July 16, 2012

One of the most important tasks we at Peak face each day is to stay focused on what matters most to us and our clients, and tune out what is simply noise. This involves making choices: which media outlets to pay attention to, what headline-making issues may have an effect on our investments, and who on the world's stage is doing or saying something that is worth serious consideration and discussion. We also regularly debate amongst ourselves how much weight to place on macroeconomic concepts versus maintaining a focus on bottom-up, company by company analysis. All of this and more constitute the ingredients baked into the decisions that drive not just our investment performance but also our culture as managers of other people's money and our own. Fortunately, when it comes down to making investment decisions in our portfolios, we tend to be unanimous.

One of the research sources we pay close attention to is Value Line. For many years I have been tracking its Industrial Composite: 900 major companies based in the U.S. with operating histories of at least twelve years. The majority of the investments in Peak's Model Portfolio* are found in this Composite. Studying Value Line provides a good snapshot not just of what is happening in our economy but also helps us make educated guesses about what we might expect in the near future. The latest Composite Report reveals that its companies are continuing to rebound strongly from the 2008-09 recession, with year-over-year profits in 2011 likely to have climbed by 10-15% when the final fiscal year numbers are in. The report goes on to say that even during the recession the average debt levels of these businesses remained reasonable, and have improved in the years since. And perhaps most striking, although this does not come from Value Line, is that the amount of cash held by the industrial companies in the S&P 500 has grown from slightly over $600 billion to $1 trillion since the start of 2007. This is positive in that their financial strength has increased, but also negative because it means that executives are hoarding cash reserves so that they will not need to depend on banks, which have problems of their own, for liquidity. America's biggest companies are holding their pants up with both a belt *and* suspenders. Being fiscal conservatives ourselves, we can relate to that. Finally, and perhaps most important to us as long-term investors, the average bang for the buck we get when buying stocks has steadily increased and is roughly twice as great now as it was 12 years ago. The book value per share of the Value Line Composite has doubled during that time, while its price to earnings ratio has steadily declined from 30 to 14, which means that one dollar buys us twice as much future earnings power today as it did in 2000.

The investment community has responded to these trends with overwhelming indifference, if it pays attention to them at all. In fact, it has gradually been turning its back on stocks in favor of bonds and even cash yielding almost nothing. In 2005, consumers' holding of stock funds was 55% and their bond percentage was 15%; in 2011, the respective percentages were 45% and 25%. Stocks are going out of fashion, as they do periodically, for two main reasons. First, undisciplined investors who were scared out of stocks near market lows as the major indexes churned sideways (often violently) have accumulated little if any profit in their accounts over the last twelve years: the stock price today of the Value Line Composite sits exactly where it was in 2000. Second, worries about a possible slowdown in China and concerns about the future of the Euro currency have poured cold water on the all-important "animal spirits" of Wall Street.

It is hard even for the experts to predict what might happen to the Euro. One thing seems apparent for the Euro zone—the consequences of the possible disintegration of its thirteen year old common currency would be drastic and the countries' leaders know it. If Greece were to leave or be forced out of the Euro zone, it would galvanize the rest of the continent into acting fast to protect Italy and Spain. As a long time lover of Italy and all things Italian, I think it is likely that the future of the Euro may eventually hinge upon the leadership of Europe's third largest economy. Prime Minister Mario Monti's ability to be a catalyst for meaningful transformations in the way Italians have historically conducted themselves will be crucial. Monti is an academic and an economist with little style or charisma (unlike his predecessor Silvio Berlusconi, who had too much of both for his own good), but he has a strong working rapport with German Chancellor Angela Merkel, who has a doctorate in physics. This relationship could prove crucial to the future of the Euro. In a recent interview, Monti's Labor Minister, Elsa Fornero, said something inspiring, and remarkable to those of us who know something about the Italian way of life: "This reform is a wager on behavior changing in many ways….Everyone, not just workers, have to understand and change. That includes youth, who need to know a job isn't something you obtain by right but something you conquer, struggle for and for which you may even have to make sacrifices….It touches Italian society at the deepest level. Italy isn't a rule-bound land but one where people right the system, tweak here and there, and engage in tailor-made adjustments."

Whatever positive transformations occur in the Euro zone will likely be achieved with great difficulty and at the last possible minute. Brinksmanship is a political game played not just here in the United States, but around the world. We will be watching with interest.

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.*