Market Comments

October 9, 2012

S&P 500	1454
10 Year Treasury	1.74%

Five years ago today, the S&P 500 traded at an all-time high of 1576. Today, the S&P 500 trades around 1454, down 8% from the all-time high set on October 9, 2007, but up 115% from the March 9, 2009 low and up 26% from one year ago today.

The third quarter saw a good recovery for equities after a weak second quarter. The S&P 500 had a total return of 6.35% during the third quarter, bringing its year to date total return to 16.44%. The S&P Midcap Index had a total return of 5.44% during the quarter and the S&P Small Cap Index advanced 5.40%, bringing their total returns for the year to 13.76% and 13.80%, respectively. Larger companies generally outperformed mid-sized and smaller companies both during the third quarter and during the first three quarters of the year.

International stocks generally lagged U.S. equities during the third quarter, but did post positive returns. The EAFE Index was up 6.08% in the quarter, resulting in a year to date total return of 9.47%.

Bonds enjoyed positive returns during the third quarter. The Barclay's U.S. Aggregate Bond Index returned 1.59%, bringing its year to date total return to 3.99%. The yield on the 10 year Treasury was essentially unchanged during the quarter, ending at 1.73%.

Against the backdrop of generally positive returns for both stocks and bonds during the first three quarters of the year, we continue to focus on four primary factors that will affect the capital markets for the rest of 2012 and into 2013:

1) Strength of the U.S. economy
2) Timing and eventual resolution of European economic problems
3) Strength of corporate earnings
4) Outcome of the fall elections in the U.S.

While we are encouraged by the positive returns for stocks thus far in 2012, we believe U.S. equities remain somewhat undervalued relative to our estimate of fair value. At the beginning of 2012, we established a fair value target of 1475-1550 for the S&P 500, based on expected 2012 earnings of $102-105 and a P/E of 14-15x; on September 14, the S&P 500 reached a recovery high of 1474.51, essentially touching the lower end of our range of fair value for 2012.

The strong move up in stock prices in 2012 raises the odds of a meaningful interim correction, but given that valuations for stocks remain well below long-term norms (the S&P 500 currently trades at 13.8x estimated 2012 earnings and 12.5x estimated 2013 earnings, versus a long-term average P/E of 15-16x), we believe that stocks remain attractive, both in absolute terms, and especially relative to fixed income, where bond yields remain very low and valuations are unattractive.

Our estimate of fair value for the S&P 500 for 2013 is around 1625 (based on index earnings of $112 and a P/E of 14.5x), which would imply upside of 12-13% over the next 4-5 quarters from the current S&P 500 level of around 1450.

Corporate earnings growth seems to be slowing, as economic data in the U.S. over the summer showed some deterioration, and Europe continues to be in recession. Earnings growth will be a key factor to support stock prices going forward. Earnings have been the primary driver of stock returns over the past three years, as S&P 500 earnings have almost doubled from $55-60 per share in 2009 to about $105 in 2012. If the trajectory of corporate earnings growth flattens out or declines in coming quarters, the equity market will lose a key support component, although the current modest equity valuation levels suggest that investors are pricing in low single digit earnings growth. We expect continued aggregate earnings growth into and through 2013, but the equity market will be strongly impacted by investors' sense of the trajectory of corporate earnings growth.

In a challenging economic environment, we believe it is critical to own companies that have strong business franchises that can grow their intrinsic value for shareholders even when business conditions are sluggish. Our focus remains on owning companies with strong balance sheets, growing and high levels of free cash flow, and attractive valuations.

Our expectation is that shareholders of companies that fit that criteria can win several ways over the next few years: 1) as companies strong financial performance drives higher intrinsic business value; 2) as valuations for our companies move from somewhat undervalued toward fair valuation levels; and 3) as companies use excess cash generation to improve returns to shareholders through share repurchases and higher dividends.

While the outcome of the November elections will have an impact on the capital markets in the short run, longer term we believe that company fundamentals will be more important in driving investor returns; our focus is on identifying those companies which appear to be best positioned to create value for shareholders for the long-term.

We continue to expect that equities will outperform bonds and cash on balance over the next several years, based on current valuations. We remain defensively positioned in fixed income portfolios in terms of duration, because expected returns for bonds going forward are low given low interest rates and the risk of higher inflation at some point in the future. We are far more comfortable accepting credit risk than interest rate risk in the current environment, because balance sheets for investment grade companies are in exceptionally strong shape, minimizing the risk of defaults. We continue to look for creative sources of investment income beyond the bond market to supplement portfolio cash flows.

We expect continued capital markets volatility during the fourth quarter and into 2013, given the uncertainty surrounding the key factors we outlined above. We will continue to emphasize high quality companies that are best positioned to perform well in the challenging environment we envision going forward.

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