



ZUCKERMAN CAPITAL MANAGEMENT

Market Commentary – Fourth Quarter 2011

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Signs of the Times

As the world watches Europe for signs of more turmoil in the European Union (EU), the U.S. economy has continued to grow at an anemic rate. While slow growth is better than the recession that Europe could experience, it does not change the fact that the U.S. economy has been unable to recover as quickly as it has from past downturns.

Despite a population increase of 30 million, there are now actually fewer payroll jobs in the U.S. than there were in the year 2000. 48 percent of Americans are now classified as “low income” or living in poverty. Although the payroll numbers in financially troubled parts of Europe may be even worse, the U.S. economy remains in much weaker condition than is typical over two years into an economic recovery.

And while Asian economies continue to drive global growth; there are signs that lower trade volumes, incipient inflation, and falling real estate prices in some major cities could impact economic growth in the region.

The Accountability Deficit Continues

In 2008 Washington Mutual became the largest bank to fail in American history, and the FDIC sued several former executives for taking extraordinary risks while “knowing the real estate market was in a bubble.” Although the FDIC sought to recover \$900 million, recently the executives were able to settle for only \$64 million – and of that sum, only about \$400,000 will come out of their pockets. The rest of the money will be paid by insurance policies that were purchased at shareholders’ expense. The final cost to all of these reckless executives who received \$95 million in compensation between 2005 and 2008 will roughly equal the price of one single family home. Executive compensation and the allocation of risk are deeply flawed in the U.S. Huge risks are rewarded with large executive bonuses, and the cost of failure is borne by taxpayers and shareholders. Sadly, in the three years since the financial crisis, little has been done to change the inequitable game that the big banks continue to play.

A Fractured Union

Although the global economy as a whole may not be as weak as bond markets currently indicate, European leaders have yet to acknowledge that the original EU structure is not viable. A monetary union without uniform fiscal policies will inevitably lead to imbalances that cannot be addressed within the existing framework. European leaders have expressed their willingness to save the EU, and the union does need to be preserved

in order to avoid another banking crisis. But saving the EU means finding a common solution that will balance austerity, growth, and political realities in 27 very different cultures and economies. This could translate to a long journey down a very bumpy road.

Rising Correlations

The environment for investors has also become more difficult because of rising correlations between major asset classes. As the global economy becomes more intertwined and as global markets react to volatility, prices within different asset classes have been moving in tandem more than they have in the past. While commodities, corporate bonds, and stocks have historically provided significant diversification benefits when held together in a portfolio, they are now increasingly correlated such that the benefits of diversification are diminished.

Of course, diversification between asset classes remains essential for investors; but expectations regarding risk reduction from diversification should be adjusted. As such, focusing on risk-adjusted returns will be more important than ever.

Healthy Dividends

Stocks with high dividend yields have been one of the few bright spots in a challenging market. Dividend-paying stocks typically benefit investors more during periods of high market volatility. With the uncertain macroeconomic backdrop, volatility may remain high for quite some time; and investors should consider an overweight allocation to stocks with high dividend yields.

Interest rates are near record lows as income oriented investors face a bond market that reflects a dramatic flight to safety. For stable income, municipal bonds continue to offer compelling value in this environment, as do corporate bonds from select issuers with strong balance sheets.

In the year to come, headline risk may continue to weigh on markets. The prudent investor should focus on a time horizon of five years or more in order to ignore impulsive market reactions. Both the structural transformation of the global economy and the reduction of debt in developed economies are bound to be disruptive, but the world remains home to thousands of well managed companies with growing profits. While it may be difficult to envision now, the next ten years could bring more wealth creation than any other decade in history.

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