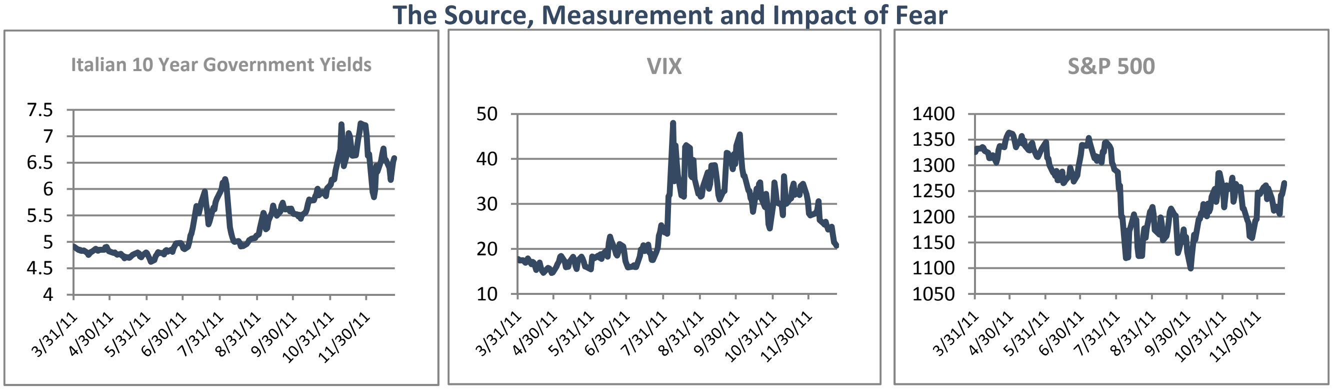
PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

Time magazine recently named the Protester as its 2011 Person of the Year. An understandable and worthy selection given the protest-driven upheaval that was felt around the world – from dictators brought down in Tunisia, Egypt, and Libya to the 'Occupy' movement that started on Wall Street and spread around the globe. Another viable candidate in our estimation would have been the Groundhog, with a nod to Groundhog Day, because the problems that plagued our economy and markets early in 2011 kept reappearing with varying intensity throughout the course of the year.

Time alluded to this problem in their selection of the Protester, which they said "embodied the idea that individual action can bring collective, colossal change." At the same time they lamented the failure of leadership as a phenomenon that transcended both geography and political leanings, stating that they didn't select an individual as Person of the Year because "leadership has come from the bottom of the pyramid, not the top." Unfortunately, if the malaise that beset markets in 2011 is to be lifted there will have to be a catalyst provided by a semblance of leadership coming from political and financial institutions that of late could be described as feckless, at best.

The Source, Measurement and Impact of Fear



There were no cyclical, let alone secular, trends to speak of that took hold over the course of 2011. The lone metric to gain traction in the investment landscape was volatility. Volatility ramped up to unprecedented levels as the summer unfolded and inevitably made the pain that equity market participants experienced feel even worse than it was. The S&P 500 has had 68 days this year with an intraday high-low spread of more than 2%. This is equal to the *total* of all such days between 1990 and 2004. Of those 68 days, 60 of them have occurred since the first of August.[i] Amidst all of the frustration this has created, we feel that a playbook is being developed which will prove to be a valuable tool in the coming year.

Permit Capital Advisors, LLC
100 Front Street, Suite 940 | West Conshohocken, PA 19428
Phone (610) 834-5870 | Fax (610) 834-5871 | www.permitcapital.com

The synchronized global slump we've been experiencing has been propagated by political paralysis and fiscal discord on both sides of the Atlantic, and a forced slowing of growth in emerging economies. The decisions regarding how investors position themselves going forward in an effort to achieve their goals will focus on the pursuit of opportunities and diminishment of risks that unfold as leaders attempt to resolve the problems that came to a head in 2011. Portfolios should focus on asset classes that can structurally withstand setbacks to that process based on current fundamental advantages. We think large cap US equities, high yield fixed income, and municipal bonds are three examples.

As of December 23, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann)	5 Years (ann)
DOMESTIC EQUITY				
S&P 500	Large Cap Equities	2.8	16.1	-0.1
Russell 2000	Small Cap Equities	-3.9	18.5	0.5
Russell 3000 Growth	US Growth Equities	2.6	20.1	2.7
Russell 3000 Value	US Value Equities	0.8	13.9	-2.3

INDEX	ASSET CLASS	1 Year	3 Years (ann	5 Years (ann)
INTERNATIONAL EQUITY				
MSCI World ex US	Global ex US Equities	-14.6	6.1	-6.7
MSCI EAFE GR	Developed ex US Equities	-11.8	8.7	-4.2
MSCI Europe GR	European Equities	-10.7	9.2	-4.6
MSCI Japan GR	Japanese Equities	-14.8	1.4	-6.8
MSCI EM GR	Emerging Mrkts Equities	-15.4	21.8	3.4

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

Large cap US equity returns have been mediocre this year, +2.71% year-to-date through December 23rd[ii], despite impressive performance from the corporate sector and surprising resiliency from the consumer sector. Businesses continue to generate solid profits and they have a high level of liquid assets fortifying very healthy balance sheets. Earnings have continued to be strong but stock prices have languished as a result of multiple compression, though potentially weakening margins may be a concern as well. The primary problem is one of risk perception, and the resolution of macro issues that we referenced above and will discuss in more detail below will be a key determinant of the asset class fortunes in 2012, but we think the base case is for mid-to-high single digit returns.

Another asset class that we continue to like, and one that we believe is structurally built to fare well in a variety of macro scenarios is high yield fixed income. Since the end of the recent recession high yield has delivered the same returns as the S&P 500 with much lower volatility. We expect the good risk-adjusted results to continue as recent spread widening appears to have fully discounted a potential recession, and deleveraging over the last several years has reduced the risk of corporate default. Also, the recent readings from the Fed's Senior Loan Officer Survey, which very accurately predicts the corporate default rate as loan officers stay close to issuing firms, is predicting those rates to remain muted.[iii]

If there is one asset class whose fortunes encapsulated the peaks and valleys of this year it would be municipal bonds. The year began with muni investors in full panic mode on the heels of Meredith Whitney's appearance on 60 Minutes in which she predicted "hundreds of billions of dollars" of defaults. What we have seen in 2011 to this point is $2.1 billion in defaults (counting only issues that missed

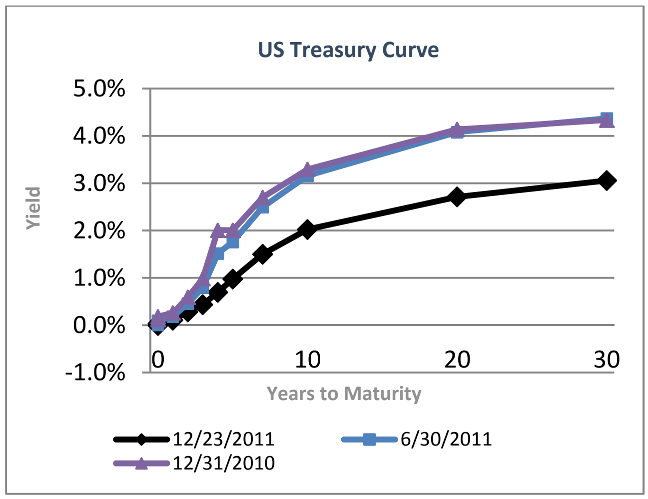
Permit Capital Advisors, LLC
100 Front Street, Suite 940 | West Conshohocken, PA 19428
Phone (610) 834-5870 | Fax (610) 834-5871 | www.permitcapital.com

payments), down from $2.8 billion in 2010, and performance since the day after Whitney's prediction of +10.5%, better than US Treasuries, corporate bonds, and equities. There are still problems that municipalities have to deal with, but positive steps for bondholders taken in 2011 include Rhode Island lopping $3 billion from pension costs by lowering benefits, California passing a budget with automatic spending cuts if revenue doesn't meet projections, and Illinois raising income and corporate taxes by $7 billion.[iv] While there is value in municipal bonds, including within insured bonds that have uniformly been discounted to the level of natural single-A status, deep credit analysis which includes a review of the Official Statement to understand the purpose of funds, is more important than ever before. In fact, the Office of the Comptroller of the Currency is proposing a rule that would remove references to credit ratings in their guidance on what constitutes a prudent investment.[v]

As of December 23, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann	5 Years (ann)
FIXED INCOME				
BofAML T-Bills 0-3 Mon	Cash	0.1	0.1	1.4
BarCap US Agg Bond	Broad US Investment Grade Bonds	7.7	6.6	6.3
BarCap Municipal	Municipal Bonds	10.2	8.8	5.1
BarCap Treasury	US Treasury Bonds	9.5	3.5	6.6
Citi WGBI USD	Global Sovereigns	7.8	4.4	6.9
BarCap US HY Interm	US High Yield Bonds	4.8	25.2	7.2
JPM EMBI Plus	Emerging Market Bonds	9.1	15.5	8.0

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar



With an eye towards resolution of the macroeconomic overhang on global markets, or the exacerbation of those same problems, attention properly will be focused on the likelihood of policies to put affected countries on a path to sustainable growth. This will be predicated upon their ability to find the right balance between efforts to reverse unsustainable medium- and long-term fiscal trends, but not do so in a way that derails the fragile global recovery. Based on lessons dating as far back as the Great Depression and as recent as the Great Recession, a degree of monetary reflation is required to fend off a full-blown debt crisis. The three parts of the world where this battle will be won or lost will be the US, the Eurozone, and China.

European leaders have taken steps at almost every turn to prolong and/or worsen the depths of the problem. In their best moments they have helped at the margins. The ECB has been extremely reluctant to expand its balance sheet, and in fact raised rates in April 2011 when its banking system was under attack. Recent steps, including successful long-term refinancing operations (LTRO) will likely help with liquidity in the banking system, but whether or not they will be sufficient to stem dramatic tightening in monetary conditions as a result of an overvalued currency is in doubt. Here, the structural blueprint offered by previous debt crisis management (the Russian ruble was devalued by 75% in ’98-’99, the Argentine peso by 74% in ’02, the Mexican peso by 60% in ’94-’95) is unavailable to the shared currency region.[vi]

It is clear to us that the only lasting solution to be offered in the Eurozone debt crisis needs to come from the ECB. Fitch agrees, stating, “Of particular concern is the absence of a credible financial backstop. In our opinion this requires more active and explicit commitment from the ECB to mitigate the risk of self-fulfilling liquidity crises.”[vii] Given the split within the ECB over the appropriateness of this role, and the debate already cost the central bank one member when Juergen Stark resigned over government bond purchases, and the dogmatic approach taken to date, it can be rightly questioned when and if such a dramatic shift is in the cards. It is our belief that only a prolonged recession or a disorderly breakup of the zone and its currency are likely to trigger decisive action, though renewed market response that pushes borrowing costs ever higher for Italy and Spain could also force the ECB’s hand.

In the US, resolution and certainty are more likely to come from the Administration and Congress than the Fed, though with an election around the corner a bold measure like the adoption of Simpson-Bowles proposals is unlikely. The Fed appears to be on the sidelines with QE3, though Bernanke called it a “viable option” in recent Q&A, unless housing prices were to crater or unemployment were to spike. According to the Taylor rule the Fed is already taking an accommodative stance, as Fed funds with unemployment at 8.6% and core CPE at 1.6% should be near 0%. While the actual range is indeed at 0-0.25%, some estimates have the actual Fed funds rate at -1.4% on the assumption that every $500 billion in Fed bond purchases ($2.3 trillion to date) would lower rates by 40 basis points.[viii]

The final leg of the economic recovery stool rests in China. The importance of China to global economic growth is well known, and growing. Chinese imports have gone from 6.5% of global trade five years ago to 10% today.[ix] It appears likely that a hard landing in China will be averted, though the fear that it will not has been enough to rock markets (particularly emerging market equities and currencies) at several points in the year. Chinese policymakers have been tightening conditions for over a year and have effectively curbed real estate and other hard asset speculation from leading to an overheating of inflationary pressures. The central government controls enough resources to stem excessive weakness in growth. Infrastructure investment can be increased to offset weakness in residential construction.

Based on the prerequisites to robust global growth, the second half of 2012 is more likely to see improvements than is the first half. By that point conditions in Europe could have the ECB in a more proactive mode; the US could find itself with more willing legislative participants; and China could be firmly on a track to encourage growth through investment as it transitions to new leadership. As those hurdles are overcome we will look to increase allocations to asset classes like emerging market equities, as well as to directional alternative investments such as commodities, private equity and distressed debt. While commodity markets would be a significant beneficiary of a clear “risk on” signal, if things go the other way they should hold up better than they did in the recent recession. Commodity markets appear to have adjusted much earlier to potential risks than they did in 2008, which explains their place among 2011’s worst performing asset classes. Even if demand growth falls further, slack within commodity supply chains looks extremely thin. Conditions vary by market but on the whole, commodity producers are not carrying much overhang in terms of either spare capacity or excess stocks, while uncertain consumers are operating on a hand-to-mouth basis.[x]

As of November 30, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann	5 Years (ann)
ALTERNATIVES				
HFRI Fund Wtd. Composite Index	**Broad Hedge Funds**	-1.6	8.2	2.7
MLM Index	**Managed Futures**	6.9	2.2	4.4
DJ UBS Commodity	**Commodities**	-0.3	6.1	-2.2
Wilshire US REIT	**REITs**	9.2	26.6	-3.3

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

	As of 12.23.11	Latest Yr End (12.31.10)	Three Years Ago (12.23.08)	Five Years Ago (12.23.06)
CURRENCIES				
US Dollar Index Value	79.93	79.03	83.81	85.32
USD vs. Yen	78.09	81.12	90.98	118.87
Euro vs. USD	1.30	1.34	1.39	1.31
GBP vs. USD	1.56	1.56	1.47	1.96
COMMODITIES				
Gold ($ / ounce)	1606.35	1420.78	840.20	621.01
Crude Oil ($ / barrel)	99.63	91.38	33.48	61.86
Copper ($ / ton)	7631.50	9650.00	2835.00	6310.00
Corn - Generic (Usd/bu)	619.50	629.00	394.75	384.00

Private equity and distressed debt are both asset classes where it will be a good time to be a provider of liquidity. One way to achieve a margin of safety in private equity is to purchase "secondary interests" at a discount. This part of the industry, where investors who typically agree to lock up their money for a decade decide they need to sell early and are willing to pay a price, used to be tiny but is now flourishing. Secondary deals in 2011 increased by 25%, to $25 billion, from 2010's record level. Estimates are for that figure to grow to $75 billion by 2015.[xi] Struggles within the private equity industry partly fuel this phenomenon. Buy-out firms bought too many companies at top prices and now must wait for the economy to recover before finding a reasonable exit. Private equity firms are holding companies for five years on average, up from three-and-a-half years in 2007, and impatient investors often can't wait that long to get back capital.

If it appears that the world's macroeconomic problems are moving closer to a boiling point than a resolution (and beyond a breakdown of the economic variables discussed, a geopolitical disruption in nations like Iran or Saudi Arabia that would lead to a spike in oil prices would deal a significant blow to the global economy) we will look to increase exposure to more defensive asset classes like sovereign bonds, and non-directional alternatives such as managed futures, and global macro and multi-strategy hedge funds. It is important to have a structural allocation to asset classes of this nature, as the occurrence of a tail-risk doesn't always come with obvious warning signals. Indeed it appears that institutional money has already begun to move in this direction, as global macro and multi-strategy funds are the only hedge fund styles that have already surpassed pre-crisis high watermarks with respect to assets under management, while equity-centric funds languish 30-40% below their peak.[xii]

Heading into 2012 it would appear that the themes from 2011 will remain in place, and that the need for monetary reflation will battle fiscal austerity and private sector deleveraging for supremacy on the global stage. We served our clients well in 2011 by identifying asset classes that were in an advantageous position based on market dislocation, as well as managers with a proven ability to weather the type of volatility that markets brought to bear. We recognize that investment challenges in 2012 will likely be different, though no less significant. We look forward to working with clients to continue to build portfolios that are up to the task.

Thank you for your interest in Permit Capital Advisors, LLC. We hope everyone has a happy and healthy New Year. Please feel free to call us with any thoughts or questions.

---

[i] Bespoke Investment Group
[ii] Bloomberg: S&P 500 Total Return Index
[iii] BCA Research, Global Investment Strategy- December 16, 2011
[iv] Bloomberg, Whitney's Armageddon Belied by Best Returns of 2011, Martin Z. Braun- December 16, 2011
[v] BMO Capital Markets, Bond Market Outlook- December 13, 2011
[vi] BCA Research, Global Investment Strategy- December 16, 2011
[vii] Reuters, Comprehensive euro zone deal "beyond reach"- December 16, 2011
[viii] BMO Capital Markets, Rates Analysis- December 2011
[ix] BCA Research, Emerging Markets Strategy- October 18, 2011
[x] Barclays Capital, Global Outlook: A Cautious Step Forward- December 2011
[xi] The Economist, Private equity: One careful owner?- December 10, 2011
[xii] BCA Research, Global Asset Allocation- November 30, 2011