Volume 3, Issue 1
January 2011

Sandpiper Capital

Gleanings

Clouds on the horizon…

1613 Laskin Rd., #200

Virginia Beach, VA 23451

757-962-4596

Fax 757-962-5038

www.sandpiper-capital.com

"According to the Federal Reserve's Flow of Funds data, the most recently reported ten year period was the only time in the last sixty years that the real value of household financial assets actually fell."

While 2010 was certainly a good year for equity markets worldwide, a glance at the table to the left reveals that total returns for the year were substantially less than 2009's as the markets shifted their attention from the current economic recovery to prospects for sustained future growth. This dynamic of modest but widely varying year to year market returns is a reflection of the ebbing but cyclical growth that the global economy has been experiencing. As a result, buy and hold investors in the major equity markets, plagued by increasing volatility and declining returns, have found it increasingly difficult to make *any* permanent headway. (According to the Federal Reserve's Flow of Funds data, the most recently reported ten year period was the only time in the last sixty years that the real value of household financial assets actually fell.) Combined with contracting homeowners' equity, this creates an especially critical need for investors to be aware of just where we are in the cycle and how much downside risk there is at any given moment. We reiterate the dominant theme of our previous commentaries; *making money is much easier if you don't lose it.* Investment advisers' tool for assessing risk budgets is their allocation model. The very first decision to be made before you can invest clients' assets is how much to keep on the sidelines. If there is 50% downside in the stock market (that is; not necessarily the percent that the market will drop, but the level to which it would fall should the cycle turn) and the largest decline that a client has the wherewithal to sustain is 10%, then you're limited to a maximum of 20% allocated to risky assets. Violating this limit can put the client in a position where a normal recovery is preempted by the need to sell assets to meet expenses, leaving less to be available for the move back up. Sandpiper's allocation model has worked quite well in that regard, in that it generally illustrates not only how far the market is from the worst case valuations but also where we are in the cycle. The tricky part has been to plot out the points to the right of the current date, estimating future S&P earnings as well as CPI inflation. This is an exceptionally difficult undertaking in normal circumstances made even more challenging by the current divergence between household economic well being and corporate profits. Our current read is that the market's downside is currently low but the cycle will likely be turning down.

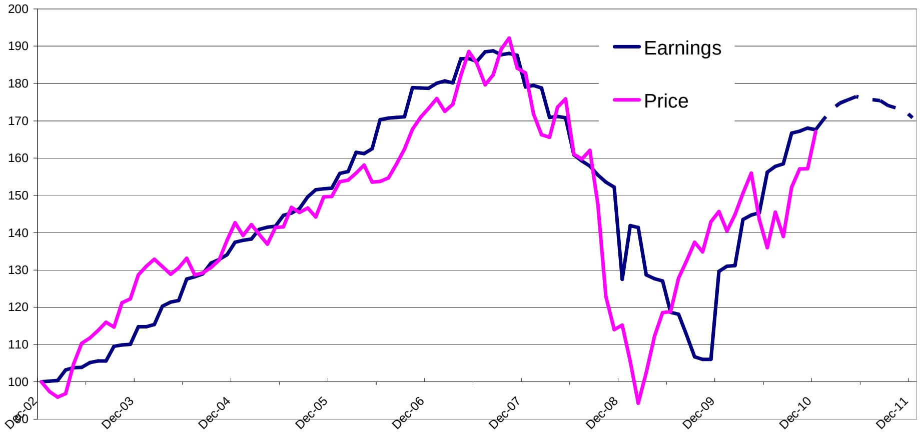
Market Returns through 12/31/2010

Index	2008	2009	2010	3 yrs
S&P 500	-36.9	26.5	15.1%	**-2.8%**
ML 1-10 yr Govt/Corp	4.1	5.7	6.0%	**5.3%**
EAFE (Dev. Mkts)	-43.3	31.8	7.8%	**-7.0%**
Emerging Markets	-53.2	78.5	18.9%	**-.3%**

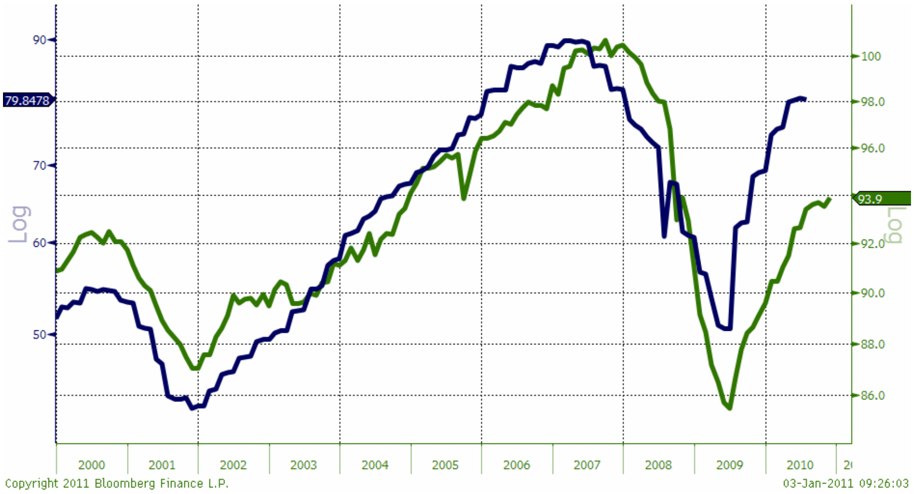
Gleanings

January 2011

With dampened demand constraining inflation, there's been a pretty direct relationship between the S&P and reported earnings, with the market anticipating both the earnings decline as well as the recovery.



To try to anticipate next year's earnings, we're looking first at the relationship between industrial production, in green on the right scale and S&P earnings, in blue. In the chart below, the IP number is advanced by five months and does a pretty good job of indicating the direction of future S&P earnings. The last four readings have been essentially flat.



In the past, when less than half of the Conference Board's leading economic indicators have been positive (the red line against the left scale below), industrial production, (in green) has tended to flatten or contract. With four out of ten of indicators negative currently, we expect that production, then profits, will begin to ebb, dampening market returns.