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Breiter Capital Management Inc.

Investment Strategy

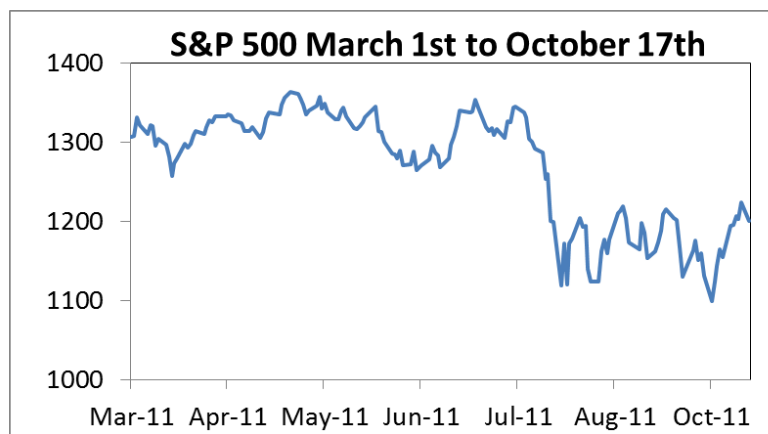
Fall 2011

Overview

- ✓ **World's stock markets sustain correction bordering on "bear market" territory in third quarter. Volatility sets records by some measures.**
- ✓ **U.S. stock market down far less than most of the world markets and especially European markets as fears of a new economic recession unfolded.**
- ✓ **Breiter Capital's Risk Control Model issued sell signals for several asset categories – the first major protective signals since a "buy" indication in April of 2009.**
- ✓ **Despite our precautionary actions of the last couple months, we are growing more optimistic about a positive resolution and potential gains for the markets in the next 12 months.**
- ✓ **Price declines in high yield corporate bonds may be creating a new opportunity for these high income vehicles to provide future price appreciation.**
- ✓ **Do you fear the media's version of the news, or the reality?**

The third quarter of 2011 didn't start too badly, but by late July the debt ceiling debate circus in Washington, DC started a swoon in stock prices. The pace of selling picked up even after Congress avoided a default (which was not likely anyway) and it soon became evident that the aforementioned shenanigans in our nation's capital weren't the real cause for the decline.

A slowing pace of economic growth with fears of renewed financial crisis related to the fiscal woes of Greece, Spain, Portugal, and potentially Italy started to unnerve investors. The lack of credible, quick action by the Eurozone monetary authorities made the news headlines seem like the movie "Ground Hog Day". Every other day seemed to bring alternating reasons for fear or relief. The short-term chart of the S&P 500 Index below shows the high level of volatility in both directions over the August and September time frame.

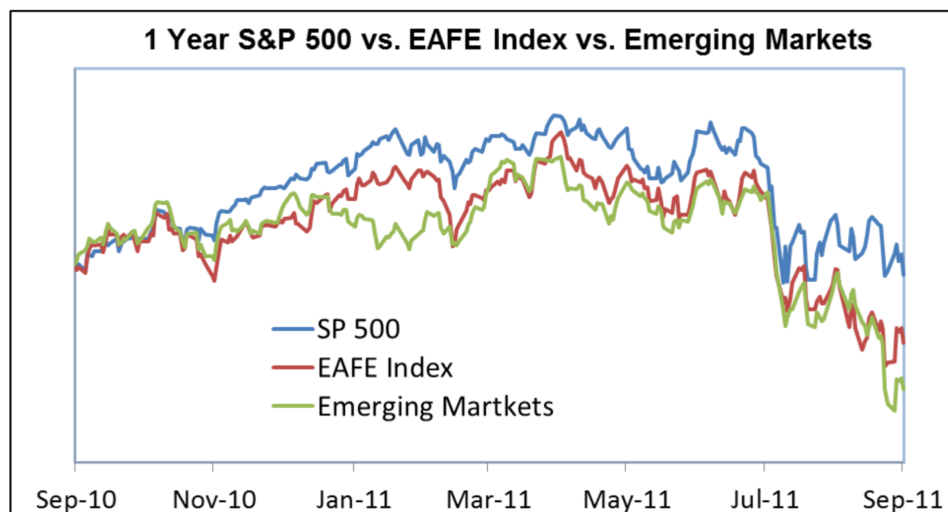


Some interesting, but not necessarily comforting details can now be calculated for this period just passed.

- The Dow Jones Industrial Average's average daily change in the last two months was 1.7% per day, more than twice the average of the last 10 years.
- There were 7 moves of more than 3% in one day.
- Daily changes of more than 1% occurred on 33 of the last 49 trading days ending in early October.

The good news, although few seem willing to listen these days, is that out of these periods of fear and volatility the markets generally have periods of above average performance, and we believe the same thing will happen this time around.

It is also interesting to note that the much maligned U.S. stock market, while down 8.7% in 2011 through September 30th, is down far less than most other markets and regions of the world so far this year. Emerging Markets, which received almost all the press about their potential over the last couple years were down almost 22% as of the end of September. The broad based measure of international stocks – The MSCI EAFE Index was down almost 15% for the first 9 months of 2011. We are glad to have limited exposure to international markets in our portfolios over the last couple years. The chart below illustrates the difference in performance of the S&P 500 vs. the EAFE and Emerging Markets Indexes over the last year.



Along the markets' recent path, the correction became severe enough to cause our Risk Control Model to advise the sale of several equity-based positions, our high yield corporate bond positions, as well as commodities and REIT's. These sales occurred predominantly in August and September.

These are the first large scale sell signals our model has issued since we put it in place in late 2008. Of course, the model gave an effective "buy" signal in early April of 2009 shortly after the market began a recovery. Sell signals can be very frustrating when viewed with a short-term perspective, especially if the market doesn't go down further while we have a large cash position. To help put this in perspective, consider the following.

Our real time buy signal at the close of business on April 7th, 2009 occurred with the S&P 500 Index at a level of 816. Our sell signal at the close of business on August 22nd, 2011 occurred at a level of 1123, a point 37% higher that the entry point almost 2 ½ years ago, not including dividends that may have been earned by the owner of stocks during the holding period.

We don't know if the current correction is over, but some indicators are starting to give us confidence that it may be close. In fact, we may obtain buy signals for some asset classes during the month of October. Our point of re-entering the equity and bond markets may come at somewhat higher levels than when we reduced exposure. Unfortunately, that is part of the mechanical or quantitative process we employ. Keep in mind that one day the sale of some assets may come before a much larger drop occurs and the protection offered by our Risk Model may then be leveraged into increased returns when we are able to buy assets cheaper than when we sold. As we have said many times, the process isn't perfect, but we believe having a process to avoid the large losses which take years to recover from is the key to solid returns, consistent with our clients risk tolerance.

I've highlighted some of the positives to consider in our many weekly updates over the last two and a half months, and why we believe the next 12 months may be a very good time to be an investor. I know that many are having trouble seeing anything but a bleak future, but it has never paid, even during tougher challenges than we face now, to bet against recovery for the economy, and the financial markets which have always led the way. The high level of negative sentiment about the future is one of the reasons I'm excited about the next year, and frankly the next decade. The bottom line is that the popular opinion is always wrong at major turning points.

On the other side of the coin, we can observe the most successful investors of our time, such as Warren Buffett of Berkshire Hathaway, and Jean-Marie Eveillard of the First Eagle Funds, who wait for moments when the average investor is scared out of his (her) mind, then start buying stocks at attractive prices. Recently, they have been joined by corporate executives (aka - "insiders") who have been buying additional shares of their own company's stock at very high rates during the August – September correction. Why would these corporate leaders buy more stock if their business was in trouble? Obviously they don't believe there is that much trouble ahead, probably not a new recession although that remains a remote possibility.

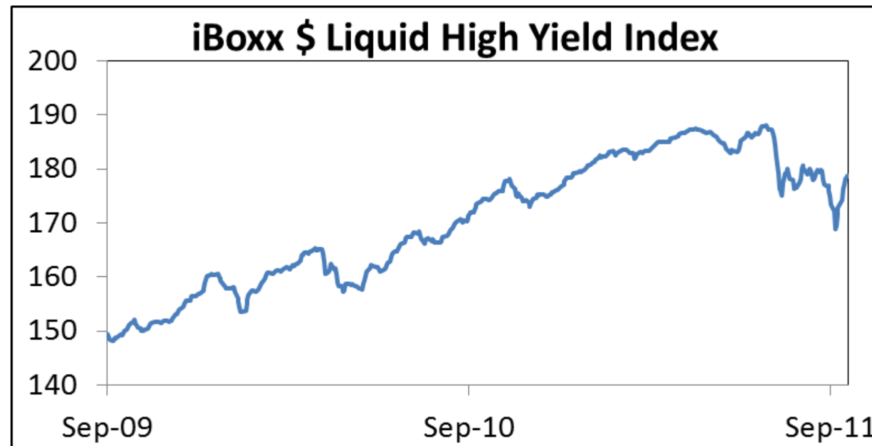
The buying activity by successful professional investors and corporate executives doesn't mean the current correction is over, but it's a vote of confidence that with a few months of patience and potentially a bit more volatility, chances are good that prices might be higher, perhaps significantly so, a year from now. But, you have to be able to look past the daily noise and news flow to buy into the concept that the future will get here, it's likely to be OK, and those that think the opposite have always been wrong.

The saying goes that they don't ring a bell on Wall Street when it's time to buy. But one interesting condition which sounds like a bell to me, and is rare in the last 50+ years is the fact that the dividend yield on the S&P 500 is presently higher than the yield a U.S. 10 Year Treasury Bond. Since 1958 this only happened once before, during the financial crisis of 2008 – in hindsight a great time to buy stocks. In addition, many companies raise their dividends on a regular basis, creating a rising income stream, a characteristic that most bonds do not offer. I could go on about the low valuations of stocks and the tremendously strong monetary (interest rate) conditions in place today, but I think you get the point.

Our process at Breiter Capital is designed to put us in a position to attempt to capture a majority of extended uptrends, avoid the majority of larger downturns, with a goal of generating attractive returns at an acceptable risk level over time. When viewed over periods of a few weeks or even a few months we may appear to be wrong, and in fact may be proven wrong. However, the strong discipline of our repeatable process will, I believe, prove out across the market cycles.

One of the asset classes we sold as the recent correction unfolded was high yield corporate bonds. In the past, these bonds were also known as "junk bonds" because they were issued by companies with lower credit ratings and the chance of default was higher. High yield bonds tend to trade more in line with equities than with government or high quality bonds and we like to employ them in our portfolios when our risk model indicates a positive trend is in place.

The recent correction has caused high yield bond prices to fall and their yields to rise. We believe this has created a new opportunity for investors to earn a high level of income and most likely some capital appreciation once a new uptrend emerges. We are watching carefully for that trend. You can see the opportunity for a combination of growth and income in this total return chart of a popular high yield bond index.



I'm always amazed at the frenzied feelings created by watching television news coverage of the financial markets. This has existed during both good and bad times, but the effect on investors is never good. CNBC is certainly the worst, with Fox News being a bit better with less yelling by the "expert" commentators.

Why someone would watch these programs while trying to stay focused on a successful, diversified investment plan is beyond my comprehension. The aforementioned Mr. Buffett and Mr. Eveillard aren't watching this stuff all day (although Mr. Buffett does seem to like to appear on TV to be interviewed).

Rather, I suggest getting your financial news from the print media which is calmer, including websites. These would start with Breiter Capital's Client View site which has live new feeds from Yahoo Finance, CNN Money, and others, as well as information about your accounts. For those who don't use the internet, the USA Today has an effective and easy to read business section.

If you enjoy the harried pace of live financial new coverage then, by all means, keep watching. But I suggest keeping in mind that the most successful, conservative investors are not doing the same.

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