FRENCH BROAD
G L O B A L
I N V E S T O R S
A LETTER TO OUR CLIENTS

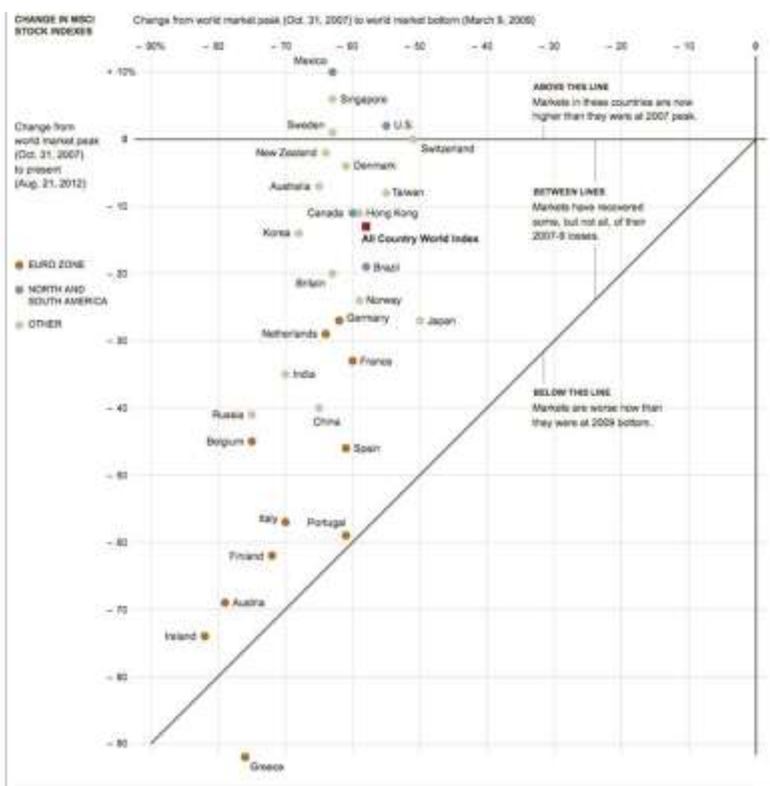
OCTOBER 2012

Dear Clients,

We experienced a nice stock market rally this summer which continued the pattern of “risk on / risk off” over the past few years. The rally stemmed from the European Central Banks declaration that they would do what was needed to prevent the demise of the Euro. Continued corporate profit growth along with the anticipation of the United States Federal Reserve Quantitative Easing III aided the rally. Perhaps we will fall back into the “risk off” mode and stocks will head down once more. However we will continue to take a longer term view that suggests that stocks in general are still undervalued with decent long-term return potential level even in a sluggish economic growth environment. In retrospect, to time the markets up and downs would have been a serendipitous adventure. No doubt that the return potential for stocks is less than before the rally, but with a price to earnings ratio (P/E) of 14× 2012 earnings estimates, U.S. stocks are still below their historical 16× average. Economic headwinds seem to be picking up which heightens the necessity to be stock pickers versus broad market participants. After all it is a market of stocks, rather than a stock market.

Stocks that we hold in your portfolios have the common characteristics that we believe they are undervalued on a three to five year time frame. In a nutshell, today’s price divided by a companies’ future earnings per share (EPS) appears attractive.

As we have previously indicated, we are very over-weighted in the United States versus foreign stocks. Attached is a graph reflecting the stock market performance of individual countries since the October 2007 peak.



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As you can see we haven't had a lot to work with outside the United States. This isn't to say that we cannot make money investing in stocks in weak markets, remember it is a market of stocks not a stock market. For instance, in the less than the one year we have held Tencent in China, it has appreciated about 50 percent and Wirecard in Germany 33 percent in six months, even though their markets have had negative returns.

It would be negligent to write a quarterly report without mentioning our Fiscal Cliff facing the United States. I do not believe Washington will allow us to take the plunge but it is a guess and not a fact. Europe's economy will continue to be hampered by the drawn-out sovereign debt crisis that has no end in sight. However progress has been made and we do not expect a Euro Zone breakup but do expect the Euro Zone to be a drag on global growth. For those wondering about their retirement needs, I have placed below a chart on how much you can spend annually over 30 years while depleting $1 million in savings over that time frame.

The annual spending allowance varies by what investment return you are able to generate / maintain over thirty years. Stocks have historically provided a 6 percent real return after inflation while bonds are today priced to provide negative real returns. Note that the returns are pretax. As a side note, the higher your current pre-retirement investment return the larger will be your retirement funds. This discussion is a good lead up to what can we expect stocks to return over the next five to ten years? Will we get near to 6 percent real returns that stocks historically returned or will they be closer to the zero return of the last 12 years? The answer is tied to what price we initially pay to participate in stocks and what will be economic growth over the time period which corporate profits correlate. If we have normal economic growth for the coming five to ten years this implies 3 percent real GDP growth, 6 percent of corporate profit growth, and a normal 16.67 P/E ratio for stocks in general (inverse of earnings yield of 6 percent). So in this example stocks over a ten year period would return 6 percent plus the P/E pick up from today's 14× to 16.67×. This would increase our expected annualized real return to about 8 percent. The chances of achieving these types of results all depends on the economic environment

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If we get less growth we will probably achieve less investment returns in general. I have listed below important points that I believe are relevant to encourage future economic growth.

1. Resolving debt / deficit issue – If not resolved it will strangle the economy either through much higher taxes, interest rates, or inflation
2. How #1 is resolved is important – Tradeoff between higher taxes and lower spending. Social Security is fairly easy to fix, adjust retirement age, and invoke some means testing and adjusting cost of living indexes. Medicare and Medicaid reform are the most difficult and crucial issues. As an example, if Medicare continues to cut reimbursements to providers then providers will tax (increase prices) to the private sector.
3. Corporate tax and regulatory reform – businesses need confidence that government will be an asset and not a liability. U.S. corporate tax rates are high but have a lot of loopholes and needs to be reformed.
4. Education reform – a long term issue but important to country's prosperity
5. Continued pension and benefits reform regarding the public sector
6. Overall tax levels – mentioned in number #1
7. Immigration reform – making it easier for the educated to remain in the country.

I wish you could be spared future market volatility. It appears that volatility is here to stay for the foreseeable future, as we are a nation and world tousled with economic challenges. On the bright side stocks are not expensive and corporations are very efficient and profitable. I look forward to meeting with you soon to review your portfolios.

Warm Regards,

Dan Jacobs CFA