NOTTINGHILL INVESTMENT ADVISERS, Ltd.

**An Update** **Vol. XV No. 4** **November 2012**

## Recent News

***Stealth Bull Market.*** *It's been said that bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. Optimism? Euphoria? Hardly. Instead, we're probably somewhere between pessimism and skepticism, and yet, U.S. common stock prices in the least-noticed major advance in decades have more than doubled off the market low of March 2009. QIII 2012 another 5-6%, and there almost certainly is more to come for a variety of entirely quantifiable reasons. Value equities deserve the emphasis in a well-diversified portfolio structure.*

***Fiscal Cliff.*** *But, there always are actual and possible bumps in the road, and how and how well this looming issue is confronted are important. We have a few thoughts, which are on page 2.*

***Gold.*** *Good diversifier with solid prospects in a world trying to inflate its way back to prosperity. We regard the barbarous relic as the indispensable third leg of the portfolio stool, and provide you with the facts, figures, and reasoning on pages 3 and 4.*

***ADV.*** *Part 2, a formal summary of our business practices, ownership, etc., recently has undergone a fairly extensive re-write. A copy of the current version is available by request.*

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## ABOUT THE FIRM

Nottinghill Investment Advisers, Ltd., is a team of professionals specializing in the disciplined management of large capitalization Value equity portfolios and widely diversified equity and balanced portfolios. Clients served include pension and profit-sharing plans, endowment funds and foundations, and taxable individuals.

## THE FLAGSHIP STRATEGY
## Value Plus

Our flagship Large Capitalization Value approach. Portfolios typically contain 20 stocks, 15 of which are selected on the basis of traditional Value criteria and five of which are selected on the basis of superior corporate and stock-price performance. This use of multiple sets of buy/sell disciplines results in a more consistent pattern of superior investment returns.

## Investment Results

| | | | End of the Period | | | | |
|---|---|---|---|---|---|---|---|
| | Value Plus (%) | Russell 1000 Value Index (%) | Firm Assets ($/mm) | Composite Portfolios (#) | Composite Assets ($/mm) | % of Firm Assets (%) | Annual Composite Dispersion (%) |
| 1997 | **26.03** | 35.18 | 15.1 | 8 | 5.2 | 34 | 0.32 |
| 1998 | **18.26** | 15.63 | 23.4 | 9 | 6.8 | 29 | 1.42 |
| 1999 | **14.97** | 7.35 | 31.7 | 10 | 9.8 | 31 | 0.53 |
| 2000 | **5.09** | 7.02 | 27.0 | 12 | 12.5 | 46 | 1.02 |
| 2001 | **0.29** | -5.60 | 31.5 | 13 | 13.5 | 43 | 0.75 |
| 2002 | **-17.17** | -15.52 | 36.1 | 15 | 17.9 | 50 | 0.46 |
| 2003 | **37.22** | 30.03 | 57.7 | 16 | 22.5 | 39 | 1.03 |
| 2004 | **18.44** | 16.50 | 70.8 | 20 | 26.7 | 38 | 0.62 |
| 2005 | **11.10** | 7.05 | 123.1 | 37 | 72.1 | 59 | 0.88 |
| 2006 | **18.23** | 22.23 | 162.3 | 40 | 97.8 | 60 | 0.79 |
| 2007 | **-6.38** | -0.17 | 162.5 | 64 | 103.3 | 64 | 0.48 |
| 2008 | **-37.10** | -36.86 | 88.0 | 59 | 63.0 | 72 | 0.99 |
| 2009 | **40.66** | 19.70 | 107.6 | 53 | 77.4 | 72 | 1.36 |
| 2010 | **13.44** | 15.51 | 80.5 | 50 | 50.4 | 63 | 1.76 |
| 2011 | **-1.79** | 0.39 | 53.7 | 37 | 37.0 | 69 | 0.95 |
| 2012 QI-QIII | **12.50** | 15.75 | 52.6 | 21 | 35.7 | 68 | -- |
| **Annualized** | | | | | | | |
| Life of the Strategy | **7.90** | 6.93 | | | | | |
| 10 Years | **8.58** | 8.17 | | | | | |
| Five Years | **-0.48** | -0.90 | | | | | |
| Three Years | **11.25** | 11.84 | | | | | |

*Nottinghill results are presented net-of-the management fee; all annualized returns are associated with time periods ending September 30, 2012*

Nottinghill Investment Advisers, Ltd., has prepared and presented this report in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS™) for the period from July 1, 1996 to December 31, 2005 and the Global Investment Performance Standards (GIPS®) beginning in 2006. No regulatory or governing body has been involved in the preparation or review of this report.

1. Nottinghill Investment Advisers, Ltd., ("Firm") is an independent, registered investment adviser utilizing a number of primarily large capitalization equity investment strategies. Berge & Company, Ltd. and BKD,LLP, Certified Public Accountants in each case, completed Firm-wide Verifications of Nottinghill's compliance with the AIMR-PPS™ for, respectively, the 1996-2001 and 2002-2005 periods. The Verifications associated with years after 2005 also were completed by BKD, LLP, and tested Nottinghill's compliance with the aforementioned Global Investment Performance Standards (GIPS®). Verifications are conducted annually; a copy of the most recent report is available by request.

2. The Value Plus performance composite (Composite A: all non-wrap fee accounts and those with a fixed annual broker charge less than 0.25% of assets), formerly Growth & Value 20 Composite A, officially was created on January 1, 2002; however, the composite as currently defined has an effective date of compliance with the AIMR-PPS™ of January 1, 1997. Berge & Company, Ltd. and BKD, LLP, Certified Public Accountants in each case, completed Performance Examinations of the investment results presented for, respectively, the 1997-2001 and 2002-2010 periods.

3. No segments of other portfolio composites and no accounts with a fixed annual broker charge are included in the Value Plus composite.

4. The most appropriate benchmarks for the Value Plus strategy are the style-specific Russell 1000 Value Index and the more broadly representative S&P 500 Index. Both are unmanaged, capitalization-weighted, and consist of primarily U.S. corporations. Index performance in both cases includes price change and income, however, neither index has any expenses. The S&P 500 Index was the sole benchmark prior to January 1, 2010.

5. Investment results include the reinvestment of dividends, and have been calculated net-of–the management fee, which was deducted from the results achieved by every account in the composite. The annual fee schedule is 1.0% of the first $1 million, 0.75% of the next $4 million, and 0.50% of remaining assets.

6. Investment results calculated net-of-the management fee are appropriate for presentation or redistribution in all settings, but must be accompanied by this disclosure language.

7. All performance calculations are based upon trade-date accounting, and, except where otherwise noted, are associated with time periods ending December 31.

8. Performance is expressed in U.S. Dollars.

9. Annual composite dispersion is the asset-weighted standard deviation of gross investment returns.

10. Exchange-Traded Fund shares may be utilized in this strategy from time to time. No other derivatives and no leverage are employed.

11. Past performance is no guarantee of future results.

12. A complete list of Nottinghill performance composites and additional information regarding the calculation and reporting of Nottinghill performance are available upon request.

# Cliff-hanger

"A billion here, a billion there, and pretty soon you're talking about real money."

"I am a man of fixed and unbending principles, the first of which is to be flexible at all times."

*--Everett Dirksen*

The so-called fiscal cliff has been getting a lot of attention over the past few months. Now that the election is behind us, we have an ever-so-slightly better idea of what lies ahead. Here are some background and a few thoughts.

What is the fiscal cliff? The term refers to the whole collection of tax increases and federal spending cuts set to go into effect at midnight on December 31, 2012. The specific legislation is something called the Budget Control Act of 2011, which broke the impasse during last year's debt ceiling negotiations and allowed all concerned to kick the can down the road, as they say. Well, the can once again is underfoot, and, in the absence of compromise, we are talking about a fairly draconian solution to the problem of runaway budget deficits at the federal level.

Please believe us, the problem is a serious one that <u>does</u> require a long-term solution. But, the suddenness and scale of this impending "solution" entail a few risks to the economy and, therefore, the capital markets. How so? Let's go over the Act's most important aspects.

**Taxes**

> The so-called Bush tax cuts will expire. The lowest income tax bracket goes from 10% to 15%; each of the three middle brackets is increased by three full percentage points; the highest bracket goes from 35% to 39.6%. On the investment front, the long-term capital gain rate, certainly one of <u>the</u> key variables in all of Capitalism, goes from 15% to 20%, and dividends are taxed as ordinary income (see above), rather than at the capital gain rate.
>
> Regarding gift and estate taxes, the current $5 million exclusion and maximum tax rate of 35% revert to the $1 million and 55% that characterized the confiscatory days of old.

**Spending**

> Here, a Super Committee was charged with finding $1.2 trillion (yes, that is a "t") in savings, and failed to do so. Therefore, we now are talking about automatic spending cuts spread evenly between the defense and non-defense sectors of the federal budget. In addition, emergency unemployment benefits no longer will be paid, and Medicare physician reimbursements are to be cut.

And, if the above were not bad enough, the so-called payroll tax holiday, during which Social Security taxes withheld from pay checks went from 6.2% to 4.2%, also will come to an end. Then, we have the new healthcare levies, which require those in upper brackets to pay an increased health insurance tax and can add another 3.8 full percentage points to the tax on investment income.

Everett Dirksen's famous quote about real money comes immediately to mind. The fiscal cliff <u>does</u> involve real money. Citi Research estimates that a full enactment of the above and other fiscal cliff features in the fine print would result in an $800 billion reduction of the Calendar 2013 federal deficit. Great, <u>but</u> that also is $800 billion yanked out of the private sector, with all that that portends for capital spending, hiring, consumer spending, and in general, a still-mending domestic economy. The accepted wisdom, therefore, is that wiser heads will prevail, prior to early-2013. We say "early-2013" because December 31 is not actually a no-turning-back, drop-dead date - any congressional compromises can be applied retroactively. Nevertheless - and this is a big "nevertheless" - there are headwinds, and a general absence of the Dirksen brand of negotiating flexibility is chief among them. In other words, the art of the compromise has become something of a lost art even though no one wants to see a recovering private sector take an $800 billion hit.

But, the operative word is "Draconian," with a capital "D," so we'll end up siding with the consensus on this one. With Mr. Obama's blessing, what we probably will get, at least over the short run (2013-2014), is a little bit of this and a little bit of that. Despite reams of data and a great deal of historic evidence, a so-called "growth" agenda capable of washing away most of our fiscal sins and featuring an actual <u>lowering</u> of taxes probably is not in the cards. Neither is business-as-usual on the spending front, and frankly, that's not such a bad thing, although the defense budget in an increasingly dangerous world does not strike us as the best place to start cutting. In fact, taxes probably will go up somewhat, spending probably will go down somewhat, and there will be some progress made on the federal deficit.

"Muddle through" has become a popular phrase, but that may be a little harsh in this case. Focusing only on the stock market, we actually are more optimistic than that because the short-term dangers associated with the fiscal cliff and the long-term dangers associated with ever-expanding deficits are so well-recognized. History teaches that stock market problems rarely stem from what is generally known. Instead, they usually stem from what Will Rogers called "what we know that ain't so." <u>And</u>, there also is the question of valuation and sentiment. As we have said many times in recent months and years, stock market valuations are not excessive, either in an absolute sense or for sure relative to the alternatives; <u>and</u>, stock market apathy remains palpable, despite a doubling of stock prices off the March 2009 market low. We'll take low-price apathy over high-price euphoria anytime.

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That is where the situation and we stand in late-2012. We believe that the problems associated with the looming fiscal cliff are well recognized and that, (almost) irrespective of the recent election results, will not be allowed to wreak sudden havoc on the private sector. We believe instead that our structural problems, serious though they may be, will be confronted in a more orderly manner and that the economy, particularly housing and manufacturing, will continue to recover at a steady pace. And finally, we believe that stocks are attractive from a valuation standpoint and will continue to provide very good total rates of return in this environment.

Now, what about gold in this environment?

# The Barbarous Relic

The Total Portfolio Management (TPM) portfolios we manage are three-legged stools. Three points determine a plane - three legs signify stability. The first and most important TPM leg is U.S. and Emerging Markets International equities. The second leg is fixed income securities in the form of three actively managed, specialty mutual funds and an intermediate Treasury ladder. And finally, the third leg is gold. This is about the all-important third leg.

Humankind has had a fascination with and a reverence for the barbarous relic from about the time our ancestors determined that rubbing two sticks together could make a fire. Since then, gold has been used to adorn ears, necks, wrists, ankles, clothing, etc.; gold has been used to cap teeth; gold has been used in numerous industrial processes; gold has been used to treat disease; <u>and</u>, gold in an investment sense has been used as an alternative to fiat currencies and as a store of value.

**Gold in the Modern Monetary/Investment World - A (Very) Brief History**

Sure, in the pursuit of gold, chariots, wagons, and tanks have rolled on land, and ships have plied the seven seas for centuries; but, for these purposes, let's focus on gold in the monetary/investment world of the modern era, and start with something called Executive Order 6102.

The year was 1933, and the Great Depression was raging. More than one economist, along with FDR and many others in Washington, believed that gold was being hoarded, thereby stalling growth and prolonging the cataclysm. The solution: Executive Order 6102, which called upon U.S. citizens to deliver on or before May 1 all but a small amount of their gold coins, bullion, and certificates in exchange for $20.67 per troy ounce. Of course, jewelers, dentists, et al. were exempted, however, the Order clearly freed up a lot of the public's long-held stash. One big problem was that Treasury gold for international transactions subsequently was raised to $35 per ounce, so all of those law-abiding citizens who had surrendered their gold suffered an immediate loss of over $14 per ounce. Then, along came the Gold Reserve Act of 1934, which, among other things, changed everybody's official exchange rate to $35. That's where it stayed until the so-called Nixon Shock when things really started to unravel.

The Nixon Shock of August 15, 1971, was a major policy enactment in response to 1970's 6% inflation rate, a worsening trade balance with our partners, and an accelerating demand for Treasury gold in exchange for overseas dollars. Wage and price controls, the economics equivalent of leeches as a cure for disease, were slapped on the American economy for 90 days, and, right out of the Smoot-Hawley playbook, a 10% surcharge was levied on all imports. And third, the gold window was closed, thereby ending the convertibility of overseas dollars into gold. The latter, of course, ended anything like a fixed value for gold, and subsequently, Gerald Ford signed mid-70s legislation legalizing gold's ownership as of December 31, 1974. By then, of course, the real market price was far above $35 per ounce. In fact, the Engelhard industrial bullion quote of that date was $182. Still, gold went on to enjoy a very prosperous five-year run as this now-freely traded asset reached $512.40 on December 31, 1979.

**Catch up time in the 70s, but really, how has gold done over time?**

Take a look at Figure 1. The Hallelujah 70s were followed by, as we in the investment business say, "sub-par results" in both an absolute sense and, for sure, relative to both U.S. common stocks and a long-dated Treasury bond. Why? Well, according to all the learned treatises, nothing stirs up the price of gold quite like economic calamity and particularly inflation, and there was no economic calamity or inflation during the healthy Reagan/Bush/Clinton growth years. But, what about the 00s? They hardly prove the reverse. Gold had a very good decade, but once again for openers, there was no inflation. Economic calamity? There was the early-decade tech bubble and aftermath, however, even factoring in the September 11 tragedy, "economic calamity" may be a stretch. 2008-2009? That qualifies, but gold's reputation as a safe haven toward which everyone runs during such times is <u>not</u> supported by the 2008-2009 facts. More specifically, gold was essentially flat over the period of maximum nail-biting, say, mid-2008 until March 2009. That's a lot better than the equity market did, but no, all the running was in the direction of another market...the Treasury market.

*Figure 1*

**Asset Class Rates of Return 1975-2009**

| | Annualized Rate of Return | | |
|---|---|---|---|
| | **Gold*** | **S&P 500 Index** | **20-Year Treasury Bond** |
| 1975 - 1979 | **23.00%** | 14.82% | 4.33 % |
| 1980 - 1989 | **-2.36** | 17.55 | 12.62 |
| 1990 - 1999 | **-3.20** | 18.21 | 8.79 |
| 2000 - 2009 | **14.49** | -0.95 | 8.46 |
| 1975 - 2009 | **5.35** | 11.74 | 9.12 |

**Engelhard industrial bullion*

So, where does that leave us? Despite an inability to prove the opposite (the 00s), there's a fair amount of centuries-old evidence supporting the proposition that accelerating inflation and/or economic calamity in general (and a weak dollar caused by one or the other) support a rising gold price.

Combining the catch up 70s with the decidedly ho hum 80s and 90s, and then tacking on the very gold-friendly 00s, we get a 35-year rate of return of 5.35%, less than half the return of the S&P 500 Index and a lot less than the return from even a long-dated Treasury bond.

**Bogie and Walter Huston went all the way to the Sierra Madre for 5.35% per year? Why own gold?**

Two reasons, and the first is quantitative. The performance of gold does not correlate very well with the performance of the two traditional financial asset classes: equities and fixed income securities. That goes for the entire 35-year period, as well as all the sub-periods of any length. This lack of correlation, of course, means that gold brings some diversification firepower to the party, and the result is a less volatile pattern of investment returns. Hence, it's a good third leg to the stool.

But, the "good diversifier" label means nothing if we're talking about a depreciating asset/asset class or one with generally poor prospects. Such does not appear to be the case with gold, and that is the second reason to own it. As stated, accelerating inflation, i.e., too many dollars chasing too few goods, and let's call it "currency trauma" in general tend to support a rising gold price. And, while a lot of slack in the worldwide economy suggests that inflation is not just around the corner, the many attempts to eliminate that slack over the past few years have produced a lot of paper currency out there, particularly dollars.

Gold...good diversifier, decent prospects.

**How much and how?**

Gold's policy weighting in all of our Baseline Total Portfolio Management (TPM) portfolios is 5% (see Figure 2). This is hardly a policy bet that will produce great wealth or save a sinking ship. This is a policy bet that will benefit the portfolio in one type of economic environment. That's what intelligent investing is all about, isn't it? Intelligent investing is the art of successfully combining several assets or asset classes, all of which do well in a different type of economic environment. Of course, if we knew with certainty what the future was going to be like, we would buy the asset or asset class most in tune, and go to sleep. But, we never have that luxury. One of the Fundamental Beliefs underlying TPM is that the future is unpredictable and diversification is very important. Gold at 5% makes sense in a well-diversified portfolio structure.

*Figure 2*

**Total Portfolio Management - Baseline Portfolio Structure**

| | | |
|---|---|---|
| **Portfolio Equities** | | **65%** |
| U.S. Large Cap | 60% | |
| U.S. Mid Cap | 10 | |
| U.S. Small Cap | 10 | |
| International Emerging Markets | 20 | |
| **Portfolio Fixed Income Securities** | | **30** |
| Treasuries, selected mutual funds | | |
| **Portfolio Non-Traditional Assets** | | **5** |
| Gold | | |

How to own gold? That used to be a considerable challenge. Scalability was a problem with coins; weight and, therefore, transportability was a problem with ingots of any size; transaction costs, gauging purity, and secure storage were problems with both. Along came Exchange-Traded Funds (ETFs), and many of these problems went away. All at once, gold could be bought and sold in size throughout the trading day, at commission levels comparable to equity trades. Transportability, storage of the asset, and the continual evaluations of its purity became the responsibility of the ETF's sponsor. Of course, none of that came free of charge, but the Funds' expense ratios were and continue to be far from exorbitant. The only caveat - and we preach this to our TPM clients all the time - is that ETF shares must be backed by physical gold. If the gold ETF is designed only to track the price of gold, we are not interested.

Five percent of total portfolio assets; gold ETFs.

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The most-asked question around here is: "Should I own gold?" Yes, you should, at about the 5% level. Let's summarize a few more thoughts on the barbarous relic.

First, gold has stirred our emotions since men and women began walking upright. Always fascinating and mystical, always revered, frequently the basis for conflict.

Second, if we fast forward to the 20th century, the hoarding of gold was considered a Depression-prolonging villain by FDR et al., and its ownership was severely restricted. That came to an end on December 31, 1974, when Americans once again could own gold for investment purposes and the final nail was driven into the old fixed exchange rate coffin.

Third, from that date until the end of 2009, gold (Engelhard industrial bullion) provided an annualized rate of return of 5.35%, comfortably ahead of inflation but below the return provided by U.S. equities and long-dated Treasuries. And, the advance has been far from straight-line. The 70s were just fine; the 80s and 90s far from it; the 00s very rewarding.

Fourth, gold may have been moving in fits and spurts, but those fits and spurts have not correlated well with U.S. equity or Treasury prices. Gold is a diversifying asset class.

But fifth, a good diversifier with poor prospects doesn't quite cut it. With gold, on the other hand, the metal's prospects in a world trying very hard to inflate its way back to prosperity seem to be well above-average.

And finally, the virtues of ETFs as a way to own gold are considerable. The shares of gold miners? Clearly, the price of gold is a large factor in their performance, however, there are others, e.g., overall stock market health and its causative factors. For this and other reasons, we prefer to own the metal - we know exactly what we are getting.

Make no mistake, we continue to be positive regarding U.S. equities, for a number of well-considered, quantifiable reasons. The bond market? Not so much (please see the August Update, "Price Doesn't Matter"), but that doesn't mean bonds of a certain kind don't have a place in a well-diversified portfolio. They do because bonds will (continue to) do well in a certain kind of economic environment.

Same with gold, and owning it at the 5% level never has been easier.