Colley Asset Management, Inc.

REGISTERED INVESTMENT ADVISOR

The Hazy, Crazy Days of 2011 and 2012's Forecast

It's time to close the books and say "buh-bye" to 2011 which, in terms of performance, could be labeled "The Seinfeld Year" of business and financial news. In terms of performance, it was a year "about nothing"...of course, that doesn't mean that nothing happened. There was plenty of drama.

The fact that you are hard pressed to find a lot of really good news out there was the real story of 2011. It was a year of shoring up, selling off, and letting defense be your best offense most of the year. Stock markets (and bond markets, for that matter) "bounced" wildly and "the dribble" was manic—mostly depressive. In Europe, the "ball was out of bounds" often and there were simply "no slam dunks", in terms of performance, to continue the basketball metaphor.

Let's take a look at benchmark performance for 2011 and then set our sights on 2012's prospects:

- Although the hopes of a normal recovery were dashed in 2011, thank goodness the U.S. economy avoided the double-dip recession. The slowdown in GDP growth disappointed and the overhang of that double-dip fear clouded the markets all year. The haziness and unclear directions stunted rallies and kept rebounds contained and short-lived.

- In the U.S., corporate earnings improved in 7 out of 12 major industry sectors and large cap companies generally did better than their smaller counterparts. The S&P 500 composite received a B/B+ report card, not the C/C- many had predicted. The S&P's low P/E valuation of 11x's (versus the 50 year historical moving average of 18.8) shouted signals in two divergent directions:

    - Undervaluation was one direction as both actual and forward P/E gauges were at attractive levels not seen since the 1987 crash;
    - Fear and an uncertain future dominated the other direction as emotion often trumped all else. Some called it irrationality and nonsensical, but it was what it was. Some thought that P/E's were low in anticipation of more problems to come.

THE GRANITE PALACE, 358 BROADWAY, SUITE 304, SARATOGA SPRINGS, NY 12866
(518) 581 0500 • (800) 581 0501 • FAX (518) 581 0525

Key Point to Ponder: 

What deterrents and catalysts make the difference?

The 2011 Nobel winning economists said it pretty simply. To paraphrase Thomas J. Sargent and Christopher A. Sims: *The banks and financial system (the lifeblood of our economy) are doing better but are still hurting...and it creates a weight that drags on the recovery...furthermore the relatively high unemployment is another anchor; The recession was deeper than thought. The lasting catalyst you need at a time like this is a patient confidence you can believe in and we are witnessing gradual progress in our irregular recovery.* This writer agreed: In short, we are experiencing a cautious optimism as we trudge through the uneven recovery.

- U.S. stock indices were disappointing in 2011 as 3 of the 4 major stock composites declined. In the "red" were the blue chip S&P 500 index, growth-barometer Nasdaq, and the small and mid-cap Wilshire, while the DJIA (with dividends reinvested and no fees) managed to provide a welcome, but feeble 4% gain. After a steep retreat post-April, most of the Dow's rally came in the last few weeks of 2011.

- The drama and volatility got to be "high pitched" for some and monotonous for others and some cried out "enough already", as the Eurozone woes and trickle effect certainly stole the most headlines in 2011. Unfortunately, the U.S. political scene had its share of troubles and opportunities, too, as the debt crisis, downgrades, budget impasses, can-kicking, and short-term fixes became the frustrations of many Americans. As expected, the VIX (volatility measure) was in direct correlation.

- The global scene took center stage a few times as events in Japan, China, Greece, Italy, and the Middle East were interpreted as mostly bearish. Stock market results in other countries around the world tell the story:

Argentina -0.6%	**Greece** -53%	**Russia** -18.5%
Australia -12.7%	**India** -22.1%	**Saudi Arabia** -5%
Brazil -16.3%	**Iceland** +2.6%	**Singapore** -33.1%
Canada -11.2%	**Japan** -17.5%	**South Africa** *even*
China -22.2%	**Mexico** -4.6%	**Turkey** -21.3%
France -18.4%	**Norway** -11%	**United Arab Emirates** -13.7%
Germany -14.8%	**Pakistan** -16.1%	**United States** *DJIA* +4.1%; *S&P 500* -3.8%; *Nasdaq* -5.5%; *Wilshire* -8.8%

- The "Oracle of Omaha" Warren Buffett and his value-laden Berkshire Hathaway was down 7% for the year. The long-revered holding company did experience an increase in book value and earnings over the year, but investors didn't acknowledge it. Even the coveted Value Line (growth index) was negative (-8.6%) in 2011.

- Income yields for U.S. Treasuries (T-bills, notes, and bonds) and CD's were rather uneventful at 0.10 to 1.50% for short-term (0-3 year) maturities. Even 10 year paper provided anemic 1.9% yields at best. Money market returns were low, too, and not all money market funds are insured (but yours, rest assured, were fully insured as chosen by CAM).

- Well-regarded bond/fixed income funds underperformed, as well. Take note of the star-studded names like Oppenheimer, Vanguard, Fidelity, Alliance Bernstein, Pimco, and the American Funds as victims of low yields and decreasing NAV's. Pricing for U.S. government sponsored mortgage agency paper was under pressure and even CMO's and Fannie Mae/Freddie Mac's were challenged by liquidity factors and wide bid/ask spreads as the mortgage/real estate and default-related problems persisted in 2011. One of the few bright spots included **A+ preferred issues** (often known as senior debentures) like **AT&T** and **GE** which **provided nice 6.375% and 6.5% income yields and remained price stable.**

- Many hedge funds (both domestic and offshore) were "whipsawed" in 2011 as most contrarian strategies failed miserably and computer-triggered hyper trading "backfired". Some active funds made 10,000+ trades per day and usually lost money as the high speed computer trading worked against itself, creating high activity and transaction costs, aside from the common 5%-10% annual fees regularly charged. Talk on the Street has put hedge fund returns in the derivative markets at -22% to -38% for 2011. Some private firms choose not to disclose performance or asset composition to the general public, but the whispers coming out are decidedly negative.

- IPO's that came to the U.S. market in 2011 lost 22% on average.

- This is not to say that there weren't some bright spots in 2011, but they were not in abundance. CAM will be highlighting some of our favorite selections for 2012, but first here are some predictions and what if's (*see next page*).

Some Predictions for 2012

	YES	**NO**
The U.S. economy will continue to recover in 2012.	85	15
The U.S. economy will do better than expected in the year ahead.	60	40
U.S. banking/financial institutions finally bottom out in 2012.	80	20
Real estate/housing/construction turns the good corner in 2012.	65	35

Median GDP growth rate in 2012	+2.7%
The 2012 stock market will closely mirror 2011's volatility and results.	25%
The 2012 economy will do worse than in 2011.	15%
Most likely quarter for the turn in Real Estate/Banks (Anticipation factor 3-6 months)	3rd Quarter 2012
Eurozone mess continues to plague 2012.	75%
Headlines of 2012 read like 2011 in Europe.	70%
Euro (EU) breaks down; some countries default.	15%-20%
Euro (EU) collapses—much more chaos.	5%-10%
The DJIA and S&P 500 get back to 2007 highs in 2012.	40%
Oil trades in an \$80-\$120/barrel price range.	80%
Middle East problems (i.e. Iran) escalate/oil supply shortages or other variables tied to a stronger recovery cause price spikes.	75%
Gold and silver pauses and resumes upward rally.	80%
Oil decreases to \$80 levels and below if zero growth/double dip.	50%
U.S. Federal Reserve and Bernanke engage in third round of Quantitative Easing (QE3) in 2012.	**50/50 chance**
If EU were to break down hard (viewed as 15% chance), QE3 becomes:	90% chance
If the U.S. economy falls victim to a double dip/further downgrade, QE3 becomes:	90% chance

TOP 10 STOCK (SECTOR) PICKS

The joy of finding winners in 2012 is tied to sector and individual favorites who earn the buy rating by reason of sound fundamentals, deserving bullish sentiment, and good forward momentum. Naturally, a few total return and turnaround picks always make the list, too.

1) **Apple** (AAPL) **stock makes the list, again, this year and scores high in every category of review.** EPS growth remains momentous with 37%-50% average growth rates for the last five years running; a golden AAA balance sheet (no debt), and an unbelievably low (and attractive) P/E of 11. Steve Jobs' passing took a bite out of momentum, but even the most conservative analysts have Apple's EPS rising by 30% in 2012. They have beaten Wall Street estimates for 21 out of the last 22 quarters and the markets where they make most of its money (smartphones, tablets, computers) are nowhere near mature. The tablet market alone has sold 64 million units this year. The iPhone's potential in China is super powerful and Apple is right now finalizing contracts with the nation's dominant carrier; this will fuel tremendous future growth.

At $400/share, shave a zero and think of it trading around $39/$40. It could easily zoom to $50 ($500) in the year ahead on fundamentals alone and this doesn't include any new "buzz". New CEO, Tim Cook, has a few things to unveil. Also, don't be surprised to see a dividend initiated to reward shareholders and reduce their large cash hoard. Other tech stocks with unique and bullish stories include **Google** (GOOG) and **Baidu** (BIDU), the Chinese search engine equivalent to Google that has met the regulatory approvals over there and is the likely platform to launch Facebook by Summer. You could own all three (3) of these tech giants.

2) **You could also own all three of these telephone stocks**: **AT&T** (T), **Verizon** (VZ), and **CenturyLink** (CTL). For a special niche play, you could also add the lesser known, small cap company, **Frontier Communications** (FTR), to the list.

These low-beta (low volatility), high-dividend yielding stocks have "total return" qualities which are especially attractive. Solid balance sheets combine with an expanding dividend history to offer the conservative and cautious investor with moderate appreciation potential, too. Dividend yields of 5%-8% obviously add a nice enhancement to returns. Even the much revered **AT&T Preferred** issue pays out (quarterly) a handsome annual 6.375% dividend and is viewed as price-stable with a fixed rate of return (and very liquid). It represents a "peace of mind" holding.

3) **If you believe in a U.S. recovery taking hold (and global) and value the international brand name popularity of Caterpillar** (CAT) and **Deere** (DE), these are two cyclical blue chips worth owning in your portfolio. You don't need both, but you also might want to consider: **CSX** (the railroad), **Southern Copper** (SCCO) with its 7% yield and #2 rating in world production of the red metal, **GE** ($22 one year price goal), **3M** (MMM; $103 one year price goal), or turnaround **Manitowoc** (MTW), selling at 1/5th of its 2006-2007 peak price with specialty in cranes, shipping and train containers, and refrigerated equipment.

4) **Energy investments certainly vary, but many bargains exist.** **First Solar** (FSLR) can arguably be viewed as one of the most oversold "green" stocks which offers leading edge solar panel technology, good profit, and market share growth as other competitive companies have faltered. A true leader in its field, FSLR is worth a look at current "dipped" prices.

Also, **Kinder Morgan** (KMP), **Enbridge Energy** (EEP), and the oil royalty trust of **Prudhoe Bay, Alaska** (BPT) offer stable payouts on the order of 6%-10% (some of which is tax-deferred) with the added caveat of capital appreciation, especially so when the price of oil is over $85/barrel. Environmentally conscious and with proven track records of efficient extraction methods and pipeline transport, these picks along with **Permian Basin** (PBT), **Enterprise Energy** (EPD), and **Linn Energy** (LINE) also could fit the bill. Other standout companies in the integrated oil/gas sector include AA rated companies **Conoco Philips** (COP) and **Chevron Texaco** (CVX). Two other considerations might also be **Marathon Oil** (MRO) and **Hess** (HESS).

5) **Some believe that the financial, REIT, and insurance stocks are worth a nibble and that many are selling well-below their often "hard to figure out" book values.** Reserve levels have improved and some that have choice commercial and performing retail properties could be very profitable in 2012 and 2013 because some have turned the corner and are raising equity capital to posture for the rebound. Not for the faint of heart, but many of these REIT's (Real Estate Investment Trusts) could also be poised for a big rebound. **Annaly Capital** (NLY) and **Triangle Capital** (TCAP) are two such possibilities and both pay attractive dividends.

Some don't mind being a "little early to the party", as we recognize that many banks and insurance companies could also be picked up and held because they are selling at sliver fractions of the 2006 and 2007 peak prices. ROE and ROA are important gauges used by CAM to pick the best of the best. **First Niagara Bank** (FNFG, with its 8% dividend) has become a "super regional" institution serving our area, in New York and Connecticut. We have others, too; some with buyout whispers adding to the allure.

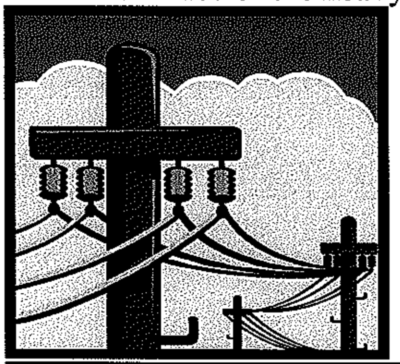
Even specialty REIT, **StoneMor Partners** (STON) could be a logical choice. Cemeteries and funerals happen to be their forte on the east coast and it is paying out a handsome 8.5% dividend. STON is enjoying some very good demographics with the aging of America. **MetLife** (MET) and **American Express** (AXP) also make the list, as does turnarounds **Bank of America** (BAC) and **KeyCorp** (KEY). Needless to say, the risk/reward potential is always a personal consideration and one that is tied to patience level, as well.

6) **Food and beverage can be viewed as mainstay core holdings in many instances.** We have several that we like in this rather recession-safe category. Our favorites include:

- **Coca Cola** (KO)
- **Pepsi** (PEP)
- **Whole Foods Market** (WFMI)
- **Fresh Market** (TFM)
- **McDonalds** (MCD)
- **Kraft Foods** (KFT)
- **Campbell Soup Company**(CPB)
- **Yum Brands** (YUM)
- **Hansen Natural** (HANS)
- **Smuckers** (SJM)

I can talk to you about particulars.

7) **Utilities are often viewed as ultra-conservative, "cash cow" picks because they are heavily regulated, cash-intensive, and often price stable over long stretches of time.** We generally avoid the nuclear reactor utilities because of the heavy intrinsic risks involved.



Two of our favorites include: **Duke Power** (DUK) and **National Grid** (NGG) which boast above average yields and specific interests in alternative and renewable power services, as well as wind and the conventional resources. Dividend yields have grown 7 years in a row, now, for both DUK and NGG and both share resilient qualities in the rough times. Conservative can be good.

8) **Specialty growth selections have the distinct honor of being the best at what they do and often have distinct and somewhat unique niche advantages as such.** Here are 12 standout picks:

- **Medtronic** (MOT): health/medical instruments or **CVS Caremark** (CVS): pharmacy, etc.
- **Starbucks** (SBUX): specialty consumer/food and beverage
- **U.S. Steel** (X): specialty metal
- **Panera Bread** (PNRA): specialty food
- **Visa** (V): financial/retail
- **Terra Nitrogen** (TNH): specialty fertilizer/seeds with 7% yield in agriculture
- **Clean Harbors** (CLH): environmental/engineering/construction
- **Waste Management** (WM): waste/pollution control
- **UPS** or **FedEx** (UPS/FDX): commerce/shipping/retail packaging
- **Disney** (DIS): recreation/entertainment

9) **Interesting situations often breed interesting opportunities**. Changes in trendlines (i.e. employment and job creation), perspective (recovery on; recovery off; recovery dulled, etc.) and external developments (i.e. political scene here in the U.S.; Europe getting better or worse) are always unfolding and they require monitoring and ongoing evaluation. They can also spell o-p-p-o-r-t-u-n-i-t-y.

If the recovery perks up, stocks in the transportation sector could respond accordingly. Watch for **Ford** and **GM** to do better. Niche companies like **Goodyear Tire** (if natural rubber prices remain low) and **Fastenal** (FAST) will do particularly well on bigger revenues and sales during a recovery. An FDA break for pharmaceutical companies **Pfizer** (PFE) and **Merck** (MRK) could be a booster shot for their bottom lines...and retailers could rally if the consumer gets healthier and spends more (watch **WalMart** (WMT) and **Target** (TGT), as well as others like **Home Depot** (HD)and **Lowes** (LOW). Some of these choices will come and go in 2012 but merit good reward, too.

10) **We'll finish with our <u>blue, blue chip list of reliable "steady-eddy" stocks, including this variety 6-pack of A+ rated companies</u>**:

- **<u>International Business Machines</u>** (IBM)
- **<u>Johnson & Johnson</u>** (JNJ)
- **<u>Proctor & Gamble</u>** (PG)
- **<u>Minn. Mining and Manufacturing</u>** (MMM)
- **<u>DuPont</u>** (DD)
- **<u>Clorox</u>** (CLX)

<u>WRAP UP</u>...

A lot more research and market intelligence will be coming your way. This primer sets the stage for 2012 just as Shakespeare's Macbeth, metaphorically, dominated the stage in 2011 (a tale full of sound and fury signifying "nothing" but high drama).

What can be concluded that will help us navigate well in 2012? The rhyme or reason analysis of the financial markets in 2011 taught us that the stock and bond markets were "out of step" and lacked rhythm. When investors are conditioned by the arrhythmia, it can help them to get more nervous, panic, stay the course, or tweak a little. Irrational or not, the markets sold off for a variety of emotional reasons, too; everything from heavy hedge fund redemptions, to forced margin selling or deleveraging moves which tripped up the markets. Europe needed cash and sold off assets, including gold and properties. This domino effect of selling fed on itself even when some very good news and better corporate results came out (to spite itself). We "tested" lows and let worst case scenarios play out, too. Some companies and some sectors didn't do well and certainly deserved to go down and stay down, but good companies sold off, too (providing opportunity or coaxing patience).

We also learned that coming out of this deep-rooted recession of 2008-2009 will take some time and almost seem like a drag at times. Some pundits prefer to label it a rut or a trading range without breakout or leadership. There are a lot of labels for it all, but suffice it to say:

> *We are cautiously optimistic about 2012. We will watch developments very closely and continue to monitor the forces and mechanics of a selloff (is it broken or a short-term pullback?) because there is opportunity out there.*

Here's to wishing everyone a happy, healthy, and prosperous New Year!

JC
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