fee is charged.

Even though the economic news has been very strong with good earning reports: In my mind there is still a lot of uncertainty in the economy. I question some of these numbers. As a result our portfolios have significant amounts of short term bonds or near money market types of investments. A number of well known money managers are also holding cash with the view there may be better buying opportunism down the road.

A well know investment management firm Litman Gregory wrote the following:

The Interrelationship of Inflation and Deflation

The U.S. is a consumption-based society. Consumer spending is 70% of the economy. America's love of spending helps explain our huge trade deficit—we Americans love to buy foreign goods. There will be a limit to how big this deficit can get but we don't know where that limit is. Our increasing consumption has been taking up a higher and higher portion of disposable income over the past 20 years, which has been partly funded by debt. Like the trade deficit, it is hard to know how much debt is too much, but we do know that debt relative to GDP has skyrocketed, almost doubling over the last 20 years. And even though net worth has also increased, debt compared to household net worth is higher than it's been in the 60 years that we have data for, and has moved sharply higher in the last five years. Debt service compared to disposable income is also higher than it's been in the 25 years of our data series. Why do we care about debt growth? We care because if debt growth slows, consumer spending will also probably slow. And consumer spending is such a large portion of the economy that this could significantly slow economic growth and profit growth. This is not a great scenario for stocks.

While it may seem odd to be worrying about this now, while the economy is doing well, as long-term investors this is exactly the type of issue that we consider when we assess risk. Concern about debt levels and consumer spending, particularly now, is linked to another big question: inflation vs. deflation. With the very simulative monetary and fiscal policy that has been in place, can we finally forget about deflation risk? Is the real risk that inflation gets out of control? These two seemingly opposite risks are connected. If inflation and interest rates (which are closely linked) rise too much, debt growth and spending are likely to contract. And if that happens, the economic contraction that results could leave us once again flirting with deflation. If deflation risk grows again, policies will become inflationary again to defend against that risk.

We continue to believe that, excluding terrorism, the most likely case is a fairly benign cycle. What is fairly clear to us is that while inflation is the near-term risk, deflation risk remains in the background. And while neither is likely to get out of control, we could be in for an economic balancing act that may define this economic cycle and perhaps others that follow. We think investors need exposure to assets that can hold their own in each environment. Thus, the defensive portion of our conservative portfolios consists of some cash even though yields are low. We also own traditional bond funds despite fairly low interest-rate yields. If somewhere along the way we become more concerned about the risk from inflation or deflation, we may need to adjust the allocations in all our portfolios. This is something we regularly think about.

In Closing

As we've been saying for some time, this is not a time to be overly aggressive or overly defensive. It is a time to be patient. We believe that on average, portfolio returns are likely to be quite decent, though not spectacular, over the coming years compared to average inflation levels. But, there are no slam dunks we can see. At some point along the way some of the risks discussed (or others not discussed) will turn into reality and there will be temporary losses. The good news is that in all balanced portfolios we have some dry powder that can be reallocated at lower prices if bargains are created. It is these opportunities that result in good long-term returns. This is why truly long-term investors should welcome temporary market declines as an opportunity to buy assets on sale. And that is what we are patiently waiting for.

Yours Truly,

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