January 17, 2012

2011 was a year that sorely tested everyone's patience, and not just here in the U.S. It was charged with fear and frustration, but also loaded with opportunities for those of us who had the discipline and cash to take advantage of them. As John McCorvie wrote in our fourth quarter *Financial Intelligence*, institutional traders flicked their switches back and forth between "risk on" and "risk off" almost on a daily basis. There was little discrimination in what was being bought and sold in the stock markets worldwide; undervalued businesses moved in the same direction as overvalued ones. Stodgy, boring companies traded in synch with the exciting and the trendy. The stock price correlation among the names in the S&P 500 hit 90% in September, compared with a historic average of 30% (the closer to 100% the correlation is, the less the differentiation between how individual stocks trade). My wife and I returned from a late July vacation in Alaska where we hiked and watched whales and grizzlies to find a financial world being ravaged by bears of a different kind: far less predictable and potentially much more destructive. In Washington, D.C., Republicans were facing off against Democrats over the national budget, and in New York, in a historically significant move, Standard & Poor's downgraded its rating of U.S. Treasury debt, all of which contributed to the volatility.

But the late, legendary investment manager Sir John Templeton once said, "I never ask if the market is going to go up or down because I don't know and besides it doesn't matter. I search nation after nation for stocks, asking: 'Where is the one that is lowest-priced in relation to what I believe it's worth?' " In that spirit, rather than letting ourselves be swayed by the extreme mood swings in the world's financial markets in August and September, we did not attempt to guess where stock indexes might be by the end of 2011, or at the end of 2012. Instead, we took advantage of what we perceived to be attractive bargains and bought new positions in PepsiCo, Emerson Electric and VISA for our Model Portfolio*.

In making these buys, we were not being dismissive of the dire warnings of some of the smartest money managers in the business, like PIMCO's Bill Gross, who wrote, "The financial markets and global economies are at great risk." Rather, after decades of collective experience, we at Peak were maintaining our focus on what can be gleaned from studying the facts available to us. We believe actions based on facts must always take precedence over action based upon worries about what *might* happen.

Speaking of facts, here are a few we have studied: first, the Institute for Supply Management (ISM) survey for December showed that a majority of manufacturing companies believed business had been improving for 29 consecutive months. It also revealed that the manufacturing sector of the economy continues to expand at a moderate but consistent pace. Second, Standard & Poor's estimated in December that the 500 companies in its index grew their earnings by 16.1% in 2011, but that earnings growth will slow to a still healthy 8.5% in 2012. Third, the S&P 500 index aggregate earnings in 2011 were $99 per share, and its price-to-earnings ratio at year-end 2011 was a modest 12.3, far cheaper than its average 17.5 times earnings since the end of World War II. By comparison, in March 1999 at the peak of the dot-com bubble, the index traded at a stratospheric 33.5 times earnings. This means to us that even if the economy were to descend into another recession, the result would be like slipping out of Peak's ground floor office windows and landing on the sidewalk, rather than free-falling from the 30th floor of a downtown skyscraper. Our worst-case scenario might result in bumps and scrapes but it would be far from fatal. Finally, and perhaps most important, all three companies we added to our Model Portfolio last summer had financial strength ratings of A+ or better, according to *Value Line*, reflecting the battleship-like solidity of the rest of the Model.

One of the most succinct pieces of investment advice I have seen recently came from a money manager interviewed in *Value Investor Insight*: "I've never understood the fascination with what I call investment pornography, like the latest thing Jim Cramer is talking about on television. We just try to stick to our knitting and the results should take care of themselves." At Peak, we believe the keys to obtaining good results in 2012 and beyond remain the same as always: be prepared to endure some short-term suffering in exchange for long-term gain, invest in and hold on to companies about which we have uncommonly strong convictions, and avoid taking anything (including the status quo) for granted.

Best regards,

Noel F. Bennett

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*