INVESTMENT STRATEGY
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Contrary to the predictions of both the ancient Mayans and contemporary seers, 2012 was not the end of the world. In fact, 2012 proved to be very rewarding for equity investors. Unfortunately, many investors reduced stock holdings throughout the year in favor of "safe" investments such as corporate bonds. In the end, the U.S. economy and stock market performed much as we anticipated with the economy strengthening and the S&P 500 Index gaining 13.4%. This was due to a more robust recovery in housing and better than expected consumer spending. The U.S. also benefitted from major technological developments in the oil and gas industry where domestic production expanded on a scale not seen in more than 30 years. In addition to the billions of direct investment in the energy sector, this new production is resulting in lower energy prices, a smaller U.S. trade deficit, and a competitive advantage for many U.S. companies.

A surprise in 2012 was the strong bounce in European and Chinese stocks after a disastrous 2011 when these markets declined 15-25%. These markets performed poorly for the first three quarters before surging late in the year. Additionally, despite the slowing Chinese economy, industrial metal prices finished the year up by mid-single digits. We anticipate weakness in metal prices over the next year or two as new production comes online at the same time China attempts to shift away from infrastructure-driven growth. We once again saw key grain prices up strongly after drought impacted the majority of the U.S. growing season. Unfortunately, major weather events seem to be occurring more frequently, compounding the already difficult situation of dwindling fresh water supplies and over-exploited fishing stocks. We expect food prices to remain in an upward trend for the foreseeable future.

While international markets and commodity prices have remained volatile, it is noteworthy that the U.S. stock market was remarkably calm in 2012. This is even more notable after the record volatility experienced during the second half of 2011. However, the year was certainly not devoid of threatening headlines. Investors remained worried about slowing worldwide growth, a breakup of the European currency union, and a lack of leadership in Washington. Despite these concerns, volatility fell back to levels not seen since 2006. In fact, at no point did the S&P 500 decline more than 10% in 2012 and at no time did the S&P 500 trade lower than its starting point.

Outside of equities in 2012, most assets have remained quite volatile over the past few years. To understand why this is occurring, it is important to review the current state of the investing world. The world is awash in an enormous amount of investment capital the likes of which have never been seen. In fact, there has been an abundance of capital in the world for the past 15-20 years. As a result, we have seen a number of asset classes taken to extreme levels once investor perceptions became aligned. For instance, technology stocks were taken to unfathomable levels in the late 90s as investors became convinced that computers and the internet would reshape the world. Even though computers did reshape the world, the profits

generated by these investments in no way satisfied the amount of capital chasing the opportunity. Following the tech bubble, we saw enormous amounts of investment pour into real estate. Although many believe this was a U.S.-centric problem propelled by lax lending standards, it was actually a global phenomenon. As an example, many European countries had housing bubbles that were more severe than in the U.S. In addition, China, Brazil, Australia, and parts of Canada are still in the midst of housing bubbles that appear to be topping out as we speak.

During the past 20 years, we have also observed an explosion of new asset classes to satisfy all the excess capital looking for a home. It is now common for individuals and large institutions to invest directly in commodities, currencies, hedge funds, leveraged exchange traded funds, private equity, and a multitude of esoteric derivatives. For instance, more than 8,000 hedge funds now manage $2.2 trillion in assets, up fourfold since 2000. Meanwhile, hedge fund returns have fallen dramatically as the average hedge fund provided a total return of only 17% after fees over the past decade. In comparison, a portfolio invested 60% in the S&P 500 Index and 40% in global sovereign bonds returned 90% over the same period.

As we have discussed in prior strategies, over the past four years investors have flooded into fixed income securities. For perspective, despite all-time low yields, worldwide corporate bond sales approached an unprecedented $4 trillion during 2012. More concerning is the massive issuance of low-rated (junk) bonds. During 2012, junk bond issuance exceeded $354 billion. In comparison, during the three years leading up to the 2008 financial crisis, a period with very easy credit, junk bond issuance averaged only $144 billion per year. As a result of this huge inflow of investor capital, the best case scenario is for fixed income investments to provide a small return above inflation. The more likely scenario is for massive capital losses as inflation and interest rates return to "normal."

Given the abundance of capital in the world, it is worthwhile to consider what investors are currently ignoring and where capital may flood to next. In our opinion, the answer to both of these questions is high-quality, dividend paying companies. It is no surprise that investors are ignoring equities after two severe bear markets over the past decade. Nonetheless, the S&P 500 has now shown gains in nine of the past ten years. Investors have been frightened away from equities because of short-term volatility and painful memories of 2008. However, equities are critically important for long-term retirement funding because they provide the highest returns, growing dividends, and adjust well for inflation over the long-term. Hopefully, the substantial reduction in short-term volatility over the past year will encourage investors to reconsider this asset class.

We believe that a shift toward high-quality equities could be triggered by several factors. As we know from experience, we have been forced to consider a greater allocation to equities to compensate for the reduced income generated by fixed income securities. For example, the average dividend yield on the 30 largest stock holdings at Keating Investment is currently 3%. This compares to a 1.9% yield on 10-year U.S. Treasury Bonds, a 2.1% yield on

the S&P 500, and 1-3% yields on investment grade corporate bonds. Up to this point, to replace income, investors have been purchasing low-quality corporate bonds with yields of 3-6%. We believe these investors will regret purchasing bonds at these prices and will gravitate to equities once losses begin to mount on these fixed income positions.

We also believe investors will move toward equities as they gain more confidence in the economic recovery. We are now in the fourth year of the economic expansion and housing is finally having a positive effect on U.S. growth. In fact, housing generated 10% of the growth in the U.S. during the 3rd quarter. Meanwhile, the energy revolution in the U.S. has helped lead the way during this expansion as an enormous amount of investment has gone into drilling, producing, and servicing the newly accessible oil and gas fields across the country. This revolution should continue for years to come as production increases and industries position themselves to take advantage of the new low-cost domestic supplies of energy. For example, plans for several large chemical and fertilizer plants have been announced to take advantage of some of the cheapest natural gas in the world.

While these are the two most likely reasons investors will move toward high-quality U.S. equities, there are several others. Many large pension funds in the U.S. are severely underfunded, although not admitting it, and will be forced to increase their expected returns by increasing their exposure to equities. In addition, equities are still cheap on a historical basis, particularly the highest quality equities. Equities also adjust well to elevated inflation. We anticipate that inflation will likely become an issue within the next few years.

Despite all the factors we believe will drive investors toward equities, we admit that it is nearly impossible to predict the exact timing of such a shift. The decreased volatility over the past year may indicate complacency among investors concerning the major macro issues still going on throughout the world. In addition, most market forecasters are predicting 10-12% gains in 2013. This makes us uneasy as the consensus forecast is nearly always wrong. Because of this, we are remaining very conservative in client portfolios by overweighting non-cyclical sectors such as staples and healthcare. As a result, if we do see a shift by investors toward equities, the market will move up sharply but our portfolios could lag the S&P 500 during this initial period. However, if unforeseen problems arise, our clients will be far more protected by this conservative positioning. At the end of the day, by buffering the downside we are best meeting our clients' long-term needs for capital preservation and growth. Meanwhile, we believe the companies we own are positioned to increase their dividends faster than earnings. This unique attribute should increasingly appeal to investment capital searching for a new home in 2013 and beyond.

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Keating Investment Counselors, Inc.