KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

INVESTMENT STRATEGY
APRIL 2012

Calmer markets have prevailed in 2012 after record volatility during the second half of 2011. The U.S. recovery is showing noticeable progress led by consistent employment gains and higher consumer spending. In addition, fears emanating from Europe have receded after Greece completed a restructuring of its debt. In fact, volatility has decreased at a faster pace than at any time since 1934. Importantly, this drop in volatility has been accompanied by a sharply higher stock market. In the first quarter of 2012, the S&P 500 Index has gained 12%, the best start to a year since 1998.

After the strong rally of the past four months, the S&P 500 Index has surpassed the market high set last April. Further, the market is now only about 10% below its all-time high set in October 2007. Despite the recent rally, stocks are still more cheaply valued than at all 34 market peaks since 1989 at only 13.4 times this year's earnings. This is due to corporate earnings increasing 60% since 2009. As a result, high-quality equities remain very attractive, especially considering the alternatives.

The alternative for low-risk investors has traditionally been interest-bearing bonds issued by governments or corporations that usually offer consistent returns along with lower volatility. As we have commented before, we have found bonds unattractive for at least the past eighteen months. However, even with yields dropping through the floor, investors continue to flood into fixed income investments in what we can only believe is extreme risk aversion in reaction to the volatile stock market of the past decade. It seems many investors have "thrown in the towel" on equity investments. These investors have been mentally drained by the volatile markets of recent years and, as a result, are overestimating the risks in stocks and underestimating the potential rewards. The constant negative blitz of the 24-hour news media has not helped in this regard.

The tendency to give in to emotion is not new when it comes to investing. However, the consequences can have a dramatic effect in limiting an investor's future wealth. The last two times we observed this behavior in comparable magnitude was during the technology mania in the late 90s and the housing bubble of the mid-2000s. During the late 90s, many investors initially avoided technology stocks because so many were new companies that generated little revenue, much less any profit. However, after watching friends and neighbors grow wealthy on paper, many investors gave in to their emotions and invested in these stocks late in the game. Likewise, almost everyone knew of a friend or neighbor making "easy money" by investing in, or flipping, houses during the mid-2000s. Often these people had little or no prior training. In the aftermath, we all know someone who experienced financial disaster from "playing" the housing market during this period.

In retrospect, these investment traps should have been easy to spot. Unfortunately, we believe today's trap is much harder to recognize for the average investor or retiree. Part of the reason the current trap is more difficult to avoid is that it is based on fear rather than greed. Additionally, it is not peers that are the major influencers. Rather, it is an overpowering media assault that constantly bombards us with everything we should fear in the world. As an example, most people would be very surprised to learn that the chance of being a victim of a violent crime in the U.S. has actually declined more than 50% since the early 1990s. However, the contemporary media would have us believe that we need armed guards to leave our house.

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The other major reason the current bubble is more difficult to recognize is because possible losses are more abstract. When it comes to housing or stocks, it is fairly straight forward that if prices decline you lose money. When it comes to fixed income investments, your primary danger is not merely a decline in the price of the bond (although at current prices that is certainly a strong possibility). The primary danger is inflation destroying the real value of interest and principal payments received in the future. Few investors realize this hidden inflation “tax” has a far greater effect on wealth than the actual taxes you pay to the government. For example, since 1965, the U.S. dollar has depreciated 86% with the worst damage realized during the 1970s. Due to inflation, it takes more than $7 today to purchase what $1 purchased then. Anyone who purchased long-term bonds (10+ years) during the late 60s or 70s would have fared very poorly in these fixed income investments, despite being “paid in full” by the underlying bond.

To put recent investor infatuation with fixed income investments into perspective, we can look at mutual fund flow statistics. Since the end of 2008, money invested in taxable bonds has more than doubled from $1 trillion to $2.1 trillion. At the same time, about $200 billion has fled U.S. stock funds, despite the significant rally in equities during that period. More frightening still is that, since November 2008, assets in high-yield funds (junk bonds) have nearly tripled from $85 billion to $220 billion. This means that fixed income investors are greatly increasing risk in a search of higher yields.

What concerns us most is these trends have not slowed during 2012 in spite of extremely unattractive bond yields. In fact, more junk bonds were sold in the first quarter of 2012 than any other quarter in history. This behavior is what occurs at the very peak of bubbles before a very painful reversal of fortune. We saw the same behavior at the tail end of the tech bubble as analysts created new ways to value internet companies. They resorted to counting the number of “eyeballs” or “clicks” an internet site received because, without any profits and little revenue, traditional valuation formulas couldn’t be used. Likewise, we saw housing activity accelerate into 2005 and 2006 regardless of the fact that most home prices were already up well over 50% during the previous five years.

For context, we present this simple chart of the interest rates on 10-year U.S. Treasury Bonds over the past 50 years. What is important to know is that bond prices move in the opposite direction of bond interest rates. Therefore, low interest rates equal high bond prices and vice versa.

As you can see, bond prices are higher (yields lower) than anything we have seen in more than two generations. To put it plainly, investors are willing to purchase Treasury bonds yielding 2% while inflation is currently 3% or more. Therefore, without rates going even lower or a significant reduction in inflation, investors are guaranteeing themselves long-term losses for perceived short-term "safety". A quote from famed 1940's and 1950's investor Shelby Cullom Davis once again seems appropriate: "Bonds promoted as offering risk-free returns are now priced to deliver return-free risk."

For the fixed income needs of our clients, we have been selectively purchasing corporate bonds that are rated just below investment grade, but from companies whose fundamentals are improving. Importantly, we have focused on bonds that have a short maturity of between 2 to 7 years with coupons of 5.5% to 6.5%. Bonds with these terms should offset inflation while providing some additional income for living expenses. However, even these modest terms have become increasingly difficult to acquire.

As a result of current bond prices, dividend-paying equities are the most attractive asset for conservative, long-term investors. Despite roughly doubling from the market lows in 2009, high-quality companies are still priced attractively and offer dividend yields of 2.5% to 3.5%. In addition, dividends have been increasing 6-7% a year, double the rate of inflation. Going forward, we expect companies to continue growing dividends ahead of inflation and earnings. For S&P 500 companies, dividends as a percent of earnings have fallen to a new low of 26% in each of the past two years. We believe strong companies have the ability and, increasingly, the motivation to raise dividend payouts back toward the long-term average of 45%. We expect retirees and income deprived investors will demand this.

High-quality equities are also greatly under-appreciated as inflation fighters. Over the intermediate to long term, high-quality equities have proven numerous times to be able to adjust for inflation effectively. For these reasons, we continue to position client portfolios in the financially superior, high-quality companies of the world

Truly yours,

Keating Investment Counselors, Inc.