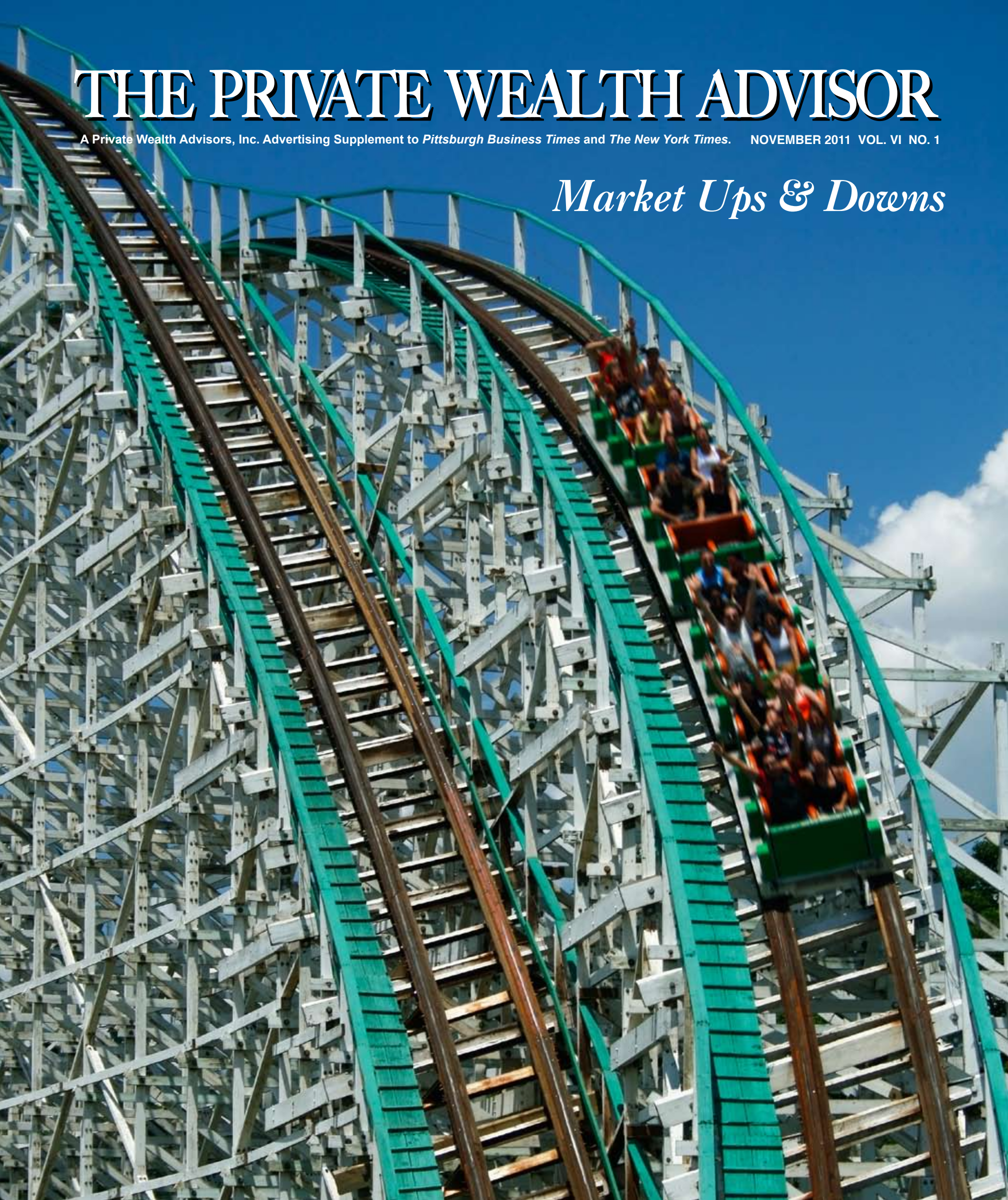


# THE PRIVATE WEALTH ADVISOR

A Private Wealth Advisors, Inc. Advertising Supplement to *Pittsburgh Business Times* and *The New York Times*. NOVEMBER 2011 VOL. VI NO. 1

*Market Ups & Downs*



# PRIVATE WEALTH ADVISORS

## Executive Editorial



by John Schneider

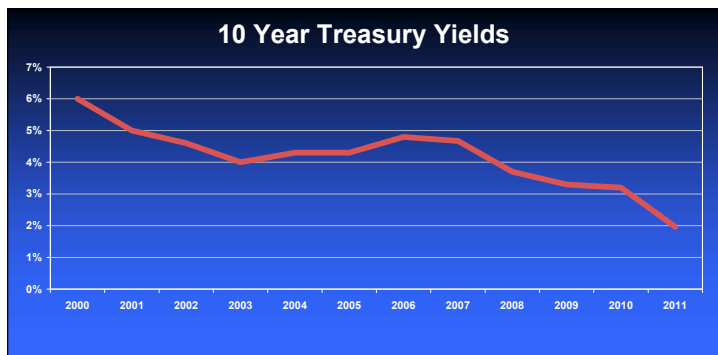
The historically low interest rate environment created by the government's actions has created challenges in terms of investing in traditional fixed income assets. Instead of being satisfied with the paltry yields offered by the bond market, Private Wealth Advisors identified direct real estate ownership as a way to capitalize on low interest rates. With real estate ownership, we believe we are in the midst of a potentially profitable opportunity.

In order to take advantage of the opportunity, we formed PWA Real Estate in 2007. This was the beginning of the downturn in the U.S. real estate market, along with the start of the U.S. Government intervention that would move interest rates far below their historic averages. Since the creation of PWA Real Estate, we have purchased over \$70 million in existing properties in cities such as Cleveland, Indianapolis, Pittsburgh and Athens, Georgia. More recently, we completed construction on a \$6 million ground up development on Pittsburgh's South Side.

When analyzing a property in terms of opportunity, it can be broken into three critical components: equity investment, debt financing and appreciation potential.

### Equity Investment

When purchasing a property, the spectrum of money invested in the deal can range from all cash to 100% financed. Currently, we are financing 75% of each acquisition and contributing 25% equity. When determining the return on the equity component, you need to analyze the operating income versus the cost of the property. This is known as the capitalization rate (cap rate).



Source: Baseline

Cap rates fluctuate over time. Currently, cap rates have moved back near their highest level over the last decade – about 10%. The current spread between cap rates and the 10 year Treasury is about 30% above the historical average, meaning prices are cheap at these levels. So, how does the cap rate translate into equity return?

Consider this example:

**Property Purchase Price:** \$10,000,000  
**Net Operating Income:** \$ 1,050,000  
**Property Cap Rate:** 10.5%  
 (\$1,050,000/\$10,000,000)

Assuming you use debt financing for the purchase, the bank will require a portion of the income to be reserved (typically \$1.50/square foot or 1.5% of revenue). This would lower the equity return from 10.5% to 9%.

If the equity contribution was 25% or \$2,500,000, the return on equity would be:

$$\$2,500,000 * 9\% = \$225,000$$

### Debt Financing

Financing a portion of a real estate purchase can add both risk and reward. The continued depression of interest rates, as seen in the graph of the 10-year Treasury, is very important. Not only do cap rates sit near their highs, but interest rates are at their lows. With both of these things in favor, the spread between the property's income generation and the cost of debt creates an opportunity. If you refer to the matrix, you can see the impact borrowing can have on the return from this portion of the investment.

Carrying the example forward, the remaining 75% would be financed at 5.5% over a 25 year amortization. The debt capitalizes on the low interest rate, making the spread between the cost to the lender and the income from the property. The debt would earn 3.5% annually (9% (after required reserves) minus the 5.5% cost of debt).

$$\$7,500,000 * 3.5\% = \$262,500$$

When looked at in term of equity invested, it translates into a potential return of 10.5% (\$262,500/\$2,500,000).

### Appreciation

In the short-run, cap rates will impact the value of the property. As cap rates moved from 10% in 2000 down to 7% in 2007, the value in properties experienced appreciation of approximately 45%. As cap rates rose

from 2007 levels, properties lost about 30% of their value. Buying properties while cap rates are on the high end of their average is a potential added benefit to buying real estate today.

While these short-term moves can appear drastic, in the long-run prices tend to move with inflation. Over the last thirty years inflation, measured by the Consumer Price Index, is roughly 3%. Building on the earlier example, if a property appreciates 3% each year the benefit is enhanced by the use of debt. Since the equity in the deal is only 25%, the appreciation is a greater benefit and translates into a potential 12% annual return.

$$(\$10,000,000 * 3\%) / \$2,500,000 = 12\%$$

Return on Debt Financing						
		Spread Between Income and Financing Cost				
		0.50%	1.50%	2.50%	3.50%	4.50%
Equity Contribution	10%	4.50%	13.50%	22.50%	31.50%	40.50%
	15%	2.83%	8.50%	14.17%	19.83%	25.50%
	20%	2.00%	6.00%	10.00%	14.00%	18.00%
	25%	1.50%	4.50%	7.50%	<b>10.50%</b>	13.50%
	30%	1.17%	3.50%	5.83%	8.17%	10.50%
	35%	0.93%	2.79%	4.64%	6.50%	8.36%
	40%	0.75%	2.25%	3.75%	5.25%	6.75%
	45%	0.61%	1.83%	3.06%	4.28%	5.50%
	50%	0.50%	1.50%	2.50%	3.50%	4.50%

*Note: Income computed as (Cap Rate - banks reserves) less financing costs.  
 Ex: (Cap Rate 10.5% - 1.5%(Res.) - 5.5%(mortgage interest))*

### A Compelling Combination

These three components, when viewed together, offer a strong case for investing in real estate today.

Our example tells the story.

**Equity Investment** – historically high cap rates increase current income (9%)

**Debt Financing** – low interest rates create a large spread on the financed money (10.5%)

**Appreciation** – prices rising with inflation, over time, and financing benefits return (12%)

Investing in real estate includes risks such as tenant rollover, lost rents and capital expenditures as well as other geographic and market risks. In addition many property owners have relied too heavily on financing their properties and suffered the consequences in the recent market declines. In order to protect against possible issues in the future properties should be managed conservatively. Income distributions should be less than the income generated from the property. A prudent way to manage a property is to use the difference to shorten the amortization on the debt and build reserves beyond bank requirements.

Currently, there are opportunities to purchase properties while cap rates are high and interest rates are low. The use of debt financing enhances the potential return for investors. With interest rates low the opportunities in real estate are compelling. ●

# Asset Allocation / Current Market Summary

## Equities

The quarterly percentage change in the S&P 500 during the 3rd quarter 2011 was the largest decline since the fourth quarter 2008, moving two standard deviations (refer to chart A).

## Growth vs. Value

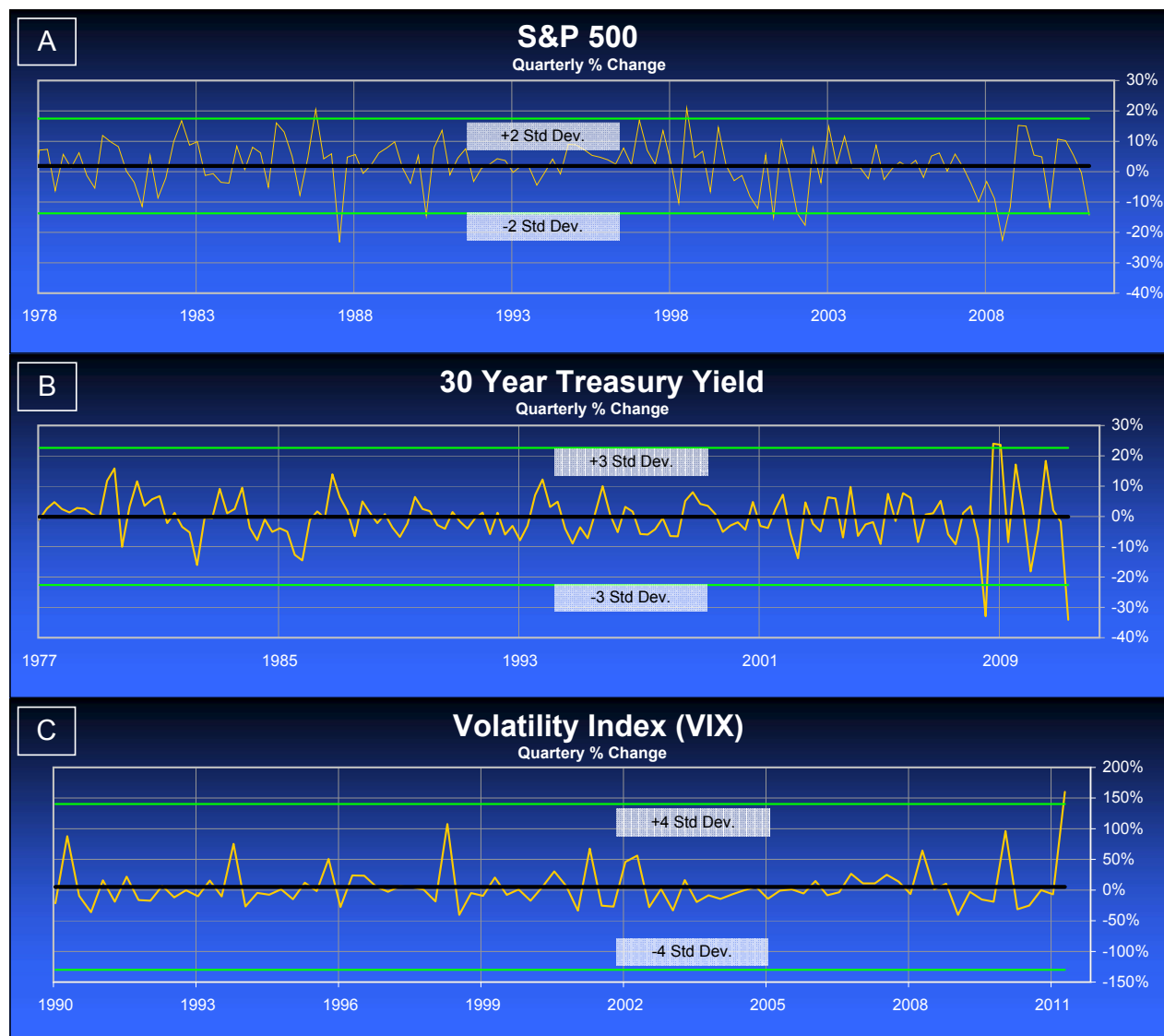
Through the first nine months of 2011, large growth stocks have outperformed large value stocks by 4.04%. The asset classes had traded close to each other for the majority of the year with growth finding some separation in the summer months. Currently they trade at 1.85 times the P/E ratio of large value stocks. Historically they have traded at 2.2 times the P/E of large value stocks, making large growth stocks approximately 16% undervalued in comparison to large value stocks. The story is the same for lower market capitalization stocks in terms of valuation with growth looking cheap. Small and mid cap growth stocks are beating their value counterparts thus far in 2011, with small growth stocks having the largest disparity (ahead of small value stocks by almost 3%).

## Large vs. Small / Mid

After an impressive move off the market bottom, small cap stocks appear to have run out of steam in the fall of 2011. Small caps (measured by the Russell 2000 Index) were down over 17% through September 2011, nearly 8% behind large caps. Based on historic relative valuations, small cap stocks currently trade 14% below par with large caps. This relationship puts the asset class approximately 1% below their fair valuation versus large cap stocks over the past 35+ years.

## U.S. Equity vs. International Equity

The issues in Europe continue to loom and risk has not dissipated from international equities. European stocks have lost about 16% through September. Surprisingly, Pacific stocks have not fared much better, losing over 13% in the same period. Valuations have improved slightly in 2011. International stocks, compared to domestic stocks, trade almost 7% below the long-term average. Emerging market stocks have sold off more than 21% and look more compelling given their growth rates.



Source: Baseline, Morningstar

## High-Yield vs. Treasuries

The interest rate spread between high-yield bonds and Treasuries increased in August and September 2011. There was a continued flight to Treasuries, which drove government yields lower. High-yield bond owners currently receive a yield premium of 7.3% over 7-year Treasuries, which is 1.35% above the long-term mean relationship. Defaults are expected to remain low for the rest of 2011, and the increase in spreads in August makes high-yields more attractive.

## Interest Rates and the Yield Curve

The Federal Reserve's Operation Twist put additional pressure on intermediate and long-term bond yields in September 2011. Referring to chart B, the quarterly percentage change in the 30-year bond yield in the 3rd quarter was the second largest ever (moving 3.5 standard deviations in the period).

## Inflation

The September PPI Index was up 0.5% prior to seasonal adjustments. The twelve month rate ticked up, but is still below the recent peak. The CPI Index had a small gain in September. The Leuthold Group does not predict a significant rise from current levels on either index through year end 2011.

## Volatility

Equity market volatility (measured by the S&P 500 VIX) had its largest quarterly percentage change ever, increasing by four standard deviations during the quarter (refer to chart C).

# Two Sides to This Story

It was the best of times; it was the worst of times. Charles Dickens' famous first words in "A Tale of Two Cities" seem to be an apt depiction of what the investing public is faced with today. Look to companies which make up the equity markets and you will find an abundance of good news which can warm the heart and, possibly, fatten the portfolio. Look to the headline news and you will find a much different picture – a gloomy, disheartening picture. So, what do you believe? And, more importantly, how does this dichotomy in outlooks impact equity portfolio strategy moving forward?

Let's start with the good news: the U.S. equity market appears to be in great shape. U.S. corporations look to be leaner than they have been in years.

## *Cash is King*

Today, S&P 500 companies have nearly \$2 trillion dollars in cash and short-term investments. That cash provides a huge cushion to weather unexpected changes to their businesses and provides a vast amount of flexibility as these companies try to grow their earnings and add value for investors.

The actual peak in S&P 500 cash was nearly \$2.5 trillion in 2010. U.S. companies cut spending, workforce and facilities in both 2008 and 2009, but now have begun to show a willingness to spend in order to better their business and attract new investors. According to a Bloomberg report in February 2011, capital spending increased quarter to quarter by the largest amount since 2004.

Budgets have increased for things like new stores, plants and distribution centers. For example, Cisco had approximately \$325 million in capital spending in its two most recent quarters. That amount is the most the company has spent since the height of the market's financial meltdown in the fall of 2008. The recent trend of increasing spending indicates many of the largest U.S. companies are at least comfortable, if not confident, with where things stand today.

Companies have options beyond increasing capital spending and many of these options can be viewed as positives for the broad market. Increasing or initiating dividends is one. This turned out to be a path taken by many big companies, who increased their dividends by a record amount in the first quarter of 2011. Since the start of the year, 117 companies in the S&P 500 said they would either start paying a dividend or raise their existing dividend. This is a 50% increase from the same quarter a year ago. According to Standard & Poors, the value of the new and raised dividends would be over \$16.5 billion.

Large U.S. companies have also looked to use their cash to buy back their own shares. Standard & Poors announced that stock buybacks for the fourth quarter 2010 increased by 80.6% from the 4th quarter 2009. For the full year 2010, nearly \$300 billion was spent by S&P 500 companies on share repurchases. That translates into a 117% pickup up from 2009 buyback activity. The cash remaining on balance sheets could be used to support stock prices and drive up earnings going forward.

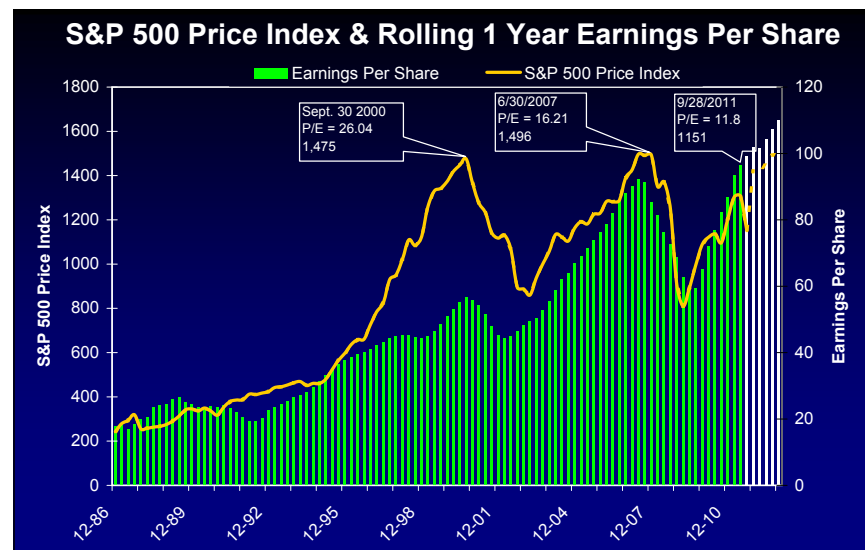
Finally, companies can use their cash to buy companies and attempt to grow their businesses through mergers and acquisitions. Activity was strong in 2010, totaling \$768 billion. That equates to a 21% increase over 2009. Acquisition spending was higher by 12% in 2010.

## *Stocks Look Cheap*

The positives go beyond cash. While all of the above make stocks more attractive, they actually look attractive on their own. As can be seen on the chart "S&P 500 Index and Rolling 1 Year EPS", valuations actually look cheap with a forward P/E on the S&P 500 of 11.8. This is nearly 31% below the 15-year average of 17.1. The five week sell-off in the market starting in late July 2011 made cheap stocks much cheaper. According to Bloomberg, nearly \$2.3 trillion was erased from the market value of U.S. stocks during the late summer selloff. The last time stocks were cheaper on average during a recession was in the early 1980s. That decade delivered well above market average returns.

In fact, stocks appear cheap on other valuation metrics as well. Cash flow per share sits at nearly \$139 which is about 45% above the 15-year average of \$95.65. Price to book also looks cheap for the S&P 500 at 33% below that 15-year average.

When you compare stock ownership to some alternatives, the case looks even clearer. The 10-year Treasury remains near historically low levels yielding just over 2%. When considering inflation and the risk of rising interest rates, government debt is not enticing. Yields are even more paltry on cash investments. A six month CD yields less than 0.50%; a two-year delivers less than 1.25%. Money market and savings ac-



Source: Baseline

counts are, for the most part, yielding less than 0.30%. It just doesn't pay to sit in cash for an extended period of time. So, why not load up on these cash rich, attractively valued stocks? The thing causing the most hesitation right now – headline news.

## *Issues Abound*

There are a myriad of macro issues hanging over the market like a series of dark clouds. Each, on its own, could be a stumbling block to the market's recovery. Together, they have created enough uncertainty to force investors to take a hard look at their equity portfolios and let fear take the lead.

The second round of the Federal Reserve's quantitative easing program (QE2) ended early in the summer. The program had several key impacts to the financial markets. One of Chairman Bernanke's stated objectives was to boost the equity markets. Through the first quarter of 2011, that goal had been achieved. As can be seen on the chart, the markets have reacted positively to both rounds of easing. From the start of the quantitative easing program through the beginning of March, there had been an 86% correlation between the size of the Fed's balance sheet and the stock market. When the spigot was cut off, the market had difficulty maintaining its footing.

At the same time, the Treasury market lost its biggest buyer. The Fed purchased over 70% of debt issued by the Treasury since QE2 started in November 2010. What happens when the largest buyer leaves the marketplace? The world's largest bond fund manager had a negative view of Treasuries heading into the summer in anticipation of higher rates. Higher rates would be detrimental to stocks as well. The overall fear in the marketplace during the summer spurred a renewed

Continued on page 5

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## *U.S. Equity Markets*

*Continued from page 4*

interest in Treasuries. How long it lasts is the question.

It is no secret that government debt in the U.S. is out of control at all levels (Federal, State and Municipal). As the federal debt neared the debt ceiling it caused debate within Congress over the proper solution to the issue. After much political grandstanding, the debt ceiling was raised and some spending cuts were announced. The actual debt issue was not an event in and of itself for the short-term. Unfortunately, it shined a light on the inability within Congress to find real solutions and create uncertainty. Then, after the deal was done, Standard & Poor's announced its downgrade of U.S. debt, which sent the markets into a panic.

The debt/GDP ratio is close to 100% and there is more than \$60 trillion in unfunded liabilities. There is no easy solution to this issue. The residential real estate market has not recovered, so property tax revenue is unlikely to increase and provide any type of offset to rising municipal debt. Unemployment refuses to show any significant decrease other than citizens leaving the workforce, so government outlays are unlikely to decline.

Spending cuts are inevitable. Higher taxes are likely. The government has benefitted from low rates up to this point. The effect the debt issues have on the equity markets going forward is yet to be seen.

While things seem bleak in the U.S. in terms of debt and unsustainable spending, Europe looks even worse. The problem which reared its head late in 2009 and then exploded in the spring of 2010 has not gone away. The European Union was created to facilitate cross border commerce through a single currency monetary system. Both European countries and banks are intertwined in a web of sovereign debt and fear of a domino effect of possible defaults remains at the forefront.

To date, the EU has bailed out Greece, Portugal and Ireland. Despite the fact that these nations only account for approximately 6% of Eurozone GDP, these bailouts were extremely important. Member states of the EU hold debt of the other members. If, for example, Greece (with public sector debt of 143% of 2010 GDP) were to default they would be unable to pay debts owed to other debt laden nations such as Portugal and Ireland. Unable to collect on the debt owed by Greece, the banks and governments in these already strained nations would come under more pressure and could be faced with the same fate. This would be the beginning of a domino effect of debt contagion in Europe. While the EU can bail out some of these small member nations, should the contagion spread to a country like Italy (with 119% debt to GDP and that makes up 16% of EU GDP) the sheer size would be too large a burden for the EU. A default of this magnitude would devastate the Eurozone economy, stock markets and overall financial system.



Source: Morningstar

### *A Time for Caution... and Opportunity*

The news has been largely negative throughout the summer and early fall 2011. Europe's economic issues have dominated the news and proven to be a very negative force on the direction of the markets. Issues in the United States have not proven much better and the threat of slipping back to recessionary levels has not gone away.

The market will likely trade in a range until better clarity can provide direction for the market. This could come from continued government efforts, both in the United States and abroad, to stabilize the global economies and better set the stage for growth moving forward. It could also come from corporations as we move through earnings season. The stock market looks to be relatively cheap. If earnings follow through, investors may be more willing to commit to the equity markets to take advantage of valuations. However, if earnings weaken significantly from what looked to be record numbers earlier in the year the market could continue to sell lower.

It is best to rely primarily on large U.S. multinationals that have significant cash positions and have globally diversified businesses. These companies should participate if the market moves higher, but also offer better stability than other asset classes. Beyond the blue chips, the market's move lower over the last few months has begun to create opportunities in some market sectors and industries. A continued move to the downside will likely create additional mispricing and provide the chance to add exposure to segments of the markets with great upside.

The fear in the market creates volatility in the short-term. While it is prudent to act with caution, we believe purchases of assets trading significantly below their long-term average valuations will result in positive portfolio performance as the market normalizes and true value is recognized. ●

For now, the imminent risk of default has been mitigated. Significant austerity measures have been put in place, much to the chagrin of the citizens of these debt heavy nations, and the European Central Bank has been an active buyer of these nation's debt in the secondary market helping to keep rates from spinning out of control. Despite the fact Germany and France have had to foot much of the bill for their neighbors' fiscal irresponsibility, they have shown willingness to explore options to provide stability and to avoid the dissolution of the European Union.

While inflation is becoming more of a concern in the U.S., it is reality in Asia. Inflationary pressures are mounting in China. Since the fall of 2010, the People's Bank of China has hiked the reserve requirement ratio for banks ten times and raised deposit and lending rates four times. The July consumer price inflation in China reached its highest level since 2008 (6.5%) and sits more than 35% above the government's target. The Reserve Bank of India decided to double the magnitude of interest rate increases in early May, showing its government's concern over the looming inflation battle and a willingness to dampen economic growth in the process.

Finally, the earthquake which crippled Japan in early March 2011 has put one of the world's largest economies behind the eight ball. According to a survey, 60% of Japanese companies were affected by production/supply chain disruptions. Japan's second quarter GDP was -2.1% and Moody's downgraded Japanese debt in August. In order to work its way out of this mess, Japan will need to print massive amounts of yen, which almost certainly will impact inflation for the country.

## "If You Build It, Will They Come?"

"It's already passed two p.m., and he's yet to serve a single customer," reported an Australian journalist in a recent documentary chronicling "China's Ghost Cities". The words described a toy shop owner in Dongguan's South China Mall. The merchant mentioned that at times it has taken as long as four to five days to move a single product. The mall - the world's largest based on gross leasable area - has been over 90% vacant since it opened in 2005, and it is a perfect example, amongst others, of why deriving economic policies from Kevin Costner movies may be problematic.

Many justifiably argue, especially given the events of the last few years, that the United States has been drifting away from the free market principles and policies that made it capitalism's most impressive creation. However, there are not many that would claim the United States is in danger of stealing any of China's centrally planned thunder. Communism's most impressive creation has come a long way from the Great Leap Forward and the millions of deaths and severe economic contraction it led to fifty years ago. Earlier this year the People's Republic passed the U.S. to become the world's leading manufacturer, and investors the world over have become accustomed to double digit GDP growth.

Being able to manipulate your economy like a video game is certainly advantageous, and it is not surprising the ability to do so has resulted in mind boggling growth in China. But as with all decisions in the world of economics and finance, rewards are accompanied by risks, chief among them in this context being inequality, inefficiencies, and inflation all characterized by perhaps the biggest property bubble the world has ever seen. Questions about the accuracy of the data aside, China's growth over the past quarter century has been remarkable and a boon to global investors, but an unnatural growth binge is no different than any other binge, and China may currently be starting to wake up with a bit of a hangover.

China moved from a centrally planned, closed economy as recently as the late 1970s to a major player in the world economy thirty years later. In that time, the role of government in managing the economy was reduced and the role of market forces and private enterprise increased. While this transition was important in the growth of the Chinese (and global) economy over this period, it should not be construed as a move to a capitalistic system. Each significant economic sector is supervised by a government organization. Economic policies and plans are implemented by various control mechanisms and monitored closely by the government. While China has moved away from a completely closed economy, the government's role in economic growth still looms large.

In November 2008, the Chinese central government

rolled out a stimulus package in an attempt to minimize the impact of the global financial crisis. Public infrastructure received the largest portion of the stimulus package, but money also flowed toward areas such as reconstruction, rural development and technological advancement. By June 2009, growth estimates for China were upped by nearly 11% to 7.2% which confirmed the immediate impact of the stimulus.

Many debate whether China is ready to make the transition from pure export dependency to the development of a domestic consumer based economy. Chinese leaders have been calling for a higher standard of living for its citizens and there has been evidence of significant wage increases. At the current pace of growth, China looks to surpass the United States as the world's largest economy as early as 2020.

In 2010, China became the world's largest exporter and the second largest trading nation overall. China's economy grew at an average rate of 10% per year from 1990-2004, which was the highest growth rate in the world. The growth fueled by the stimulus caused China to account for close to 50% of the global growth in both 2009 and 2010. These high annual growth rates will be important for China if they hope to generate the necessary jobs each year (approximately 15 million) to put new job market entrants to work. While the growth in China seems to be on a clear trajectory upward, the Chinese economy has obstacles in its path.

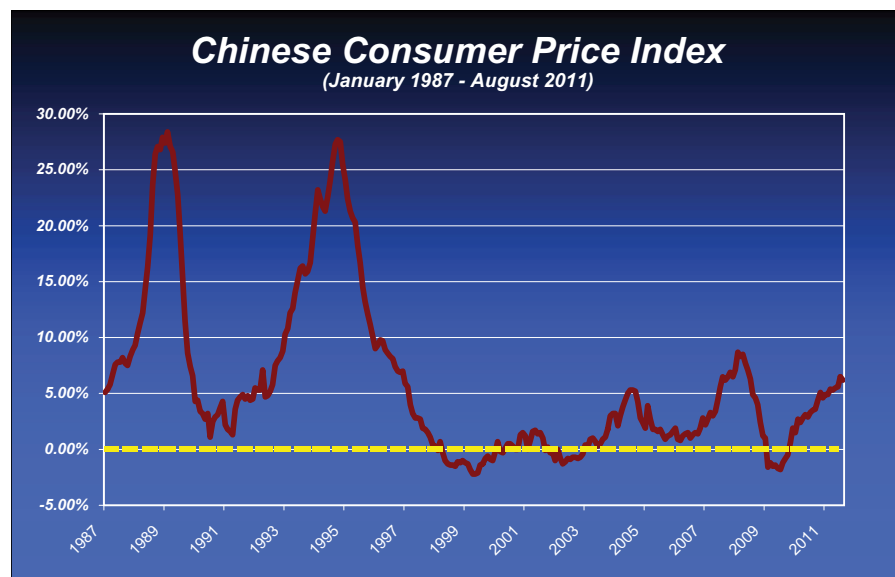
Many issues have stemmed from the largely stimulus related influx of money into the system. For decades, China's economy has been greatly aided by a consistent stream of state subsidies in the form of commercial bank lending. In 2011, it appears lending has reached levels far in excess of what many believed, and it may be difficult for the Chinese government to curtail lending. The truth is this lending has been going on for some time and seems to be in the fabric of the Chinese economy despite the sea of targets, quotas and red tape.

Chinese banks move money to state owned enterprises. This does a few things. It keeps Chinese goods competitive on the global market and also helps to create profits. Another by-product is it promotes a low

unemployment rate. Non-performing loans will likely be a consequence of this practice as well, but there has only been one major crisis (last decade) to date. Leaders began to have serious discussions regarding the economy overheating five years ago. Unfortunately, an export slowdown caused by the financial crisis in 2008 forced the aforementioned stimulus package.

In 2010, China failed to remain within its bank loan and money growth targets. The money supply grew by nearly 20% in 2010, which was almost 16% ahead of the 17% growth target. Chinese banks issued the equivalent of \$1.2 trillion in new local currency loans in the same period. These loans were 6% ahead of the government target.

While China has stated it will tighten monetary policy and reduce lending to citizens in 2011, inflation is a major concern for policy makers. In November 2010, inflation hit 5.1%. This stirred a rate hike in December,



Source: Leuthold Group

followed by several more in 2011. The March 2011 inflation report showed inflation continuing to move higher, reported at 5.4%. In April, the fourth rate increase in 2011 was announced and a three year high of 6.5% was reached in July. Food prices seem out of control, rising more than 14% in June 2011 alone. Despite government efforts to control them, property prices continue to shoot upward. This, most likely, is inflating a market that was already witnessing bubble like conditions.

Commercial property is in high demand. Even though the government has made an effort to slow large commercial deals by raising bank reserve requirements, these transactions continue. It has been estimated that more than 1.7 million square feet of new office space is being constructed in just Shanghai.

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## *International Markets*

Continued from page 6

According to Cushman & Wakefield, foreigners account for over 40% of Shanghai's commercial real estate sales. Even though lease yields have been cut in half, foreign investors are still clamoring to buy into China's growth story. The market is already overheated and, barring a slowdown in 2011, will probably only become more inflated.

While China cannot be directly compared to the United States when discussing a real estate bubble (more money up front in transactions, little evidence of fraud, little securitizations of mortgages), this massive growth has created real concern. It has been reported that there are approximately 64 million vacant apartments in China, creating the "Ghost Cities" referred to at the start of this article. The vacancies can be linked to the widening gap between rich and poor in China.

China has approximately 1.4 billion citizens, many living on less than a few dollars per day. Even though these people make almost nothing by American standards, their cost of living is only getting more expensive. Housing costs are skyrocketing. In China's most populous cities, housing prices are rising by about 1% each month according to the National Bureau of Statistics. Also, the prices of newly constructed residences rose in 78% of the cities monitored.

Residential housing investment (as a percentage of GDP) has tripled to 6% in the last eleven years. Housing prices have reached nosebleed levels in certain areas. Over the last eight years, housing prices in Beijing have increase as much as 800%. For the country as a whole, an increase of 140% has been seen in that time. The result: a year over year decline in home purchases of more than 50%. Housing, which exists in abundance, is just not affordable to the vast majority of Chinese citizens.

Chinese government officials clearly had become nervous. Earlier this year they implemented a number of new measures aimed at curbing the rise in housing prices including not allowing inhabitants of major cities to purchase second homes, raising down payment floors, introducing new property taxes, and raising the borrowing costs for developers. As demonstrated in the chart below these new policies had an immediate and very significant effect on housing prices in most of China's major cities; the most drastic slide occurred in the capital, Beijing. While prices stabilized for the most part over the following months, dramatic short term price decreases in any asset class are typical symptoms (in hindsight of course) of vulnerable bubbles. Many analysts and organizations expect prices to continue to slide through year end and into next year, when a glut of subsidized housing will hit the market.

Given China's notorious opacity, it is difficult to confirm the data regarding the country's economy. Stats may be exaggerated or massaged by the central government. What is clear is the Chinese government is determined to be proactive in addressing the inequality, inefficiency and inflationary issues which could be roadblocks to continued high growth.

We know rate cuts and increased regulation will be on the horizon in an attempt to wrangle inflation, but the government's plans go beyond inflation control. Local government debt is piling up from the massive economic stimulus. The government will take steps to tackle the issue. According to Reuters, China's banking regulator plans to shift the equivalent of \$300-\$470 billion in debt off the books of local governments. This type of move will not be uncommon for a government doing its best to reduce the risk of a wave of defaults which could threaten the stability of the Chinese economy.

The news is certainly not all bad for China. The country still boasts enviable growth compared to the other large world economies and continues to run surpluses when many others are faced with staggering deficits. What must be recognized is China's path to economic domination is not without hurdles. It is difficult to ascertain the risk of direct investment in China, and while they can surely deal with domestic problems on their own due to their relative fiscal prudence over the years, it would certainly pose a risk to global growth if they had to focus efforts and resources inward.

The United States, on the other hand, presents a much clearer picture. We know the warts of the U.S. economy. It has not looked pretty as economic news continues to disappoint as we move into the fourth quarter, but for equity investors it may be better to dance with the devil you know in the short-term.

It will be a long time before we can truly judge the merits of China's more closed, government driven system against the more open market, capitalistic system employed by the majority of developed nations around the world, primarily the United States. China's stellar growth can be alluring, but that kind of growth brings its own baggage. With cities built on the back of this growth, but essentially empty due to economic inequalities, it is hard to know when (or if) Chinese citizens will make the move. We do know, in order for standards of living to rise in China, economic growth will need to continue on its current path and inflation will need to be addressed in the coming years. The long-term growth story still looks attractive in China. In the short-term, Private Wealth Advisors prefers to invest in large U.S. companies who can benefit from emerging market growth but offer increased stability during this uncertain time. ●



Source: Soufun; CREIS; Citi Investment Research and Analysis

## *Caution:* Diminishing Opportunities Ahead

A person's feelings about risk are influenced by prior experiences. When it comes to investing, the most recent experiences are often the most prevalent. Although the last two years have been very good to those willing to take risk by owning stocks, the prior eighteen months were extremely painful. So, while the stock market was poised for a major move upward in 2009, many investors had not regained their appetite for risk, which took a severe beating the prior year.

Instead, investors looked for safer opportunities. After the financial crisis drove nearly all asset classes lower throughout 2008, even historically low risk bond categories offered significant upside. So, money began to come off the sidelines (out of money markets) and moved into fixed income investments. At first, it appeared to be investors taking the first step in incrementally increasing risk within portfolios. The transition to equities took a while. Eighteen months from the market bottom investors finally began to jump back into the equity market. The "buy anything" mentality within the bond market seemed to be ending in early 2011 with flows to stocks increasing, but the volatility during the summer caused uncertainty with respect to equities.

In December 2010, money began to flow out of numerous bond sectors. Unlike prior months, where most of the bond outflows could be pinned on the municipal market, corporate and Treasury bonds were also being sold. Leading up to the December divestitures, bond funds had experienced a 99-week stretch of inflows following three months of outflows as a result of the financial crisis. The string was snapped and it appeared as if equities could become the destination of choice for investors. Unfortunately, the thirst for fixed income was not quenched. The summer saw massive bond buying again (mainly Treasuries). In August 2011, taxable bond ETFs saw greater inflows (\$4.3 billion) than any other ETF category. Bond opportunities are even less abundant today and bond risk is on the rise.

After decades of falling interest rates, we are now faced with record lows across the yield curve. At these levels, the yield on traditional bonds is far from awe inspiring. Plus, there is the threat of rising rates. The combination has turned the risk/reward profile for many fixed income assets classes on its ear.

Interest rates in the 4th quarter of 2009 were at their lowest point since the 1960s, excluding the 2008 financial crisis. On top of that, the excess cash being pumped into the system via the Federal Reserve's quantitative easing programs pushed investors toward

risk assets (such as equities) and away from Treasuries. These factors seemed to increase the likelihood of rising interest rates prior to any Fed initiated increase in the Federal Funds Rate.

Rates did move higher in the 4th quarter of 2009 into the 1st quarter 2010, as the 10-year Treasury moved from 3.2% to 4%. Then, in April 2010, Greece's ability to service its sovereign debt was called into question. This news was followed by default fears in the remaining PIIGS nations (Portugal, Ireland, Italy, Greece and Spain). Fear of European debt contagion and a potential collapse of the European Monetary Union spread across the globe.

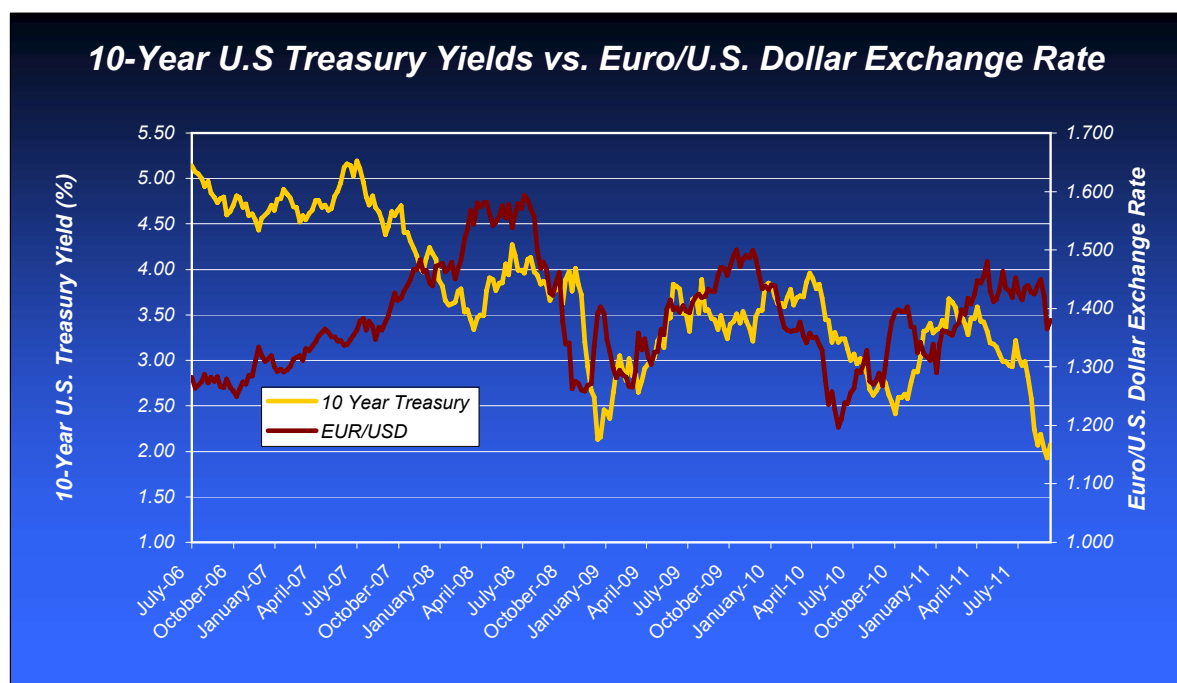
With the euro and U.S. dollar being the two primary reserve currencies for the world, investors seeking refuge from European woes fled to the dollar. As you can see in the chart "10-Year U.S. Treasury Yields vs. Euro/U.S. Dollar Exchange Rate", this began to occur in the summer of 2008. This, in turn, led to large sums of money moving to U.S. Treasuries. As debt concerns heightened and the equity markets moved lower from mid April 2010 through late August 2010, interest rates saw a rapid decline. The 10-year Treasury fell from 4% to under 2.5%, nearly a 40% decline in yield. Since mid 2008, the euro/U.S. dollar relationship has acted like a leading indicator for interest rates in the United States.

In the fall of 2010, the Federal Reserve initiated a second round of quantitative easing with the purchase of

short to intermediate-term Treasury securities from the primary dealers. At first glance it would be expected that this artificial demand for Treasuries would drive interest rates lower, which in fact was Chairman Bernanke's stated objective. However, these purchases created an easy money environment which prompted investors to increase their exposure to risk assets. As a result, the fixed income market sold off in late 2010 and early 2011 as we witnessed yields on the 10-year Treasury jump from 2.4% to 3.6%. Much of the high quality fixed income gains, garnered during the Euro crisis, were given back.

Against the backdrop of continued global economic turmoil and the Federal Reserve's policy decisions, the health of corporate America was witnessing improving conditions. Non-financial corporate credit strengthened in 2010. This was due to both better operating performance and improved liquidity.

According to Standard & Poor's, margins were propped up by limited wage growth and strong cost control. There were 50% more credit upgrades than downgrades in 2010. This was a stark reversal from 2009, where credit downgrades were five times the number of upgrades. Many of the upgrades could be traced to the high-yield category as credit access for companies with speculative debt improved significantly. This trend was a direct result of the Fed's quantitative easing policies, as financial institutions balance sheets have been strengthened which has allowed for more speculative loans. As upgrades occurred, the ap-



Source: Baseline

Continued on page 9

# PRIVATE WEALTH ADVISORS

## U.S. Fixed Income

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petite for risk increased. Prices for high-yield bonds and floating-rate bank loans rose 15.2% and 10.2% respectively as cash continued to pour into those asset classes.

The inherent risk for these credit sensitive fixed income investments was also on the decline. Default rates peaked in the 3rd quarter of 2009 at 13.4% and have declined to under 3% today. The primary reason for this decline is the Fed's zero interest policy, which has allowed many distressed corporations to refinance debt and avoid default.

The environment in the fixed income market has changed dramatically through the financial crisis in 2008 and subsequent recovery over the last two years. Today, investors are faced with the following: historically low interest rates, an improved credit market and an increasingly uncertain global political and economic environment.

### Historically Low Interest Rates

In early fall 2011; the 10-Year Treasury was under 2%. We believe we are at a trough in the interest rate cycle. Interest rates have been kept artificially low for much of the recovery through Fed monetary policy and the dollar's role as a reserve currency. Yet, as the Fed muddled through its second round of quantitative easing, interest rates rose.

Given the basic investing tenet – as interest rates rise, bond prices fall – the low level of interest rates is a major threat to traditional bond prices. In order to combat this dynamic, we favor a fixed income portfolio with a low duration approach which limits the portfolio's sensitivity to rising rates.

One of the main strategies within this approach is an investment which acts as a hedge against rising interest rates. Specifically, adding short positions against the 30-year Treasury bond. As 30-year interest rates rise, the value of the short position rises with it.

Long-term interest rates are targeted since the short to intermediate end of the yield curve was the primary recipient of the Fed's first round of quantitative easing. The issues in Europe created enough fear to push investors back to Treasuries in mid 2010. The result was the 30-year Treasury yield falling to 3.5%. The long-term average yield on the 30-year UST has been 7.7%. The decline in yields throughout the summer of 2011 made holding an interest rate hedge difficult and the Fed's decision to lengthen the maturity of its balance sheet applied additional downward pressure on longer-term rates. Given the massive debt the U.S. government and the ongoing trade and budget deficits, history suggests rates will move back toward their historical mean, making the hedge profitable in the future.

### Improving Credit

In a low yielding fixed income environment, bond investors are faced with a dilemma: either buy long maturity bonds or take on credit risk. In the context of our total return strategy, we have chosen the latter. The collapse of the credit markets in 2008 presented a great opportunity to purchase credit sensitive assets at significantly depressed prices. Making the decision to add to this area of the bond market greatly benefited fixed income portfolios over the subsequent two years as prices recovered. Today the opportunity for substantial price appreciation has evaporated as spreads have compressed and valuations have returned to near historical norms.

However, we recommend exposure to both floating-rate bank notes and high-yield bonds. Both assets classes perform well in a rising interest rate environment. Floating-rate bonds reset their rate on a regular basis, greatly reducing interest rate risk. High-yield bonds pay a rate high enough to compensate investor for any duration risk associated with the securities. With default rates below 3% (and the potential to go even lower) the risk of default is not a great concern in the short-run.

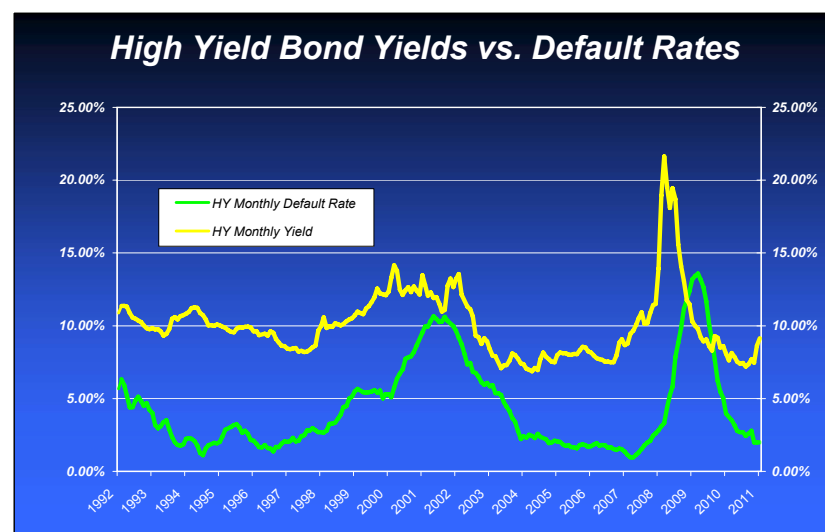
Although our near-term outlook for the credit markets remains positive, if the economy sours significantly going forward we could see spreads widen substantially and bond prices fall. The zero interest rate policy of the Fed has allowed for loose covenants in regards to refinancing and has enabled companies which would have faced default function on life support. Credit research and asset selection will be extremely important moving forward and these credit sensitive positions should only be a portion of an overall fixed income strategy.

### Uncertain Global Political and Economic Environment

In order to better diversify fixed income portfolios, we recommend a Global Macro strategy. This approach targets foreign sovereign debt and currencies. The strategy allows for either long or short positions, which dampens the overall risk to the portfolio. For example, at the height of the European crisis in 2010 investors who were short Greek debt profited from a downgrade and substantial rise in yield. Essentially, a Global Macro strategy is a top down approach to investing internationally. Rather than looking for specific company

debt, it looks at foreign economies from a fundamental perspective and the currency and arbitrage opportunities that may be associated with each.

The goal of this strategy is to diversify away from the United States, have zero correlation to the U.S. equity markets and have a position where reasonable principal protection is achieved without sacrificing yield. Over the past decade, the maximum drawdown on any twelve month period has been 2.75%. Since the global economies are highly fragmented, this strategy allows for exposure to foreign debt and currency markets without a major increase in risk. Given the increased frequency of political unrest throughout the world (most recently the Middle East) and the delicate nature of the global



HY Monthly Yield as reported in the Merrill Lynch US High Yield Index Source: Leuthold Group

economic recovery, this could be a strategy which takes on an increase role within our fixed income portfolios in the coming months.

These ideas, working in tandem, create a fixed income portfolio well equipped to handle the likelihood of rising interest rates in the coming years. Floating-rate and high-yield bonds use rate resets and above investment grade yields respectively to greatly reduce the effect of rising rates. The Global Macro strategy diversifies the bond portfolio outside the United States while taking little risk with regard to both credit and interest rates. The Treasury short position lowers the duration of the total portfolio and provides an asset which will directly capitalize on rising rates. While we have made the decision to accept more credit risk, we are being compensated in terms of incremental yield. These pieces help to create a fixed income portfolio positioned to work well in a rising interest rate environment. ●

# Key Factors for Asset Allocation Decisions

## ● Fixed Income / Equity

The allocation of your investment assets between equity and fixed income is largely dependent on three factors: cash flow needs, risk tolerance levels and current market forces. While the first two are client specific and also the primary drivers for overall allocation, market forces should not be ignored. The S&P 500 Index forward price/earnings ratio stood near 11.8 at the end of August 2011.

This level put stocks a good bit below their 15-year historical average of 17.1. Traditionally, buying stocks at these general levels has resulted in returns above the long-term average. While there are many risks to investing in equities in the short-term, the increasingly low yield environment in the Treasury market makes equities relatively attractive.

## ● Equity Allocation

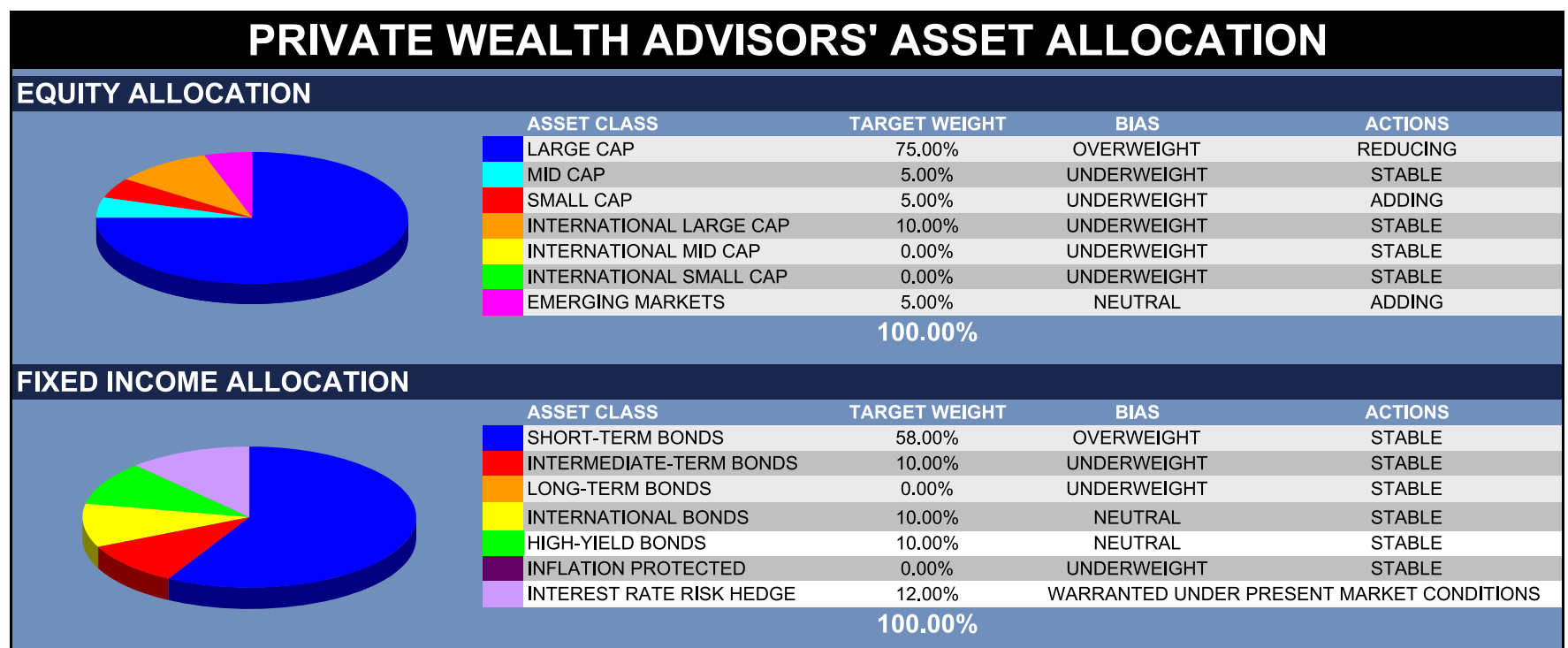
Our bias toward large companies versus small companies continues. Economic concerns are at the forefront with a series of poor reports in August. We continue to be more comfortable holding large, multinational companies with strong balance sheets going forward. Valuations, based on forward earnings, look attractive, but the economic recovery is very slow and the market will likely be choppy in the short-term. Through the first eight months of 2011, utilities is the best performing sector gaining over 10%. Health Care was the next best sector (up over 7%). We continue to favor the technology sector. These stocks have displayed

strong earnings in the recovery, continue to hold large cash positions, have global businesses with solid emerging market exposure and have started to increase acquisition activity. On top of all those factors, valuations for the sector are very attractive. We maintain our exposure to dividend producing stocks. Thus far, 2011 has been a strong year for defensive sectors of the market. These stocks should aid portfolios if the market continues to drift lower. We have added exposure to some risk assets, such as emerging markets, which became much more attractive after the 3rd quarter selloff.

## ● Fixed Income Allocation

Bond yields throughout the summer of 2011 as money moved back to Treasuries, putting them near record lows. The draw of Treasuries is surprising given the paltry yields, but the appetite for risk in the market remains very weak. Nonetheless, we believe Treasuries are particularly unattractive given their low yield and susceptibility to interest rate risk going forward. We continue to hold floating rate bank loans as a primary short-term fixed income vehicle. This asset class has stabilized after a difficult 2008 and a strong recovery in 2009 and 2010, and the floating-rate component of these assets essentially takes interest rate risk out of the equation. We have looked to further diversify bond portfolios with a low volatility, international fixed income strategy. High-yields are not overly attractive, but spreads over Treasuries widened significantly in August. The health of

corporate America bodes well for the short-term strength of credit sensitive vehicles. We recommend a long-term interest rate hedge position. Given the major deficits facing the U.S. government, it is our belief that rising interest rates and inflation are inevitable. This position will benefit fixed income portfolios as long-term interest rates move higher. The continued flow to Treasuries has continued to hamper our position, but we feel the long-term upside has not changed. Our preferred solution to the low rate environment is to commit a portion of a portfolio to real estate properties or limited partnerships owning a variety of properties. Real estate generates an income stream, often higher than today's low bond yields. In addition, properties have a higher likelihood of appreciating over time versus other fixed income investments, thus adding to a portfolio's total return.



Changes are made to our portfolios throughout the year but not discussed in print until the next issue is released. Managing a portfolio purely based on changes printed herein will not accurately reflect the tactical decisions made within Private Wealth Advisor's portfolios. This information is not intended to be used in trading or managing your investments. There are risks associated with investing, including the possible loss of principal. Investing involves various risks such as currency, political and economic. Investments focusing on a single category, sector or asset class may experience greater price volatility. Investment categories such as emerging markets, real estate, currency, fixed income and equity investments include additional risks, many of which have not been discussed here. Please review investment prospectuses and disclosure documents for discussion of risks before investing.

# PRIVATE WEALTH ADVISORS

## *Who We Are - What We Do*

### ● *Tactical Asset Allocation Portfolio Management*

Our proprietary modeling strategy is used to determine opportunities in various asset categories globally. Asset allocation decisions are formulated by our Investment Committee using a long term relative valuation matrix.

*The strategy has two primary goals:*

- Reduction of risk by minimizing exposure to expensive segments of the market.
- Improved portfolio returns by investing in undervalued segments of the market, using both passive and active management to execute these strategies.

### ● *Individual Managed Stock Portfolios*

The S&P 500 Index is used as the benchmark for investing in individual stocks for our clients. We rank sectors top to bottom using technical indicators and fundamental analysis.

Once our Investment Committee chooses the sector allocation for the portfolios, our team of research analysts populate each sector to our desired weightings using individual stocks and sector/industry indexes.

### ● *Individual Bond Portfolios*

Private Wealth Advisors uses an array of fixed income opportunities when designing our bond portfolios for clients. We balance interest rate risk and credit (default risk) for our clients by using available fixed income instruments. An example portfolio might consist of individual municipals and corporate bonds, closed end mutual funds, index funds and actively managed open end mutual funds.

### ● *Real Estate Portfolio*

The professionals of PWA Real Estate, an affiliate company formed in 2007 in order to provide further diversification for clients whose portfolios have historically have been a mix of stocks, bonds, and cash, seek opportunities to build diversified property portfolios for our clients. Real estate is acquired with the goal of providing high current income, along with tax benefits for our clients.

Please see [www.pwarealty.com](http://www.pwarealty.com) for more details.

### ● *Alternative Investments*

In addition to real estate, Private Wealth Advisors employs a variety of alternative investment vehicles appropriate for a client's risk tolerance, investment goals and investment experience, e.g., oil and gas limited partnerships and long/short portfolios. Our goal is to provide competitive returns while managing overall portfolio risk.

### ● *Coordinated Financial Advice*

Our principals have a combined 70 years of experience in counseling clients in virtually all areas of personal finance including:

Estate and Trust Planning  
Retirement/Elder Care Planning  
Income Tax Planning  
Business Succession Planning  
Employee Benefit Planning  
Philanthropic Planning

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