October 2, 2012

Dear Client,

There is a Wall Street saying “Don’t fight the Fed” meaning that if the Federal Reserve is easing monetary policy, buy stocks, and if the Fed is tightening monetary policy, sell stocks. Well, the just completed third quarter was all about the expectation and realization of further Fed easing, along with the European Central Bank (ECB) jumping on the easy money bandwagon, as well. The net effect was global equity markets advancing mid single digits during the quarter.

Year-to-date, U.S. stock market indices have increased on average in the mid teens while bonds have progressed based on the different sector credit risks: U.S. Treasuries up marginally, Corporates improved high single digits and High Yield issues better by the low teens. The portfolios that I manage are all higher for the year, mostly in the mid to upper single digits, proportional to the amount invested in stocks. Funds not invested in stocks are in short-term Corporate and U.S. Treasury bonds for safekeeping and future deployment, which provide minimal return.

Over the last five years, roughly from the last recent market high achieved by the Standard & Poors 500 (S&P 500), my accounts over $100,000 in assets have gained on average a bit over 3% annually compared to less than 1% annually for the S&P 500 with dividends reinvested. This is a function of minimizing losses during the last market downturn by not being fully invested in stocks at all times. So while an under-investment in stocks has held back this year’s portfolio performance, it has added significant value to both performance and risk reduction over the longer-term.

That said, I am not resting on previous preservation of capital to try to win the performance race; it is that I have not found a large number of attractively priced businesses compared to the risks associated with an investment. In addition, I was surprised by the Fed easing, both the occurrence and the magnitude, and therefore had portfolios more conservatively positioned than might have otherwise been the case.

The recent history of Federal Reserve Quantitative Easing (QE, purchase of assets to increase the money supply and to lower interest rates) started with QE1 in November 2008 with the Fed commitment to purchase $500 billion of mortgage bonds. The program was expanded in March 2009 to $1.25 trillion. Both the initiation and expansion coincided with market panics about the continued existence of the U.S. banking system. QE1 ended April 2010.

QE2 began in November 2010 in response to Fed concerns about a slowing economy and a weakening stock market. It was a commitment to purchase $600 billion of U.S. Treasury securities and terminated in June 2011. Operation Twist, a plan to sell short-term U.S. Treasuries and buy long-term Treasury securities in order to lower longer-term interest rates, commenced in September 2011 and was extended in June 2012 until the end of this year. Operation Twist was also implemented during a time of economic slowing and a weak stock market.

What is being called QE Infinity (QE3) was announced September 2012 and calls for the open-ended purchase of mortgage bonds at a rate of $40 billion a month until the unemployment rate declines. QE3 has the potential to be much larger than the other programs combined. This program coincides with global economic softness; however, the U.S. stock markets have recaptured all of the losses since the recent highs of 2007. So the Fed begins what could be the biggest program yet with the elections less than 2 months away and asset prices of all types stable to improving to fully priced to in bubble territory. Government interventionists appear to know no bounds.

Enclosed please find your portfolio report covering the periods through September 30, 2012, and as always, if you have questions please contact me.

Best regards,

Peter V. Hedberg