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At HeadInvest, we bring our breadth of experience to a disciplined investment process focused on achieving success for our clients.

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EUROZONE AND BRETTON WOODS Following the chaos of competitive currency devaluations in the 1930's and the war that followed, international leaders met at Bretton Woods in New Hampshire to devise an international currency regime that would provide a stable foundation for economic growth. The outcome was a system that pegged the currencies of the major developed nations to the dollar, which in turn was pegged to gold. The result was several decades of expanding international trade and prosperity, as economic actors were soothed by relatively stable exchange rates. The creation of the Eurozone had a purpose similar to that of the Bretton Woods system, though at a regional level. It sought to remove currency fluctuation as an impediment to trade and capital flows within Europe.

Both currency regimes eventually came under pressure as a result of substantial trade and capital flow imbalances. The Bretton Woods system came to an end when U.S. trade and fiscal deficits incurred to fund the Vietnam War—known as the guns and butter policy—led to large outflows of gold from the U.S. In 1971, President Nixon ended the convertibility of the dollar into gold. What followed was a system of fiat currencies backed by nothing of permanent value, but which allowed the stress in the system to be discharged by exchange rate fluctuations rather than the physical location of gold.

The Eurozone countries have also developed wide disparities in fiscal and trade deficits. Germany has prospered greatly from the system, reforming its own institutions to maintain and improve competitiveness and raising its exports to Europe. Other nations, especially on the periphery, have simply feasted on the cheap and easy credit that became available to them, while neglecting fundamental competitiveness and falling further behind. Locked into a single currency, there is no release valve.

This time, the problem is not gold outflows, but whether financing will continue to be available to profligate nations. The solution to this problem is difficult and the answer, so far, is maybe not. The crisis poses a Hobson's choice: Either some nations adopt fiscal austerity that is likely to reduce living standards for a decade, or else the Eurozone is at least partly dismantled with untold consequences on capital formation and economic activity.

Recent developments in the Eurozone have relieved investor concerns about an imminent and disorderly restructuring of the continent's private and sovereign debt. However, the crisis has depressed confidence and investment to the extent that it is likely that Europe has already entered recession. While economic indicators in the US have recently picked up, there is a significant chance that, coupled with our own problems, a European recession could lead to recession here.

INVESTMENT OUTLOOK It is always hubristic to make forecasts about the coming year. A correct forecast would require getting the economic and corporate profit fundamentals right as well as guessing in which direction the public mood will swing. While many forecasts are available on TV and in the financial press, these serve very little purpose other than to stir emotions.

The best investment posture is to balance the risks and opportunities through asset allocation and sensitivity to valuation. If you have money in the stock market that you anticipate spending in the next year or two, the cost to you of market volatility may be quite high. On the other hand, if you have an investment horizon of a decade or more in which to absorb the volatility, chances are you will be much better off ten years from now. What you do if you're in the middle depends on your financial circumstances.

In absolute terms, the valuation of the stock market today is not demanding. The forward price earnings ratio for the S&P 500 is a mere 12 times, below its long-term average. This ratio takes into account the risk that companies may not meet their sales and earnings forecasts for the coming year as a result of any of the uncertainties and headwinds they face. Relative to bond yields, the stock market has rarely been as inexpensive as it is now.

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MarketComment.

A TALE OF TWO YEARS The price of the S&P 500 stock market index was essentially unchanged in 2011. The last time it changed so little over the course of a calendar year was 1970. In both years there were numerous twists and turns in the economy and markets. It is instructive to consider the differences underlying the surface similarity.

Despite the stock market outcome, the year 1970 was not at all boring. It was the first year of a decade of economic underperformance which, until the last decade, had been the worst for stock market performance since the Depression. In that year, Canadian labour minister Pierre Laporte was kidnapped and killed by Quebecois terrorists, four students were shot and killed by the Ohio National Guard at Kent State, a cyclone struck East Pakistan (now Bangladesh) and killed an estimated 500,000 people, and after a crippling explosion, Apollo 13 just barely made it back to earth. There was a mild recession when interest rates were raised to quell inflation. The stock market fell nearly 30% through the spring but recovered when monetary policy was eased later in the year. The stock chart from that year looks like a "V", straight down, then straight up.

The year 2011 has not been boring either. The natural disaster in Japan caused untold damage, killed an estimated 15,000 people, and led to meltdowns in three nuclear reactors at the Fukushima Nuclear Power Plant. The Arab Spring—a revolutionary wave of demonstrations and uprisings—has fundamentally reshaped North Africa and the Middle East, though not necessarily in the direction of greater political stability. The Eurozone crisis has overturned governments and undermines the grand project of "nation-building" designed to consolidate Europe's economic power.

Though the U.S. stock market did fall nearly 20% from its high during the year, perhaps most notable about the market's performance was the unprecedented level of volatility. Daily price swings in the S&P 500 index averaged 2.2% in the month of August, the most for any August since 1932. Prior to the Lehman collapse, the fifty-year average volatility was 0.6%. Thus in August, 2011, the market was nearly four times more volatile than its long-term average. The rest of the year did not really feel much calmer.

STURM UND DRANG Two things are remarkably different between now and 1970. First is the degree of public attention focused on the economy and markets by the financial media. In the early nineteenth century, there emerged in Germany a movement in literature and music that came to be known as "sturm und drang," usually translated as "storm and stress." The artistic objective of this movement was to frighten and create extremes of emotion in its audience, a reaction against the putative rationalism of the Enlightenment era.

In the 1990's, there developed in America a financial press that capitalized, at first, on the market's success. Today, the media are fully engaged in sturm und drang. The result is that uncertain fundamentals have become charged with fear and other extreme emotions that are not necessarily appropriate to the circumstances. But let's face it: bad news sells.

The other major difference is the amount of trading that occurs in the markets. The total annual dollar trading volume of the U.S. stock market in 2011 will approach \$60 trillion, or 400% of gross domestic product. In 1970, it was closer to 20%. Much trading is now done by algorithmic and high-frequency traders, perhaps as much as 75% of the total. The average holding period for a stock has fallen from five years in 1970 to three months today—or a nanosecond for many high-frequency trades.

As a result of this frenzied trading, the character of stock markets has changed in a way that makes them more difficult to understand. This has led to a decline in public confidence in the markets. We hope the SEC or Congress will soon address the allegations of market manipulation which may be at work.

The potential silver lining is that the market's focus on relative value obscures the absolute values of individual businesses on offer in the marketplace. Our investment methods are designed to focus our work on absolute values. We have built portfolios of investments in those companies whose stock prices compare favorably with underlying value. What is required is patience and confidence that these values will ultimately express themselves in stock prices, despite the increasing volume of trading that does not serve investors.

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PortfolioMatters.

BY CARL GERCKE, CHIEF INVESTMENT OFFICER

Two factors are distinctive characteristics of the investment climate we face today: equity market volatility and low interest rates. Both factors pose challenges to investors. Both can be addressed by adding high-dividend stocks to portfolios.

Equity market volatility is especially painful if the only way to generate cash is to sell stock. Dividends, however, are a reliable source of steady cash no matter what the market mood. Dividend yield is more predictable than price appreciation; in addition, it tends to grow over time. Of course, price appreciation will hopefully come eventually, but in the meantime, dividend stocks “pay you to wait.”

MANY STOCKS NOW YIELD SUBSTANTIALLY MORE THAN BONDS, WHOSE YIELDS ARE AT HISTORIC LOWS.

Many stocks now yield substantially more than bonds, whose yields are at historic lows. Even high quality dividend stocks, however, are inherently riskier than bonds. In important respects, dividend stocks represent a kind of “middle ground”, often with higher risk than bonds but lower risk than non-dividend paying equities. Adding an allocation of dividend stocks to retirement portfolios, for example, has been shown to support higher withdrawal rates and extend portfolio life.

COMPARING YIELDS*			
S&P 500	2.1%	1-YEAR TREASURY	0.2%
CORE HEADINVEST	2.3%	5-YEAR TREASURY	0.8%
DIVIDEND MODEL	4.1%	10-YEAR TREASURY	2.0%

*Yields shown for the core HeadInvest and Dividend Model portfolios vary with price and are shown for illustration only.

Dividend stocks are useful tools to investors who are trying to meet the challenges of today’s investment environment. It is important, however, not to rely on dividend portfolios exclusively for equity market exposure. While dividend stocks may outperform broad market averages in periods of market stress, it is almost inescapable that dividend portfolios do not offer the growth potential of portfolios without a dividend constraint.

DIVIDEND STOCKS ARE USEFUL TOOLS TO INVESTORS WHO ARE TRYING TO MEET THE CHALLENGES OF TODAY’S INVESTMENT ENVIRONMENT.

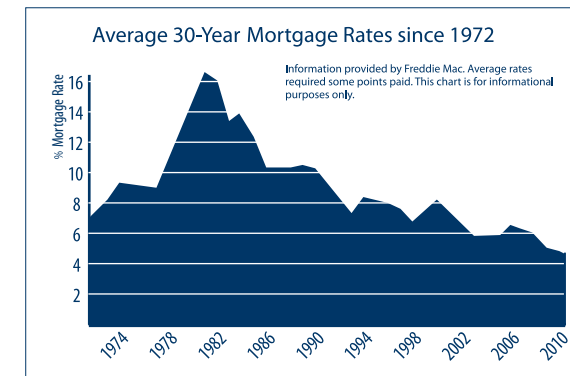
For two decades, HeadInvest has employed its **Price/Value Analysis** to guide our security selection. While this method is useful in helping us to establish the proper relationship of stock price to business value, it is agnostic with respect to the level of dividends paid in any one year. Because of its emphasis on important financial metrics, including value, financial quality and return on investment, we continue to enthusiastically apply our **Price/Value Analysis** in our core equity portfolios.

HeadInvest is responding to current market conditions in two ways. First, we have added a yield screen to our **Price/Value Analysis** to focus on higher-yielding stocks that also meet our valuation criteria. Second, we are developing a separate broadly diversified model portfolio that emphasizes above-average dividend yield. Many will find this additional equity strategy compelling in the difficult economic environment that we now face.

For Your Information.

BY KENNETH BLASCHKE, PORTFOLIO MANAGER

As we help clients plan for success, we are often asked to provide input on all things financial. Each quarter this portion of the HeadInvest Quarterly will be dedicated to information you can use.



With a mortgage often one of the largest financial commitments for families, we thought it would be useful to provide some insights at a time when rates are hitting historic lows for both 30 and 15 year mortgages.

In the table below, we show the options now available to a family with a 30-year mortgage taken out 3 years ago at 5.75% (1) Do nothing; (2) Refinance

ASSUMPTIONS: INITIAL LOAN AMOUNT: \$800,000, RATE 5.75%, TERM: 360 MONTHS, 36 PAYMENTS MADE, PAYMENT (\$4,668.58), CURRENT BALANCE (\$767,267.10)	
OPTION 1	DO NOTHING: ZERO SAVINGS
OPTION 2	REFINANCE: NEW 30-YEAR MORTGAGE AT 4.25%.
	PAYMENT REDUCED BY (\$893.93)
	OVERALL SAVINGS \$153,745.12
OPTION 3	REFINANCE INTO A NEW 30-YEAR MORTGAGE AT 4.25%, KEEP PAYMENT THE SAME.
	PAYMENT REDUCED BY (\$0)
	OVERALL SAVINGS \$364,182.36
	NEW TERM 246 MONTHS (20.5 YEARS)

to a new 30-year mortgage to reduce their payment by \$894 and save \$153,745 over the life of the loan; or (3) Refinance to a new 30-year mortgage, keeping their payment the same and saving \$364,182 over the life of the loan which will be paid off after 20.5 years.

Which option to choose? When considering refinancing, the right choice is the one that fits your overall financial goals. HeadInvest takes a comprehensive view of your financial picture and can often offer advice—unrelated to investments—that can help you meet your goals.

SHORTS

HOLIDAY INTERNET SALES UP 15%

U.S. retail sales, excluding automobiles and gasoline, are on track to rise about 4% in November and December to \$35 billion compared with a year ago. The increase was led by Internet sales which rose 15%—the same percentage as in 2010 according to market researchers at ComScore Inc.

DEBT CRISIS



GLOBAL POPULATION HITS 7 BILLION

The UN’s doughty demographers have declared that October 31st is the day on which the world’s population reached 7 billion. The next billion people will take 14 years to arrive, the first time a billion milestone has taken longer to reach than the one before.

We value your Comments

Please provides us your thoughts and suggestions, including content ideas, by emailing your portfolio manager or info@headinvest.com.

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