INDIVIDUAL ASSET MANAGEMENT, INC.

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# The Year Ahead

## 2012

Individual Asset Management is a Registered Investment Advisor

**Inside this issue:**



**Points of interest:**

- **Bond alternatives in an era of low interest rates.**
- **The collapse of natural gas prices - what this means for investors.**
- **The new normal in Europe and emerging markets.**

As I write this in the third week of January it strikes me how similar the investment markets are to this point last year. Once again we have had a recent run-up in equity markets after an up-and-down year; once again bond markets in the US have outperformed stock markets despite professional money managers' expectations to the contrary (mine included); and once again we see relatively good corporate earnings contrasted with continuing uncertainty in European sovereign debt markets.

At one point I was considering simply re-publishing last year's outlook newsletter. But of course nothing is ever exactly the same and some interesting nuances have emerged in global economic and investment markets recently. First of all, it seems clear that the European sovereign debt issue is coming to a head. Standard & Poors recently downgraded the debt of nine European countries, with Portugal joining Greece in the "junk" rating category (known politely as "below investment grade"), and France losing its AAA rating. These downgrades were widely expected and long ago factored into investment markets; stock markets actually rallied after the announcement.

Secondly, we are seeing continued improvement in the US economic picture. Perhaps the statistic I find most interesting is that the United States has added more manufacturing jobs since the start of 2010 than all the other G7 nations combined. This is despite on-going US political gridlock that impedes any type of meaningful economic, tax, or debt, reforms. Perhaps this manufacturing statistic is more a comment on general weakness in most G7 nations than on US strength, however it does seem that the US economic outlook has at least stabilized.

The third difference from last year is that inflation in emerging markets has calmed down. Last year there was concern about growing inflation, especially in China and India, however recently Chinese inflation has come down along with growth as the Chinese government has put in measures to curtail property prices and lending activity. Commodity prices have not gotten out of control, as seemed possible this time last year. Instead we had a sell-off in commodities in the second half of 2011 as China's growth slowed.

All-in-all it would seem like a relatively good environment for equity investments if not for the 800 pound gorilla in the room that is the European sovereign debt crisis - more on this later.

The other issue that has recently become interesting is the Iranian situation. As a result of Iran's continuing insistence on developing nuclear capabilities, most of the world has ramped up economic sanctions against the country to the point where by July Iran could have a limited market for its oil. This has led to Iranian threats to blockade the strait of Hormuz, which would disrupt global oil supplies. While it seems unlikely that Iran could blockade anything, given the US naval presence in the region, it is possible that global oil supplies could be constrained later this year leading to an increase in commodity prices. I would say that the expectation of such an environment could well affect commodity markets in the first half of the year.

So in summary, and despite last year's incorrect forecast of declining bond prices, I continue to be cautiously optimist on non-European equity markets in the near future, with an eye towards hedging this exposure should the European situation get out of control.

# Europe



Investment markets seem, for the moment, to be shrugging off the European sovereign debt issue - perhaps because it has been on the table for so long, or perhaps because there is some hope that slowly but surely European governments are getting to a solution (inevitably the "solution" must be either bond defaults by countries such as Greece and possibly Portugal, or massive support for these countries' debts by other EU members, mostly Germany, in the form of Eurobonds or debt guarantees).

The reality, however, is that Greece faces considerable debt calls in March that cannot be met without some form of further bailout, and the EU community as a group faces a trillion Euros worth of debt rollovers this year into a market that may not be too welcoming.

Investors holding Greek sovereign debt are being asked to take a 50% loss on the face value of their bonds and further losses by re-negotiating the bonds to a lower interest rate. Total losses would be in the 70% to 80% range if the deal goes through. Furthermore, investors are asked to do this "voluntarily" in order to avoid triggering a technical default of the Greek debt. Frankly this is a farce - clearly there is nothing "voluntary" in taking a 70% loss. If the losses are deemed voluntary then creditors would not benefit from any insurance they may have purchased on their bond positions in the form of credit default swaps - a complete travesty that undermines the intended function of the CDS market.

I cannot see a happy way out of the European debt situation. Probably the best case scenario would be that the EU follows the lead of the US and pledges virtually unlimited support for the European sovereign bond market in the form of a stability fund and bond purchases as well as guarantees by the European Central Bank. This could be accompanied by the issue of Eurobonds guaranteed by the whole EU and an eventual fiscal union. If this happens then that would likely keep the EU together and buy the region some time; perhaps allowing weaker countries to work off their debt over many years.

If agreement on such steps cannot be reached then it seems the only other way would be for a Greek (and possibly others) default, perhaps accompanied by a withdrawal from the Euro zone - this would be very messy and would likely undermine the whole concept of European monetary unity.

Another issue to note is the ponzi scheme in which the EU is currently engaged. In essence the ECB lends to European banks at low interest rates in order to shore up their finances (since they are taking losses on EU sovereign debt), with the expectation that the banks will re-invest these new funds into yet more EU sovereign debt - thus supporting this market and helping to keep lending rates lower for countries in need. This is a grand game of musical chairs and when the music stops someone has to take the losses on the sovereign debt. The only way this could end otherwise is if the music keeps playing long enough for countries such as Greece to regain their economic footing and run a budget surplus sufficient to pay down their debt - a very unlikely scenario, especially while they are in the Euro zone and therefore cannot devalue their currency vs. their European trading partners.

So the bottom line is that, despite the recent rebound in European equity markets and some successful EU sovereign bond auctions, I would say that investing in European banks is risky despite much lower valuations. Also, it is difficult to make a case for a strengthening Euro; which would affect European shares and bonds generally. Having said that; if some dramatic steps are taken to support the banks and sovereign debt by the ECB and the EU community, then that would likely placate investors for a while and we would see a rebound in European equity markets.

While the situation is somewhat better in the UK, this region is struggling with slow growth and inflationary pressures. For these reasons, I would also expect a generally weakening British Pound over the next year.

As we can see from the chart below, US markets outperformed British, Canadian, and especially EU markets in the last quarter; helped partially by a stronger USD. I think the conservative investor might want to bet on this trend continuing over 2012. If the EU does get its act together then that should lift all markets.


* Euro Zone (EZU), UK (EWU), Canadian (EWC) and US (SP500) stock markets for 2011 in USD.

# Currencies



As the chart below shows, we have generally seen a weakening trend in the US Dollar over the past ten years. In 2008 this trend was interrupted by the financial crisis, when investors fled to the safest investments they could find - these are still considered to be US Treasuries. This caused the USD to strengthen.

Since then, the Canadian Dollar and the Chinese Yuan (a managed currency) have strengthened vs. USD and the Euro and British Pound have jumped around but gone more or less sideways.

Currency investment has diversification benefits as compared to stock market investment. However, major currencies are also generally mean-reverting - it just isn't possible for the USD to continue to fall against it's trading partner currencies forever, since at some point US goods would become so cheap that demand would increase and the USD would change course as more people bought US goods. This is generally true over the long term, but the long-term could be a decade or more.

If economic and fiscal conditions in Europe improve, we may well see the USD resume its downward trend vs. the Euro and Pound as countries like China continue to diversify their currency holdings away from USD. However, at this point, it looks like Europe could be in a bit of a mess for a while so it might be best to focus on currencies of commodity-producing nations such as Canada and Australia.

It might not be a bad idea to have some exposure to US Dollar investments this year. Recently we have seen signs of an uptick in manufacturing activity in the US as global companies benefit from a weaker Dollar and experience higher outsourcing costs in many emerging markets where wages have increased dramatically in the last few years. While the playing field is still far from level between US wages and, say, Chinese wages, many companies are realizing that better infrastructure and productivity in the US, coupled with a large domestic market and better quality control and intellectual property protection, may outweigh the wage issue.

Much thought has been given over the last few years to the possible emergence of a new global reserve currency. For many years the US Dollar has been the only global reserve currency, used in international trade settlement and widely held by central banks. When the Euro emerged, central banks diversified into Euros, and now it seems the Chinese Yuan is becoming more widely accepted as a settlement currency for trade in certain regions.

While China has a long way to go before the Yuan could qualify as a reserve currency, it is clear that the first steps are being taken. Recently it was announced that London would become a center for Yuan currency trading outside Hong Kong and China. This, along with relaxation of controls on Yuan-denominated bond issuance, are major steps on the road to making the Yuan a world currency.

For this reason, I would expect central banks to continue diversification away from the US Dollar once the current debt crisis has passed. Another beneficiary of this diversification might continue to be Gold and other commodities, as investors seek hard assets in place of US Dollar assets.

**"Currencies tend to be mean-reverting over the long term as a result of purchasing power parity - but the long term could be ten years or more."**

# Commodities



As the chart below shows, it has been a very interesting and diverse year in commodity markets. Broad commodity markets, as represented by the Dow-Jones - AIG Commodity Index, were about flat all year until the third quarter when they dropped 15% on renewed fears of global recession from the European debt crisis.

In general, most commodities dropped on these fears, however the price of oil has recovered as the US has shown some economic strength and perhaps also as a result of middle-east tensions from the Iranian nuclear confrontation.

The story of the year though has been the collapse in US natural gas prices, which have fallen from about $4.80 to below $2.50 in the last half of the year. This collapse was brought upon by the continued exploitation of what is known as "shale gas". Without going into much detail, the bottom line is that as a result of new drilling and recovery techniques, the United States is now basically swimming in natural gas. Until a few years ago companies were seeking permits to build Liquefied Natural Gas (LNG) terminals at certain US ports to facilitate the importation of natural gas from overseas - now these permits are being reversed to build facilities to export gas.

Another interesting statistic is that the price of natural gas is much higher outside the USA because shale gas is not as prevalent in some regions or has yet to be developed.

Recently, President Obama announced an effort to (finally) focus on making natural gas more accepted as a fuel in the US (which I guess means little given the political situation and the likelihood that Republicans would try to block any Democratic initiative just out of principle).

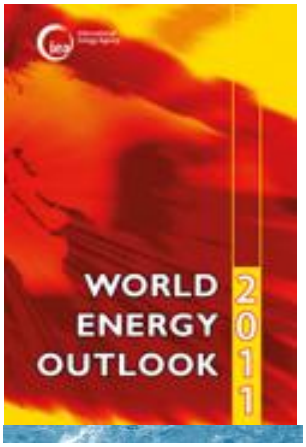
Also, a recent *International Energy Agency* paper makes a good case for the rapid acceptance of natural gas as a fuel in many parts of the world in the near future and predicts the current gas glut might dissipate by 2015.

Finally, just recently Chesapeake Energy, one of the largest natural gas exploration companies in the US and the leader in the commercialization of shale gas, announced they are cutting back on natural gas production and focusing on oil since nat-gas has become uneconomic.

So we have historically low natural gas prices, increasing demand, and perhaps the beginning of consolidation and supply cutbacks (at least in the US), (plus possibly a LNG export market at some point in the future). This is a situation worth monitoring from an investment perspective as the strongest companies in this field will likely benefit, perhaps starting later this year or next. Near-term, nat-gas producers will be suffering due to low prices.

While it has been a difficult year for most types of investments, gold has held its own - up 10% for the year. Interestingly, silver prices have been very volatile and ended down 10% for the year. Silver is a smaller and more speculative market, whereas gold prices are affected not only by supply-demand fundamentals and speculation, but also by investors' views on inflation, US Dollar, and economic uncertainty.

It seems that gold is becoming more and more accepted as an alternative store of value to currencies in general and the USD in particular - a trend that will likely continue. In my view, the people predicting a $5,000 gold price in the near future are likely overly optimistic, but gold still seems a good diversifier within a portfolio of other investments.




***World Energy Outlook - 2011 special early excerpt - Are we entering a golden age of gas?***


* Commodity fund performance for 2011:
Broad commodity index (DJP), Silver (SLV), Natural Gas (GAZ), Oil (OIL), Gold (GLD).

# Emerging Markets



It wasn't a very good year for emerging markets as the broad emerging market index (EEM) did not recover from the sell-off in early August and ended down 20% for the year in USD terms. A combination of slowing growth rates in the emerging world, recession fears in the developed world, and a somewhat stronger US Dollar were the drivers for the sell-off.

The Russian and Chinese markets both ended down 20% for the year despite relatively high oil prices (a driver for the Russian market) and still good growth as well as a gradually strengthening Yuan in China.

The Indonesian market was volatile as is normal for such a small market but it outperformed on a relative basis, ending the year flat. Indonesian sovereign debt was recently up-graded to investment grade status, and the country is generally benefitting from its exposure to mining. 30% of the index is in financials, which should benefit from the relatively healthy local economy.

Also of interest is the relative underperformance of the Indian market, down about 25% in local currency and almost 40% in USD terms. This market suffered from increasing interest rates (and therefore a weakening rupee), government controls on investment, as well as the general sell-off in emerging markets as a result of the global economic uncertainty.

There have been signs that the government may be kinder to foreign investors in the future; Vodafone recently received a favorable tax judgment in the Indian courts and the local stock market has been opened up to foreign investors. Foreign direct investment in India increased 13% in 2011 vs. 2010 even as the local stock market and currency fell. It might be worth looking at this market in 2012 as the underlying growth story remains and the country becomes more investor-friendly.

It is interesting to note that the formerly high-flying BRIC countries (Brazil, Russia, India, China) as a group did poorly in 2011, underperforming the emerging market index by 10%.

It is in a way encouraging that investors seem to be looking further afield in emerging markets than just the BRIC countries - this implies a growing acceptance of emerging markets as mainstream investments rather than as a niche part of portfolios.


* Emerging market fund performance for 2011:
Broad emerging market index (EEM), Indonesia (EIDO), China (FXI), Brazil (EWZ), India (INDY).

An asset class that has become more popular in the last couple of years, as emerging country fortunes have eclipsed those of many developed countries, is emerging market debt. The chart at right shows how various non-US debt funds performed in the latter half of 2011. There was a general sell-off in September that affected emerging market as well as inflation-protected debt, followed by a further sell-off in mostly EU government bonds towards the end of the year. Asian debt was the best performer in the group.

There may well be some pickup in these markets if global economic conditions improve and the US Dollar weakens, but even after the sell-off yields on emerging market debt are historically low and one must ask whether the yields justify the risk.


* Emerging market debt fund performance: Asia Local Currency (ALD), International Government (IGOV), International Inflation-Indexed (ITIP), Emerging Market Local Currency (ELD)

# Income



The European debt situation and the generally large sovereign debt in many other developed countries, most notably the US and Japan, highlight the risks of investing in sovereign bonds. Even if countries such as the US, Japan, Germany, and so on, are not likely to default on their debt obligations, the very low yields available today on investment grade bonds hardly makes investment worthwhile. Given the fact that the first few years of Baby-boomers are now retiring, and people in retirement tend to favor income-producing investments, it seems there should be considerable demand for alternatives to bonds.

These alternatives should pay a good income stream, should be relatively conservative, and should offer diversification benefits to stocks.

This is a tall order and the fact is, as we saw in the panic of late 2008, nothing offers the diversification benefits of US Treasury Bonds; pretty much all other assets fell during this time period. Nevertheless, panics aside, there are a number of investments that offer at least some diversification and have many of the other properties in which we might be interested.

I mention some specific examples below; these are not necessarily recommendations, just examples. It should be stressed that all of the income alternatives mentioned below are likely more volatile than fixed income investments.

**"Bond alternatives should pay a good income stream, be relatively conservative, and should offer diversification benefits"**

**Preferred Stock:** This is generally mid-way between common equity and bonds in terms of risk although in a panic it tends to behave more like stocks. Preferred shares pay a higher dividend than common shares and receive dividend payments before any such payments are made to common stock investors. As an example, Goldman Sachs 'B' preferreds had a 6.2% yield when issued and currently have a 6.5% yield, whereas GS stock yields about 1%. In return for less volatility and higher dividends, the preferreds' investor gives up much of the capital gains upside as compared to common stock.

**Real Estate Investment Trusts:** These come in two flavors; mortgage trusts and equity trusts. Mortgage trusts get their cash flow from mortgages and therefore their fortunes are tied to the spread between their borrowing rates and their lending rates. As inflation increases, generally the government raises the Fed Funds rate and short-term interest rates rise. At some point short-term rates rise faster than long-term rates and this is when mortgage REITs underperform. Equity REITs get their cash flow from property rents and sales, which tend to increase with inflation, so these are less sensitive to rising interest rates. An example of a mortgage REIT is Annaly Capital, which currently pays a 14% dividend but its stock price fell 50% in late 2005 as interest rates compressed (and again in 2008 during the bank crisis). General Growth Properties is an example of an equity REIT that specializes in shopping malls. It was relatively unaffected by interest rate compression in late 2005 but got killed in 2007 and 2008 as real estate prices fell and consumers cut back on spending during the recession - its share price went from $50 to $1 (yes $1) during this time period.

**Royalty Trusts and Master Limited Partnerships:** These are similar to REITs but the income stream comes from other types of assets, mostly from oil and natural gas producing properties. Canadian Royalty Trusts generally try to replenish their reserves, whereas US Royalty Trusts generally do not. This leads to differences in taxation of dividends and obviously the US Trusts have a finite life. MLPs may replenish their reserves and are structured as limited partnerships, which means different tax treatment again. An example of Canadian and US Royalty Trusts are Enerplus in Canada and Great Northern Iron Ore Properties in the US; an example of a MLP is Kinder Morgan Energy Partners. It should be noted that recent tax changes in Canada have brought about the conversion of most Canadian Royalty Trusts to a high-dividend paying corporate structure.

**Business Development Companies:** This is basically a private equity investment for the common man. Normally private equity investments have high minimums but certain companies have created funds that invest in private rather than public companies - these are BDCs. Some, but not all BDCs have good yields; for example the Blackrock Kelso Capital Corp. sports a yield of 11%. We can expect that BDC share prices will be highly correlated and probably somewhat more volatile than the S&P500, but the high dividends give us a cash-like, uncorrelated, income stream (as long as they are paid).

**Infrastructure Funds:** These funds invest in certain infrastructure plays. For example, they might be toll-road operators, getting a cash flow from the tolls, or railroad or port operators. Generally they pay good dividends and are somewhat less volatile than stocks. Their stock prices are usually highly correlated to stock markets. The Macquerie Global Infrastructure Fund is an example.

**Dividend paying common stock:** Let's not forget these - you can get a 5% plus yield in some blue chip companies these days, and others, like GE for example, are increasing their dividend payouts as their business improves. Generally such companies tend to be less volatile than the stock market as a whole; although of course highly correlated to the stock market.

San Francisco office:
580 California St., Suite 1200
San Francisco, CA 94104
tel: +1 (415) 439-4891

email: iam@iamadvisors.com
web: www.iamadvisors.com

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Our focus is purely on portfolio management and financial advice, we do not have conflicts with investment banking concerns and our research is entirely impartial. Our clients enjoy access to the professionals who actually make investment decisions, not just to sales representatives.

As times have illustrated, a static portfolio strategy cannot be effective in every economic climate. At Individual Asset Management we develop a global investment strategy that is appropriate for market conditions as well as for your specific goals and risk tolerance.

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Until next time,

**Tom Zachystal,** CFA, CFP®
President

## In Summary

European sovereign debt issues and a slowing global economy weighed on investment markets in 2011, especially in the latter half of the year. Most recently there are signs that the European issues can at least be pushed off into the future to be gradually dealt with over time rather than leading to an imminent collapse of the Euro zone. Data out of the USA suggest a gradually recovering economy. Emerging markets have slowed their growth rates but are still doing quite well, with India and China continuing to grow at above 8%. In addition, a number of emerging market countries, most notably China, have taken measures to curtail inflation and are now in a position to perhaps re-focus on growth initiatives.

If not for the continuing uncertainty in Europe, we might expect a pretty good year for riskier assets such as stocks and high-yield debt.

Unfortunately, while it looks like the major European powers may figure out at least a temporary solution to the EU debt issues, it is increasingly clear that austerity measures will not be easy to enact or maintain in places such as Greece; which implies that Europe may well slip into a Japanese style period of extended low-growth and poor stock market performance.

An emerging risk is the Iranian situation; which could have implications for the price of oil later this year.

The low price of natural gas and improving US economic fortunes bode well for US industrial firms, especially those exporting to emerging markets.

All-in-all, it seems like a good year to focus on US exporters and certain emerging markets; as well as continued diversification into gold and other commodities.

**The IAM newsletter discusses investment and financial planning issues.**

**If you have questions regarding the information in this newsletter or on other investment or financial issues, or if you would like to suggest topics for upcoming newsletters, please contact us by email or telephone at the numbers listed on this page.**