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Investment Review and Outlook

The bond market remained volatile in the third quarter as investors continued to focus on the prospect of Federal Reserve "tapering" of its quantitative easing program. But stock market investors viewed that uncertainty as idiosyncratic to the bond market and continued to pour money into equities. The stock market ended the quarter near its all time highs and appears to have been crowned the new "safe haven" of the investment universe.

We continue to favor equities over bonds over the longer term. However, we believe there are a number of reasons to be somewhat more vigilant in the current environment including:

1. Corporate profit margins are near a record high and well above historical averages.
2. With Washington dysfunction deeply entrenched, fiscal stimulus will continue to be reined in.
3. Easy monetary policy will eventually begin to recede.
4. Several high profile stocks and sectors are showing some signs of investor euphoria.

Nevertheless, we are not bearish on stocks. There are still a number of attractively priced sectors and stocks to choose from, even after a five year bull market. We believe that stock returns will be lower in the months and quarters ahead. But we still believe stocks could return as much as 5-10% per year on average over the next few years. That type of return will not be easily replicated by most other asset classes.

Our modus operandi in the intermediate term is to stay invested but to incrementally focus on defensive strategies. That may result in below market returns if the stock market continues to soar to new highs. But we believe it will help buffer investor portfolios should the outlook become choppier.

Fool's Gold

Happy 5th Anniversary! The depths of the financial crisis are now five years in the rear view mirror. But many government policies that were instituted at that time are extant. And certainly the remaining ill effects of those policies are still being felt through many parts of the economy, including structurally high unemployment and yawning budget deficits.

Like many other economists and financial market analysts, we believed that the unprecedented fiscal and monetary stimulus would ultimately result in much higher inflation. Thankfully, that has not happened so far, giving the financial system time to de-lever and heal itself from the extreme excesses of the housing bubble. Despite tepid growth of the economy, the housing market and the financial system have recovered.

But we remain convinced that the Federal Reserve's unconventional monetary policy carries longer term risks of inflation. One may argue that, in contrast to the bout stagflation of the 1970's, the US is now part of a global economy, which helps to buffer economic imbalances. But many other countries such as the UK and Japan are employing even more aggressive monetary policy than our central bank. Therefore, we believe that investors would be prudent to have inflation hedges in their portfolios.

We have had a number of inflation hedges in our managed portfolios for some time. We have favored a number of oil and oil service stocks that we still believe are relatively cheap, even today. They have been performing reasonably well, albeit trailing the overall market indices this year.

Most disappointing have been our gold stock investments, which have been a drag on portfolio returns, especially this year. But we believe that inflation risks have not receded and that gold investments have an important place in our client portfolios to help protect against the uncertainties ahead. No fooling!