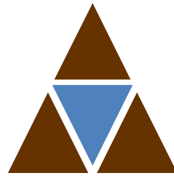


ALAMAR CAPITAL MANAGEMENT

January 19, 2012

The year 2011 did not perform up to initial expectations from an equity investor's perspective. The overall market, as defined by the S&P500, was up roughly 2% while the vast majority of active managers produced even lower returns. We navigated the market storms quite well for a second consecutive year and returned over 9% for our clients. Since our inception we are up around 38%, before fees, on a cumulative basis, while the S&P500 is up 17.5% during this time frame.

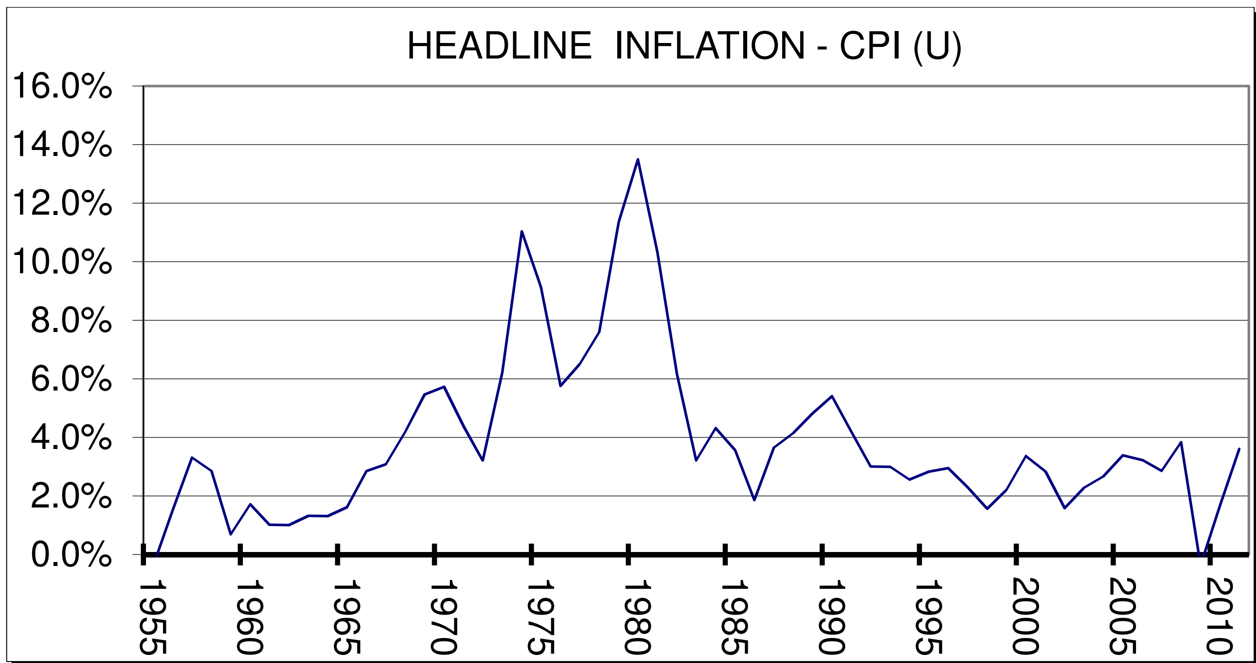
In this year-end writing we will discuss some of the questions and issues you, our clients, have asked us to address.

CASH LEVELS

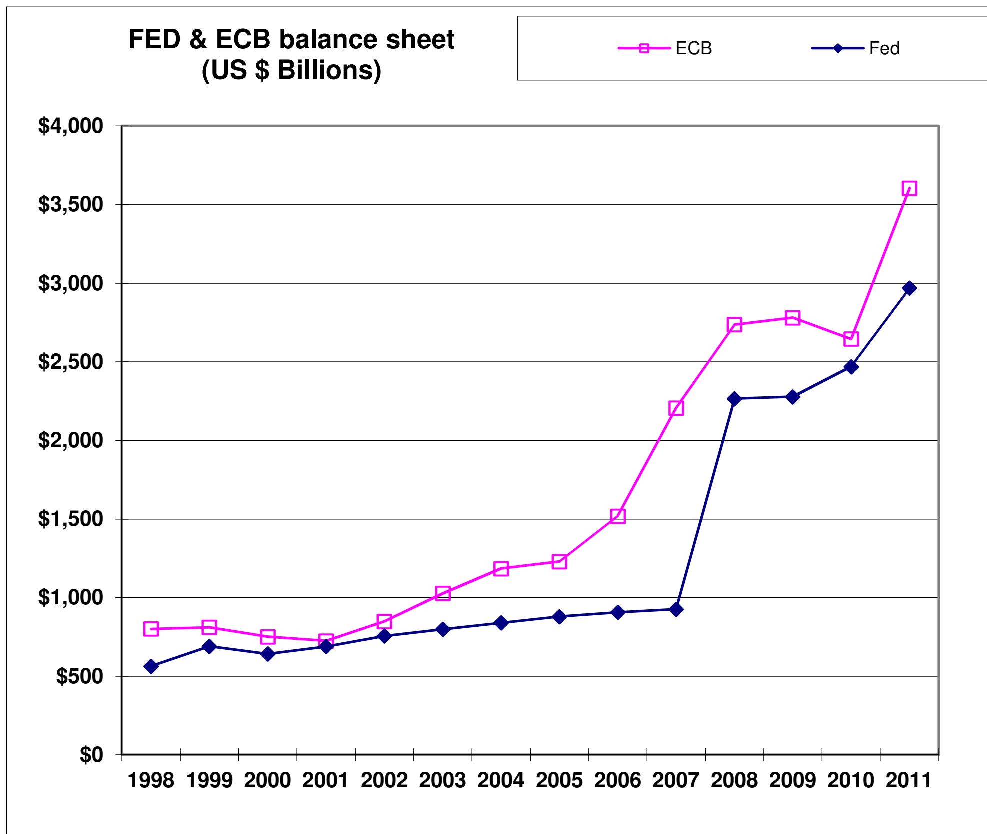
One of the questions that comes up on a recurring basis is our rather high levels of cash reserves. In August and September of last year close to a quarter of the portfolio was in cash though cash levels have come down since then. Ideally we would prefer to be fully invested and have minimal levels of cash since cash produces no returns in this low interest rate environment. However, the current investment environment is far from ideal. The constant barrage of negative news headlines around the world from a potential government default in Europe to a Chinese hard-landing creates a turbulent investing environment. It is during these volatile times that wonderful investments present themselves for patient, long-term investors. Besides allowing us to sleep well at night, high cash levels give us the wherewithal to pounce when opportunity beckons and we expect an opportunity-rich environment this year. Note that despite the high levels of cash we substantially outperformed the market, and most managers, last year.

INFLATION & INTEREST RATES

Another question that comes up often is our outlook on inflation and interest rates. While we are not economists, and do not make predictions on inflation and future interest rates, we do avidly follow these measures. What is abundantly clear, from the data published by the Bureau of Labor Statistics (BLS), is that inflation is already here. The graph below shows headline inflation as measured by the Consumer Price Index (CPI). In November 2011, CPI was up over 3% year-on-year.



The increase in money printing by the Federal Reserve is having an effect on inflation. Eventually the higher inflation will impact interest rates. The size of the Federal Reserve balance sheet was up 20% last year and is now close to $3 Trillion. The Fed and the European Central Bank (ECB) are in a race to debase their respective currencies. The figure below shows a comparison of the Fed and ECB balance sheets.



SWIMMING AGAINST THE TIDE

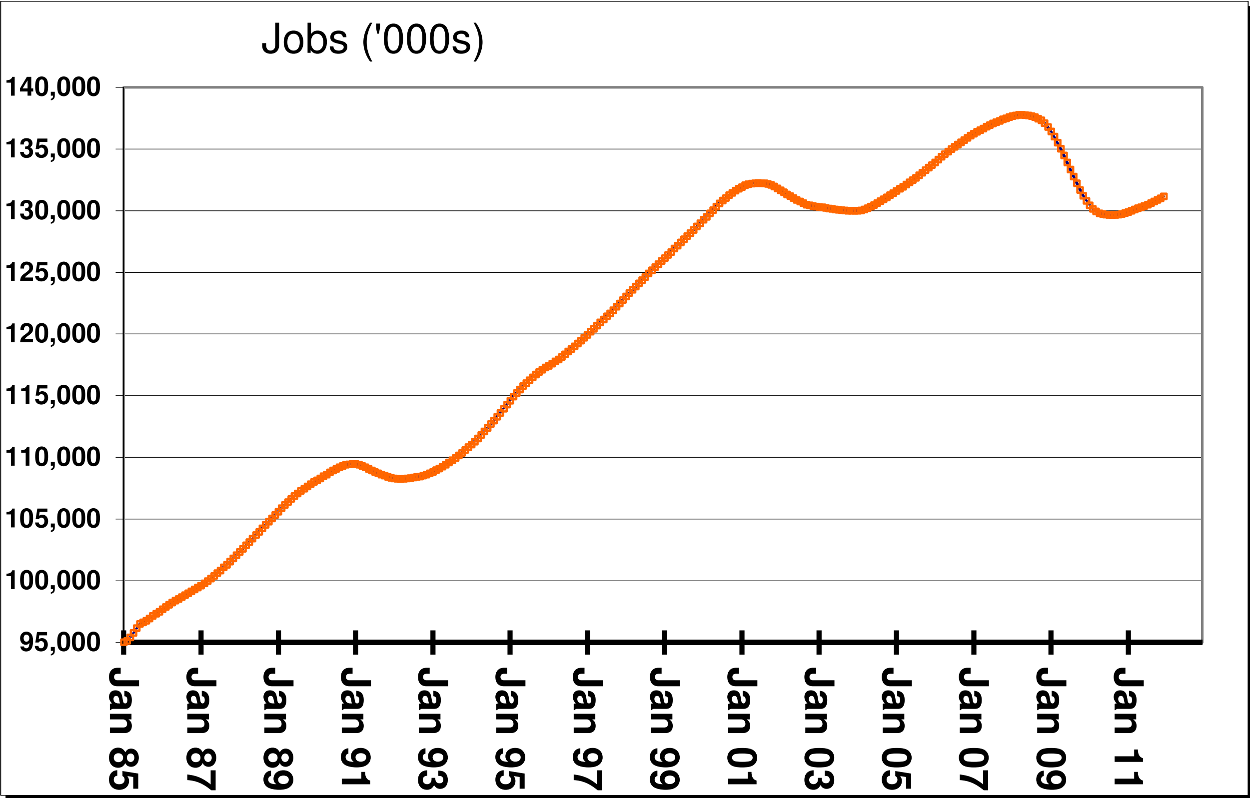
Investing in long-term bonds yielding less than 3% with inflation over 3% is a sure-fire way to lose money on a real basis. At a minimum, investments must return over 3% annually just to maintain a constant standard of living. Anything less will result in a slow but certain degradation of wealth over the long run since living costs are rising over 3% annually. We are therefore perturbed to see investors rushing into low-yielding bonds and no-yielding money market instruments. In essence these investors are looking for return-free risk. The Table below shows cash inflows and outflows, in billions of dollars, to and from various categories of mutual funds as tracked by the Investment Company Institute (ICI).

Year	Equity Funds	Bond Funds
2007	$91.3	$108.8
2008	-$233.9	$27.6
2009	$4.8	$375.5
2010	-$36.7	$241.1
2011e	-$143.8	$137.1

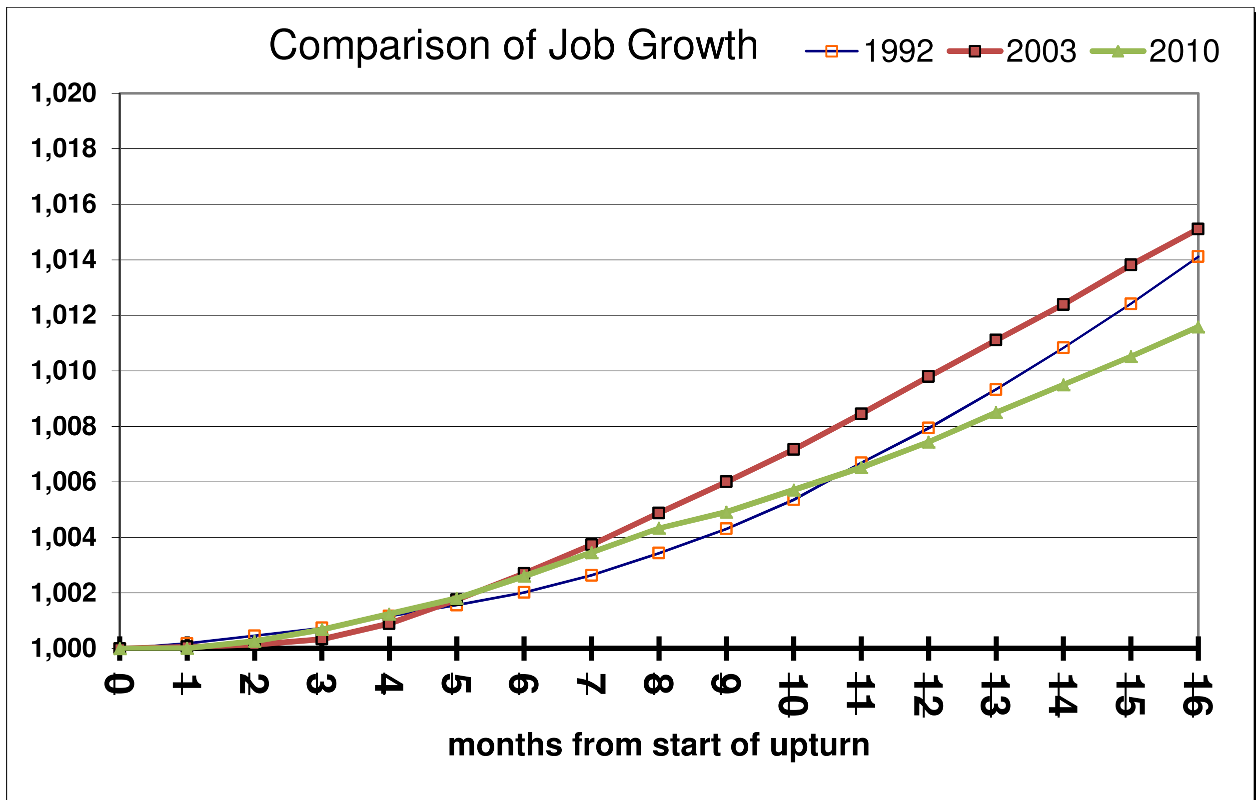
Over the last 5 years, mutual fund investors have pulled $317 Billion out of stock funds and moved $890 Billion into bond funds. (2011 is an estimate; final figures will be available in a few months.) Investing in a 10-year treasury bond yielding 2% will, by definition, return a puny 2% annually if held to maturity. However, the risk in this investment is considerable. If inflation stays at 3% the investor has locked into a negative 1% real-rate of return, annualized, for 10 years. A $1000 investment will deflate to $900 at the end of 10 years. If, due to excessive money printing, rates go up by 1% (100 basis points) the investment will immediately suffer an 8.5% loss. A 200 basis points increase to 4% interest rates will result in a 16% loss to this investment. Investing in bonds given such odds seems risky to us.

JOBS, JOBS & MORE JOBS

The economy, as best as we can see it, seems to be on the mend. The most important metric on the economy we track is jobs. After over 2 years of job losses there seems to finally be some, albeit slow, job growth. The employment picture below shows the steady uptick in jobs.



We also compare the current pickup in job growth to the previous two episodes (1992 and 2003) and the view so far looks favorable. The figure below shows job growth indexed to 1000 at the start of each recovery. After 16 months since the start of the current recovery, jobs have increased by 1.16%. In comparison, after 16 months, jobs had grown by 1.4% in the 1992 recovery and 1.5% in the 2003 recovery.



CONCLUDING THOUGHTS

Last year, the year of the Rabbit as per the Chinese calendar, was not particularly favorable for the equity markets. Will this year, the year of the Dragon, fire up better returns? While we cannot predict the market, we are fairly confident that equities, at these levels, provide a better alternative than cash or bonds given current treasury yields of 2% or less. We wish you peace, joy and investment success in the New Year!

We welcome comments and feedback. If you would like to receive future commentary from us or know of others who would appreciate our thoughts please let us know.

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Disclosures

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