

# The Carnegie Counselor

THE CARNEGIE INVESTMENT COUNSEL NEWSLETTER

THIRD QUARTER 2011

## Managing Risk

The economic world and financial markets were a scarier place this last quarter. The European sovereign debt and banking crises moved close to the brink several times. Consumer confidence fell as the risk of the U.S. economic recovery moving from a crawl to a stall has increased.

Today unemployment remains high at over 9 percent, home prices are off 32 percent from their peak, China's economic growth has decelerated and governments are perceived as dysfunctional in the U.S. and Western Europe. There is a broad-based societal lack of confidence in the future.

The global equity market prices declined sharply this quarter as investors priced in the fear of a slowdown and the uncertainty around events in Europe. Risk was shunned. The S&P 500 declined 13.9 percent for the quarter (7 percent in September). Year-to-date it is down 8.7 percent, but up 1.1 percent over the last twelve months. In September oil, aluminum, paper, steel and even gold prices were down. Small-cap stocks and emerging market stocks were both down over 22 percent in the quarter. The one place to hide continued to be bonds, as the pursuit of safety pushed the price of bonds higher. The yield on U.S. Treasuries, despite losing the AAA rating, is now at a 130-year low. Not even your parents saw yields this low.

Despite the permeating gloom (and there is much to be gloomy about),

most economic indicators are still registering tepid economic growth. Manufacturing is still expanding, consumer spending has held up, corporate profits continue to be strong and business inventories are lean. Global stock valuations have reached historically attractive levels, and in many cases dividend yields are competitive with bond yields. When this occurs, equities begin to attract funds away from the bond market.

The central focus of our emotional angst has been the European financial quagmire. Events in Europe have see-sawed our equity markets with every negative headline. Greece has tremendous debt, but the combined Gross Domestic Product of the country is less than the state of Maryland's. The holders of their debt are primarily the European Central Bank and European banks. We have worked to un-tether our exposure to the European banks, or Euro government obligations. A year ago we had less than 2 percent exposure; today we have none. We have scaled back exposure to European indexes, mutual funds, preferred stocks and bonds. If the austerity plan in Greece is not well-received or the aid-package approved, we will not be left holding the notes.



### In the news

Pease to be Honored in Sedona  
**Jim Pease**, Senior Portfolio Manager for Carnegie, will be presented the **2011 Lifetime Achievement-in-the-Arts Award** by the City of Sedona, AZ on November 10, 2011. Jim has lived in Sedona for over fifteen years and has been an integral part of the community. Congratulations Jim!

While not directly linked to European troubles, we are aware a recession across the pond will impact our economy and investments. During 2011 we have raised the bar in quality for our stock investments, winnowing the smaller capitalized companies in favor of stronger financials. Speaking of financials, the banking/insurance/brokerage sector continues to be the worst performing area of the stock market losing over 23 percent on the year. Our exposure to this area throughout client portfolios has never been lower. There is risk to owning only 2 percent of a sector that is nearly 14 percent of the stock market. When financials rebound, they will move fast and the risk will be missing this bounce. Reviewing the 10-Qs, 8-Ks and financial reports of dozens of banks recently, it will take years before any bounce will occur. The Federal Reserve has pushed interest rates low to help the banks make money, and this hurts the yield on the bonds we purchase on your behalf.

Reviewing the bond commitments, expectations on returns appear to be at historic lows. This year we have been hired by no less than a dozen new clients taking advantage of our fixed income prowess. Apparently, earning 4-5 percent looks rosy compared to zero in a money market. Clearly not many firms have the skills, network, research and patience to buy individual bonds. We have even built bond portfolios for other investment advisors' clients. For years we have bought short-duration bonds and held them to maturity to mitigate risks. This removes interest rate risk, reinvestment risk, liquidation risk, and we believe quality risk. While we are confident interest rates will eventually rise, it will be several quarters ahead based upon the actions of the Federal Reserve. Fortunately, our new clients understand the risks of bond funds. Unfortunately, with bond prices

at historically high levels, this could be the next bubble and millions of investors in bond funds will experience equity-like losses holding bond funds. Your bonds will be fine as long as we hold them until maturity.

We are maintaining a cautious short-term stance and expect continued volatility. Any lessening of the anxiety about Europe should cause the market to respond positively.

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We believe each company in which you own shares will have higher earnings in 2015 with commensurate higher share prices. All have higher earnings today than in 2007 when the market last peaked. If prices slide in the interim, it only creates an opportunity to buy shares cheaper. Only on Wall Street are discount prices considered a bad thing. This past quarter created outlet sale prices, and we took the occasion to add shares to your portfolio.

Difficult investment periods accentuate the importance of our service. We believe an independent firm with a deep bench of experience, low fees and no conflicts-of-interest is the proper model. Our ranking in Crain's Cleveland Business as the fastest growing investment firm (over \$100 million in management) lends credence to our structure. Thank you for your confidence and referrals. Touching on the last quarterly note, a client suggested our switchback route had taken us down to Atlanta on our way to



As a truly independent investment management and planning firm, Carnegie Investment Counsel has a rich history of providing careful and responsible management of your financial assets to reach your short and long-term goals.

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Boston. It may feel like we have detoured to Atlanta, but we are only in New Jersey and still have time on our side. Enjoy the best season of the year; it is guaranteed to be colorful and hopefully fruitful.

Best Regards

