CENTURION Asset Management

Year-Ending 2011 Q&A

Kevin Broderick, Managing Partner and co-head of Centurion's retirement plan division, sat down with Paul Liebezeit, President and Chief Investment Officer of Centurion Asset Management, for a conversation regarding the volatile markets in 2011 and his outlook for 2012. What follows is an excerpt of that conversation.

During 2011 investors experienced several stops and starts in the markets, but the domestic and international economy and financial markets have been consistently downtrodden. What is your perception of any recent improvements? Was 2011 truly a poor year, or understated - overstated?

It was an extremely challenging year for investors and portfolio managers. Considering where we have been, with a 20% swing between the high and low intra-year on the S&P 500 index, it may feel worse to many investors, but it may be a bit over blown purely based on the start and end points. We wrote a Market Letter earlier this year that mentioned the idea of falling asleep at the beginning and waking up at the end of the 1st quarter. At that time, the market was approximately the same level as the start of the quarter - a zero percent return. However, during the quarter the market moved up and down by more than 10%, a huge variance. That also sums up the entire year where the variance was approximately 20%[1], yet it looks as though the year will close with a 0% return on the S&P 500. Thus, it depends on your perspective.

If you take the position that intra-year gyrations of the markets will not affect your long-term investing attitude, then 2011 was a rather flat year, and you simply accept what the market bears. However, if you are more concerned with capturing growth, and reducing risk – i.e. a more attentive investor – then you may have anxiety from the events that provided both opportunity and peril in 2011.

Many investors were depressed over the last three quarters of the year, mostly from U.S. credit downgrades [by S&P] in August, and Congress barely reaching an agreement to raise the debt-ceiling limit. Couple these events with the European financial issues and the bailout of Greece, and you have highly negative pressures playing on investor psyche. Beyond the headlines, the average comparable mutual fund was off almost 3% going into the end of the year[2], underperforming the S&P 500, so as investors heard the poor news at home and around the globe, they also saw issues with their investments in passive mutual funds. This has led to a lack of confidence by investors, so the feeling of most U.S. investors is negative while the returns have been flat.

What is your outlook for U.S. and Global economic growth in 2012? Are we in a global recession?

We feel we are in a major global slowdown, not quite a full recession, led by overseas economies and not the U.S. Europe in our view has fallen into another recession only shortly after the last one. Emerging market economies are struggling and we are reducing our outlook for the EM group overall. China is slowing down after phenomenal expansion during the 2005-2010 period, and our forecast there is reduced as well.

Domestically we are forecasting sluggish, rather anemic growth in the first half of 2012, while the back half we feel will pick-up. For the past few years since the "great recession" of 2008-09 we have written that the U.S. economy will have starts and stops, and will struggle to stay above 2% growth, however we accept that process as we are realistic that an economy cannot turn around quickly after becoming tremendously overleveraged. The deleveraging process on personal, corporate, and governmental balance sheets is incredibly difficult to digest without bumps along the way. Accepting subpar economic growth is part of the recovery process.

We expect the U.S. economy to muddle through and grow at a slow pace, the unemployment rate to slowly decline but not by more than 2% in 2012, and core CPI [Consumer Price Index] inflation to remain flat year over year, but show signs of picking up late in 2012. However, the unfinished issues of a resolution to the U.S. financial crisis will provide noise that leaves the economy very cautious even when we have confirmed signs of growth. In aggregate, the US may not be heading back into recession, but we see the rest of the globe, led by Europe's sovereign and banking crisis, teetering on the brink.

Several major market pundits made poor calls in 2011 – Bill Gross, John Paulson, Meredith Whitney to name three – how did so many get it so wrong and where did you end up?

The year certainly turned out quite differently than most pundits expected in the 2011. We experienced Treasuries that greatly outperformed stocks and most bonds. As the 10 year Treasury yield slid significantly during the year, the market price of these bonds rose, and may have a year-end return in the neighborhood of 7.5%[3]. Back in January (2011) many pundits pegged the 10 year T to end

the year with a yield of 3.4% - we said 3.0%[4]- but it will end the year under 2%, a pretty wide margin. What came as a surprise was the flood of U.S. investor money to the Treasury market after S&P downgraded the U.S. of its triple-A rating, lowering it to double-A-plus. Investors fled U.S. stocks and in a flight to safety bought U.S. Treasuries. The opposite outcome that bond master Bill Gross anticipated in February when he sold those assets.

Meredith Whitney caused a stir, leading to our firm fielding many questions, when she strongly suggested on *60 Minutes* that municipal-bond defaults would total in the hundreds of billions of dollars in 2011. This was off the mark. The first few months after her pronouncement were bumpy for muni bonds, but 2011 is ending with returns of 10%[5], and very little in the way of defaults in the sector. Her call turned out to be wrong due to a few factors. Any issues that turned up in 2009 or 2010 were one-off events, caused by specific malfeasance in a municipality, and not a systemic problem of municipal health. Further, the supply of new munis to the market was weak, thus increasing the price bid for existing bonds, and a sign of the prudency of municipalities to avoid greater debt burdens.

Lastly, well known money managers like John Paulson [Paulson & Co.], and Fairholme's Bruce Berkowitz, were down well into the double digits. These are very smart people who can make very concentrated investments in a portfolio which may cause greater volatility than the Centurion approach. By contrast, since you asked, we approach equity investing through moderate diversification, utilizing an overweight versus underweight philosophy across all sectors. We are ahead of the benchmarks in each of our models year to date.

What is your take on asset allocation across Large Caps and Small Caps for 2012?
Over the past 85 years in the month of January, small stocks have outperformed large stocks often, with an average return of 4% for small, and 1.1% for large stocks[6]. Our feeling is that while small caps trailed large caps in 2011, 2012 may prove to be a competitive year. During a recovery phase, there are periods when the economic environment is rather bleak like 2011, and investors tend to pull on the reins and avoid small caps in favor of large caps. However, when opportunity abounds at a discounted price and the clouds have thinned a bit, investor appetite for small caps typically increases and a bounce back in small caps occurs. Our call is to still favor large caps as a quality and size play, but have an eye turned toward small caps and will be increasing our positions as warranted.

My team's interest is in the retirement plan space. What have you seen as missed opportunities in pension funds, and where can the opportunity be in 2012 and beyond?
Retirement focused pension plans underwent a transformation from 2005-2011. Many investment committees were hearing stories of how "alternative investment portfolios" (AIP's) were a cure for the volatility they experienced in long only stock investments. Many large plans, inclusive of Calpers (California Public Employees' Retirement System), were increasing their positions in these investments upon the advice of apparently sophisticated consultants. Unfortunately the credit crisis of 2008 caused the private-equity and real-estate based AIP's to have severe liquidity issues, putting pressure on pension funds to invest more capital. In order to do this, Calpers and others had to sell large portions of their other holdings to raise cash to put into the AIP part of the plan. This caused lots of turmoil in the markets, especially among pension plans.

We do not foresee this type of challenge facing pension funds and the equity markets in 2012, and instead we are focused on the opportunities across liquid stock and bond positions for these plans. Our approach has been to capture opportunity and avoid peril through prudent asset allocation and investment management - the same principals exist with our Private Client [individual] investors. Because of our desire to seek liquidity with portfolio construction, we feel the ability to rotate between the Equity and Fixed Income markets, and among multiple allocations within each asset class, allow plans to find anomalies in the markets and take advantage of those opportunities.

You run a model that focuses on dividend paying stocks, will dividend paying stocks outperform in 2011?
We think these types of stocks will outperform in 2012. For a long time we have leaned toward finding stock investments that provide a cash payment regardless of the direction of stock price. Receiving a cash dividend is a great way to reduce losses, or increase gains, on price movement. This philosophy may be attractive to investors in 2012. There appears to be a lot of nervousness among investors, and this level of dipping their toe into the water may be a prudent approach. Meanwhile, from an analyst's perspective, we see companies with a stockpile of cash since the financial crisis. They may make acquisitions, increase capital expenditures, or perhaps increase or implement dividends, all of which are positives in our view. When we screen the market for our model portfolio, one of the measures is the dividend payout ratio, a measure of the percentage of earnings paid to shareholders in dividends. This has led us to such companies as TJ Maxx, Public Storage, and Phillip Morris, significant performers in 2011.

What do you think is the potential influence of the election year we are entering?
Recently I was reading some election year related facts that indicated since WWII the S&P 500 index has not had a losing year in the third year of a presidential term. We look to be heading to a fraction over the 0% mark for 2011, which would be neat to preserve the streak, but I would not make a fundamental call that we should rely on this type of data when expressing economic or investment viewpoints.

So what did the data say for an election year?
It said the market was up about 5.5%[7] in those years. But from my perspective, do not anticipate it solely based on that data.

But in terms of an "influence", it is likely we will see a strong push from the Obama administration to appeal to Americans and push forth an accommodative strategy – whether that is in the form of blocking or promoting programs – to garner votes. That is only natural for an incumbent. This may mean the economy and financial markets have a good chance of picking-up, but it is not a lock. As mentioned, the modest historical return during an election year indicates there is hope.

Ok, finally a gold question. What's happened recently and where is it going?
In 2011, for the 11th straight year, gold prices will end the year higher. However the last several months have been challenging as the commodity has traded down below $1,600 an ounce from its peak at $1,895 an ounce in September. While declines of greater than 15% are very unsettling, this correction seems to be more about profit taking than fundamentals. The largest declines came in the last two weeks of the last two quarters, which indicates to us that investors and portfolio managers are booking profits.

The case for holding gold has not changed though. The "kryptonite" to rising gold prices may be high sustained real interest rates from a highly liquid currency. For this to unfold, the Federal Reserve Board would have to significantly change its stance on interest rates and take a stricter approach. If they raise rates, it could easily squelch the positive vibe gold has felt for several years. But our view is the Fed will stay true to their word and remain accommodative, thus continuing the growth prospects for gold.

1 Standard & Poors 500 Index point value 5/2/2011 (high 1370) and 10/4/2011 (low 1074) difference calculation 21.6%.
2 Barron's, Vol XCI No. 52; 2011 Dow Jones & Company; Vito Racanelli.
3 Barclay's Capital US Treasury 7-10 year MV (USD).
4 Barron's, Vol XCI No. 52; 2011 Dow Jones & Company; Randall Forsyth article, quoting Jan Hatzius Golman Sachs U. S. Chief Economist.
5 Barclays Capital Municipal TR (USD).
6 S&P Small Cap 600 TR, S&P 500 TR (large cap).
7 Market Week, page M1, Barron's Vol XCI No. 52, 2011.

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