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Robbing Peter and Suing Paul

A 1600's phrase, "robbing Peter to pay Paul," originated when taxes had to be paid to St. Paul's Church in London and St. Peter's in Rome. The current idiomatic definition is something like, "To solve a problem in a way that benefits one party, but makes another problem worse, and in so doing, creates no net gain." This principle rings true as global events unfold regarding bailouts, rating agencies and Government policy. This Newsletter will outline some of the conflicts we see in today's financial system and why we continue to avoid the sector.

We also discuss how we have allocated portfolios in view of our expectations for volatility resulting from the fear of uncertainty, juxtaposed with the continued unleashing of economic growth throughout parts of the world.

Banking Woes

As our clients know well, Hamilton Point does not invest in companies in a particular industry unless we are convinced that the sector is marked by relatively healthy competition, regulatory clarity and the provision of "value-added" products, among other criteria. It should therefore come as no surprise, that we reduced and later sold all of our financial stocks during the last four years. The wisdom of this decision was reinforced in the recent meltdown, but was also confirmed upon learning that AIG sued Bank of America for $10 billion for mortgage securities fraud and that the U.S. Securities and Exchange Commission (SEC) was potentially suing Standard & Poor's (S&P) for downgrading U.S. debt. After all AIG and Bank of America were willing sub-prime mortgage participants (dealing in securities rated AAA by S&P) and both were bailed out by U.S. taxpayers (causing our country's debt to get downgraded). To us, this all seems about like the U.S. Post Office suing the U.S. Navy, as we see little "net gain" from such enterprise, and hence the title of this Newsletter.

On a related front, the downgrading of America's debt by S&P bears further mention. While more the symptom of many problems than a cause, the timing of the downgrade was horrible since it was in the midst of the third (or fourth?) phase of the European debt crisis. Current worries of another global banking problem are real, and supported by data. The contrarian in us was alarmed when Jamie Dimon of J.P Morgan said recently that he is "totally comfortable" with what is going on in Europe and that although his bank has manageable exposure to European banks, they are not going to "cut and run." Famous last words….maybe?

2008 Re-Run?

It is hard not to be reminded of the gut-wrenching 2008 period when witnessing this summer's market volatility and erosion in confidence, but we do not see the current turmoil as being as scary as 2008. This time around most large global banks and brokerages are better capitalized (thanks to government bailouts and monetary policy) and we now know that—right or wrong—governments will rescue any large bank needing help (Bank of America). Similarly, governments and central banks are already "experienced" with last-minute backstops for everything from money-market funds to overnight bank lending to keep liquidity flowing. In short, the European debt

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crisis is indeed a huge problem (and one that has helped propel our Gold position higher), but hopefully the Lehman Brothers "run-on-the-bank" scenario of 2008 is less likely this time around.

We also find comfort in the incredible strength of corporate balance sheets now as good companies have produced tremendous cash flow and either built their cash balances further, paid debt down or refinanced it at super low rates. Parenthetically, too much corporate cash resides outside America and under current laws would be subject to high taxes if brought home. We suspect that if America ever reworks its tax structure, these companies will be allowed to bring this cash home under better terms—and that could be quite bullish for stocks.

Finally, we must mention that the strength in developing markets, though slowing recently due to developed world woes, is still a huge positive long-term theme and these emerging consumers are now three years further down that path with literally millions more people on the journey. Most of these fast growing economies are some 40% larger than they were just four years ago and, importantly, are reducing their traditional reliance on exports to the exhausted West, by selling, or even importing, goods and services to their own emerging consumers.

"Flying by Instruments"

We think Americans are rightly angry at much of what we see from all of our political and economic leaders. However, in a macro sense, it would be a mistake to judge the health of the global economy by just looking at the USA or Europe. Sure, these economies need restructuring, their banks remain troubled and both face prospects for slow or no growth for the foreseeable future. That does not mean, however, that the *world* is broken, and thus we cannot let anger or fear, overwhelm our judgment when investing for the *long term*.

In a world with a near 0% return on short-term bonds and money markets and uncertain prospects regarding long-term inflation that could crush real returns on long-term bonds, even cash and fixed income investors are not truly safe.[1] We believe investors must be vigilant in seeking an adequate *real* investment return in what remains a volatile world requiring prudence – not fear – as a guide. So what is Hamilton Point doing?

We continue to position portfolios to protect capital on a relative basis by avoiding investment sectors facing headwinds while seeking those on the side of a global capitalist equation that includes continued emerging country growth, ongoing productivity enhancements and a never-ending race for global natural resources. Quality, including dividend-paying stocks, remains the bedrock of investment portfolios – not just a style to add when markets get uncertain. We believe strongly in a "balanced" portfolio to dampen volatility, the fixed income portion of which is similarly focused on quality holdings and diversified to include global bonds and inflation protection.

In short, it is easy to get caught up in depressing economic news, frustrating political rhetoric and nonsensical corporate spats between entities that owe their survival to the taxpayers. These are all disappointing events, regardless of the "winners," that rob the public of confidence and create no net gain for our country. Investors must take note of this, but like pilots facing foggy conditions, we must "fly by instruments" in making prudent investment decisions by evaluating fundamentals of companies as opposed to blind indexing or fear-induced reallocations. In so doing, though performance can never be guaranteed, we believe investors can benefit from many of the positive trends unfolding in the global economy, thereby producing *real* gain over the long-term.

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1. Again, the emphasis is on long-term portfolios. For short-term purposes or liability matching, 100% fixed-income investing may be entirely appropriate.