January 10, 2013

Annual Review and 2013 Perspective

"A pessimist sees the difficulty in every opportunity;
an optimist sees the opportunity in every difficulty."
Sir Winston Churchill

2012 will be remembered as the year when it wasn't easy being a long term investor, but it proved to be very rewarding. The "kitchen sink" of significant difficulties plagued investors including:

1. European fiscal union crisis
2. Political paralysis in the U.S. over deficit spending
3. An ugly and divisive Presidential election
4. Uncertain tax policy culminating in the "fiscal cliff"
5. Middle East turmoil
6. Continued high unemployment and slow growth

The above wall of worry led to investor pessimism. Outflows from equities by the average investor, both individual and institutional, continued during the year in favor of bonds and cash. Meanwhile, our clients enjoyed gains in the range of about 9% to 17% net of all fees and expenses from our unlevered defensive equity and our traditional equity strategies! This coupled with moderate gains in our bond portfolios and other alternatives permitted our clients to achieve a more than satisfactory blended return from an individualized asset allocation.

Thus the resilience of the American people and Corporate America once again demonstrated that despite ongoing fear and uncertainty, opportunistic long term investing is alive and well. Winston Churchill's quote describes the typical confused and scared pessimistic investor whose sentiment is negatively influenced by biased media driven headlines and noise. That pervasive pessimism in many cases masks the underlying opportunities for long term investment.

That is not to say that we don't face serious challenges in 2013 and beyond from:

1. Annual deficits and massive cumulative debt
2. Geopolitical concerns in the Middle East
3. Subpar domestic economic growth and resulting high unemployment
4. The need for structural reform of Social Security and Medicare

5. Impact from Obamacare
6. Economic and political turmoil in Europe

It is our view that many of these concerns will be worked out over time but will require our patience and ability to endure market volatility. It seems that none of the above are surprises and hopefully politicians and central banks will be able to deal with them. In addition, painful sacrifices will need to be made by both Americans and Europeans who are coming to grips with past fiscal irresponsibility.

Despite these challenges there are good things happening that give us "optimists" reason to look forward with a fairly positive view. The improving soundness of our financial/banking system and the strength of many of our corporations are encouraging. The development of our domestic energy reserves is leading to possible energy independence and a manufacturing renaissance in the United States (politicians at both the Federal and State levels have to cooperate). This will lead to many benefits including job creation and enhanced national security. After years of turmoil, our housing sector is picking up, which also is contributing to job growth as well as once again creating wealth among our consumers. And greater certainty as relates to tax policy will also permit both consumers and businesses to once again plan for the future. Finally, pro growth agendas and emerging middle classes in China and other emerging countries, as well as a more growth oriented government in Japan, add to our cautious optimism.

Yet our optimistic view recognizes that we must endure and tackle the serious challenge of unsustainable debt levels. This will lead to contentious political negotiations on entitlement reform in Washington that will likely unsettle equity markets. However, that will give an opportunity to those investors sitting with cash on the sidelines to redeploy that cash to the equity markets. In addition, as interest rates trend up at some point, long duration bond investors will suffer paper losses that should cause them to shift into the equity markets. Down the road, these two factors, along with solid fundamentals including fair valuations and some earnings growth, should contribute to further stock market gains.

So, much of the crowd still doubts the sustainability of the reality of our sounder banking system; a housing recovery; significant stock market gains; robust energy exploration; a mini manufacturing boom and the potential for politicians to work together in Washington. We see opportunity in this. However, we believe that given potential volatility and uncertainty from ongoing political negotiations and geopolitical issues, prudent diversified asset allocation with a bias towards defensive equities still makes the most sense for almost all clients. The key is to not get panicked out of equity holdings. And having sufficient defensive and traditional equity allocations in high quality multinational companies (for the most part) while bonds and cash offer paltry returns seems to be a sound formula for reasonable investment gains over the longer term. We continue to believe that a prudent asset allocation spreading one's capital amongst our security; defensive and traditional equity and private investment (real estate and private equity) baskets makes long term investing sense. However, at this time we believe the bull market in bonds is over (1983 to 2012) and we would overweight our defensive equity investment strategies.

It has been almost five years since the great "decession" (the term I've coined to describe the recession/almost depression of 2008). Our financial system has improved dramatically and the housing crisis has now turned the corner. Our government can now turn to putting our fiscal house in order by constructively dealing with both our current deficit and cumulative debt. The world economy is still growing and despite the aforementioned challenges we still have opportunities as investors. However, patience, caution, and prudent diversification are needed when looking for sustainable investment gains.

Also, of importance to the evolution of our company and our representation of you, I would like to share with you the following promotions to key personnel reflecting their achievements and greater responsibility in the investment and wealth management functions within our organization:

Philip Malakoff	Senior Vice President – Wealth Management
Edward Palleschi	Senior Vice President – Wealth Management
Brian Gamble	Vice President – Wealth Management
Michael Bernstein	Assistant Vice President – Wealth Management

Finally, in an effort to better communicate with you, we invite you to visit our newly refreshed website at http://www.fliinvestors.com. We believe that you will find it more informative and easier to use.

We look forward to working with you this year in guiding your wealth management. Please feel free to call upon us for any help you might need.

Best regards,

Robert D. Rosenthal
Chairman and
Chief Executive Officer

*The forecast provided above is based on the reasonable beliefs of First Long Island Investors, LLC and is not a guarantee of future performance. Actual results may differ materially. Past performance statistics may not be indicative of future results.

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