VERITY Asset Management

Market Commentary and Outlook

Core Allocation

September 30, 2012

INDEPENDENT ADVICE ACTIVE MANAGEMENT

It's Axiomatic

Brian Kurtzer
Senior Portfolio Manager

Q3 2012 was an extraordinary period for the stock market. At the beginning of the quarter, most of the market chatter focused on the elevated risks stemming from the European debt crisis, the potential for a severely slowing U.S. economy, the notion that China was heading for the proverbial "hard landing" and all sorts of pseudo political/economic concerns that were predicted to come to the fore once the market began to focus on the impending presidential election.

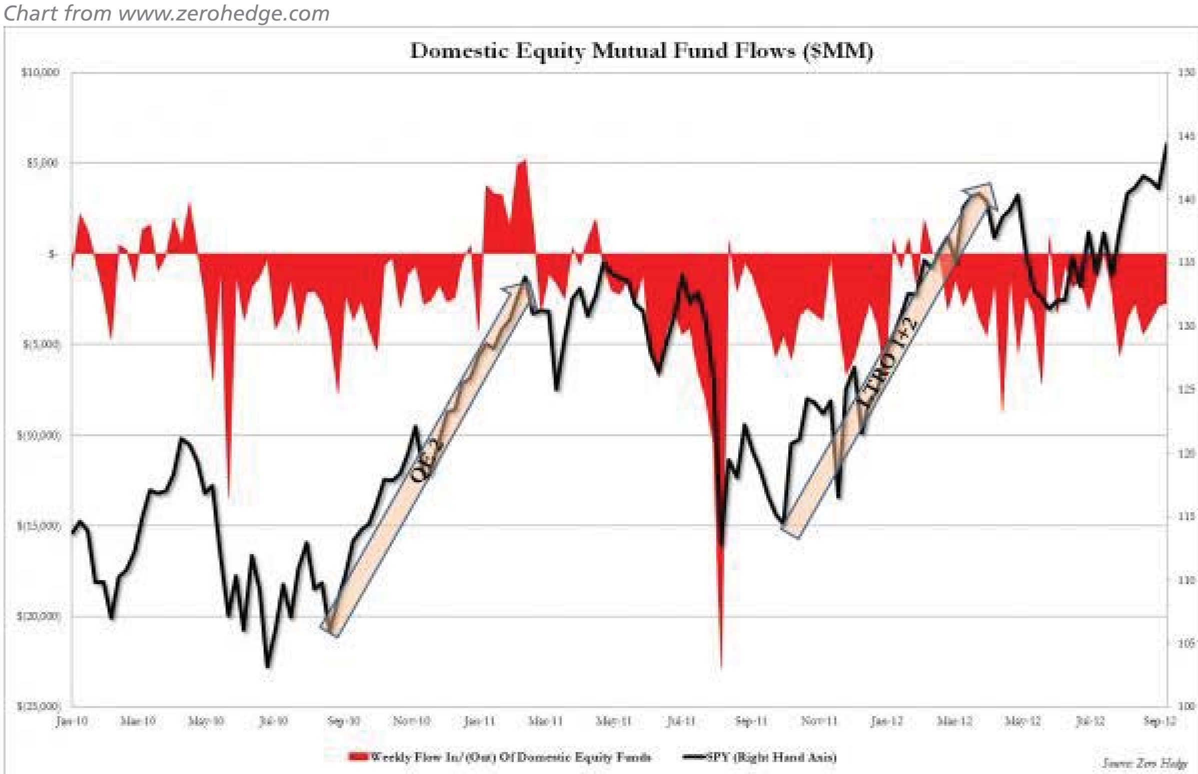
The market's response was the same as it has been following every temporary pullback since the important lows of March 2009--U.S. stocks again moved significantly higher, with the S&P 500 ultimately closing 5.76% above Q2's closing price.

Target Allocation by Asset Class / Strategy

55.5%	Equities - Domestic & Foreign
22.0%	Gold, Energy & Commodity Related
5.0%	Merger Arbitrage
6.5%	Equities - Short (Leveraged 200%)
3.0%	Bonds - Foreign
0.0%	Bonds - Domestic
7.0%	Cash

So is there any sense to be made of market behavior that some deem a total economic disconnect? When you listen to financial journalists, the pervasive message is that there is reason to be terrified and run to "safety". Retail investors have been doing just that for more than two years, as the accompanying chart depicts.

Chart from www.zerohedge.com



However, also note the graphical overlay of Federal Reserve programs (represented by the bars) and the S&P 500 price action (represented by the black line). As retail investors bail out of stock funds month after month, the market continues its bullish advance. Certainly, it appears that there is a direct correlation between the actions of the Federal Reserve and subsequent stock market price appreciation. And since it has been our contention for a number of years that liquidity provided in response to the ongoing global debt crisis will be a prime factor underlying the major movements of many markets, there is really no surprise here.

This brings to mind one of the most repeated market "truisms" of all time:

• ***Don't fight the Fed.***

For 2012 and on, we need to include the addendum, "… or the European Central Bank, or the Bank of Japan, or the Bank of England, or the People's Bank of China ..." Well, you get the idea--that's a pretty imposing wall of accommodation and liquidity buttressing any significant market declines for the past three years and probably for the foreseeable future.

Now, most investors would not make central bank activity the sole factor in their decision making and would argue that the economy has been feeble over the past three years. They would say that fundamentals have to come into play at some point, and the economic fundamentals have certainly stunk.

This calls to mind another saying that we've repeated numerous times over the years: "***The economy is not the market, and the market is not the economy.***" The most relevant fundamentals in determining the value of a stock or group of stocks are derived by first examining earnings and then discounting for the future. Ultimately, valuations don't come from unemployment rates, GDP, tax policy or other factors if actual corporate earnings say otherwise.

Consequently, the relevant fundamentals to examine are the "as reported" earnings per share of the S&P 500. For the past six quarters through June, they were: 21.44 / 22.24 / 22.63 / 20.64 / 23.03 / 21.62. In only two prior quarters in history were reported earnings higher than 21.44 -- 21.47 in Q3 '06 and 21.88 in Q2 '07. Estimates for three of the quarters of 2013 are currently between $25 and $26 per share, so even a 10% miss would result in record earnings next year.

None of this diminishes the fact that this market is continually subject to macroeconomic news that could move it dramatically. And the potential for unexpected events to impact the future earnings of certain segments of the market is huge.

But the market's persistent rise since March 2009 doesn't really seem so confounding when you strip away the noise and focus on the unprecedented global central bank activity and the notable growth in corporate earnings. In fact, it seems to make complete sense.

At the end of 2010, the chief market technician at Raymond James, Art Huprich, published his own list of market truisms and axioms. Tops on his list was the following:

• ***Commandment #1: Thou Shall Not Trade Against the Trend.***

While many retail investors have not followed that advice, we have been paring our portfolios to concentrate on our strongest longer term convictions, where trends are solidly in place. Among those convictions, biotech, gold, and grains were all up significantly during Q3, helping the Core model to keep pace with the S&P 500 during a very strong quarter for equities.

In contrast, we continue to see extreme risk in many bond markets and have gradually exited those we regard as high risk / low reward propositions. Historically low interest rates and questionable credit quality lead us to concede much of that space to others who believe they can continue to "squeeze more blood out of those stones". The appropriate Art Huprich axiom here may be:

• ***Don't think you can consistently buy at the bottom or sell at the top. This can rarely be done.***

Finally, seeing the broad market nearing its all time highs for the third time in a dozen years may reinforce the notion among some that now is not the time to be invested. However, it is very hard to dismiss the implications of the monumental actions of the world's central banks--devaluation of currencies and monetary inflation seem inescapable, which means the effect on those concentrated in cash and fixed income may ultimately be devastating. Perhaps what we face is most creatively expressed not in a market axiom, but rather the words of a noted "philosopher".

• ***A nickel ain't worth a dime anymore. ~Yogi Berra***

We encourage you to review earlier editions of our Market Commentary, which may be found on our website at http://verityinvest.com/investment_management/commentary. Please feel free to contact us for more detailed information and insight into our process and our current thinking about market risks and opportunities.