KWAG March Update

This past Friday (March 9th, 2012) marked the three year anniversary of the stock market lows reached following the mortgage market meltdown and subsequent recession. However, what many don't realize is that it also marked the three year anniversary of one of the greatest three year stock market rallies in history. As we enter the fourth year of this amazing bull-market run, many investors are wondering whether the rally can continue? We believe it can, based on the fact that stock prices remain low relative to corporate earnings and corporate cash flows. In fact, we believe corporate cash flows will continue to grow significantly going forward, due to the same macroeconomic drivers that have been in place since the bull market began.

Looking Back: The Last Three Years

We have actually been anticipating the arrival of March 9th, 2012 because we knew it would provide a perfect opportunity to illustrate both the surprisingly predictable erratic behavior of the equity markets in the short run and the not-so-surprising resiliency of corporate America. Below, you will observe the average annual return on each of the nine Morningstar style boxes over the three years since the market lows were reached on March 9, 2009. We assure you, these numbers are NOT typographical errors, and they provide a valuable perspective on market behavior, from how irrational investors can collectively become when become fearful, to how rapidly such irrationality tends to self-correct.

3-Year Morningstar Index "Average" Annual Return
03/09/2009-03/09/2012

Value	Blend	Growth		Averages
24.55%	28.58%	29.59%	Large	27.57%
39.23%	38.16%	34.81%	Mid	37.40%

44.02%	**38.66%**	**36.40%**	**Small**	**39.69%**

S&P 500 = 29.23%, Russell 2000 = 35.32%

Educational Reinforcement

There are numerous investing lessons we could point to over the last few years, but there are three we want to reinforce today. First, it should be obvious to even the most casual observer that it is impossible to "time" market swings. When the market is falling, as it was from late 2008 through early 2009, no one knows how far prices will fall in the short run and no one knows when the bottom will be reached. What we do know, is that following the herd and selling into a major market downturn is a bad idea. Think about all the investors who panicked and sold out of the stock market at or near the market low and have been waiting for the fear (which remains today) to subside before getting back in. This means most of them are still waiting with their money still sitting in cash earning next to nothing…and these poor folks have missed what will almost certainly be the biggest market rally of their lifetime. How can you recover from that? Truth is, you can't. To make matters worse, investors are notoriously slow learners and tend to make the same mistakes over and over again. In fact, a similar (but thankfully smaller in magnitude) situation occurred this past summer, when many investors overreacted to the debt-ceiling debate and subsequent S&P downgrade of U.S. debt.

Second, proper diversification into small and mid-cap stocks not only reduces risk, but also enhances portfolio returns over time. For years, we have written about both the "small-cap premium" and the "value premium" that have always existed. Unfortunately, most investors never capitalize on these well-known premiums, because many investors simply ignore the academic literature. In fact, in the table above you'll see that the returns on large growth stocks averaged 29.59% over the last three years while small value stocks averaged 44.02%, for an average annual difference of nearly 14.5%. Compounding the average annual difference

over the three year period results in a total difference of more than 50% between the two asset classes! Yet, large growth is still far and away the most popular sector of the market for investors, often to the exclusion of everything else. To us, on the other hand, diversification across all style boxes still makes perfect sense…and a 50% better performance over just three years seems like a pretty big difference to us.

Finally, the vast majority of investors tend to hold portfolios that look a lot like the S&P 500 index (i.e. large cap stocks with a growth tilt) and are under the illusion that they are therefore "well diversified". In fact, nothing could be further from the truth. Referring to the table above, you'll see that large-cap stocks averaged 27.57% annually over the last three years, while small-cap stocks averaged 39.69%. It doesn't take a rocket scientist to figure out that if you didn't own small-caps (or mid-caps for that matter) over the last three years your portfolio is worth significantly less than it should be. As we've said numerous times over the years, if you DO NOT own small and mid-cap stocks, you are avoiding over 90% of the companies that trade on the major U.S. exchanges and you are also avoiding the strongest areas of the market that have historically provided the best long run returns. Again, the table above shows that large stocks averaged returns in the mid to upper twenty percent range over the past three years, while mid and small caps averaged from the mid-thirties all the way up to the mid-forties! Those are some major differences and illustrate just how valuable small and mid-cap stocks can be in a portfolio. It also raises the question of why most investors ignore small and mid-cap stocks in their portfolios altogether…but that's an issue for another day.

Looking forward

As we look forward out into the great unknown, we remain optimistic about corporate America and our portfolios for reasons that should sound familiar, since we've elaborated on each in the past. First, interest rates are near all-time lows and seem likely to remain that way for the foreseeable future. This translates into

record low capital costs for corporations and consumers alike and acts as a significant economic stimulus. Second, global labor costs remain low and this scenario is not likely to change until the world's developed countries work through the current deleveraging cycle, which will take quite some time. Third, technological advancements continue to surprise even the most optimistic observers in terms of their impact on corporate productivity. This allows companies to leverage inexpensive labor with higher productivity and should continue to provide a major boost to corporate profitability going forward. Finally, global markets continue to expand in both scope and size which gives America's highly competitive corporations plenty of new markets to expand into. In fact, in recent months we've seen domestic (U.S.) imports from China decline while at the same time domestic exports to China have continued to increase. This is the first time we can remember these two events occurring simultaneously.

There are a number of other positive macroeconomic factors in place - like an accommodative Federal Reserve and an accommodative Chinese Monetary Policy. However, there are also some negatives which continue to dominate the headlines - like the European debt situation and political gridlock in the U.S. For now, we believe the bad news looks to be fully "priced" into the stock market, which is good news for stocks since it potentially limits our downside risk exposure. We'll provide a more in-depth analysis of the good, the bad and the ugly of the global economy in the upcoming quarterly newsletter, so stay tuned!

In Closing

In the meantime, thank you for your continued confidence in our firm. As usual, if you have any questions or concerns regarding our updates, your portfolio or any of our investment strategies, please feel free to contact us immediately. We always look forward to hearing from you and appreciate all of your continued referrals.

Enjoy the start of Spring!

- ***Joe & The Gang at KWAG***