

Fourth Quarter 2011 Commentary

Happy new year! We hope that your 2012 is off to a healthy and prosperous start. In this letter, we want to share with you a review of the recently ended quarter and year. We will also borrow from Mark Twain to help us convey our message of why we think it is a good idea to be investing in the stock market.

An Interesting Year

Stocks rebounded sharply in the fourth quarter, jump-started by the strongest October for the S&P 500 since 1991 and the biggest monthly point rise ever for the Dow Jones Industrial Average. The volatility that we experienced in the third quarter did not abate, with the equity markets then falling in November, only to rebound at the end of the year. The S&P 500 ended the quarter with a gain of 11.8%.

The fourth quarter marked the culmination of a year that saw wild price volatility in the stock market as a reaction to a number of macroeconomic and geopolitical events around the world. The year started with mass protests in the Arab world, as thousands took to the streets. What started in Tunisia spread to Egypt, Yemen, Syria, and Libya. All of these countries, with the exception of Syria, experienced regime changes amid the uprisings.

There were also large protests in many European countries, including Portugal, Italy, Greece, and Spain. These countries, referred to by the acronym of PIGS, are implementing wide-reaching austerity measures to deal with ever-increasing debt levels. Greece seemingly made news on a daily basis in the latter part of the year, as the stronger economies of Germany and France provided rescue packages to restructure Greek debt.

At home, the U.S. economy struggled to regain its footing, stalled by dysfunction in Washington and a housing market that remained depressed. S&P downgraded the U.S. credit rating in August, triggering the wildest price swings in stocks for the year. With unemployment hovering around a problematic 9% for most of 2011, many pundits predicted a double-dip recession. That dire prediction did not materialize, however. The resilient U.S. economy keeps chugging along, albeit at a very low rate.

Amidst all this turbulence around the world, stocks finished the year around where they started, after bouncing wildly in between. The S&P 500 started the year at 1257.64 and finished at 1257.60 on December 30. Dividends added 2%, marking a positive return for the index.

Why It Pays To Listen To Mark Twain

As we mentioned in our holiday newsletter, we have no idea how the stock market will perform in 2012 (and we do not think anyone else knows either). There are so many factors which will affect the market in the year—the presidential election, the Eurozone debt crisis, interest rate and



currency fluctuations, etc.—that it is practically impossible to know what the market will do in such a short time frame.

Our confidence rises, though, when we think about the long term. In previous communications, we have shared with you two reasons for why we are optimistic about equity returns for the next ten years. We would like to reiterate those two and add one more:

Low Valuation Relative to GNP

In investing, valuation is key. One of Warren Buffett's rules of thumb in knowing when it is a good time to invest in the stock market is to look at the aggregate valuation level of U.S. stocks in comparison to the Gross National Product (GNP): "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you." Currently, the combined market cap of the stocks in the S&P 500 is around \$12 trillion, and annualized GNP is running at about \$15 trillion, giving a ratio of 79%.

Poor Ten-Year Historical Returns

For the ten-year period which ended on December 31, 2011, the average annual return of the S&P 500 was 2.9%. Since records began in 1928, there have been 12 other occasions in which the average return of the index over a ten-year period has been less than 6% per year. In each of those 12 occasions, the average annual return for the subsequent ten-year period was at least 7% and averaged 13%. We think the odds are good that the next ten years will see an extension of that streak to 13.

Large Recent Redemptions From Equity Funds

Many stock market participants approach investing by looking at the rear-view mirror instead of through the windshield. Their behavior is further impacted by emotions such as fear, greed, and envy. Thus, when it comes time to deposit or withdraw their money, they do so at exactly the wrong times. For instance, the single-largest year on record for additions to equity mutual funds is 2000, when investors deposited over \$300 billion. The next two years saw the market drop -12% and -22%, and the annual average return over the following ten-year period was +1.4%.

The single-largest year on record for withdrawals from equity mutual funds is 2008, when investors yanked \$234 billion from their accounts. The market then advanced +26% and +15% over the next two years.

What this means is that equity flows are somewhat of a "contrary indicator." That is, if you see large in-flows to the stock market, it may be time to consider pulling back a bit on your investments. Similarly, if you see large withdrawals from the market, that may be precisely the time when you should be adding to your account in a significant way.

So what happened in 2011? Final numbers have not yet been released, but monthly figures through November and estimated December data indicate that investors withdrew \$125 billion



from the stock market in the year. This is the second-largest year on record, and is more than three times larger than the third-largest year's withdrawals.

How does this bode for the future? While we recognize that past performance is never a guarantee for future results, we also bear in mind Mark Twain's famous declaration that "history doesn't repeat itself, but it does rhyme." Therefore, this data point gives us more cause for optimism than for pessimism.

Conclusion

From Mark Twain, we want to conclude with a look back at a quote from Sir John Templeton that we highlighted in our newsletter. The famous investor once declared that "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." While the current environment is not as pessimistic as the one in early 2009, we see a skepticism that signals satisfactory long-term returns.

Thank you for your referrals, confidence, and support. We look forward to reporting to you again in three months.

Sincerely,



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