

*This letter is dated January 2012*

## **Excess Caution Can Lead to Danger**

The S&P 500 Index<sup>1</sup> ended 2010 at 1,257.64 and finished 2011 at 1,257.60<sup>2</sup>, virtually unchanged for the year. That is as the crow flies, but in reality transportation can include many turns along the way, rush hour traffic and airport security. The stock market found itself in the same vicinity at the year's beginning and end, but there was plenty of turbulence along the way.

The dividend yield on the S&P 500 increased from 1.8% at the beginning of the year to 2.0% at the end of the year. We expect dividends paid by public companies to continue to increase over the next several years. Investors in individual bonds, on the other hand, are locked into a fixed income stream during the life of the bond. As of year-end, the 30 year U.S. Treasury bond yield was 2.9%.<sup>2</sup>

Let's assume that a buyer of a 30 year Treasury Bond at 2.9% holds the bond for 5 years, then decides to re-evaluate his options. At this juncture, the bond has 25 years until it matures. Let's assume at that point 25 year Treasuries are priced to yield 5% to maturity. In this scenario, we would expect the investor to be able to fetch a price of about 70.4 cents per dollar of his initial purchase price, a decline of almost 30% in value. The point is that investing in long term Treasuries, historically a perceived safe haven, exposes investors to interest rate risk. We are not predicting where interest rates will be in five years, but given that rates are near all-time lows, rates' moving higher over long term is a distinct possibility.

Historically, gold<sup>3</sup> is sometimes touted as product that would hold its value even if the U.S. dollar and other "paper" currencies decline in value. I can speak only for myself, but if monetary currencies became worthless, I'd be bartering my possessions and talents for goods other than the luxury metal. From its closing price in 2004 of \$435.60 per ounce to the 2011 closing price of \$1,531.00, gold has risen 260%. At the end of 1979, gold cost \$459.00 an

ounce. A person purchasing an ounce of gold at that time, 25 years later had an investment worth \$435.60; 25 years with no interest and dividends and a decline in value of 5%. If he hung on to that ounce of gold purchased at the end of 1979 through the end of 2011, over the entire 32 year time period his investment would have increased by an average annual rate of return of 3.9%. Inflation as measured by the CPI (Consumer Price Index – which is a gauge of inflation) over that same time period increased from 76.70 to 226.23<sup>4</sup>, for an average annual increase of 3.4%. Whether the recent surge in gold was a ‘catch up’ to inflation or a ‘ramp up’ in intrinsic value is moot. Gold prices falling by 15% or more in 5 of those 32 calendar years, however, is an important factor to consider in our opinion.

It seems not long ago that real estate was viewed as a safe haven. In the United States today, both residential and commercial real estate on average are about 30% lower than they were 5 years ago.<sup>5</sup>

The natural inclination to run to safety when sensing danger transcends the financial markets. I learned to snow ski at age 40 with my then 9 year old daughter and 7 year old son. It was the first time to the slopes for all three of us. After one beginners’ lesson on the bunny slope, the instructor looked at each of us: “Max, you are definitely ready to hit the real slopes. Madison, the same goes for you. Dad, you need some more work.” So while Maddie and Max were literally off to bigger and better things, Dad labored through more lessons on the bunny. Finally, an instructor said, “I think you’re ready to give the green slope a try.” I distinctly remember the hesitation in her voice as she motioned to the green lift chairs taking skiers to the smallest of the ‘real’ slopes. “Really!” I replied eager to move on from the bunny. She replied, this time *intentionally* emphasizing her reservation, “I *think* so”. Good enough for me, off I went to give it a try. While riding the green chair to the top of the slope, my innards were occupied by butterflies of fear fluttering their wings wildly. After a very ungraceful exit from the lift chair, I worked my way over to the slope. Before descending I repeated to myself what had been emphasized during my extended stay on the bunny: “Keep turning to avoid going too fast”. As I began to descend, my speed exceeded my comfort zone, so I immediately turned right. Immediately, my pace slowed! Now, cutting across (as opposed to down) the slope at a comfortable pace I was running out of room. I was able to successfully turn again, this time left and more left until heading across the slope in the opposite direction. My plan to head down the slope in a continuous S formation appeared to be successfully under way! Feeling more confident with this brief success, my speed began to pick up a bit as the slope became steeper. “Turn to slow down” still

prominently repeating in my head, I turned more left. Then, realizing I had turned too much, I tried to offset by turning right, but the inertia of my skis going left seemed irreversible. Skis now pointed directly up hill, I caught a glimpse of the top of the slope (embarrassingly closer than expected) before the proverbial accelerator was punched. Flying downhill backwards I quickly realized in succession 1) we had not covered safe backwards skiing in my beginners lessons 2) nor had we covered how to turn yourself around in the event you find yourself involuntarily skiing in reverse, 3) apparently the correct technique for turning around was not intuitive to me as my fast furious and instinctive attempts were to no avail, 4) I had no choice but to intentionally fall, which I promptly did!

Whether skiing or investing, a turn toward perceived safety can result in a precipitous slide backwards. We work to thoroughly evaluate risks and return potential of investment options including those that are widely considered “safe havens”.

Confidence is earned through experience and achievement. Every experienced veteran was at one time a novice. Phony swagger of the untested often has a crash like ending. Be it a gray hair or a rookie, knowing what you *don't* know is every bit as important as knowing what you *do* know. Our team<sup>6</sup> has over 100 years of industry experience including three portfolio managers with a combined 50 years, which includes some of the best bull and worst bear markets in market history<sup>7</sup>.

We are finding great businesses with strong management trading at prices below our estimate of their intrinsic value. Many of these businesses are paying attractive dividend yields and have a long history of raising payments to shareholders.

It's an honor to be on this journey with you. We will continue our due diligence with the goal of helping protect and grow your hard-earned assets.

May 2012 be a wonderful and prosperous year for you and your family.

Paul D. McCauley  
January 2012

Rest of the Story: With much encouragement from my son and daughter, I stuck it out. After much trial and error on Sunday afternoons, I can now safely navigate the slopes with them!

<sup>1</sup>S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in the market index.

<sup>2</sup>S&P 500 Index year end prices, dividend yields, as well as the 30 year Treasury yield are per Thomson One.

<sup>3</sup>Gold prices quoted herein are per "Closing Annual Gold Prices For Over 200 Years Since 1792" chart found at [www.onlygold.com](http://www.onlygold.com). The 5 calendar years since 1779 when gold fell by 15% or more were 1981 (from 594.9 to 400.0, 27% decline), 1983 (from 447 to 380, 15% decline), 1984 (from 380 to 308, 19% decline), 1988 (from 487 to 410, 16% decline), 1997 (from 369 to 287, 27% decline)

<sup>4</sup>Historical CPI data is per [www.inflationdata.com](http://www.inflationdata.com)

<sup>5</sup>As of October 31 2006 the index was valued at 203.55. As of October 31, 2011 the Case-Shiller home price index closed at 138.56, representing a 32% decline in value over the 5 year period. Historical information regarding the Case-Shiller Index was obtained from [www.ycharts.com](http://www.ycharts.com) The Moody's National Commercial Aggregate Commercial Real Estate Index closed at 168.54 on October 31, 2006. On October 31, 2011 the index closed at 111.36, representing a 34% decline in value. As of the writing of this letter, the 4th Quarter 2011 figures for both of indices had not yet been released, but they are not expected to vary greatly from the 3rd quarter close.

<sup>6</sup>Listed below are the names, titles, and years of experience (as of the date of this letter) in the investment industry for each Madison Group team member:

Phil McCauley, Portfolio Management Director, Financial Advisor, 21 years  
Paul McCauley, Senior Portfolio Manager, Financial Advisor, 17 years  
Doug Kraft, Portfolio Manager, Financial Advisor, 12 years  
Nathan McCauley, Financial Advisor, 2 years  
Sandy Ballard, Portfolio Management Associate, 11 years  
Joanne Beck, Portfolio Associate, 24 years  
Tina Oberhausen, Client Service Associate, 26 years

<sup>7</sup>Below are S&P 500 Index valuations at the peak and troughs of significant bull and bear markets since Phil, Doug and I entered the business in 1990, 1999 and 1994 respectively:

1990 – 1993 Strong start for 1990's, 60% gain  
From 294.51 on 10/11/1990 to 470.04 on 10/18/1993

1995 – 1999 Technology Boom, 235% gain  
From 457.20 on 1/2/1995 to 1,532.13 on 3/23/2000

2000 – 2002 Tech Bubble Burst, Decline of 50%  
From 1,532.13 on 3/23/2000 to 768.63 on 10/09/2001

2008 – 2009 Financial Crisis Bear Market, Decline  
From 1,576.67 10/11/2007 to 666.79 on 3/6/2009, Decline of 58%

Information obtained from Thompson One.

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**Past performance is no guarantee of future results.**

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**Indices are unmanaged. An investor cannot invest directly in an index.**

For index, indicator and survey definitions referenced in this report please visit the following: <https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions>

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