

## Quarterly Market Update

March 31, 2012

### The Market and Mean Reversion

To understand Market results during the first quarter of 2012, one should be familiar with the concept of “mean reversion.”

In analyzing the Investment Market, we should start from what is perceived to be normal behavior patterns or the “mean.” If we imagine that “mean” to be a straight line, with some elasticity, we can better understand the market and a concept called “mean reversion.” Under normal conditions, the greater the risks one assumes in the stock market, the greater the returns will be over time. High volatility in the market produces a high risk environment and low volatility produces a lower risk environment. The same principle holds true for the bond market but to a lesser extent. High volatility will lead to higher risk and low volatility will lead to lower risk but bond returns in both cases will not be as high as stock returns. When investment results deviate from this norm, history has shown that in a short time it will self-correct, or return to the norm, in what is referred to as “mean reversion.” In other words, the market norm is like an elasticized line, if stretched in one direction it will naturally return to its normal position.

Keeping the concept of “mean reversion” in mind, we can explain market behavior during the first quarter of 2012 by first looking back at 2011. Calendar year 2011 displayed high volatility, characterized by a record number of trading days and stock price changes in excess of 1%. It was a high risk market for investors in common stocks. However, equity returns for 2011 were basically zero. The equity investor was not rewarded for being invested in a high risk market throughout the year. Conversely, bond investors were handsomely rewarded in 2011, even though they assumed much less risk than equity investors. Thus, market behavior was pulled in a different direction from the mean.

The first quarter of 2012 demonstrated a “mean reversion” for both stock and bond investors as the market pulled back toward the norm. This quarter was characterized by an inordinately small number of volatile trading days in U.S. equity markets. The most popular risk measure of market volatility, the VIX (The Chicago Board of Options Exchange Market Volatility Index), declined substantially through the first quarter and ended at near record lows. In spite of this low risk measurement, the leading indicators of stock returns showed above average gains. The Dow Jones gained 8%, the S&P gained 12% and the NASDAQ gained more than 18%. The normal range for stock gains is between 1.5% and 3.0%.

Meanwhile during the first quarter of 2012, bond markets, as typified by U.S. Treasury 10-year Notes, increased in yield from 1.8% to 2.2%. Bond prices move inversely to yield changes, so bond investors in 10-year Treasuries lost money during this quarter. During the last 15 months, bonds provided a higher return, overall, than stocks. However that differential is rapidly shrinking as the market pulls back toward its norm. We expect stocks to do much better than bonds in 2012, bringing their respective returns, over time, into closer alignment with their respective historic returns

Our investment stance is unchanged. We seek maximum investments in equities and minimum investments in bonds. To date in 2012, we are being well rewarded and believe that we will continue to benefit throughout the remainder of the year.

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