



Third Quarter 2011 Commentary and Outlook

In recent quarterly letters we have discussed conditions that could move investors away from equities. These included a deepening of the eurozone sovereign debt crisis and slowing domestic growth that would cloud the outlook for corporate profits. As we moved through the third quarter, we saw elements of both. Eurozone interbank rates rose to levels that indicated the sovereign debt crisis was intensifying. Domestically, disappointing reports on employment, housing, and economic growth all pointed to prospects of weaker consumer demand and lower corporate earnings. The dysfunctional response of the federal government on the debt ceiling issue further undermined the confidence of consumers and businesses alike. All combined, these developments contributed to an unfavorable environment for equities, and market indices declined sharply as a result.

Concerns over domestic economic growth will persist until investors are persuaded that some measure of fiscal or monetary policy will cause a change of direction in the current cycle. Investors' concerns over international affairs will be even more difficult to resolve. The systemic risks surrounding eurozone debt suggest this issue will remain the primary influence on global financial markets until the crisis is resolved.

The Euro: Dysfunction by Design

At its birth only 12 years ago, the euro currency served as an imperfect expression of the optimism of its 11 member nations for bolstering economic growth and reducing threats from the ambitions of any one nation state. It was conceptually flawed in that no country in the monetary union was prepared to cede control of its economy and, as a result, fiscal policy remained the purview of individual members. This willfully naive approach to economic policy worked well during the period of prosperity that existed through the middle of the last decade; in this environment adoption of the euro currency grew quickly to 17 countries. However, with the financial crisis of 2008, the fault lines of fiscal autonomy running below the surface of the monetary union began to make themselves felt in jarring ways.

Just 19 months ago, Greece revealed that its fiscal profligacy had resulted in a level of debt that threatened its national solvency. A decisive rescue package coupled with a credible austerity plan for the country could have put the developing crisis to rest. But it was not to be. The absence of a single decision-making authority instead brought indecision, inconsistency, endless quarrels, and posturing instead of the measured response that was needed. Investor confidence was undermined. The issue snowballed, bringing Italian and Spanish sovereign debt into question and threatening first the entire European banking system and ultimately the global financial system and economy.

Forging a Liquidity Solution

Eurozone banks hold nearly half of the €6.5 trillion (\$8.7 trillion) of debt issued by eurozone governments. These holdings are very large relative to the equity capital of the banks and show signs of heightened credit risk. To avoid a European banking system failure and its resulting damage to institutions and economies globally, it is imperative that European authorities devise a mechanism to recapitalize European banks and restore investor confidence.

This situation is akin to that of the US financial system during the subprime credit crisis. It is complicated but inherently solvable. Policymakers should be able to get past the political, legal, and financial obstacles to achieve the necessary result. There is no benefit to any single country or region — inside or outside Europe — for a disorderly default or breakup of the monetary union. Germany, China, the United States, and the Persian Gulf countries all have significant stakes in seeing the liquidity crisis resolved. For Germany, the situation may represent a singular opportunity to advance its strategic and economic interests within the monetary union and beyond. The pressure being exerted on European monetary authorities from countries around the world is intense if not unprecedented.

While the estimated cost of two trillion euros, needed to effectively address the problem, is large, the same global interests that would be served by a coordinated financial rescue have incentive to help marshal the resources necessary to restore liquidity. Short of this, a monetization of the troubled debt by the European Central Bank is possible, but given Germany's cultural aversion to inflation, it is not a high-probability policy option.

Restructuring for Solvency

A program that effectively provides funding to meet the liquidity needs of troubled sovereigns will be welcomed by financial markets. However, such a plan is unlikely to resolve the root problem, namely the high levels of public debt from countries on the periphery of the eurozone. This solvency issue is longer term in nature than the liquidity crisis and stems from a debt overhang that can be resolved only by fiscal measures and economic growth. Ultimately, effectively dealing with the solvency issue will require low interest rates, a depreciated euro relative to the currencies of principal trading partners, and ample amounts of patience and time.

The longer term issues surrounding the eurozone's political and financial architecture will remain for some time. Modifying eurozone membership, makeup or structure may be a later option; however, in the midst of crisis, such a reform makes little sense.

As authorities develop the strategy and tactics to address this crisis, our financial markets are likely to continue to fluctuate, alternating between fears of financial meltdown and optimism that a stabilizing program will soon be revealed. Ultimately, a sustained reversal of the markets' recent downward trend will require the announcement and implementation of a credible program that takes the eurozone sovereign funding issue off the table for the foreseeable future.

Formidable Challenges to Growth

It is worth noting that when the systemic risk associated with the eurozone sovereign debt crisis gripped the financial markets in the third quarter, correlations rose to historically high levels. This condition was the complete opposite of the environment experienced in the first six months of 2011, when correlations were considerably lower and stock selection was rewarded. In the third quarter, differentiated performance through stock selection was severely challenged. For example, stocks with a cyclical component (such as auto related) basically traded as one, ignoring in some cases the components of value that were very large relative to the market value of the company. We believe once the systemic concerns weighing on the market are relieved, correlations will recede and stock selection will again be rewarded. When this develops we fully expect the intrinsic value embedded in your portfolio to be reflected in above-average returns.

While the systemic risk described will ultimately be resolved, we continue to believe we are in an economic environment constrained by, among other issues, consumer deleveraging, limited credit availability, and fiscal restraint in the public sector. These conditions will generally present a headwind to growth in corporate profits. The current economic environment and unsettled market is presenting an outstanding investment opportunity to acquire businesses that are well positioned to compound earnings at accelerated rates due to strong secular trends and/or unique business characteristics. For example, businesses with strong recurring revenues such as subscription models that have annuity like characteristics should shine in this environment and we are focusing our research efforts in these promising areas.

Sincerely,



Michael A. Steinberg
Managing Partner