



Market Commentary

More of the Same in 2012?

2011 was a frustrating year dominated by macroeconomic events. From the tragic Japanese Earthquake to the tragicomic European sovereign debt crisis, the year saw investor expectations whipsawed with correlations between risky assets increasing to levels not seen since the depths of the financial crisis. A late autumn recovery recouped a good portion of the losses, enabling the US stock market to end the year slightly better than flat, but most of the world's equity markets were unable to escape double digit losses. US Treasury bonds were the primary beneficiary, with the Barclay's US 20+ Year Treasury Bond Index posting a 19% return. Despite having much better public and private balance sheets, emerging markets bore the brunt of the flight from risk. China and Brazil suffered from expectations of weakening growth and higher inflation while Southeast Asia was the best performing region. Although the Arab Spring, the Japanese earthquake and the European Sovereign dominated headlines, 2011 also was the year that it finally became impossible for politicians, bureaucrats and investors to deny the magnitude and long term consequences of the debt. Prior to last year, one could still find respectable people arguing that some variant of a typical cyclical recovery was right around the corner. Eurozone politicians believed and hoped that a quick return to 3% real GDP growth would bail out their heavily indebted economies and the US congress similarly hoped for growth to save them from making the difficult decisions necessary to reduce record budget deficits. The reality is that recovering from the collapse of a generation-long debt expansion will take years and force radical changes in accepted political wisdom and social contracts - a fact that is only beginning to dawn on leaders across the developed world.

European Sovereign Debt Crisis is not Over

The European Sovereign Debt Crisis may accelerate as Spain and Italy each have over 20% of their outstanding debt maturing during the year. EU policy makers have yet to create a credible, comprehensive response to the problem. The solution will likely require the issuance of "Eurobonds" –bonds backed by the entire EU rather than an individual country combined with greater control over the budgets of member states. However Germany currently opposes Eurobonds and the EU risks a political backlash if its bureaucrats attempt to control the actions of popularly elected officials. The longer the political process stalls without a comprehensive solution, the greater the risk that the markets will resolve the problem by refusing to fund Italy and Spain along with the banks that are heavily indebted to them. The overall magnitude of losses in a default by Italy and Spain are of a similar magnitude of the losses on US residential mortgages and

would potentially have a similar effect on the global economy as the 2008-2009 financial crisis. While direct exposure to risky European sovereign debt is easily managed, avoiding the potential secondary impacts of a collapse would require the more or less complete avoidance of all risky assets for a decade or more, given the recent experience of overly indebted economies such as Japan. European-based multinationals such as Nestle or Novartis, which comprise the overwhelming majority of client exposure to the continent, have a diversified global revenue stream that should insulate them somewhat from the bleak outlook in their home markets. These companies should find themselves in a similar position to Japanese multinationals during Japan's two decade slump, albeit with much better starting valuations. Global companies like Canon were able to thrive, earning positive returns during the 1990s and 2000s despite the 70% cumulative decline in the value of the Japanese equity market over the period.

Better Expectations for the US

The impact of the European debt crises on the US is mixed. The US dollar benefits from being perceived as a less bad currency than the Euro, which helps maintain the current low interest rate environment. On the negative side, exports have been the largest driver of economic growth since the economy came out of recession and a stronger dollar and weaker global trading partners does not bode well for our balance of payments. While the consensus of economic forecasters polled by Bloomberg predicts higher GDP growth for the US, a decline in exports poses a downside risk. Housing and commercial real estate construction continues to languish and it is difficult to imagine a significant recovery in domestic employment without a strong rebound in these industries. Likely the result will be continued growth in GDP and employment, but at a level insufficient to materially improve the average household's financial situation.

Outlook for Comstock's Investment Themes

Comstock's investment themes – Quality Real Assets, Emerging Markets, Opportunistic Credit, Alternative Beta and Bulletproof Liquidity had mixed performance last year. Quality stocks generally outperformed and we were pleased to see several managers who had lagged during the low-quality dominated years of 2009 and 2010 handily beating benchmarks and peers. Valuations and dividend yields still support the continued outperformance of higher quality companies.

Emerging markets, having suffered the greatest declines in 2011, may offer the best value in 2012. Risks exist that China's unsustainable investment binge of 2008-2010 could result in a down-

side shock and banking collapse – but given the opacity and insularity of the Chinese banking system it is impossible to say whether the day of reckoning is days or years away. Brazil may rebound, particularly given that the country became a net oil exporter last year, mitigating some of its dependence on Chinese consumption of iron ore and other raw materials. Southeast Asia should continue its stable growth led by consumer spending and its competitive labor costs.

Credit was another risky asset that suffered in 2011. Yields on BB-rated (one notch below investment grade) industrial bonds began and ended the year yielding around 6.5% with a hundred basis point spike in October. B-rated bonds had a 50 basis increase in yield, ending the year at 8.5%. Distressed credits suffered the worst. While still short of offering a better risk / reward than high quality stocks (particularly after income taxes are factored in), an opportunistic allocation to select credits can add value to a portfolio of stocks and high grade bonds.

Alternative beta strategies, which attempt to obtain less correlated returns by assuming other forms of compensated risk-taking or by exploiting known behavioral phenomena, had mixed performance. Arbitrage strategies held up well but it was a very poor year for systematic managed futures which were whipsawed by the rapid changes in sentiment that occurred throughout the year. Hedge funds, largely driven by their large equity exposures, posted their worst performance since 2008 and the industry began to see net outflows late in the year. Several marquee name hedge fund managers suffered large losses, including the over 50% decline in John Paulson's flagship fund which became famous in 2007 for its successful bets against subprime mortgage backed securities.

Diversification entails creating a portfolio consisting of long term investments that, at any given point of time, will contain some that are underperforming. Even though emerging markets equities and certain alternative beta and credit strategies had a bad year, they still warrant a role in portfolios and may turn out to be this year's star performers. The overriding criteria is that there are sound economic fundamentals supporting long term rates of return for these assets sufficient to compensate investors for the risk they are taking and a financial structure that minimizes the risks of permanent capital loss. While the potential for upside surprises certainly exist, investors should be prepared for another difficult year as the developed world continues to struggle with deleveraging from the global financial crisis. Risk management and diversification comprise the key success factors. The Federal Reserve's interest rate policies have forced savers into the position of either accepting certain real losses on safe investments whose yields are well below the current rate of inflation or assuming the short term price risk of real assets, such as stocks, that offer acceptable long term real rates of return. This situation can only be managed by maintaining adequate short to intermediate term liquidity reserves held in high quality fixed income instruments combined with a high quality diversified portfolio of risky assets. There are no magic bullets for investment success in any environment, let

alone the recovery from a global debt deflation. Knowing what you own and why provides a basis for sound decision making and maximizing the probability of investment success.

- *By Steve Browne, CFA, CIO*

Questions? Please give us a call! (713) 977 2694.

Smart Investing Webinar

Our Fourth Quarter 2011 Market Update and Economic Outlook webinar will be held on Wednesday, January 18, 2012 at 2pm, central time. Our discussion will address the impact of government deficits, murmurings of a second recession and recovery on investment portfolios as well as the kind of opportunities we find attractive.

To RSVP for this call contact Alison Moss at 713.977.2694 or email her at:

Alison.Moss@paulcomstockpartners.com

NEWS



Comstock partners with FamZoo's online virtual family bank

Comstock is proud to partner with FamZoo. We invite you to register and get your family started down the path of financial education that will empower them to enjoy a financially fit life for years to come. This service is offered free of charge to our clients and their extended family.

How it works: Register your family account through the link provided on Comstock's website under Smart Investing Resources - Resources for Parents. Once the family is registered, parents run their own private online "Bank of Mom & Dad" that can be fully customized using a variety of tools including IOU accounts, automated allowances, chore charts, budget worksheets, compound interest, savings calculators, loans, and more. Kids learn to save patiently, spend wisely, and give thoughtfully while collaborating with their parents in a safe, educational environment. Sign up your family today!