# PCA PERSPECTIVES

*Permit Capital Advisors' Monthly Thoughts on the Investing Landscape*

PERMIT CAPITAL ADVISORS, LLC

October was categorically a huge month for equities, and more broadly for risk assets. The S&P 500 posted a double-digit return, which according to SeekingAlpha.com has only occurred 27 times since 1928, a period spanning just under 1000 months. In a story that should be getting old by now, the push/pull of investor's animal spirits was brought to us by forces emanating from Europe. There is an old adage that states 'when the U.S. coughs, the world catches a cold.' A recent update would appear to be 'when Europe speaks, the world hangs on its every word and assumes that something lasting is being created.' We've written in past letters about the danger of reacting to European head fakes, as the market seems permanently inclined to do. This calls to mind another adage, 'the definition of insanity is to do the same thing over and over and expect different results'. Although, contrary to popular belief, this adage isn't so old. While it has often been misattributed to the likes of Benjamin Franklin, Albert Einstein, and Mark Twain, the current consensus is that it was originally coined by Rita Mae Brown in the book *Narcotics Anonymous,* which seems befitting given the fact that one would need to be under the influence of something to believe most of what is reported out of Europe as anything resembling a comprehensive solution.

**As of October 31, 2011**

| INDEX | ASSET CLASS | 1 MONTH | YTD | 1 YEAR | 5 YEAR (Annlzd) |
|---|---|---|---|---|---|
| *DOMESTIC EQUITY* | | | | | |
| S&P 500 | Large Cap Equities | 10.9 | 1.3 | 8.1 | 0.3 |
| Russell 2000 | Small Cap Equities | 15.1 | -4.5 | 6.7 | 0.7 |
| Russell 3000 Growth | US Growth Equities | 11.4 | 2.6 | 9.9 | 3.0 |
| Russell 3000 Value | US Value Equities | 11.7 | -1.6 | 5.9 | -2.0 |

| INDEX | ASSET CLASS | 1 MONTH | YTD | 1 YEAR | 5 YEAR (Annlzd) |
|---|---|---|---|---|---|
| *INTERNATIONAL EQUITY* | | | | | |
| MSCI World ex US | Global ex US Equities | 9.7 | -9.3 | -6.4 | -4.5 |
| MSCI EAFE GR | Developed ex US Equities | 9.7 | -6.4 | -3.6 | -2.0 |
| MSCI Europe GR | European Equities | 12.1 | -4.9 | -4.7 | -2.2 |
| MSCI Japan GR | Japanese Equities | -0.3 | -11.0 | -2.2 | -5.1 |
| MSCI EM GR | Emerging Mrkts Equities | 13.3 | -11.3 | -7.4 | 6.8 |

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

The drama unfolding in Europe has resembled a three-act play, appropriate given the role of the Greeks, and within each act the storyline has remained the same: crisis unfolds, brinksmanship exacerbates the crisis, markets force action, action is shown, action is taken away. In Act One, which took place in the summer of 2010, the need for a Greek bailout, a rumor of a bailout, and the initial agreement on a European Financial Stability Facility (EFSF) all transpired over the course of three months. Two of those months led to global equity markets moving significantly (more than 7%) in either direction. In Act Two, from the winter of 2010, Chancellor Merkel called for private investor haircuts and the EFSF first bond sale attracted solid demand. Two more months of big equity market moves ensued. In the most recent act which just transpired, Act Three, doubts about the Greek default, enhanced fears about Italy and Spain, and ultimately a proclamation from the European Union all occurred in a three-month stretch. This period produced three big market moves, often occurring both intra- and inter-month. As we have noted consistently, the only "known" in the market right now is that volatility is structurally entrenched. The key to ultimate investing success, defined in this case as the ability to stay on track towards the attainment of individual goals and objectives, is to manage the volatility. This is defined as not being unduly influenced by excess fear or euphoria while also not turning a blind eye to opportunity brought about by dislocation.

That's not to say that measured analysis of current economic and market conditions is easy. There are considerations, both positive and negative, that ultimately have the significance to meaningfully impact global markets over both shorter and longer horizons. At the highest level what the global economy is attempting to achieve is a redistribution of debt and deficits. This is no easy task, whether it is in the context of the U.S. relative to China or within the confines of the Eurozone. The U.S. versus China balancing act is made more difficult by the role of political landmines, mainly entitlements. We recently attended a presentation by former Bundesbank President and member of the Governing Council of the European Central Bank (ECB), Axel Weber. Mr. Weber addressed this issue, stating that the needs in the two global powers were mirror images of one another. In China, the lack of a sound social security system holds back domestic demand and leads to an inflated savings rate because the Chinese people are forced to save for themselves. In the U.S., a bloated entitlement system overburdens public finances and constrains savings because there, to this point, has been a disproportionately small degree of private participation.

In Europe, the lack of political congruency has been well documented, as debtor nations hold out from agreement in an effort to reduce the pain of austerity while lender nations hold out for increased haircuts and private market participation. Nowhere is this dichotomy more pronounced than within Germany. On October 26th the main chamber of Germany's legislature voted overwhelmingly to give more firepower to the EFSF. Within that same session, however, the caveats included the fact that such additional firepower would have to come without additional German guarantees, no to Eurobonds, and no further financing of stricken countries by the ECB.[i] We feel the stated ECB exclusion is misguided – the fiscal picture in both the U.S. and the U.K. is arguably much worse than either Italy or Spain, yet active balance sheet expansion by the Federal Reserve and the Bank of England has stemmed any crisis, bought time for fiscal reforms and averted a panic run on the banks.

As noted earlier, it's important for investors to be able to balance, and in some cases separate, macro beliefs with the fundamentals of capital allocation decisions. For several reasons, small signs are beginning to appear that indeed this may be taking place. The recent equity rally in October was accompanied for the first time by a spike in the sovereign spreads of crisis-stricken countries. Any continuation of a reduction in asset class correlations would be a real positive, as it would allow the benefits of diversification to reappear. We believe the ECB may hold the key to this dynamic, as an effort to actively monetize troubled debt by expanding its balance sheet could put pressure on the euro but simultaneously boost global stocks. This would be a clear break from the tight recent correlation of a weakening euro and falling stock prices. Primary sources of a positive fundamental view are also coming from both China and the U.S.

In China, it appears that the dreaded hard landing could be avoided and that monetary tightening has come to an end. Money supply has been brought down below the targeted range, small businesses are scrambling for loans, and perhaps most importantly, there has been a sharp drop in food prices. Even though manufacturing PMI rebounded in October above the important 50 level to 51.1, authorities have begun easing credit to the private sector and indeed policy appears set to shift from fighting inflation to preserving growth. In the U.S., signs of economic stability are feint but evident: domestic auto sales are moving back towards historical averages, non-defense capital goods orders have rebounded to levels on par with the average since the mid-90s, while unemployment is still a significant concern the average monthly net gain in private-sector jobs is back to roughly the same as it was in 2004, and housing, while also still a concern and not a likely driver of near-term growth, has shown signs of stabilizing.[ii] All of these factors could be taken as evidence that at the very least the worst is behind us. This statement must be accompanied by a big asterisk, however, in the face of lingering global tail risks.

As we've been communicating for some time, these tail risks cover contributions from both the U.S. and Europe. In the U.S., the worn story is political and involves an attempt to get our fiscal house in order. The statutory deadline of November 23rd is appearing both hollow and improbable. Despite the bipartisan letter sent to the Deficit Reduction Committee (DRC) calling for "big bang" long-term steps, the proposals that have come out of late are at best, less ambitious, and at worst, back-tracking on the Budget Control Act. Recent stories include: the group of 33 Republicans that sent a letter to their members on the panel insisting on no net tax increase, the Democratic caucus complaining to their members on the panel about dissatisfaction with Committee procedural practice, using lower forecasts of war funding assumptions to get to the targeted deficit reduction rather than structural reform, and our favorite, the plan to have the DRC agree to a few hundred million of revenue increases but then assign the task of finding them to other congressional committees, whose decisions would be non-binding. If the DRC does not come to agreement on $1.2 trillion in deficit reduction, there are mandated cuts that would impact Medicare payments, security/defense allocations and non-defense spending. Sadly, and scarily, even if the DRC does come up with the $1.2 trillion in "savings" the CBO projection has the debt trajectory of the U.S. continuing to rise based on forecasts of growth, spending and revenues. Closer to $3 trillion in 10-year deficit reduction is required to ensure that the United States controls its own economic destiny.[iii]

The biggest risk on the global stage continues to be Europe. Clearly the political instability in Italy, where Prime Minister Berlusconi has pledged to step down after his parliamentary majority was lost during a routine vote on budget matters, and Greece, which appeared close to naming a new prime minister and cabinet on the heels of the Papandreou referendum debacle, had the proceedings halted when the proposed heir apparent, Antonis Samaras, balked at Eurozone demands for a written commitment to fiscal targets. Out with the old, in with the same. While the market may or may not be recalibrating expectations about the European crisis at its current scope and scale, we cannot ignore the possibility of a crisis on a new level, namely the disorderly breakup of the euro, either in whole or in part. Greece would be the trigger for such a move, and while conventional wisdom states that Greece would be shooting itself in the foot, a look at the facts of the situation aren't as clear. Over the next three years the primary balance, or the deficit that must be closed by cutting spending or increasing taxes before considering interest expense, moves from -5.0% to -1.3% to 0.8% according to IMF estimates. The fact that Greece is moving much closer to balance before interest raises the incentive to default on its external debt without the proper concern for external impact.

While mindful of the above, other, more idiosyncratic risks are likely to arise as a result of fallout from existing circumstances. While the impact of these may be fleeting in nature, the accumulation of such risks could move investor sentiment towards a dangerous tipping point. The most recent example is the collapse of derivatives and commodities giant, MF Global. The firm was apparently brought down by a giant bet, to the tune of $6.3 billion or five times the company's tangible common equity, on global sovereigns made by former NJ Governor and head of Goldman Sachs, Jon Corzine. An interesting sidelight to the analysis focuses on the fact that the bet may not have been purely motivated by the fortunes of the sovereign debt market, but also by an accounting approach that the company appeared to be taking. Motivated to act by diminishing net interest income in the face of declining interest rates (the company generated a significant portion of its revenue from the interest it generated by investing client collateral cash in higher yielding cash-like investments), the company made the bond purchases using something called "repo-to-maturity".[iv] That means the bonds themselves served as collateral for a loan. The key part for accounting purposes is that the transaction was treated as a sale, removing the assets and liabilities from MF Global's balance sheet and distorting the value-at-risk. Such maneuvers involving accounting techniques and hidden counterparty exposure ring all too familiar to wary market participants.

Given the plethora of considerations above (and as we asked in our August PCA Perspectives, what is 'signal' and what is 'noise'), we feel it is important to continue to remind clients of the need to separate their market views from their investment strategy. There continue to be investments that we think offer opportunistic enhancement along with the ability to withstand conflicting market forces over time. One such investment is within what we call defensive high yield. Sitting at the nexus of traditional equity and fixed income asset classes, high yield is far less volatile than equities because the high coupon component provides investors with a cushion, and we feel that it remains an attractive way to play the upside of a stabilizing global economy with the downside of disruptive risks to that stability as well as the potential for earnings disappointments. High yield bonds trade based on their spread over Treasuries rather than interest rates, and of late that spread has ranged from 750 – 900 basis points, which is an entry point that has historically been very attractive. The empirical evidence shows that at that level, while things don't always turn positive immediately they have always turned positive over a one-year basis, and over three- and five years have produced outsized returns in the upper-teens that exceeded equities for the same periods. If the breakup of the euro and European contagion are indeed about to create a "Lehman moment", it's instructive to look at what actually happened with September of 2008 as an inception. If you had invested in high-yield at that time, spreads were at 900 basis points which was close to historical highs. You would have had to endure a stretch of increasing uncertainty in which spreads widened to an unheard of 2,000 basis points during the next six months. Despite this horrific turn of events for your investment you still would have managed to record a one-year return of approximately 20.4%.[v]


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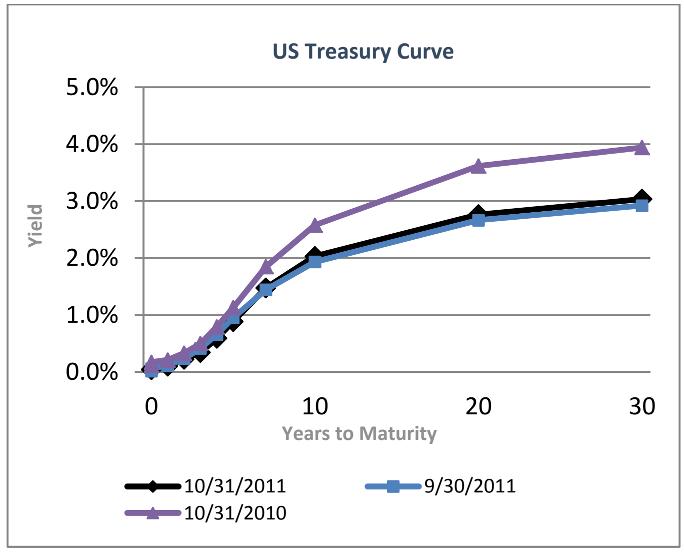
**As of October 31, 2011**

| INDEX | ASSET CLASS | 1 MONTH | YTD | 1 YEAR | 5 YEAR (Annlzd) |
|---|---|---|---|---|---|
| *FIXED INCOME* | | | | | |
| BofAML T-Bills 0-3 Mon | Cash | 0.0 | 0.1 | 0.1 | 1.5 |
| BarCap US Agg Bond | Broad US Investment Grade Bonds | 0.1 | 6.8 | 5.0 | 6.4 |
| BarCap Municipal | Municipal Bonds | -0.4 | 8.0 | 3.8 | 4.8 |
| BarCap Treasury | US Treasury Bonds | -0.8 | 8.0 | 5.3 | 6.5 |
| Citi WGBI USD | Global Sovereigns | 0.5 | 7.1 | 3.7 | 7.5 |
| BarCap US HY Interm | US High Yield Bonds | 6.1 | 4.3 | 5.2 | 7.7 |
| JPM EMBI Plus | Emerging Market Bonds | 4.4 | 8.3 | 4.0 | 8.4 |

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




Within high yield we favor a more defensive approach, and the analytics behind investing during risky periods supports this philosophy. At those elevated spread levels BB-rated bonds outperformed CCC-rated bonds by 1,174 basis points over three months and 926 basis points over six months.[vi] We favor an active manager in this space that has a twenty-year track record of avoiding defaults better than high yield indices have, with an extremely small segment of his portfolio rated CCC+ or below. The fundamentals of the asset class also remain favorable. Companies in this space have actively refinanced debt maturities taking advantage of lower interest rates to reduce borrowing costs. Further, they have harvested cash to strengthen their balance sheets – a move that is unequivocally positive for bondholders at the expense of equity investors and other stakeholders. Also, the upgrade/downgrade ratio in dollar terms within high yield sits recently at 1.8x, impressive relative to the 2008-2009 figure of 0.4x.

Another pocket of fixed income that remains an area of focus for many of our clients is municipal bonds. As we've discussed over the years, individual credit analysis has always been of paramount importance and that has never held true more than it does today. We also believe that investors are best served in today's municipal market by keeping their duration shorter than normal. The yield curve is currently flat but it is beginning to steepen. The yield difference between bonds maturing in 2012 and 2020 has recently increased to 216 basis points.[vii] If it were to approach its level from the beginning of the year of 300 basis points, longer-term bonds would be greatly affected.

For our equity allocation we continue to believe that larger cap equities offer the best risk/reward tradeoff. Stock selection has been important in the space of late, as those companies that dominate their industry are best positioned to withstand global turmoil. Two such examples are consumer staples, where Walmart revenues of $405 billion account for 29% of the sector total, and energy, where ExxonMobil revenues of $383 billion account for 31% of the sector total.[viii] Global leaders, in some cases with yields superior to traditional fixed income options, are a compelling allocation for the equity portion of an investor's risk bucket. There are however valuation considerations that must be carefully monitored. The gross operating surplus for companies in the non-financial sector of the S&P 500 was recently equal to 30% of their gross value added, the highest level in six decades.[ix] Further gains in this metric will depend upon the direction of unit labor costs, which even in this high unemployment environment seem more likely to rise than fall.

We continue to be vigilant about opportunities to utilize alternative asset classes in portfolios both structurally and tactically, and think there are interesting elements to both right now. Structurally our hedge fund managers continue to become more defensive, as gross leverage at 2.5x and long/short equity bias of 37% are both at twelve-month lows. Hedge fund managers also became more defensive as evidenced by sector bias, as the ratio of cyclical to defensive strategies dropped throughout recent reporting periods and the sectors where bias was increased looked to be Health Care and Consumer Staples.[x]

**As of October 31, 2011**

| INDEX | ASSET CLASS | 1 MONTH | YTD | 1 YEAR | 5 YEAR (Annlzd) |
|---|---|---|---|---|---|
| *ALTERNATIVES* | | | | | |
| HFRI Fund Wtd. Composite Index | Broad Hedge Funds | 2.4 | -3.5 | -0.5 | 3.3 |
| MLM Index | Managed Futures | -0.5 | 3.1 | 3.9 | 4.2 |
| DJ UBS Commodity | Commodities | 6.6 | -7.9 | 1.6 | -0.8 |
| Wilshire US REIT | REITs | 14.7 | 8.6 | 11.9 | -1.6 |

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

| | Latest Month End (10.31.11) | Latest Yr End (12.31.10) | One Year Ago (10.31.10) | Five Years Ago (10.31.06) |
|---|---|---|---|---|
| *CURRENCIES* | | | | |
| US Dollar Index Value | 76.17 | 79.03 | 77.27 | 85.32 |
| USD vs. Yen | 78.17 | 81.12 | 80.40 | 116.98 |
| Euro vs. USD | 1.39 | 1.34 | 1.39 | 1.28 |
| GBP vs. USD | 1.61 | 1.56 | 1.60 | 1.91 |
| *COMMODITIES* | | | | |
| Gold ($ / ounce) | 1714.85 | 1420.78 | 1359.40 | 606.60 |
| Crude Oil ($ / barrel) | 93.19 | 91.38 | 81.43 | 58.73 |
| Copper ($ / ton) | 7981.50 | 9650.00 | 8186.75 | 7372.50 |
| Corn - Generic ( Usd/bu) | 647.00 | 629.00 | 582.00 | 320.75 |

Within what we call directional alternatives, we think public real estate through REITS looks attractive on a selective basis. Here, just like within high yield, we think the right active manager is key to an allocation that an investor can feel comfortable making in the current environment. Public real estate has great advantages in terms of liquidity and transparency, but the tradeoff includes a recognition of the fact that pricing can be subject to wide variations relative to underlying value due to macro events, market psychology and expectations about future events. This is demonstrated in recent market mood swings around relatively predictable long-term net asset values, cash flows and dividends. We invest with a manager in this space that has an attractive long-term record built upon the idea that sustainable value arises from such dislocations and the ability to deviate from market benchmarks during their occurrence. Currently the manager believes there are opportunities presented by macro “risk off” periods in sectors of the market including retail, multi-family, industrial and hotel REITS. In each sector the discount to net asset value plus the yield makes the group very attractive on a risk-adjusted basis.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To sum up our feelings about, and reaction to, markets that can safely be called unprecedented with respect to volatility and level of 'noise', we think the job of an investor and advisor is to properly manage within a long-term volatility profile. We don't believe that we are out of the proverbial woods but we also don't believe an investor with a time horizon of at least one year should be camping out on the sidelines waiting for the "all clear" signal. Our philosophy on portfolio construction is to build an 'all weather' portfolio designed to withstand challenges both foreseen and unanticipated. Our philosophy on selecting managers and specific investment opportunities has been to primarily focus on low-beta managers in high-beta asset classes. When an asset class is inherently volatile we focus on managers with the fundamental security selection skills to mute that impact. During stretches like the seemingly interminable one that markets have experienced in recent years, this ability to capitalize on "risk on" markets while not facing substantial relative drawdowns when the pendulum swings back too far the other way is the best way we know to grow terminal wealth. The math works, and the smoother ride keeps investors invested. We look forward to continuing this practice with clients going forward.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

*The opinions contained in this document are intended to be an unconstrained review of issues and topics and are not intended to be applicable to any particular client or portfolio. Actual investment decisions for client portfolios are made with consideration to these views, but may differ based on changes in the economic environment and specific client portfolio mandates. There is no guarantee that historical risk, rates of return, or scenarios discussed will persist in the future. All investments are subject to risks. Investments in bonds and bond funds are subject to interest rate, credit and inflation risk.*

*Certain statements in this document may include forward looking statements and forecasts that involve known and unknown risks and uncertainties. The views expressed above should not be construed as recommendations, an offer to sell, or a solicitation of an offer to acquire any security, investment product or service. No representation is given as to the accuracy or completeness of the information in this document, and views are subject to change based on changing market and economic conditions. Clients are encouraged to discuss any of the opinions or topics in this publication with a representative of Permit Capital Advisors, LLC.*

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[i] The Economist, The country of "no", p.63, 10/29/11-11/4/11
[ii] Barron's, Streetwise, p.11, 11/7/11
[iii] JP Morgan, Eye on the Market, 11/4/11
[iv] Bethany McLean, Did Accounting Help Sink Corzine's MF Global?, 11/1/11
[v] JP Morgan, Credit Strategy Weekly Update, 10/7/11
[vi] Ibid.
[vii] S&P Index Research, Market Attributes Fixed Income, October 2011
[viii] S&P Valuation and Risk Strategies, Cross Market Commentary, 11/8/11
[ix] Capital Economics, The Capital Markets Analyst, Q42011
[x] Credit Suisse, Monthly Hedge Fund Industry Update, October 2011