



January 15, 2011

“Another year over and a new one just begun...” – John Lennon (1940-1980)

Turning the calendar page to a new year brings feelings of rebirth, resolution and redemption to many people. In the investment business, the end of the year marks two important performance milestones – the end of the fourth quarter and the end of the full year. And yet in many ways, the New Year is a lot like the old one; the fundamentals which were key drivers of the market (or even our lives, if you will) change little from December 31 to January 1. All of the most recent investment themes, the global concerns and the little bits of dread that often haunt our dreams are carried into January. The self promises we make to lose weight, be better parents (or children), drink less, show more kindness and so forth eventually smack into the concrete reality that change is tough! Despite this, we resilient humans can each year somehow find the gumption to still be hopeful that good things may be just around the corner.

For the investment professional, the New Year also represents another opportunity to “outfox” the market. This is the challenge that keeps us fully engaged in the endeavor of helping our clients reach their long-term goals.

Fourth Quarter Review

For the quarter, the S&P 500 rose 10.7%. December’s gain of 6.5% was the best performance for a December in seven years. This positive performance comes despite persistent high unemployment, a tepid housing market and slower-than-expected U.S. GDP growth. In our view, this underscores one of the key themes we have been presenting for many quarters now – the stock market is not the economy and the economy is not the stock market. The forces which drive the one may influence the other, but the overlap in these forces seems to be much less than most people think. This is why focusing on just one thing, be it a small thing like an oil spill, an earthquake, a Grecian debt crisis, or even a big thing like the economy, interest rates or currency exchange rates, can often lead one to conclusions that may ultimately not be the true driving force of the market.

Although nowhere near as wonderful as 2009, 2010 represented another very good year for the stock market, with the S&P up by 12.8% (14.6% total return). One could say that 2010 was another year where the market climbed a wall of worry. The year was

marked with numerous crises and big, surprising events. It featured a correction slightly bigger than a normal bull market correction, which no doubt tested the conviction of the sturdiest bulls. Yet, despite all of the bad news we saw in the media, there was much to cheer about in 2010. We saw a strong recovery in both the banking and auto industries – two areas of great concern during the global credit crisis. The consumer, who was expected to deleverage and retrench for years to come, came out of the cave and helped retail sales to post stronger-than expected growth for the year.

The bond market has finally begun to act as if the economy is once again growing. Over the last month or so, U.S. Treasury yields have risen about 15-25 basis points in the short part of the yield curve and 100 basis points farther out. The cautious tone we were espousing last quarter seems to have been prescient. Still, bond returns for the full year were attractive enough to convince bond holders to stay the course or even buy more. At some point in the future the prospects of higher inflation, something that the experts have been predicting for several years now, may start to impact the bond market as well. Time will tell.

Here's what the fourth quarter looked like by the numbers:

Index	4th Qtr 2010	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	7.9%	13.4%	13.4%
S&P 500	10.7%	14.6%	14.6%
NASDAQ	12.2%	17.6%	17.6%
Russell 2000	16.2%	26.4%	26.4%
MSCI EAFE	6.6%	7.8%	7.8%
MSCI EAFE Small Cap	10.5%	19.8%	19.8%
MSCI Emerging Markets	6.7%	16.1%	16.1%
Barclays Aggregate Bond	-1.8%	5.9%	5.9%
Barclays Municipal Bond	-7.2%	-0.9%	-0.9%
Dow Jones Commodities	16.2%	16.2%	16.2%

What a Fox Knows

We wish to thank Rodney N. Sullivan, editor of the Financial Analyst Journal, for the theme of this letter. It was he who got us thinking about the symbolism of the fox by using this quote from the ancient Greek poet Archilochus: "The fox knows many things; the hedgehog, one great thing."

At first glance, the meaning of this phrase may not be clear. At some level, knowing "one great thing" sounds very attractive. "Knowing many things" comes across a bit negative – something like: "a jack of many trades, master of none." As we pondered deeper on this simple line, we concluded that Archilochus was perhaps not passing judgment on the relative merits of foxes and hedgehogs (and what their archetypes

may suggest about humans), but simply that foxes and hedgehogs are different, and that understanding this difference may teach us something about ourselves.

Are You a Hedgehog?

The hedgehog is a spiny mammal native to parts of Europe, Asia, Africa and New Zealand. These nocturnal insectivores are noted for their unique covering of spines. Perhaps the "one great thing" to which our poet was referring was the hedgehog's unique defensive system. When threatened, the hedgehog can roll itself into a spiny ball effectively hiding all of its vulnerable parts, leaving the would-be predator limited options.

So what kind of human can be likened to the hedgehog? According to Isaiah Berlin, the famous social/political philosopher, the hedgehog is someone whose view of the world can be articulated in a single, defining idea. In philosophy, that would be someone like Nietzsche, who thought that all human behavior could be understood by the one idea of "will to power," that is, our desire to expand our power. In politics, that might include Marx who viewed the history of mankind as the history of class struggles. In economics, it might include Keynes, whose defining idea was that the ups and downs of business cycles could be stabilized by monetary and fiscal policies.

Clearly great power resides in the hedgehog model. Fierce debates continue to this very hour about how to address many of the big questions in politics, sociology, economics and so forth. At the forefront of these fights are passionate thinkers who know that the solution to any given problem is just one thing. Are you a hedgehog? If you find yourself thinking or saying things like, "What we need to do to fix _____ (some big problem) is _____ (one thing)," you may be a hedgehog. Like the poet, we are not prepared to offer a value judgment on the hedgehog or his human mimics, but we do want to look at the fox for points of contrast.

The Fox

Unlike hedgehogs, foxes are found nearly everywhere on the globe. From the arctic fox, which makes its home in the frozen north countries, to the big-eared fennec fox that calls the Sahara Desert home, these dog-like critters are well known by humans, and have been a part of folklore, mythology and literature for centuries. In ancient Mesopotamia, the fox was considered a sacred animal, one closely associated with chief deities. In China, Korea and Japan, the fox represented powerful spirits and would sometimes run errands for the gods. In ancient Peru, the fox was supposedly a warrior that would vanquish enemies simply with the power of its mind.

In more modern times, we find the image of the fox in many places. In literature, we find it in Uncle Remus' stories in the guise of Brer Fox, the cleverest of the animals. The English word "shenanigan" actually comes from an Irish word which means "I play the fox." The stories of the mysterious masked man, Zorro, are also linked to this image; "zorro" means "fox" in Spanish. Children's books and movies are replete with the fox.

The general impression is that foxes are generally considered sly, clever, cunning and perhaps mischievous. Humans have hunted the small creatures for centuries, but at the same time respect them for their smarts and resiliency. Although the fox is generally considered a carnivore, its actual diet is more varied than one might think. In addition to the meat one would expect them to eat (rabbits, rodents, etc.); they also consume grasses, berries, insects and eggs. Our fox experts tell us that most foxes eat about 1 kg of food each day. Another surprising fact that we learned is that a male fox is called a "reynard" while the female is known as a "vixen".

Are You a Fox?

Thinking back to the poet's phrase, we ask ourselves, "what are the 'many things' a fox knows?" First of all, being an omnivore requires the fox to be resourceful and constantly in search of food. Being hunted by humans would also make the fox vigilant and constantly aware of its surroundings. We get further insight to the fox's character by the old Tswana saying "Only the muddy fox lives." In other words, only an active person, who is willing to get a little muddy, will progress in life.

In Isaiah Berlin's model, the fox is the person whose world view cannot be summed up in one idea. The fox will need to pull from many disciplines in an attempt to describe society, politics or the economy. The fox would be more of a generalist and the hedgehog more of a specialist. According to Berlin, great thinkers such as Aristotle, Moliere, Balzac and Goethe would be grouped in the fox model. If you find it hard to explain the big picture things in life with one simple idea or model, you may be a fox! Again, we wish to stress that neither model is perfect and the world is probably better off by having both hedgehogs and foxes.

Investment Implications

Are you still with us? Mr. Sullivan, in his article about foxes and hedgehogs, actually submits that the fox model is superior to that of the hedgehog in one significant way – foxes are better investors than hedgehogs! He says, "Foxes... are skeptical of a single, unifying theory. Drawing on a wide variety of ideas, they pursue many divergent ends and generally possess a sense of reality that prevents them from formulating a grand system of everything, simply because they find the world too complex to be boiled down to a single idea or theory. Foxes stand ready to adjust their thinking in accordance with actual events."

He goes further by suggesting that the "charismatic investment manager with the compelling narrative of how the future will 'certainly unfold' [the hedgehog] is probably wrong. " On the other hand, "the 'boring' investment manager, who couches her idea about the future in an array of 'however's,' is probably right about what is going to happen." He sums up his admiration for the fox model investor with this: "...they prefer a freethinking, eclectic approach that combines the virtues of many techniques. They have a generalist mentality and thus do not adhere to a particular style. They are open

to methods that can be adapted to circumstance. An innovative, fox-like investment approach may very well set aside parsimony in favor of a looser, more qualitative plan – for example, one that mixes fundamental and quant investing and that integrates bottom-up stock selection with top-down global macro investing. Such a rich process that explores the many possibilities could indeed offer the best chance of success – say, in recognizing when a new world order is upon us."

We would like to say that our investment approach is absolutely foxy, but we can't. We are aware of our hedgehog-like bias in two ways – we are value oriented and decidedly bottom-up in focus. On the more positive side, we do use quant techniques and will employ technical analysis from time to time. We are also aware of the macro issues, especially concerning where we are in the business cycle and whether we are in a bull or bear market. If the hedgehog-fox dichotomy covers a spectrum (and is not a simple binary function) we would place ourselves somewhere in the fox part of the distribution. Our position on the spectrum would explain our general disagreement with those who conclude that the markets are impacted by just one thing. Charismatic prognosticators who appear in the media and state with great passion and confidence that the key to the markets will be _____ (fill in the blank – currency, housing, employment, gold, China, the economy, sunspots or the Hindenburg Omen, etc.) will usually find us disagreeing with them with equal passion. In this way we feel more like the fox.

Be the Fox

Our key message this time is that the markets continue to be volatile, challenging and full of uncertainty. Even this new bull market, which as of this writing is nearly two years old, has unfolded with what seems like more-than-usual uncertainty. We can recall with great clarity the voices which seemed to be most often heard in the early part of 2009. These voices were coming mostly from hedgehogs – those who "knew" exactly what was going to happen – and it wasn't going to be pretty (predictions of 5,000 on the Dow Jones Industrial Average, for example). Those of us who remained calm (at least somewhat) and stayed the course, didn't raise cash and didn't give up, were despondently uncertain, but ultimately rewarded. We still are very uncertain. Yet, we trust the basic principles of investing which have enriched investors from the beginning of our industry. We understand the power of central tendencies. We know how sentiment works. We have shown the ability to identify cheap stocks. We can read chart patterns. We can determine the current nature of the market – whether it's a bull or a bear. All of these things give us confidence that we can help our clients reach their long-term financial goals.

Despite our knowledge and experience, we greatly respect the uncertainty inherent in the capital markets. Yet, trying to find little bits of certainty (like that a certain stock is horribly undervalued) is highly rewarding. One of the most important facets of our fox-like, eclectic approach to the markets is that we do not know everything. This keeps us ever striving to learn more, trying to better understand the forces at work and giving our best every day. We hope the results will always be a good measure of our "best efforts."

The Outlook

We see nothing in the near-future that could change our generally positive views on the U.S. and global economies and the U.S. stock market. World economies are growing, and most forecasts are calling for 2011 to be at least as strong as 2010. Corporations are flush with cash. As we have mentioned before, there are five things companies can do with this cash: raise dividends, buy back stock, buy each other, increase capital spending, or hire new workers. These things are all positive either for the economy or the stock market.

Earnings have surprised on the upside for six quarters in a row now. The consensus for 2011 is for EPS to grow at least 10%. Despite the gains over the last two years, the market's valuation remains modest compared to long-term averages and much below market peak valuations. Goldman Sachs makes the point that the U.S. economy has grown 15% since 2005, but the stock market is only 1% higher. We see many facts such as this which suggest the stock market could continue to perform well for the foreseeable future.

"Perform well" of course, does not mean stock prices will move in a straight line. Even the best bull markets are often punctuated with corrections from time to time. As long as these corrections result in a big, negative knee-jerk reaction by the media and the vocal "experts" who appear frequently there, we remain convinced that these corrections are simply buying opportunities (like the May to September one last year). Only when the consensus response to these corrections is "buy, buy, buy!" will we begin to worry.

Bonds have begun to show a bit of the weakness that one might expect from such an expensive market. Yet, the returns for the year may still be an impediment to wide-spread sale of bonds. Retail investors seem infatuated with bonds to a potentially unhealthy degree. But until we see either a big change by the Federal Reserve regarding monetary policy or an unexpected uptick in inflation, bonds will probably still attract the attention of individual investors.

One technical factor that we hesitate a bit to mention is the U.S. Presidency cycle. Studies have shown that the third year of the term of nearly every U.S. President since the 1950s is usually the best year of the four for the stock market. Pundits have tried to find reasons for this (the quest to get re-elected, working with a mixed Congress, etc.), but we really don't know why it happens. We just have observed that it does. Given our proximity to Washington DC, we think this is a factor worth watching. And, of course, watching the shenanigans going on in Washington is always good theater – be it comedy or tragedy...

Sincerely,

Wolf Group Capital Advisors