J.J. BURNS & COMPANY, LLC

3rd Quarter Newsletter, October 2012

THE SECRET IS IN THE DIRT

Ben Hogan was generally considered one of the greatest golfers in the history of the game. He was known for his profound influence on the theory of the golf swing. To this day he remains renowned for his ball striking ability and his rhythmic swing. In 1946, Hogan coined the term "The secret is in the dirt," from figuring out how to prevent hooking the golf ball (right to left). After 11 months of grueling practice sessions, led by passion and determination, the "secret" was born. Hogan could produce a successful, flawless swing eliminating the hook. He went on to win countless tournaments in his lifetime.

It is my goal through the writing of this quarter's newsletter to share these similar insights by digging into the data of the real economy. The insights provided assist our team in formulating portfolio management structure, and moreover, help to inform and educate you, our client.

THE JOBS REPORT

Last week The US Bureau of Labor Statistics (BLS) reported a big drop in the unemployment rate from 8.1% to 7.8%. The US economy created only 114,000 new jobs last month, while the unemployment rate decreased to 7.8%. This is the first time unemployment has been below 8% in 45 months. However, at the same time The BLS reported contradictory data as the total employment level increased despite the low new jobs number. How does this work and why the discrepancy?

Basically, the surveys are conducted by qualified individuals calling on a sampling of the American population. For example, current employment statistics are based on a survey of approximately 141,000 businesses and government agencies representing approximately 486,000 worksites throughout the United States. Hours, earnings and monthly job estimates are tallied for the states and major metropolitan areas. For the household sampling, which measures how many people in a household are employed, The BLS calls on approximately 60,000 households. Again the numbers are tallied on how many people in a household are employed. There is no discrimination of part time workers as they are counted as employed with this specific report.

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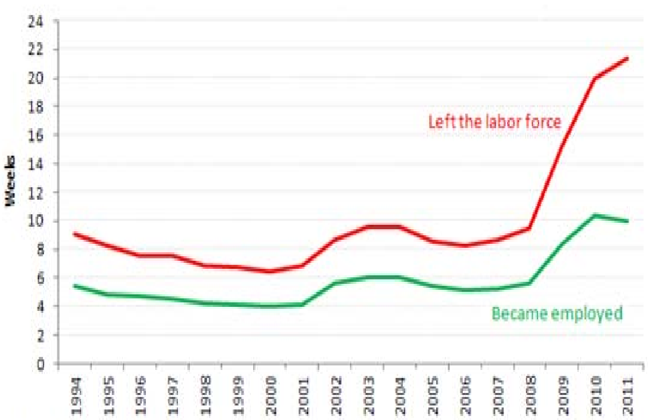
The notoriously volatile household survey report showed 873,000 more jobs and 418,000 more Americans are now in the labor force.

On the face, this data suggests we may have turned the corner on jobs and the economy, whereas more Americans are getting back to work. In July this survey showed a 195,000 slide and an August decline of 119,000. In August, 26 states reported an increase in their unemployment figures and now in September was a massive surge of 873,000 jobs. This data suggests we were in virtual recession in July and August, but today we have miraculously boomed to the strongest rate of employment seen since January 1983, when President Reagan was in office. In September, 2.5 million persons were marginally attached to the labor force, essentially unchanged from a year ago. These individuals were not in the labor force, wanted and were available to work, and had looked for a job sometime in the prior 12 months. They were not counted as unemployed because they had not searched for work in the 4 weeks preceding the survey.

Median number of weeks of unemployment for persons who became employed or left the labor force, 1994-2011 annual averages



Source: U.S. Bureau of Labor Statistics

The unemployment number that is most often used by the government and the media is known as the "U-3" number. This is the number, which declined from 8.1% to 7.8% unemployment in September. Let's dig in a little more. According to the BLS the U-6 unemployment rate was unchanged in September at 14.7%, while the "official" unemployment rate dropped from 8.1% to 7.8%. The U-6 unemployment rate counts two more groups of people as "unemployed" or "under-employed," whereas the official U-3 rate does not.

The U-6 unemployment rate includes the following:

- People who are employed part time but wish to have full time work.

- People who are "marginally attached" to the workforce. These are people who are not currently looking for work but want a job and are available for a job and have looked for work sometime in the past 12 months.

If an individual is seeking full time employment but cannot find full time work, he may resort to a part time job working 15 hours/week. He would be counted as being employed in the official rate calculation. Furthermore, if he gave up trying to find a job because the labor market is unyielding of employment, then he would not be counted as being "unemployed" in the official unemployment numbers.

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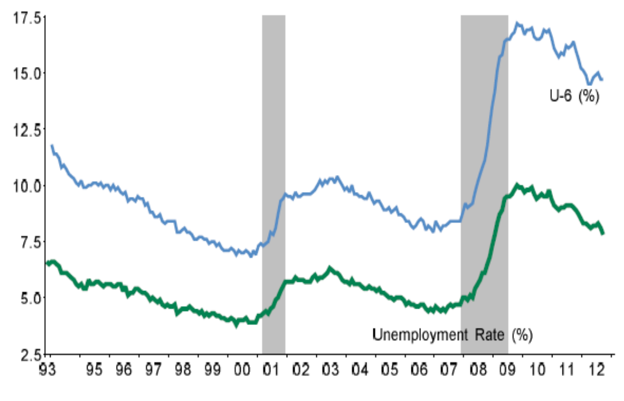
If more than 600,000 people threw in the towel last month and took temporary part time work for the upcoming holiday season as well as temporary government jobs, which much of this data represents, you have more people employed. The U-6 unemployment rate, which is a broader measure of unemployment and under-employment, remained stubbornly unchanged at 14.7%. The U-6 data is more representative of labor utilization.



Source: Reuters EcoWin Pro

REAL WORLD OBSERVATIONS

Over the last several months I have travelled throughout the United States. From the west coast to midatlantic region, mid-west as well as northeast and the deep south. The two big takeaways for me were that high unemployment rates plague most of the country, and drought conditions are being felt at the farming level and will likely impact the entire country next year. Unemployment rates in Oregon, Florida, Connecticut, New York, Georgia, North Carolina average 9% unemployment. California (10.6%), Rhode Island (10.7%), Nevada (12.1%).

It's surprising how little is reported in the media about the drought. Corn is a main ingredient in many food items as well as ethanol and feed for livestock. Ethanol represents some 40% of gasoline production, and nearly 50% is feed for livestock. Expect higher meat prices, especially beef and pork (which adds to the inflation component). The implications are economically significant. As an example, a bale of hay typically costs $10 to produce. With drought conditions today, the same hay costs $60. A farmer will be required to purchase the bundled hay and ship to where it is needed from more remote locations. Raw materials costs for food preparation have doubled and tripled in some cases, yet the producers have been reluctant to increase food costs for the end consumer. This is at a tipping point. Certainly a few trips around several states in our nation does not make for a proper economic analysis alone, however armed with data and current trend analysis, it allows us to be better informed and well prepared to ask appropriate questions to business leaders as well as portfolio managers.

Taking an even broader look around the globe, debt balances by many developed economies have increased from $80 trillion to over $200 trillion (governments, businesses, and households). On average debt is increasing at 11% whereas population growth is approximately 1.5%. Gross domestic product, which is the goods and services an economy produces in a given year is averaging 3.8%, and declining. The below graph shows the divergence as government expenditures are outpacing revenues. Both remain well outside historical norms.

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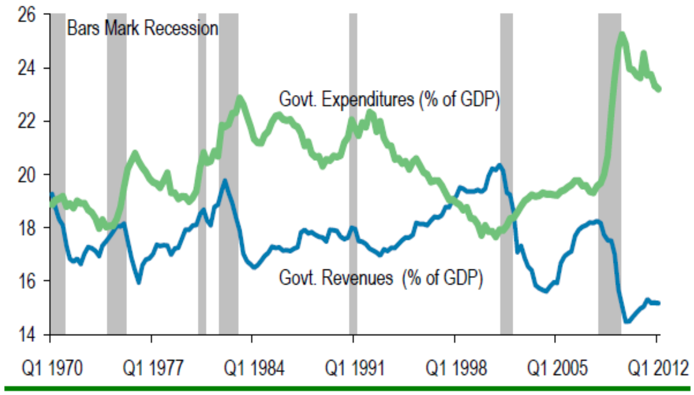
Revenues vs. Expenditures (% GDP)



Source: Reuters EcoWin Pro

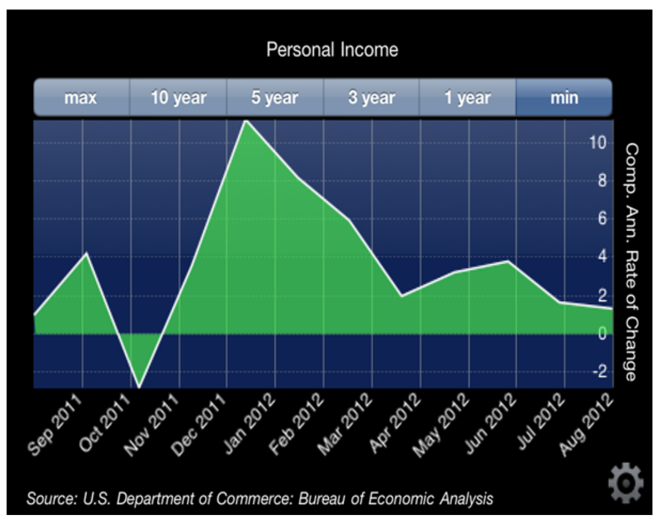
Developed world economies are utilizing infinite monetary leverage and today most central banks have an open-ended printing press to create paper money. One does not have to look far to see the potentially damaging effects of deflation. The Japanese economy has remained in this cycle for over 20 years. This is the largest peacetime debt accumulation we have ever had in economic history. In war, we typically spent and accumulated debt. At the end of war, the losers remained in debt and the spoils of war went to the winner. Jobs were created, gross domestic product grew, payrolls increased and we paid off our debt utilizing appropriate levels of credit.

Today, especially in The US, the first few trillion dollars that world governments "printed" went to make up for the financial hole created by all the private debt leveraged prior to the bursting of the real estate bubble. It also prevented a real depression from beginning by creating the liquidity necessary for the banks and the real economy to function. (This needed to be done.) It's equally important to understand we went into this crisis with a highly leveraged amount of debt.

This represents a secular change in the economy. This is no "garden variety" slowdown or temporary employment decline. This is a major shift and monetary policy alone cannot resolve the issue.

GLOBAL ECONOMIC SHIELD

We have created a global monetary shield, which protects risk assets, especially stocks. Monetary easing has a significant impact on the real economy. The effects are supposed to be improved aggregate demand, which would expand more jobs and capital spending, so the consumer would be able to comfortably spend on goods and services. The Federal Reserve is hoping once again to stimulate the economy with a wealth effect. Personal spending declined .3% in August. This was the largest setback of the year. The personal savings rate is likely too low to kick start the consumer into a spending mode, as it stands at 3.7%. In fact many consumers who are spending, do so forsaking current personal savings.



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The pace of economic activity is weakening. Profits are faltering and wage earnings are slowing down. GDP has declined to a real 1.7% annual rate. This was the weakest performance since the third quarter of 2009. Income is what drives expansions. Income drives confidence, spending and prosperity. The Wall Street Journal recently reported student loan default since October 2009 has increased by 9%. This is double what it was five years ago. The government estimates 20% of students who took on student credit will likely end up defaulting.

There have been over 270 stimulative policy initiatives announced around the world over the past year. The Bank of Australia and Bank of Japan are ready to ease again. Nothing central banks have done to date has increased earnings expectations.

Below is a summary of the Downside Risks

- Uncertainly surrounding Eurozone economies.
- Slow down in manufacturing – globally
- Chinese Slowdown – indications may show far worse than initial assessments
- Earning in 3rd quarter and beyond look challenging.
- Uncertainty surrounding Fiscal Cliff, tax policies, spending cuts, etc

The Financial Times recently ran this story – "Economic Recovery on the Ropes." The Brookings Institute FT global recovery index is slipping even with equity markets in most parts of the world being pushed higher by central bank asset price manipulation. This by the way is the answer to why equity markets, especially the S&P 500 index, are rising. It is not because earnings are on fire. The International Monetary Fund (IMF) reduced its 2012 world GDP forecast to 3.3% from 3.4%. This reduction is dramatic given the stimulative measures happening in the world economy.

Their statement was:

"The recovery has suffered new setbacks, and uncertainly weighs on the outlook. Downside risks have increased and are considerable."

<u>THE HOUSING BOOM</u>

The reason why the massive housing boom had such a positive impact on spending in the last economic cycle of the economy was primarily because financial innovation allowed households to tap their home equity. Certainly lack of regulation helped this, however, the engineered financial tools allowed the average person to utilize all the borrowed cash to purchase boats, cars, and vacation homes. This flood of cash flow created the abundance of spending not seen by many previous generations. It's no wonder why we have many older clients who typically recognize and comment on the differences in spending habits from a younger generation.

The most powerful and enduring cash flow is that which comes from personal income. Furthermore, the most significant part of personal income is that which comes from wages and salaries. Manipulating market pricing and flooding the economy with steroid-induced easing from the Fed (aka: QE3) generates more asset bubbles.

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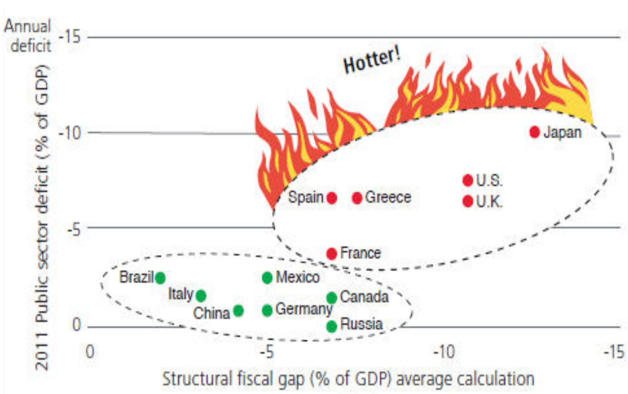
Finally, I felt the below missive is important to understand. It is written by one of our managers, Bill Gross, Founder & CIO, Pimco, who is the largest bond manager in the world:

“As one of the “Ring” leaders, America’s abusive tendencies can be described in more ways than an 11% fiscal gap and a $1.6 trillion current dollar hole which needs to be filled. It’s well publicized that the U.S. has $16 trillion of outstanding debt, but its future liabilities in terms of Social Security, Medicare, and Medicaid are less tangible and therefore more difficult to comprehend. Suppose, though, that when paying payroll or income taxes for any of the above benefits, American citizens were issued a bond that they could cash in when required to pay those future bills. The bond would be worth more than the taxes paid because the benefits are increasing faster than inflation. The fact is that those bonds today would total nearly $60 trillion, a disparity that is four times our publicized number of outstanding debt. We owe, in other words, not only $16 trillion in outstanding, Treasury bonds and bills, but $60 trillion more. In my example, it just so happens that the $60 trillion comes not in the form of promises to pay bonds or bills at maturity, but the present value of future Social Security benefits, Medicaid expenses and expected costs for Medicare. Altogether, that’s a whopping total of 500% of GDP, dear reader, and I’m not making it up. Kindly consult the IMF and the CBO for verification. Kindly wonder, as well, how we’re going to get out of this mess.”



Source: IMF, BIS, CBO, PIMCO. As of July 2012.

STOCK MARKET, EARNINGS & ALLOCATIONS

S&P 500 and Weighted Indices

Looking at earnings of the companies which comprise the S&P 500 leaves little to be excited about as a whole. A handful of technology stocks comprise one-third of the market value of the top 25 names in the S&P 500 Index. The market is driven by these top 25 names. They comprise nearly 40 Percent of the S&P 500 Index’s valuation. Technology, counts up to one third of the top 25’s valuation. This leaves little room for diversification if you are an index investor in weighted averages. We believe in broad asset class diversification and as such do not see the prudence in weighted average investing. Having more “equal” weightings of the components in the indices over a 5 year period would have yielded far better portfolio performance (some 2% better than the S&P 500 weighted index). Removing Apple from the index yields earnings growth of the S&P 500 nearly zero for the 1st quarter of 2012 and only 1%-2% of recent. A colleague at UBS recently said, “if you strip away one single company from the index, it’s like seeing light through a prism.”

WHERE WE LOOK TO INVEST

Cash Flow Is King

The data and comments I shared with you above may likely send a message of more conservatism and asset protection than before, which tends to make our human nature feel worried, like it’s “time to run for the hills.” There are many opportunities within the global

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markets once a path has been mapped out. Having a clear understanding of where we have been and the type of medicine being applied helps to chart the most appropriate course with confidence in moving forward. We have made solid progress and expect nothing less moving forward with continued fine tuning.

As conservative as we have been especially towards the stock (equity) markets, we have never advocated that cash should be considered a substantial asset class. Cash may provide the opportunity to preserve capital, but it earns 0%. In fact factoring inflation you actually lose purchasing power. In a 0% interest rate world notwithstanding all the uncertainties across financial, economic and geopolitical concerns, cash is not king. Cash "flow" is king.

A range of outcomes can happen in a post asset-bubble world. (i.e., stock prices rising today on the back of recession risks escalating) This creates a need for more diversification in portfolio management, not less. It's important to be flexible on the back drop of interest rates remaining at 0% for an indefinite period of time. Diversified allocations supported by a backdrop of dividends, interest and cash flows are keys to weathering the storm.

Asset Allocations

1. We are and have continued to seek relatively secure sources of income for cash flow generation – Residential vacancy rates edging down by only 4.5% and rental growth steady at roughly 1% per quarter still represent opportunities. In commercial or more specifically high end retail space, healthcare and consumer non-cyclical areas, real estate investment trusts and bonds have steadily had income flows from 2%-6%

2. Intermediate investment grade corporate bonds typically of large corporate institutions in more defensive sectors of the economy have generated returns averaging 6%. Given the strength in corporate balance sheets this is perfectly reasonable.

3. Short-term high yield corporate bonds, with current default rates less than 3% (significantly small), are perfectly reasonable and provide significant cash flows. Bonds at a reasonable price in the high yield arena have typically provided 80% or more of the return of the more risky equity markets with no definitive income as substantial as the cash flow from these bonds.

4. Dividends and the growth of dividends on stocks which have little debt represented on their balance sheet. Additionally, these companies continue to have the capacity to grow dividend streams. This includes large-cap US technology companies where growth in dividends has been solid.

5. Energy Delivery: Through ownership of pipelines for the shipment of gases and oil. These vehicles provide steady and predictable cash flows ranging from 6%-7% income. Favorable tax and inflation hedges.

6. Emerging Markets (EM): These markets are among the least expensive in the world. Governments have the flexibility as well as liquidity in their currency to utilize their own respective central bank intervention. Many are learning what not to do by looking at

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developed economies. EM countries comparatively have strong national balance sheets, and many have excellent demographic backdrops. I speak more from the sovereign debt side of these countries as their debt to GDP rations are far less then America and developed nations. Higher quality EM bonds collectively are earning 5%-6%. Emerging markets also offer other opportunities in diversification to their local currency – an additional benefit as the dollar continues to weaken relative to other currencies.

7. With the Fed taking interest rates into a deeper negative territory, there is a timeworn inverse relationship between yields and the price of gold. We remain positive on commodities, especially gold and gold mining companies which we have recovered from their slide in the second quarter.

Digging into the gritty details is critical so we may have a clearer understanding of the world economy. This allows us to properly design asset allocations in each client portfolio. What is vitally important to portfolio management is relative weightings to asset classes, i.e., stocks, bonds, real estate, commodities, alternatives, etc. In popular finance media, this gets little attention. Yet in all academic studies it shows this to be one of the most important decisions an investor makes. It's far more important than stock selection for example, yet "owning the hot stock" is all anyone tends to speak about.

We will continue to be diligent in our process to thoughtfully rebalance your portfolio based on written targets within your plan. Should you have any questions on any financial matter, please don't hesitate to call.

ANNOUNCEMENT

Please welcome our newest team member, Jessica Evans. As Manager of Client Services, Jessica's duties will include regular communication to our clients and administrative activities. A graduate of the University of Maryland, with ten years of experience in e-commerce, Jessica will also be leading our initiative to rebuild our website. Please join me in welcoming her to our team at JJ Burns & Co.

It's a beautiful time of year as we bear witness to the change of seasons from summer to fall. It reminds me, that we live in a world of constant change.

Respectfully and Warmest Regards,

JJ

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