August 9, 2011

Dear Investor,

While the past few days in the marketplace have been difficult to comprehend, mixed with indecision and volatility, we do not believe this slide is a corollary to the “Great Recession” that began in 2007. Based on last Friday and this Monday, the S&P 500 Index, which represents the large-cap sector of the US stock market, suffered one of the worst two-day declines in history. The S&P fell 11.1%, and is now down 18% from its late April high of 1364. The Russell 2000 Index, which represents the bottom 2000 smallest companies in the Russell 3000 Index and 98% of the US equity market, has declined even more, down 24% from its early July high. While we expected summer dips of 5-10%, we are surprised by the size of this correction. A lack of leadership in Congress, continued stress in Europe, weak first-half US Gross domestic product (GDP) growth, the soft July manufacturing number and the downgrade of US debt by Standard & Poor’s weighed heavily on investor confidence. Fears of a double-dip recession among developed nations were at the root of investors’ risk aversion. We believe fear in the marketplace has shifted from the risk that a shock will push the US into recession to the fear that we are already in one. However, neither we at CIG, nor most economic analyst believes this is the case. Most economists continue to forecast slow but growing US GDP of 1.7% in 2011 and 2.3% in 2012. Further, last Friday’s decent payrolls report seemed to dispel imminent recession views.

On the bright side, the recent ten-day rout has left equity valuations as compared to earnings at levels of cheapness not seen since the 2008/2009 low. The forward price-to-earnings (P/E) multiple of 11.1 times the consensus 2011 earnings estimate of $100 is almost 400 basis points under the average of the last decade and below the long-term average since 1973 (which included single-digit multiples in the 1970s). In fact, the lone bright spot has been continued strong corporate earnings that grew 17% on a year-over-year basis in the first quarter of 2011 and are on pace to post 18% growth in the second quarter. This should act as a buffer in the intermediate term to continued selling as clearer heads prevail.

The drivers of earnings growth include international sales exposure, low effective tax rates, low borrowing costs and a weaker US dollar. While S&P 500 earnings growth has remained robust in the face of slower economic growth, the pace of profit expansion may wane if GDP slows.

So, while valuations look cheap, the critical question is what happens to valuations if the U.S. falls into recession. As it turns out, the average post-WWII recession drop in earnings is just 10%; this includes the 52% drop in 2009 (following the banking collapse) and the 31% in 2001 (after the technology bust). Even with the risk of recession, and a 10% or 15% haircut in earnings, the market would still be selling at a discount to its long-term average multiple at these price levels.

Furthermore, with the debt ceiling debate in the rear view mirror (at least until the 2012 elections), the domestic outlook is showing signs of stabilization. However, a lot will depend on the Congressional “Special Committee” delivering the required cuts and which areas are affected by said cuts. Further, if the European Union (EU) gets its act together, then this could prove an opportune time in all the capital markets.

Although we are observing unique behavior of asset classes whereby the selloff has spread among most of these assets classes regardless of historical correlation, we continue to be convinced of the importance of diversification across multiple classes to weather the volatility in uncertain times and help provide portfolio performance over the long term. Specifically, our current approach at CIG is to target approximately 40-45% of our client’s portfolio to domestic equities, a relatively low level of exposure when compared to most professional allocators that target 60% on average. We also target exposure to international equities (approximately 10%) including both developed and emerging market economies, as well as 10% in commodities, including holdings in gold,which have historically provided protection from both inflation and other domestic and international turmoil. Additionally, we invest about 12-15% in fixed income and 12-15% to private real estate investment trusts (REITs), helping to provide stability and income to the portfolio along with potential for long-term appreciation with real estate. Finally, we allocate about 5% to cash for safety and liquidity.

Remember in times of seeming chaos, there is danger AND opportunity. While we recognize both, we feel the opportunity outweighs the risk and that the markets are overdone for this segment and due for a correction.

That said, it is important to focus on our long-term strategy on days like we have seen recently. By controlling emotions, staying disciplined and investing in multiple asset classes, we believe this helps us to weather these storms, but at the same time to participate in the long-term potential upside of the capital markets.

Sincerely,

Osman R. Minkara
Managing Principal

David Martin
Vice President and Senior Portfolio Manager

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