CAZ Investments

Quarterly Letter

Whatever It Takes!

"*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough*." This is a direct quote from Mario Draghi, President of the European Central Bank during his speech on July 26, 2012. That speech sparked a market rally during the 3rd quarter. Adding even more fuel to the upswing, the U.S. Federal Reserve in late September decided to launch another round of quantitative easing that has been labeled by many as "QE Infinity". Conspiracy theorists around the world are trying to figure out when the secret meeting of the world's central bankers occurred in which they all agreed to throw as much money at the economy as needed. Whether or not bond buying programs are prudent this seems to be the tactic that will be used to avoid problems until the last of the central bankers has finished their term!

The central banks in the U.S. and Europe have told us they will spend as much money as necessary, for as long as necessary (regardless of how much they have to borrow from future generations; no matter how much debt they create) to avoid an economic slow-down and to rescue countries that are in financial trouble. When one contemplates how the central banks are essentially borrowing money from the government to buy bonds from the government, it really can be disturbing. One can't argue with success, though, at least when one measures success by rising asset prices ~ even if such price gains are temporary or unsustainable. To be fair to the world central bankers, they are limited in the scope of what they can do. Their powers are effectively limited to interest rate policy and liquidity. Interest rates can't go much lower. Therefore, the bankers are pumping Billions of dollars of additional liquidity every month into the monetary system. Whether or not the central bank actions will create jobs, or permanently stimulate the economy, only time will tell. However, what has been clear is that the central banks have done their job motivating the "animal spirits" to take asset prices higher. That would include stocks, bonds, gold, oil and other assets. Yet, what the bankers and their actions have not shown is meaningful progress in actually stimulating an economy to create more jobs, productivity or tax revenue.

Lack of Political Leadership

The clear culprits for the lack of economic growth are the politicians. Their lack of leadership, on both sides of the aisle, is disturbing. Trillions of dollars of capital remain frozen on the sidelines waiting for clarity that the economic, regulatory and taxation environments are safe and logical. Only when companies feel comfortable with the answer to that question will they make new capital investments which create new job opportunities. So, while the central bankers say they will do "whatever it takes", they are limited in their scope and effectiveness by the inept policies of governments around the world. Only time will tell if/when these policies, and policy makers, will change for the better.

Climbing the Wall of Worry

There is an old Wall Street saying that stocks usually climb "a wall of worry" to higher prices. That has certainly been the case this year as we have had outstanding price gains compared to the less impressive changes in the economic fundamentals. Investors have gradually "thrown in the towel" and put money to work because they fear missing the markets' rallies while holding their money market fund that was yielding close to zero. This is what fuels a rally, when people who were either previously selling stocks or sitting on the sideline decide to buy.

This year the impetus to climb the wall and buy longer-term investment assets has been created by two factors. One is the fact that the central bankers around the world have stated clearly they will provide a backstop for the market by doing "whatever it takes" to keep the rally going. The second factor, which actually is a long-term positive, has been corporate profits which continue to be resilient in the face of a mediocre economy.

We love it when markets rally! Clients are happy, and it creates a positive frame of mind for nearly all participants in the marketplace. So, we are not complaining one bit. However, the more that markets rally in anticipation of an improving economy, which may or may not actually improve, the more expensive stocks become. Expensive stock valuations make us nervous because once the market runs out of buying fuel to continue the rally the market is more susceptible to significant declines as sellers begin to dominate the activity.

Countdown to Election Day and Taxageddon

The clock is ticking down towards Election Day and the "taxageddon" debate. As of this writing the election is too close to call. The odds-makers believe that, regardless who wins the White House, the Republicans will continue to hold the House while the Senate will remain in the hands of the Democrats. That means that a stalemate is highly likely and the debate around the "fiscal cliff" will be ugly. The last quarter of 2012 has the potential to deliver high levels of volatility. Clearly, the initial focus will be on the elections. Then, all eyes will quickly focus on the negotiations in Congress to avoid "taxageddon".

Those negotiations have already begun. Rest assured no concrete proposals are likely to be disclosed until after the election. We believe that Congress will reach some compromise that avoids disaster and pushes the debate forward to mid/late 2013. It is in neither party's best interest to see a calamity because of an impasse. While there will be a lot of posturing and finger pointing, our leaders will likely find some temporary solution.

Market Outlook

In the meantime, the status quo will remain. Everyone will hold their breath hoping no financial disaster occurs in Europe, and a compromise will be reached on the "fiscal cliff" in the U.S. While those risks indeed do remain, corporate spending and hiring will likely remain moderate at best. Consumers will spend, but their exuberance will remain in check. The markets could move dramatically either direction this quarter. The thing that could allow for a dramatic rally would be meaningful tax reform, and a clear fiscal path to deficit reduction and economic growth. The odds of that happening are…..(?????) but if it were to occur that would be a real market moving surprise.

For several quarters, we have maintained our investment outlook rating on the CAZ Scale [1= most pessimistic; 5= most optimistic] at a "**2**". We remain at that level today. The impact of this cautious stance means we have made solid profits so far this year, but we could have made more if we would have been more optimistic and aggressive. We can live with our chosen trade-off of preservation of capital vs. chasing more aggressive growth during this environment. At no time will we take undue risks with your capital simply based on a hope that a fairy tale ending will be orchestrated by easy money policies of the world central bankers. We will become more aggressive when solid fundamentals at companies, and within the economy, justify the risks. Alternatively, we need to see underpriced assets reflecting all but the worst case scenario before we would be willing to be more aggressive with your capital. Right now, we don't see either of these scenarios. Instead, we see an economy that is teetering on the edge of a significant slowdown. We see asset prices that are fairly valued at best and expensive at worst. These are the reasons we remain a "2" on our investment scale.

Whenever we maintain a somewhat cautious stance, we will always lag a rapidly rising market. However, we should always do a significantly better job preserving capital should the markets turn into a rapidly falling market. Based on our nervous view of the world, we are very comfortable with our more defensive dynamic. As we have said for several quarters, our primary objectives are to protect your assets, to participate at some level in a market rally should one occur, and to get paid while we wait for the politicians around the world to get their act together.

We have positioned your portfolios to accomplish those objectives and are pleased with the results thus far.

We will continue to stay the course with our emphasis on capital preservation with the opportunity for growth. We will enjoy these higher asset prices but stay disciplined whereby we sell investments as they get expensive and buy new investments when they get inexpensive. Finally, we will continue to identify cash flow streams from interest, dividend and distributions from our investments to pay you while we wait for a better environment. At the same time, we will continue to explore some unique opportunities in asset classes that are mispriced and/or offer substantial opportunities because of multi-year trends.

Thank you for the confidence you have demonstrated in our organization over the years. We are always available any time you need us. Please let us know if there is anything we can do for you as we close out 2012.