

Now that we are two years removed from the depths of the credit crisis of 2008, we can take a retrospective look at how we have fared. I am very pleased to report that despite the extreme volatility of the market and immense uncertainty of the U.S. and global economies during that time, CAP Partners clients did not sell a single share out of fear. In fact, when the market declined to its 10-year low in March of 2009, we were aggressive buyers—not sellers.

While the market has improved, there are still plenty of areas for concern. Unemployment, housing, rising interest rates, the Euro zone debt crisis, and our federal debt, to name a few, present challenges to investors. Yet, challenges can also provide opportunities for investing, and these are very much on our radar as we search for investment ideas.

### Treating Investments as Cash: The Cardinal Sin of Investing

One of the reasons we, as a group of investors, fared well is that we did not treat our long-term investments as cash. When markets become extremely volatile and share prices fluctuate wildly, investors tend to forget their long-term investment time frame. They begin to treat their investments as cash—not wanting the share price to fluctuate. However, I would argue that these investors would never treat their cash as investments and expect growth-like returns on their cash. Thus, volatility and price fluctuations of investments should be expected if not even capitalized on. This is why it is important to know which pools of money are for the short term (cash), and which are for the long term (investments).

The problem of treating investments like cash is that it usually leads investors to convert those investments into actual cash, eliminating any possibility for that money to recover in value. This is the cardinal sin of investing because once you move into cash and out of the market, the next inevitable move is to try to determine when to go back into the market. This happens when investors eventually realize that they do not need the money now. Unlike the majority of investors who cashed out on the way down, and who are now dipping their toes back into the market, we have stayed the course and weathered through the worst of the recession to come out on the other end reaping the rewards.

The rewards of staying the course and not changing investment objectives from growth of capital to preservation of principal can be seen in the market's breathtaking recovery. From its low on March 9, 2009 to the end of the year 2009, the S&P 500 Composite Index gained 68% in that 10-month period.<sup>1</sup> In 2010, the market returned an additional 15% to put the total recovery thus far at over 86% with dividends reinvested.

Holding onto our shares during the downturn was very much counter to what the general investing public was doing—which was selling. In fact, in 2008 a net \$197 billion was redeemed or sold out of stock mutual funds as the market dropped 37% that year.<sup>2</sup> These are the same investors who are now contemplating returning to the market after it has increased 86% the last two years. This is the antithesis of investing: selling low and buying high.

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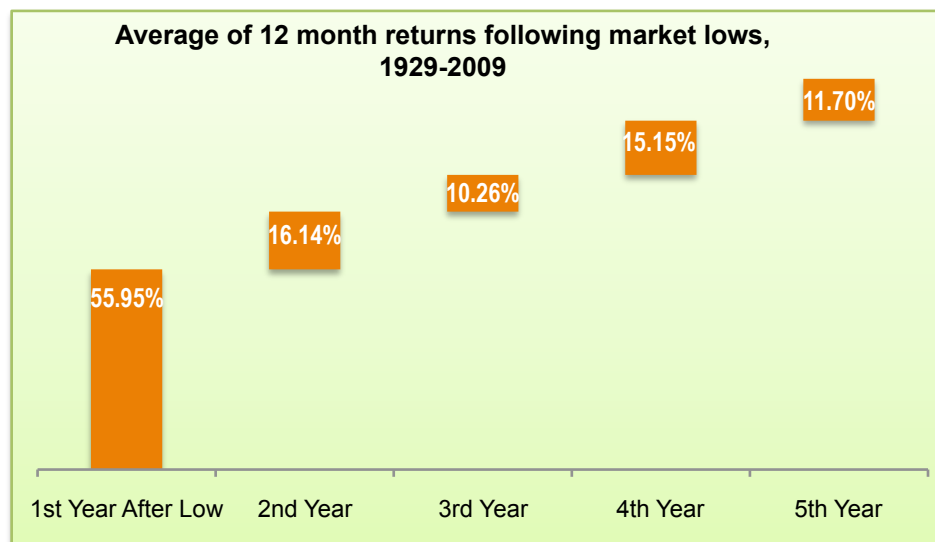
<sup>1</sup> Source: American Funds Insight, Spring 2010

<sup>2</sup> *ibid*

## Historical Returns of a Bull Market Recovery

Due to the rapid recovery of the market the last two years, there is some sentiment that the market cannot continue its advance. However, looking back at past market recoveries shows a pattern of positive returns the first five years after a major market decline. Dating back to the Great Depression in the early 1930s, there have been 17 market declines of 15% or more, including this most recent one from Oct. 9, 2007 to March 9, 2009. In each of the 16 recoveries following each downturn (not including this current one), the market produced on average positive returns in each of the first five years of the recovery.<sup>3</sup>

From the graph, we can see that the market's momentum has tended to continue for several years after a market bottom as the economy gradually improved. Even though we have had one of the fastest market recoveries ever, we can say with some confidence that the market is not



overvalued due to: 1) interest rates remaining low for the time being and 2) earnings of corporations recovering and beginning to grow again. However, we remain cautious, as always, in what we buy and assess each investment opportunity on an individual basis.

## The Impact of Dividends

The “easy money” has already been made in the first year of the recovery with a 68% return. We expect gains to be modest moving forward. In fact, we anticipate a significant portion of returns in the next few years to come from dividends as opposed to appreciation in share prices. Dividends are cash payments that corporations pay to investors (generally every quarter) from the profits they make. This is essentially the only true type of return because you receive it in the form of cash, which enables you to reinvest the cash and achieve compounding of returns.

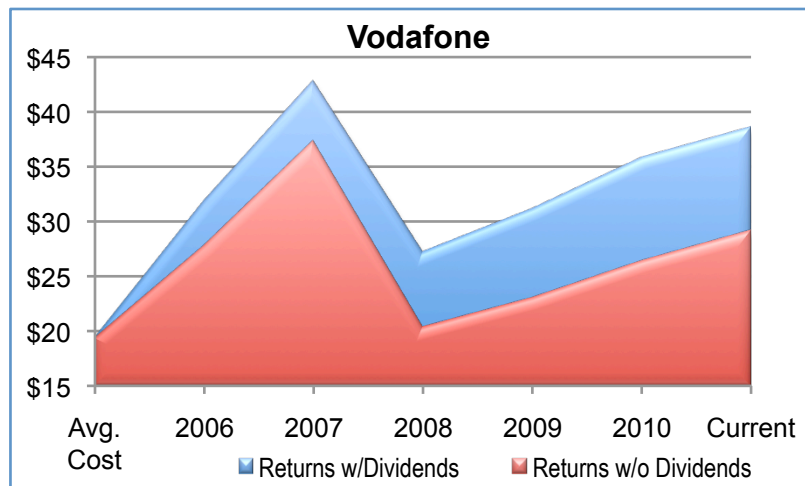
Most people associate investment returns with the appreciation of the share price. However, the impact of dividends as a component of long-term investment returns is substantial. Taking a hypothetical example of a \$100 investment in the market (represented by the S&P 500 Composite Index) on December 31, 1929, if no dividends were received or reinvested, it would have appreciated to \$5,863 on December 31, 2010.<sup>4</sup> On the other hand, if dividends were

<sup>3</sup> Source: The Long View: Climbing the Wall of Worry, July 2010

<sup>4</sup> Source: The Long View: Gaining Ground Slowly, January 2011

reinvested, the same \$100 would have grown to \$146,729 after 80 years. The difference is a factor of 25 times, and shows the power of compounding and the effect that dividends can have.

A real life example can be seen in one of the positions we currently own in client accounts, Vodafone Group, a British telecommunications company.<sup>5</sup> Vodafone is the second largest wireless phone company in the world, and is a 45% owner of Verizon Wireless. We first bought shares in the company in January 2006 at an average cost of \$19.38 per share. With Vodafone's most recent closing price of \$29.21 per share, it would represent a 50.72% appreciation in the share price.<sup>6</sup> At the same time, over the past five years of owning the shares, we received a total of \$9.38 per share in dividends (cash), giving us a total cumulative return of 99.1% before reinvesting the dividends.<sup>7</sup> This equates to a 14.85% annual return over the last five years. The impact of the dividends in this case doubled the return we received from our shares in Vodafone.



Our focus on dividends as an essential part of total return can be seen in our emphasis on owning equity mutual funds and individual stocks that pay a dividend rate higher than the overall market. Currently, the dividend yield on the S&P 500 is approximately 1.8%. In one of our stock positions, Taiwan Semiconductor, the largest semiconductor chip foundry in the world, the current dividend yield is 2.9%. Since we have owned this stock since January 2007 at an average cost of \$10.08 per share, the annual dividend we are receiving of \$0.3727 per share produces a yield of 3.7%. This is not only twice the market's dividend yield, but almost a full percentage point higher than the yield an investor would receive if they bought the stock today at the current price of \$12.94 per share.<sup>8</sup>

In this same example, clients who have owned Taiwan Semiconductor the last four years have received a cumulative return of 43.85% or an annualized rate of return of 9.52%.<sup>9</sup> More importantly, because they are receiving a dividend yield of 3.7% each year, they can have confidence that the 8% annual return we seek over the long term in order to meet their financial goals is already half way achieved. In other words, we would only need an additional 4.3% in the appreciation of the stock price each year to meet the 8% growth rate. This is one of the reasons I continue to believe that our constant search for dividends on behalf of clients is a worthwhile endeavor.

<sup>5</sup> Stocks mentioned do not apply to all client accounts since client portfolios are constructed uniquely based on each clients' investment objective, risk tolerance, investment experience and investment time frame.

<sup>6</sup> Closing price is as of Feb. 11, 2011

<sup>7</sup> In March 2006, Vodafone paid a one-time special dividend stemming from the sale of its Japanese operations to Softbank, a Japanese internet company.

<sup>8</sup> Closing price is as of Feb. 11, 2011

<sup>9</sup> Returns include dividends received, but not reinvested.

Another factor that will bolster our search for high dividend yields is that more than 1,000 companies have increased their dividend rates in the last year. When companies increase their dividend payouts, it signals to investors that they are confident of their future prospects and are committing themselves to pay this higher dividend rate for years to come. Companies that pay dividends are generally some of the healthiest companies around. We will continue our quest for dividends and look forward to reporting more examples of their impact in client portfolios.

## Gold: An Inflation Hedge or Hype?

Over the past two years, I have been asked numerous times if gold is a good investment. It is a fair question when everywhere you turn, you encounter a commercial over the radio or TV that says you can sell your gold jewelry for cash, or someone you know is hosting a gold selling party. It is natural to ponder the potential investment opportunity that everyone seems to be getting in on.

Gold and other precious metals, such as silver, have always been a popular investment in periods of high inflation and as a hedge (protection) against the U.S. Dollar. In today's environment, inflation is not a major concern the way it was in the 1970s and early 1980s. The dollar, on the other hand, has weakened the last few years relative to other major currencies such as the Euro and the Japanese Yen, but is still the de facto currency of the global economy. So before one rushes out to pan for gold at the nearest riverbed, let us look at the facts.

The current price of gold is \$1,365 per troy ounce.<sup>10</sup> On December 6, 2010, gold closed at an all-time high nominal price of \$1,424 (not adjusted for inflation). The nominal price refers to the dollar amount one would pay today for an ounce of gold. Since gold has been investors' favorite choice for hedging inflation, we must look at how well the price of gold has kept up the last 30 years with the rise in consumer prices (inflation).

On January 1, 1980, the price of gold was \$612.56 per ounce.<sup>11</sup> Based on the Dec. 6th closing price of \$1,424, the precious metal's price appreciated \$811.44 or 132%, which is more than double the price 30 years ago and may look to be a decent return at first glance. However, if you were to calculate the annual rate of return over those 30 years, it would only represent a 2.85% return. In comparison, the annual inflation rate over the same period was 3.47%.<sup>12</sup> In fact, if an investor bought gold in 1980 at \$613 per ounce, it would have to be worth \$1,707 per ounce today to even keep up with inflation and have the same buying power as 30 years ago. In other words, gold has not been an effective hedge against rising inflation over the last 30 years. Furthermore, any investment that you make in something that is currently trading near its all-time high price is counter to the old adage of "buy low and sell high".

	Gold	Equities
Jan. 1, 1980 Price	\$612.56	\$108.00
Dec. 6, 2010 Price	\$1424.00	\$1223.00
Cumulative Rate of Return	132%	1032%
Annual Rate of Return	2.85%	8.43%

<sup>10</sup> Price is as of Feb. 10, 2011. Troy ounce is a unit of weight used for precious metals, specifically gold and silver. A troy ounce is equal to 480 grains or 31.04 grams.

<sup>11</sup> Source: [www.marketwatch.com](http://www.marketwatch.com)

<sup>12</sup> Source: [www.inflationdata.com](http://www.inflationdata.com)

On the other hand, one of the most effective assets to own to offset the effects of inflation is equities (stocks). Using the same starting point of January 1, 1980, the S&P 500 Composite Index, which is a broad measure of U.S. stocks, had a closing value of 108.<sup>13</sup> On December 6, 2010, the S&P 500 closed at 1,223.<sup>14</sup> The stock market's rise in that period would represent a 1,032% increase or an 8.43% annual rate of return, which far exceeds the 3.47% rate of inflation during the last 30 years. In other words, an investor in equities would not only have retained its purchasing power, but also received an additional 4.96% growth rate per year. This is the primary reason to own stocks for long-term goals such as retirement and college.

### The Perception of Active Management

Usually people think of an investment adviser as someone making recommendations to a client to buy or sell an investment. Yet, one of the most important pieces of advice that an adviser can give a client is to neither buy nor sell, but to hold. As I stated in the beginning of this letter, at the depths of the financial crisis in late 2008 and early 2009, we were opportunistic buyers in the stock market. In 2010, after the market's recent rally, we were cautious about buying due to rising stock prices. As a result, the main message to clients this past year was to maintain their positions. This can be seen in the number of trades we've conducted over the last three years.<sup>15</sup>

	2008	2009	2010
<b>Total Reallocations</b>	377	284	262
<b>Buys</b>	243	151	107
<b>Sells</b>	134	133	155

As the chart above shows, in 2008 we conducted a total of 377 reallocation trades where we bought and sold positions within client accounts. Of that total amount, 243 were buys and 134 were sells—an almost 2:1 ratio of buy vs. sell trades. In 2009, our total number of trades was 284, and we had 151 buys and 133 sells. Last year, our total reallocation trades continued to decline to 262. It was the first year since 2007 that sells (155) outnumbered buys (107). The pattern of buy trades outnumbering sells in 2008 reflects our attempt to buy low as the market was finding its bottom. When sells outnumbered buys in 2010, it showed a decrease in investment opportunities due to the market rebounding over 86% from its lows in 2009.

The total number of trades made the last three years also follows the same pattern as the number of investment opportunities we capitalized on. For example, in 2008, we were able to identify three new companies to invest in (Boeing, Roche and Visa). That number more than doubled to seven companies in 2009 as the market hit its 10-year low (Jacobs Engineering, JP Morgan Chase, Mosaic, Nintendo, Potash, Procter & Gamble and Southwest Airlines). Last year as the market continued its recovery, we were only able to identify three companies that met our investment criteria (Banco Santander Brazil, Goldman Sachs and Iron Mountain).

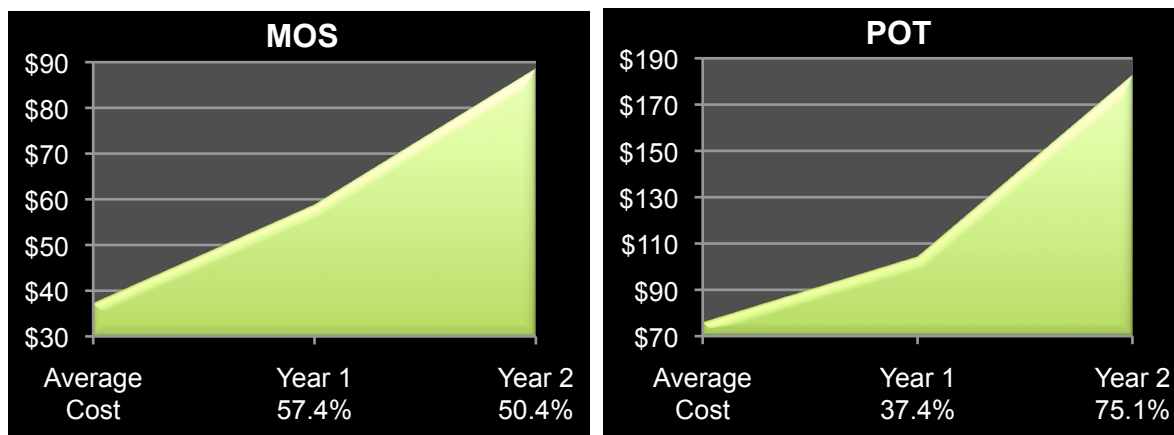
<sup>13</sup> Source: [www.marketwatch.com](http://www.marketwatch.com)

<sup>14</sup> *ibid*

<sup>15</sup> Trades mentioned were conducted exclusively within fee-based accounts custodied at TD Ameritrade.

It should be noted that 300-400 trades per year may seem like a lot, but with only 128 accounts that we conduct trades in, it amounts to only 2-3 trades per year per account.<sup>16</sup> This is quite low and shows our strategy of holding investments for long periods of time—typically three to five years for stocks. For mutual funds, it’s even longer. Thus, our value to clients as investment advisers is not only demonstrated when we buy or sell.

In fact, the value of our advice to hold positions in 2010 can be seen in two agricultural mining companies that we have owned the last two years, Mosaic and Potash. In my last market commentary letter to clients in April 2009, I wrote about Mosaic and Potash and our investment thesis for buying them.<sup>17</sup> Below are graphs showing the appreciation in the share prices of these two stocks in the first and second year of owning them.



As you can see, even though their stock prices rose dramatically the first year, both stocks continued to rise in the second year. If we sold both positions last year, we would not have participated in their sustained appreciation. Our total return thus far from Mosaic and Potash are 136% and 148%, respectively.<sup>18</sup> Typically, when we have doubled our returns in stocks, we would either sell the position or sell the gains and reinvest elsewhere. In this situation, we continue to maintain our original number of shares in both companies due to the fact that farmers’ demand for Potash and Mosaic’s fertilizers are forecasted to remain strong for the next several years. The primary reason for both companies’ stocks performing so well recently is a result of potential merger activity in the industry, not necessarily from their earnings. We believe that the companies’ earnings will drive their share prices in the next few years.

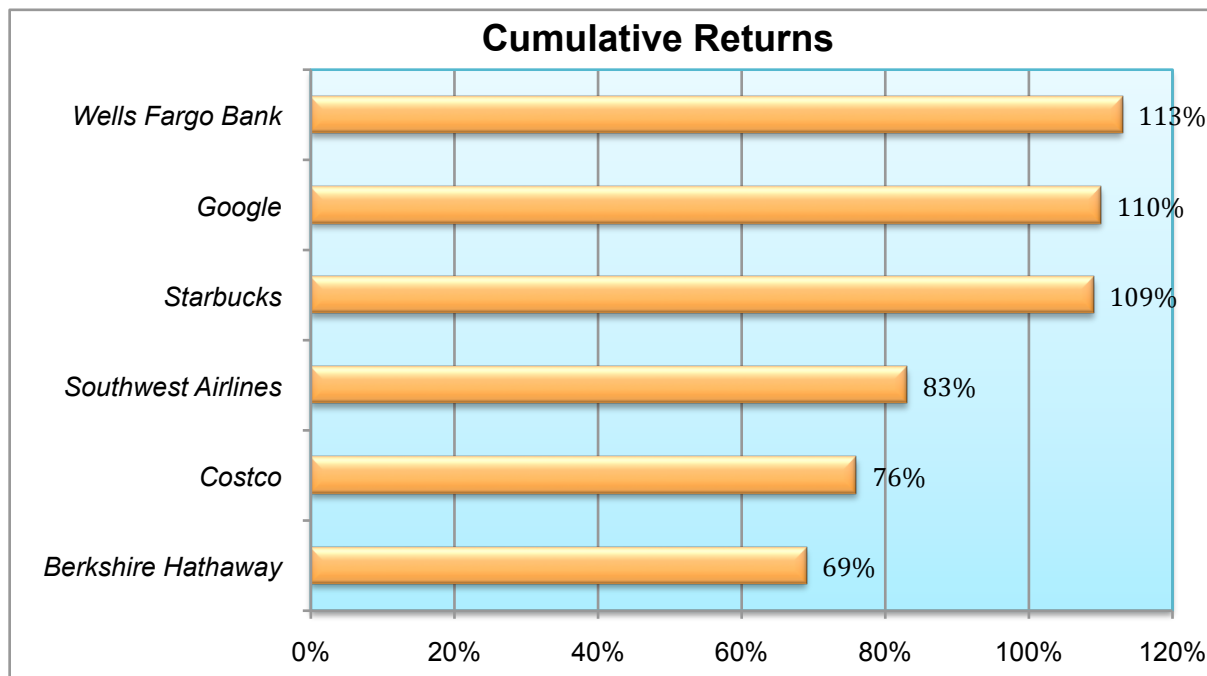
The examples of Mosaic and Potash show that active management of investments also involves holding positions, and not just buying and selling them. Thus, holding is very much an active form of investing, not a passive one, since it requires continuous monitoring and researching of an investment. As a result, just because we are not trading does not mean that we are not adding value to clients.

<sup>16</sup> ibid

<sup>17</sup> See [www.cap-partners.com/news.htm](http://www.cap-partners.com/news.htm)

<sup>18</sup> Total returns for Mosaic and Potash are based on their closing prices as of Feb. 11, 2011, and exclude any dividends received and reinvested.

Below is a chart showing investment results in other positions we purchased in client accounts during the last two years that have produced stellar returns and that we continue to hold.<sup>19</sup>



Without the fortitude to buy these companies at the depths of the market's decline, we would not have earned these robust returns. Be assured that when the next market downturn occurs, we will use this experience to capitalize on the investment opportunities that a downturn presents.

I hope this letter has helped to validate the confidence you have placed in our investment process. I applaud our clients for having the courage and foresight to stay invested. I want to congratulate you on the extraordinary results you have attained, and I look forward to reporting on the state of your investments in the future. Thank you for your continued commitment to long-term investing.

Thomas F. White  
Managing Partner  
CAP Partners, LLC

February 15, 2011

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. **Past returns are no guarantee of future results.**

<sup>19</sup> Cumulative returns do not include dividends received.