PERKINS INVESTMENT MANAGEMENT

FIRST QUARTER CIO UPDATE

UNCOMMON VALUE℠

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Strong Returns, Questionable Fundamentals

U.S. stocks posted impressive gains in 2012, with the S&P 500 Index rising 16.00% for the year, despite relatively flat performance of -0.38% during the fourth quarter. Although the Perkins portfolios enjoyed solid absolute returns throughout the year's broad market run-up, our risk-disciplined investment style resulted in a performance lag on a relative basis. Looking ahead, the real question seems to be how much more steam does this rally have left? All in all, there simply does not appear to be that much driving stocks higher outside of the Federal Reserve Board's (the Fed's) commitment to extremely accommodative monetary policy and investors' cautious euphoria that perhaps things are not that bad, mixed with a fear of missing out on any further stock gains.

We realize it can be frustrating to experience short-term underperformance, particularly when the market seems to be on such a strong upswing. It remains unclear, however, how long investors will continue to shrug off the major uncertainties facing markets worldwide. The low-quality, low-volume momentum lifting stock prices could just as easily quickly dissipate should one or more of these macroeconomic threats suddenly take a negative turn. Given this environment, we continue to place tremendous faith in our investment process and the team implementing it. After all, it remains essentially the same team and same process that has guided our firm through 30 years of investing, including the 2008 financial crisis, a time that proved devastating for many equity investors. It appears as though many of the challenges that made 2012 so problematic could persist into the new year, though easy liquidity combined with the current prevailing sense of investor complacency could also very well lead to more of the same – rising markets on questionable fundamentals. Our fear in this type of climate, of course, is that investors overexposed to risk may experience painful reminders of how market momentum can quickly – and unexpectedly – cut both ways.

If anything, the lessons that can be drawn from the years leading up to 2008 serve as a reminder of the importance we place on sticking to the consistent research discipline that has served many of our long-term clients well through the years and avoiding the herd mentality that can transpire in the late stages of a momentum rally. By seeking to minimize capital losses in difficult markets and capture solid absolute returns during strong periods, we strive to maximize the effects of compounding and deliver outperformance across full market cycles relative to our portfolio benchmarks and peers. There is little doubt that this approach can lag during strong, broad market gains, sometimes dramatically as it has recently, but ultimately with stock investing it often can be much more important how much you lose when everything is falling versus how much you gain when everything is rising. We saw a similar trend in the general equity run-up period between second quarter 2004 and first quarter 2007. Things quickly changed course a few months later when stocks (as measured by the S&P 500 Index) tumbled a precipitous 50.17% between October 2007 and February 2009. During that severe downturn, our flagship portfolios significantly outperformed and were in position to positively compound over the next several years, vindicating this cautious, systematic approach to securing long-term strong performance. Indeed, these portfolios have outperformed their respective benchmarks since the market peak in October 2007 to recent year end. Unfortunately, investor memories can sometimes be short.

We have seen this type of investment pattern time and time again, and it helps us remain steadfast in our commitment to our process and the team stability that has been so crucial to our success in the past. We continue to focus on what we do best: seeking to find high-quality companies with strong balance sheets and strong, recurring free cash flows that are trading at attractive valuations. These types of stocks have historically tended to outperform over time, and we remain confident they will continue to do so in the future, even though they have trailed as a group over the past few years.

No Real Risk Resolution

Our current market caution is not necessarily because we are bearish; in fact, there is certainly good news to get excited about. Stocks appear fairly valued with the S&P 500 Index trading at 14x 2013 year-end earnings estimates and offering an impressive 2.11% dividend yield, compared to the paltry 10-year U.S. Treasury yield of 1.76%. Corporate balance sheets remain on solid footing, and the large number of company share buybacks and dividend increases should be further supportive for recent equity levels and we would expect merger and acquisition activity to pick up. In addition, the U.S. labor and housing markets seem finally to be moving, at least modestly, in the right direction, as does consumer spending. Liquidity from central banks around the globe also continues to flow unimpeded, particularly in the U.S. where the Fed has clearly stated its intent to keep interest rates low well into 2015 and embarked on a new round of quantitative easing efforts.

Yet these positive dynamics continue to remain highly susceptible to the broader negative macroeconomic factors hanging in the background, none of which have meaningful long-term solutions. In Europe, for example, European Union (EU) economic leaders continue to utilize more verbiage versus action when it comes to monetary policy to solve their fiscal problems. On the plus side, a complete euro meltdown seems to have been avoided for now, and markets appear to be responding favorably to the European Central Bank's Outright Monetary Transactions open-ended sovereign debt buying program. This liquidity boost has helped offer much-needed short-term relief to the region's financially strapped countries, but it may ultimately only be buying time until the EU's productive core of Germany and its Northern European neighbors tire of footing the bill for the fiscal malfeasance of the southern tier. Moreover, euro-zone banks continue to see deposit outflows, further pressuring the overall financial system's health. Gross domestic product (GDP) estimates have also continued to decline across the Continent, and it has yet to be seen how this slowdown may ultimately end up affecting other global economies.

China appears to have avoided a hard economic landing for the time being, but general global growth estimates have continued to be revised down. U.S. GDP forecasts are also trending lower, with the Fed revising its 2012 estimate to 1.9-2.4% from April's 2.4-2.9%. Furthermore, there is mounting risk of U.S. recession as the economy navigates the difficult one-two punch of the year-end fiscal cliff's austerity measures and higher taxes, delivered with the increasingly familiar toxic partisan posturing and last-minute game of political chicken. This type of contentious polarization seems only to be designed to elevate American malaise and investor anxiety. It also makes it unlikely that Washington – never a model of efficiency even in good times – will be able to tackle some of the difficult issues our nation faces until forced to do so by crisis, not a hopeful prognosis to solve our country's substantial, lingering economic problems in any timely fashion. Add to this the fact that at some point the Fed will need to start unwinding its prolonged – and largely untested – stimulus efforts, each round of which has continued to create a somewhat artificial sense of economic stability while having diminishing impact on any actual sustainable improvement. These efforts cannot go on indefinitely, and who knows how the economy and investors might react when this liquidity spigot dries up? Worse, what happens when the Fed starts the difficult process of paying down its vastly expanded balance sheet and higher interest expenses worsen the deficit?

Though none of these issues may actually end up torpedoing stocks in the year ahead, they should give investors reason for serious pause. The current bull market generally began in March 2009, and it is starting to look a little long in the tooth from our perspective. While we have been surprised by the duration and velocity of the upward momentum, trading volume has remained incredibly light. Volatility is also low, with the CBOE Volatility Index (VIX) ending 2012 at 22 and declining 2.9% over the year. With this lack of participation depth we do not think it would take much to push markets in a new direction. Earnings growth has remained one consistent bright spot (and stayed stronger for longer than we anticipated), but current S&P 500 Index earnings are forecasted to increase more than 7% in 2013, which seems to be a high hurdle given slowing GDP, persistent pricing pressures and continued waning positive effects from cost-cutting initiatives. At some point, a reversion to the mean is likely to materialize, and investors may be unforgiving.

Taking in all of these collective risks, there is a lot of uncertainty to digest. That being said, we continue to find solid companies that we are interested in investing in over the long term, but for many we are waiting for the right risk/reward entry point. We look forward to being opportunistic, especially if volatility increases.

Looking Ahead

So what might investors expect in 2013? We still believe that stocks offer the strongest long-term potential, but there are three possible short-term scenarios that could play out in the months ahead. Markets might maintain their upward trajectory. Conversely, they could experience a steep selloff that drives stock prices lower. We believe that the most likely outcome at this juncture, however, appears to be an environment where markets continue to muddle through their current difficulties, while remaining immensely vulnerable to external shocks. We also expect more normalized, single-digit market returns, with significant portions delivered through stock dividend payouts. Our current moderately defensive positioning also continues to factor in some very poor downside price target scenarios to help account for today's elevated macroeconomic risks. This outlook may prove to be too cautious in the short term, but we would much rather sacrifice a portion of gains on unexpected upside rather than unduly risk capital in market downturns. In our experience, it is these defensive characteristics in difficult periods that have been much more important in securing higher returns across full market cycles. It can be easy to forget when equities seem to be rising nonstop that indexing and other market-exposed strategies offer no protection when the good times end, much to the potential detriment of long-term performance.

As we enter 2013, we want to thank you for the confidence and trust you have placed in Perkins Investment Management. Our investment team is firmly committed to our value discipline and remains heavily invested in our strategies right alongside you. We continue to be excited about our portfolios' long-term investment potential and look forward to serving you for many years to come.

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