



QUARTERLY COMMENTARY First Quarter 2012

For more than a quarter century, we have urged investors to maintain a high degree of portfolio flexibility. With countries and banks around the world currently on the edge of insolvency, that message has never been more important. Since Y2K, investors with traditionally structured portfolios containing relatively fixed allocations to stocks and bonds have not fared well. Despite two rallies of more than 100% each, the S&P 500 has returned a mere 1.35% per year since the market peak in 2000, a dozen years ago. Despite not participating heavily in those strong up phases, Mission's clients have seen portfolio values rise by 70% century-to-date before fees, which vary based on portfolio size. In addition to long-term portfolio performance advantage, clients have benefitted by being able to sleep soundly. Their portfolios earned positive returns in eleven of the twelve completed years of the 21st century. Only a loss of less than 1% in 2008 marred an unblemished record. With the S&P 500 dropping by 37% in that ill-fated year, few lamented a fractional loss. We anticipate that our flexible asset allocation approach will continue to provide great benefit in the years ahead with massive uncertainty affecting world economies and virtually every investment asset class.

Investors' attention has become focused on the powerful rally that started in October and turned 2011 from a weak year into one with a 2.1% positive return for the S&P 500. That equity strength continued into the New Year and has prompted in many investors the kind of enthusiasm earlier exhibited during the dot.com boom that ended the 1990s and the housing bubble rally that peaked in 2007. As is the case today, the Federal Reserve was the great facilitator of those earlier booms. We find ourselves again in a familiar position urging caution, as we did in those two prior instances of financial excess. Long-term clients, readers and attendees at our seminars since the late-1990s have heard our warnings about unsustainable debt burdens. While the Fed and other central banks around the world have supported periodic stock market rallies by printing money, those positive effects have not been permanent, and central banks have had to resort to repeated printing to prevent economic collapse. Each episode increases already dangerous debt levels for today's population and makes the burden on future generations ever more onerous.

Despite the greatest flood of rescue money in history, world economic recoveries have been muted at best. Europe may already have fallen back into recession. The U.S. recovery is the weakest in the post-war era. Japan can't seem to get out of its two-decade-long funk. Even the BRICs (Brazil, Russia, India, China) are slowing perceptibly. Whole countries have had to be bailed out. Now comes Spain with Italy waiting in the wings. Can central bankers continue to pull financial rabbits out of their hats? Will investors maintain their faith that these masters of the improbable will be able to solve crises of excessive debt by creating ever more debt? Or will they be seen eventually to resemble the wizard behind the curtain in the *Wizard of Oz*?

Cracks in that edifice of investor faith are becoming more apparent. Notwithstanding unlimited loans to European banks to shore up their shaky balance sheets and to enable them to buy otherwise

hard-to-sell sovereign bonds, interest rates on Spanish and Italian debt are rising ominously once again. Perhaps investors are beginning to doubt the efficacy of European central bankers' attempts to solve sovereign debt problems that are probably unsolvable.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

I have written frequently about the comprehensive studies that Carmen Reinhart and Ken Rogoff have profiled in [This Time Is Different](#). In analyzing 800 years of financial crises, they describe a common phenomenon they refer to as the moment at which markets go “bang.” That moment refers to the point at which borrowers can no longer borrow at reasonable interest rates, because potential lenders doubt they will be repaid. We witnessed this event most recently in Greece. When the “bang” occurs, interest rates skyrocket, and funding markets essentially shut down. As rates on Spanish and Italian debt rise, investors have every reason to ask why, if those countries are unable to pay the interest and principal on existing debt, there should be confidence that they will be able to repay even greater levels of debt in the future.

Money is starting to flee the endangered countries in Europe. Foreign investors are selling an increasing amount of those sovereign bonds. Governments are barring withdrawals of capital from countries and are prohibiting cash transactions above relatively small levels to make the transfer of large amounts of money difficult. These are symptoms of countries whose citizens fear default and currency devaluation.

So far, such worries are not typical in the United States. In fact, faith persists that Chairman Bernanke has the resolve and the power to keep our securities markets healthy. While that conviction could be well founded, I believe it unlikely. The mantra “Don’t fight the Fed” is well known and, more often than not, sound. Following it slavishly, however, would have periodically led to spectacular losses. It is important to remember that the Fed was aggressively dropping interest rates throughout the 2007-09 stock market collapse, when the S&P 500 declined by 57%. Today people are focusing on the Fed’s successful actions from 2009 to present. The resulting stock market rally, however, has not even brought prices back to the levels of five years ago. Investors who followed the Fed throughout that period are still under water, and, by historical standards, this rally is long in the tooth.

Mission has discussed at length our belief that the long weak cycle that began in 2000 likely has several years to run. That period will probably encompass both rising and falling markets but with a downward bias that will work against a traditional buy and hold approach, as has been the case century-to-date. We anticipate that flexibility and liquidity will be rewarded as volatility powerfully influences all asset classes.

We are attempting to maximize risk-free returns in today’s difficult, high priced environment. With the plethora of stress points throughout the world’s economies, however, we expect that patience will provide numerous opportunities over the months and years ahead to add stocks, bonds, gold and possibly non-U.S. dollar denominated assets at prices that will prove very profitable over the long term.

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