YOSEMITE CAPITAL MANAGEMENT

First Quarter 2013 – COMMENTARY

Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed. – Ben Graham

A sense of relief seems to have come over many financial markets participants. Several headline issues have come and gone, some positive economic numbers have been posted, domestic stocks and bonds had solid returns in 2012, China may have engineered a soft landing (relative to its situation), and even news about the Euro crisis has abated.

We remain positive about the future of the financial markets for the long term. But we caution that the short term, which is anything less than three or four years, is not predictable with a significant degree of consistency. This means anything can happen, either positive or negative, so investors must be prepared to withstand a fair amount of volatility on their long term path to investing success.

Stock market fluctuations are likely to increase, perhaps as early as in the next few weeks. This could be triggered by any number of reasons, such as:

Disappointing earnings guidance

Poor domestic economic data

A reversal in China (currently their strong quarterly GDP data is on a streak of one in a row so a positive trend has technically not yet been established)

Political posturing from made-for-the-news-media events like the farcical debt ceiling non-issue

A return to the reality of the problems with the Euro (this is our odds-on favorite because their structural problems with the construction of their monetary union are far from resolved)

Regardless of the proximate cause of increased volatility, investors need to keep a few thoughts in mind before the markets begin their next set of gyrations of any sort.

Volatility is NORMAL. This is not a matter of if, but when. Since 1900, according to Ned Davis Research, stock market declines of 5% or more (called a "dip") occur about 3.4 times per year on average, which translates to about every three to four months. Declines of 10% or more (referred to as "corrections") take place about once a year on average. The stock market declines of 20% or more (commonly known as a "bear market") happen about once every 3.5 years on average. So the financial markets have always been volatile and always will be. As a rough rule, higher long term returns require higher volatility.

The future is always uncertain. There is always something to worry about and there is always something that could lead to disaster of one sort or another, whether at the peak of a boom or the trough of a bust. No one can consistently know how much or when the markets will rise or fall, how complicated situations will play out, what unknowable events will occur (by definition), etc.

Risks are unavoidable. There are always risks with any action or inaction, which means avoiding certain risks means taking on other risks. For example, investing in stocks increases the risks of portfolio fluctuations but simultaneously increases the odds of long term growth while lowering the risks of loss of purchasing power from inflation. Conversely, avoiding the risks of portfolio fluctuations by avoiding stocks increases the risks of not achieving long term goals and increases risks of loss of purchasing power from inflation.

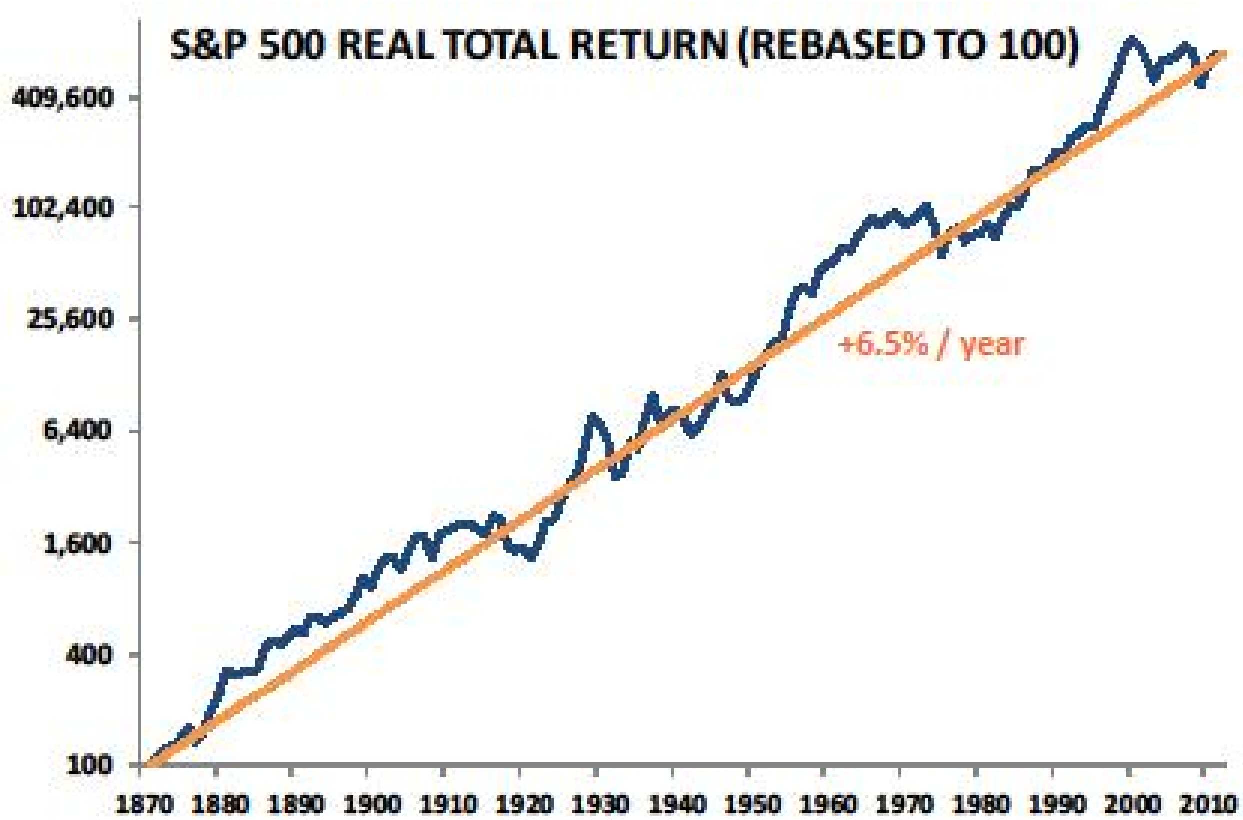
So how do successful investors deal with the market's periodic fits, uncertainty, and risks?

Maintain a proper long term investing plan. This includes an appropriate strategic asset allocation to optimize the long term risk/reward tradeoff relative to goals and objectives as well as continued contributions (if not retired) or reasonable withdrawals (if retired). Numerous studies have shown that the proper ***asset allocation***, sufficient ***time*** to allow compounding, ***quantity*** invested, and the ***discipline*** to stick to the plan through thick and thin are the factors that provide the vast majority of tangible benefits for a portfolio in the long run. Of far less importance is security selection (which stocks to buy or sell or which funds to own), while frequent trading, trying to avoid drops in the market, and engaging in emotional reactions to current events have been proven to be detrimental to one's financial health.

Embrace volatility and don't try to avoid it. The proper asset allocation already mitigates the effect of market swings on a portfolio. For retirees, a lower allocation to stocks reduces the amount of volatility to the portfolio. For those growing their portfolio, new contributions buy more when prices are lower. Regardless of investing status, low prices and high prices are excellent opportunities to rebalance a portfolio. Market volatility is part of the price investors must pay to achieve long term goals.

Keep a long term perspective. Market drops are not permanent (see Exhibit 1). This proved true for the stock market in 2009, 2003, 1998, 1990, 1987, 1982, 1974, etc. etc. etc. There has been 100% recovery from all bear markets in stocks and bonds the United States has experienced in its entire history. If one does not need the bulk of their principal for many years, it does not matter what the dollar amount of the portfolio is between now and then.

Exhibit 1



Source: Pragmatic Capitalism, December 20, 2012

Ignore the news media, especially during market panics. That is, don't let short term current events affect a long term investment plan. The news media are not talking about your portfolio and what is in your best interests. Remember how this industry gets paid: by increasing advertising revenue, which occurs with more viewers/readers. They increase their followers by stoking controversy and fueling emotion, a mortal enemy of proper investing. They do not get paid to inform in an unbiased manner, to be right, or, especially in the case of the financial news media, to help investors.

So when volatility increases and the markets turn spastic, sit back, relax, and enjoy the show!

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Inflation is a topic that has been on investors' radar recently. While some alarmists have been screaming about hyper-inflation ever since the Federal Reserve first took aggressive action to combat the Great Recession in 2008, many reasoned people legitimately wonder how the central bank's current policies will in fact ultimately affect inflation.

A review of how we got into the present situation is in order. The economy is suffering the effects of a credit bubble that burst. During the credit bubble, too much money was lent and borrowed without either party concerning themselves with how the money was going to be paid back. After the bust, financial institutions were on the verge of collapse and many consumers were faced with debts they were unable to pay at all or with great difficulty. Thus financial institutions and consumers faced years of repairing their balance sheets, the former by raising capital and the latter by paying down debt (deleveraging) via curtailed spending.

In this scenario of a credit bust, deflation becomes the main risk to the economy. The Federal Reserve took extraordinary measures to prevent a deflationary cycle similar to what occurred during the Great Depression in the 1930's (the last time the United States had a credit bust). After lowering the federal funds rate to zero, they engaged in several measures of so-called "Quantitative Easing" whereby the central bank pumps money into the economy by buying bonds in the open market. The goal of pumping money into the system is to simultaneously stimulate corporate business activity to spur growth, create a wealth effect by causing asset prices to rise (especially housing and stocks) that would in turn increase aggregate demand, and allow businesses and consumers to refinance at very low rates.

By itself, **pumping money into the system does not automatically cause inflation**. The Fed is just trying to replace money that was vaporized in the credit bust. So it is simply not true that high inflation (let alone hyper-inflation) is a foregone conclusion, all else equal. Inflation happens when **too much money** is in the system **relative to economic output**.

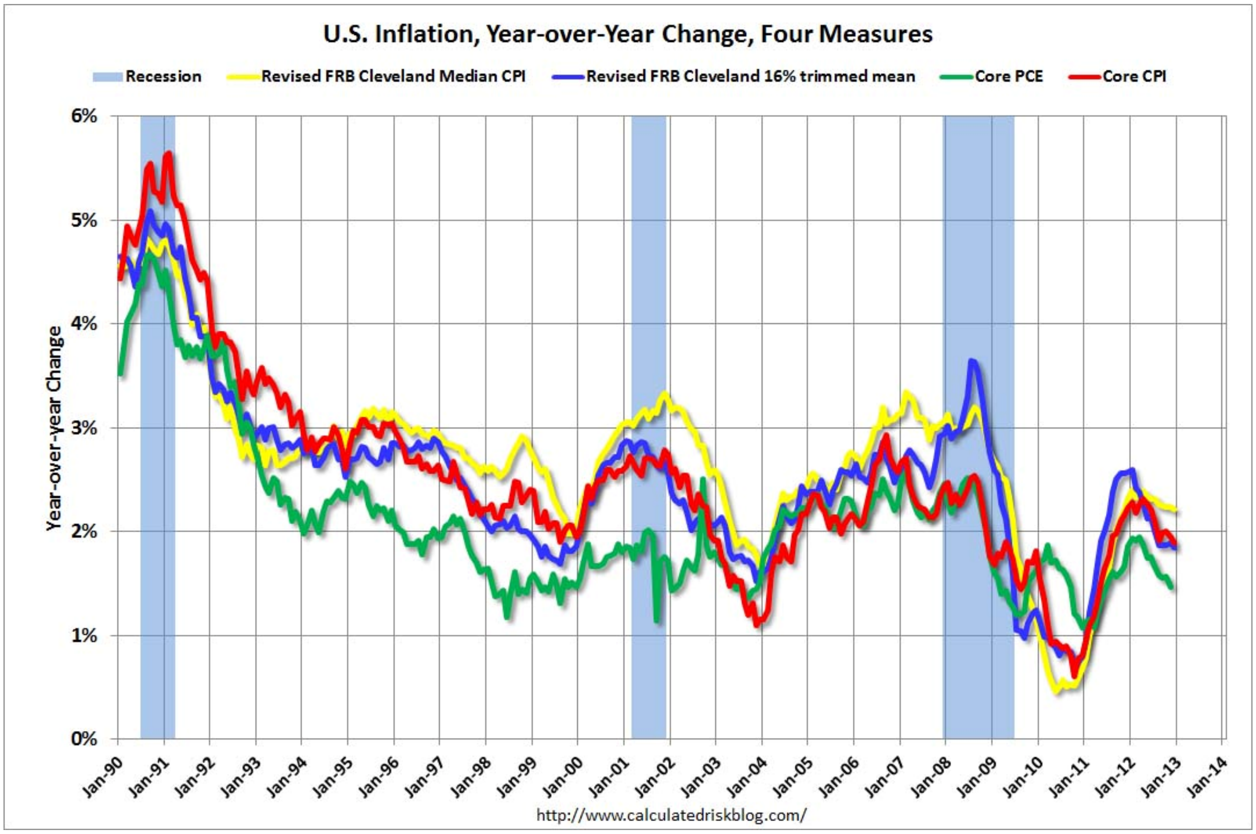
An analogy to what the Fed is doing would be a car, where the economy is the engine and money is the oil that lubricates the engine. The credit bust is like a vandal unscrewing the nut at the bottom of the drain pan and letting the oil out. The Fed sees the oil all over the ground, replaces the nut on the drain pan, then begins to pour oil into the engine. But the Fed cannot ascertain exactly how much oil the engine needs, so it starts with one quart, then another, then another, hoping to be able to stop just in time so the engine has enough oil to function properly.

There are two dangers to this process. One is the Fed doesn't pour enough oil in, with the result that the engine does not run properly and eventually seizes again. The other is the Fed pours in more oil than required, which would allow the engine to run for a while but increases the risks of other problems and nasty messes that are difficult to clean up.

The Fed has stated they intend to maintain their aggressive easing policies until there is substantial evidence of a stronger economy. As long as that mindset exists the risk of the Fed not stimulating enough is probably much lower than the risk of over-doing the stimulus. Given that the Fed cannot know how much money to pump into the system is too much until afterward, the concern about inflation at some point in the future becomes legitimate. However, there are two major points to keep in mind.

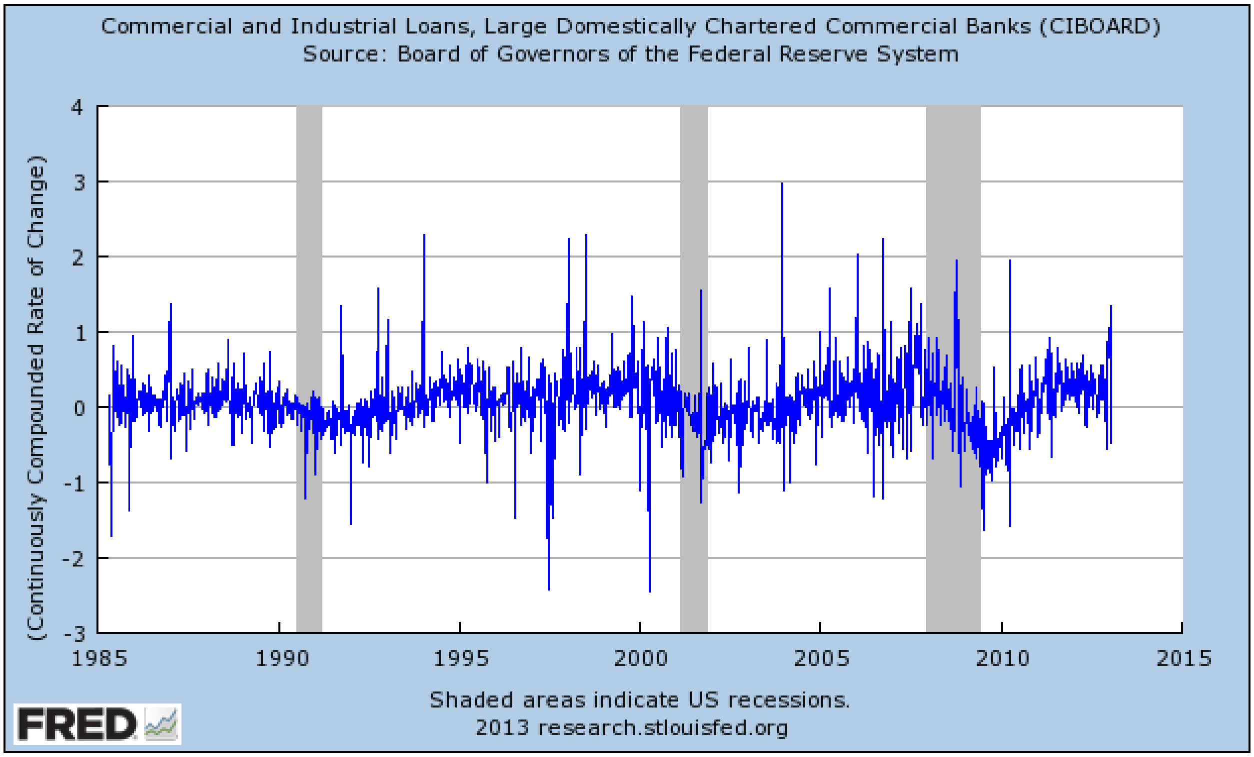
First, there is currently a paucity of evidence of overstimulation given the low level of overall inflation (see Exhibit 2), low real economic growth, and relatively high unemployment, among other factors. Regardless of the recent actions of the Federal Reserve, in the long run **the vast majority of money that is created in the economic system comes from banks via their lending operations**, and currently bank lending is hardly in overdrive (see Exhibit 3). Thus the current situation suggests inflation is likely to remain low, perhaps less than 3% on average for the next one to three years.

Exhibit 2



Source: Calculated Risk, January 16, 2013

Exhibit 3



Source: Federal Reserve Bank of St. Louis, January 16, 2013

Second, when the need arises the Fed will be able to reverse their Quantitative Easing by simply selling bonds into the open markets which would in turn take money out of the system. They will also increase the federal funds and discount rates, among other tools, to limit excessive bank lending.

> Theoretically the process is easy but knowing when to act is very difficult. So we suspect that if the Fed is even close to decently timing any action to quell inflation another group of critics, led by the political class, will howl with anger like rabid dogs that the Fed is risking another recession. Being a central banker will be most difficult at this point as so many ignorant politicians will forget that the Fed's primary job in their role of maintaining price stability is to take away the punch bowl just as the party gets started.

We remind clients and friends that all of our commentaries are available on our web site (http://www.yosemitecapital.com/news-commentary). As always, please contact us if you have any questions. We wish you a healthy, happy, and prosperous 2013!

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