4101 Main Street, Suite C, Hilton Head Island, SC 29926
T: 843-342-3044 F: 843-342-3244
www.victoriacapitalus.com

SPEED BUMPS AND POTHOLES

APRIL 2011

OVERVIEW

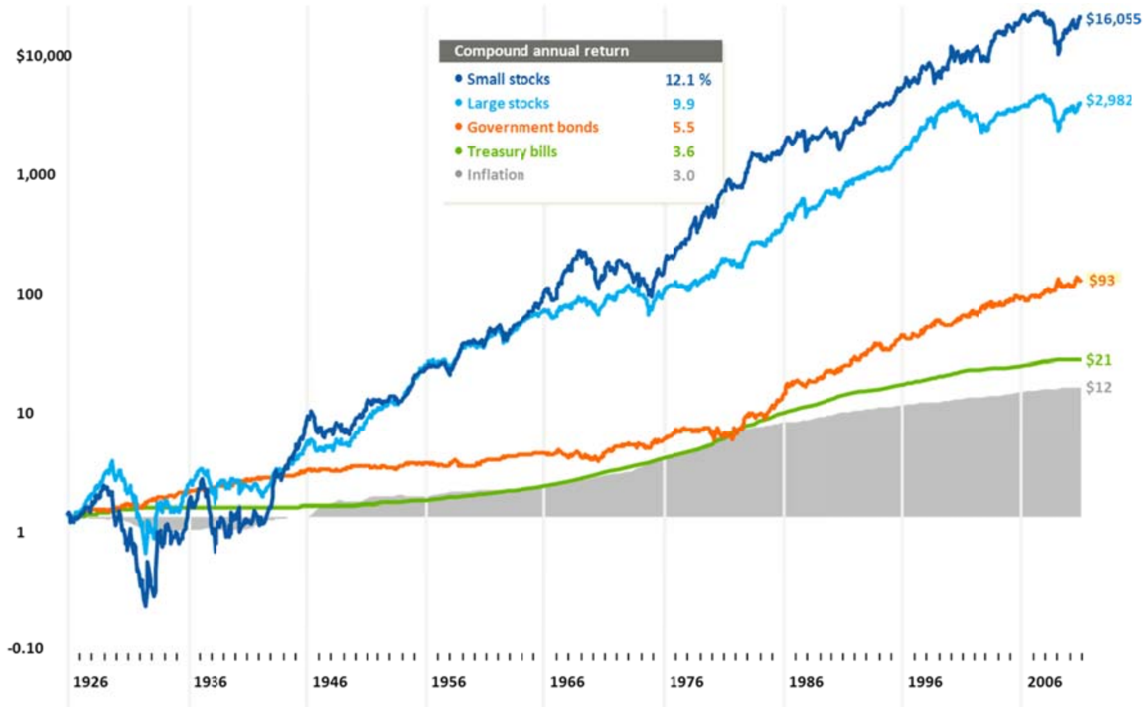
Now that the cold winter has passed, we anticipate a spring and summer that brings warmer and sunnier weather. At this time of year, many take their annual vacation that often begins with a family car trip. As with most annual road trips, travels involve navigating through both familiar and unfamiliar territory. Traveling through a familiar area often involves having adequate warning about the location of obstacles such as speed bumps. Unfamiliar areas may be rife with unexpected hindrances such as potholes. Despite these impediments, getting to the destination successfully requires concentration, vigilance and the ability to change course, if necessary.

The past few years cannot be characterized as a typical environment for investing as we have had to endure several “investment obstacles” along the way. As active managers, we attempt to anticipate these bumps by shifting our investment strategy to minimize the impact of something we expect to happen. We are less adept at avoiding the investment potholes that are hiding under some economic or political puddle that conceals the true depth of that impediment. Investors who ignore these investment obstacles can cause long-term damage to their portfolios. Depending on how “fast” an investment portfolio is travelling, a speed bump can cause irreparable damage as can a deep pothole—particularly if that pothole turns out to be a sinkhole!

The traditional way to reduce such investment risks in a portfolio is to diversify among both types and numbers of securities. While investing in assets such as real estate or art can be very rewarding, such investments can be extremely illiquid requiring investors to take large losses if forced to sell. By investing in groups of securities that represent broad segments of U.S. and foreign economies, the risks posed by investment obstacles can be substantially reduced.

Why do we favor common stocks as the investment of choice for long-term growth of capital? The reason is that equity securities have demonstrated the highest rates of return over time compared with other types of financial instruments. Note in Exhibit #1 the long-term performance of stocks versus other financial assets. While stocks are more volatile over the short-term, over the long-term, investors experience a superior return that is not risky relative to the much lower rates of return from fixed income securities. This higher compound return produces substantially greater wealth even after market declines.

Exhibit #1
Stocks, Bonds, Bills and Inflation
1926 to 2010



Source: Morningstar, Inc.

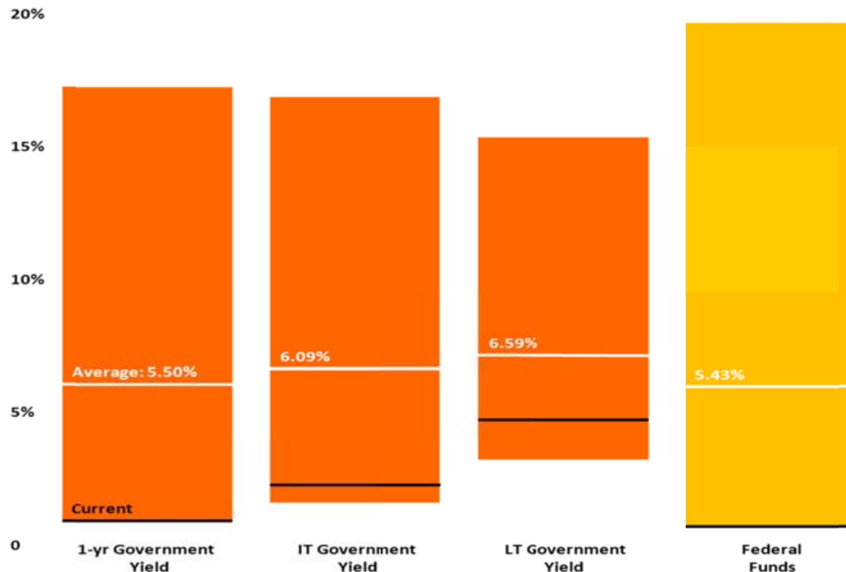
When measured as a group of stocks such as the S&P 500 index, the return is less volatile than a portfolio of just a few equity securities where individual stocks can expose investors to large losses. A recent example of such a disaster was Enron, a major energy company that went bankrupt resulting in significant losses in the savings of employees who owned the company's common stock in their retirement plan.

Common stocks as a group have provided a high rate of return but with an increased amount of price fluctuation or volatility. The reason for the difference in return and volatility is that a share of common stock represents ownership in a company. As an equity holder, the investor's return is determined by either the dividends paid by the company or the increase in value of that stock in the market. The investment risk is that an individual company can encounter problems and miss a dividend payment or worse, go bankrupt. On the other hand, there is really no limit as to how high a stock price can go when the outlook for the company is positive. The bumps and potholes have the biggest effect on small company stocks as they have fewer resources than the bigger companies. The long-term return of small stocks demonstrates that these companies can survive tough times more successfully than their bigger brethren—much like our ability to navigate through stormy weather by actively managing portfolios.

Another important assumption in designing an equity portfolio to save for the future is making assessments about the economic and political environment that can affect the direction of stock prices. We recognize the importance of being long term investors but changes in portfolio strategy may be necessary to avoid that next speed bump or pothole. Elections, court decisions, regulations and changes in taxation can all have lasting effects on companies, industries and financial markets.

These events can also have a marked effect on fixed income markets – both fixed principal (money market funds) and fixed income (various types of bonds). Bonds have always been touted as a key part of a retirement plan because they are a liability of an issuer. As such, an investor receives a stated amount of income and a return of principal at the end of the stated period. This guarantee becomes more valuable as an investor ages and requires a larger position in bonds. Over the past 30 years, investing in bonds has produced attractive returns as investors experienced both high levels of income and an increase in the principal value of the security. However, the decline in yield on long-term government bonds from 14% to 4.5% over the same time period (see exhibit #2) leaves investors with a very different perspective on bond investing: since current yields on bonds are close to all-time lows, the outlook is for continued low yields and/or a weak total return when interest rates rise. Implementing a traditional investment strategy of increasing a portfolio's asset allocation to bonds at this time should include the assumption of potholes on the horizon.

Exhibit #2
History of Interest Rates
July 1954 to December 2010



Source: Morningstar, Inc.

INVESTMENT STRATEGY

Historically stock performance is a good leading indicator of economic activity so that a strong first quarter (the best first quarter since 1940) intimates that the balance of 2011 will experience better economic growth. The leaders by industry during the first quarter were concentrated in energy and industrial stocks, the places where one might expect to see some manifestation of a resumption of a strong global expansion. Commodity prices continue to rise along with oil prices all pointing to growing demand for these products around the world. With the exception of the slowly recovering housing industry and the reconstitution of state and local government finances, the balance of the economy seems to be on a solid cyclical recovery path.

There could be a few speed bumps ahead of us. The first concern is that rising oil prices will linger as we approach the summer months which would harm consumer confidence and their spending habits. Even though we spend less on gasoline to power our vacations, we are still heavily dependent on this commodity and higher prices will permeate virtually everything we spend our money on. Holding energy stocks seems to be a good safety valve against continued increases in oil prices. On the other hand, those susceptible consumer stocks could also be in for a bumpy ride.

Another inevitable bump in the road will follow closely behind signs that economic growth is picking up momentum. The Federal Reserve will undoubtedly respond to a stronger economy with higher interest rates. Historically, a move to raise interest rates back to some normal balance, i.e. a Fed funds rate in the 3-5% range may, at one point in time or another, unnerve market participants. The return of "tight" money has been a harbinger of an economy that has risen to a level of unsustainability. The Fed sees its job as one of keeping a lid on demand in order to avoid a surge in inflationary pressures.

Offsetting these growth speed bumps are the other type of speed bump: austerity policies that could lead to an economic downturn. An attempt to cut government spending before the private sector picks up sufficient momentum could put a crimp in an otherwise normal cyclical recovery. The prospect of another expiration of the Bush tax cuts (read major tax increase) looms at the beginning of 2013 -- especially if the progressives regain power in the 2012 elections. Since the Las Vegas prognosticators are not in a betting mood yet, we will wait until the clouds clear before taking a hard look at how the politics of 2012 could affect retirement portfolios.

CONCLUSIONS

The outlook for common stock investing remains favorable as the economy recovers and corporate profits benefit from rising sales and improving profit margins. The strong global economy is the underlying factor in the resurgence of the industrial sector and other commodities based business. Between now and mid-year 2012 the stock market should positively reflect these trends.

On the other hand, fixed income investing requires a higher level of conviction on the direction of interest rates. Investors who stay in short-term fixed income securities will find that the yields on such investments will be low relative to equity investments. For long-term bond investors they may experience a decline in their principal value if interest rates rise. Unfortunately, the low levels of current interest rates are not encouraging enough to make a serious commitment to the bond market. Reasonable alternatives for conservative investors remain higher yielding corporate bonds and income-oriented common stocks where there is a better chance of getting a higher total return.

Diane V. Nugent — Thomas E. Nugent
President — Chief Investment Officer