TW ADVISORS

Third Quarter 2012

Let the Good Times Roll

Despite a considerable amount of hand-wringing from most investors, equity markets around the world charged higher during the quarter. Equity returns were remarkably consistent with most major indices, regardless of capitalization or style, gaining a little more than 6%. Fortunately, our stock selections allowed our portfolios to beat the S&P 500 index by a percent or more.

The wall of worry the market climbed is quite substantial: fear of a eurozone collapse, economic slowdown in China, lower real income for America's middle class, the potential U.S. fiscal cliff at the end of the year, and a rather poor earnings performance by corporate America. In fact, analysts expect companies in the S&P 500 index to report a 2.7% year-over-year decline in third quarter operating profits, according to FactSet Research. If these numbers hold up, that would be the first drop in quarterly earnings in three years. However, all these negatives are well known to investors and perhaps already reflected in stock prices.

Believe it or not there are several positive developments for the economy and stock market. The most important being the collective stimulus efforts of central banks. Since the start of July, central banks in China, Brazil, South Korea, Australia, South Africa, Israel, Colombia and the Philippines have reduced borrowing costs. The two most important central banks, the Federal Reserve (Fed) and the European Central Bank (ECB) both announced open-ended programs of quantitative easing (buying debt with newly printed money) and pledged to do "whatever it takes" to avert another financial crises. It has rarely paid to "fight the Fed" and we think this time will be no different.

While deleveraging inflicts pain, it is a necessary evil to return the world economy to firm footing, and there has been decent progress on this front in the private sector and in state and local governments. Total consumer borrowing is $1.3 trillion below its 2008 peak due to lower credit card and mortgage debt. This improvement is showing up in higher home prices, a hopeful sign that the U.S. housing correction is finally at an end. Other conditions that drive our optimism are rock-solid corporate balance sheets, bank capital as a percentage of assets at a 60 year high, and a phenomenal increase in domestic oil and gas production which is lowering costs for consumers and attracting chemical and manufacturing companies.

Dividends are now a hot topic with investors and a major factor supporting stock prices. Our portfolio saw several meaningful dividend announcements: McDonald's increase their payout by 10%, Microsoft by 15%, Yum! Brands by 18%, Walgreen by 22%, GameStop by 67%, Cisco by 75% and Dell initiated a dividend for a yield of 3.2%. With very few safe options for income investors Blue Chip stocks look like a good bet. For example, Walgreens is yielding 3% and has paid a dividend for more than 79 years and has increased its dividend for 37 consecutive years.

Dividends might be in the news in the fourth quarter as well. Cash-rich companies may pay out special dividends to take advantage of the current 15% tax rate that is set to expire at the end of the year. Likewise it might be wise to sell stocks with long-term capital gains to guarantee the current 15% rate. Please contact us or your financial advisor to discuss the wisdom of this strategy.

To summarize our current position, while we acknowledge there are many risks we feel those are already reflected in the market and stock prices will drift higher as investors begin to recognize the positive developments outlined above. Analysts remain very bearish and continue to recommend a below-average weighting to stocks. Moreover, despite strong returns from equities investors have pulled money from U.S. stock funds for 18 straight months. Mutual fund investors have consistently bought high and sold low. However, if progress stalls in Europe, if we don't deal with the fiscal cliff in the U.S., if earnings turn out worse than expected, or if prices rally too far, too fast, we will not hesitate to raise cash. But, in the meantime, we expect to continue to own a diversified portfolio of high-quality, dividend-paying stocks. Let the good times roll.

James Tillar, CFA **Steve Wenstrup**

"I could be wrong, but you look like a man trapped in low-yielding financial instruments."