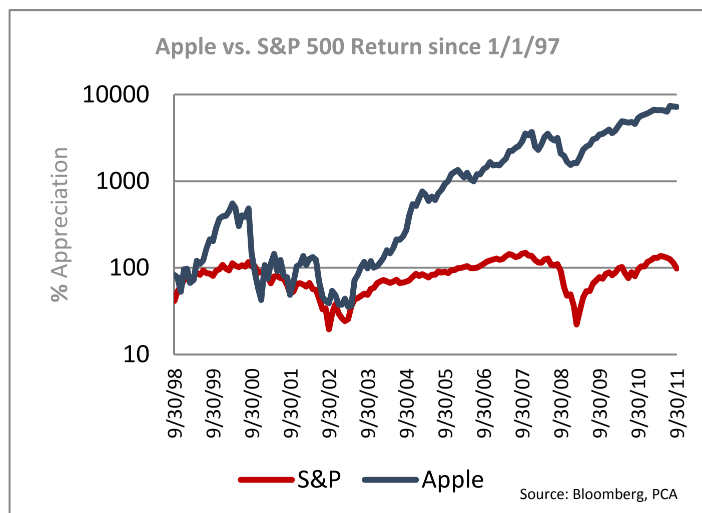
PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

PERMIT CAPITAL ADVISORS, LLC

Much of what is written in the financial press these days deals with the somber topic of jobs, and most often we come away with a feeling of hopelessness based on the enormity of the challenge and the seemingly insufficient capabilities of those charged with addressing it. Last week much of what was written dealt with the somber topic of the passing of Apple co-founder and CEO, Steve Jobs. However, rather than hopelessness over such a profound event, most came away with a feeling of optimism based on Jobs' story, and the unquestionable way in which he improved the world for generations to come. Our clients made a lot of money over the years investing in Jobs' Apple stock. Where they will be well served in an effort to grow capital today would be to follow closely the philosophy Jobs adhered to in building the value of that stock.

Of the various iObits that we read following Jobs' passing, one that stuck out was written by Tiernan Ray in the Technology Week section of Barron's. The title of the piece was *Jobs' Secret Ingredient: Patience*, and in it Ray reflected on one of the underappreciated aspects of Apple's success. As Ray described, "Steve Jobs didn't hit a home run every time, but he got on base more than most CEOs, and that made all the difference"….."Although Apple's stock is up an astonishing 7200% since Jobs returned from an exile in 1997, much of the success came from steady, patient work, not brilliant flashes of inspiration". Ironically, or appropriately, we think investors today will be well served to heed this sentiment. As market focus continues to toggle between micro and macro forces, we believe that long-term success will derive not from identifying ultimate tops and bottoms, but rather a mindfulness of inflection points and a vigilant eye for opportunities that shake out of violent dislocations. This is where an investor can be rewarded by the patient accumulation of investments, often acquired when unease is significant, that over time benefit from a prudent margin of safety and solid fundamentals. Too often, rather than this patient approach to building a portfolio, investors sit on the sideline and wonder whether to go "all in" or "all out".



As we've said in the past, we recognize that putting money to work in an environment this volatile can be a scary proposition. There is a reason the VIX Index, which measures market volatility, is often known as the *fear index*. The VIX has spiked above 40, getting as high as 48 on August 8th, several times since the end of July. To find opportunity and value requires an analysis of what is driving this fear and

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

whether or not the level of fear is warranted. In this market sources of fear, and potential opportunity, include the European financial crisis, the US economic recovery and fiscal positioning, earnings, and China.

There was a point in time where swift and decisive action would likely have been able to ring-fence the crisis in Europe and maintain the carnage to a peripheral sovereign grouping. Having been allowed to fester it is now a broad sovereign crisis with a banking kicker. The haircut that European banks would have taken on bonds of Greece, Ireland, and Portugal is dwarfed by that which they may be forced to take on bonds of Italy and Spain, not to mention the ensuing rise in non-performing loans as a result of the contagion effects. While leaders, and journalists, throw head fakes at the market, a meaningful solution still eludes participants. There has been much discussion about the actions required out of the 'troika' of the ECB, EU, and IMF. We believe the key lies with the ECB. It has been postulated that the European Union could swap all existing Greek bonds into EU-guaranteed debt with the support of an enhanced European Financial Stability Facility – this would be the Eurobond solution. In reality, however, based on events to date this would be politically and legally challenging and far too time consuming. After all, there are 17 parliaments that need to approve EU actions. The ECB on the other hand could act in more unilateral fashion, and negotiate with the Greeks as the sole counterparty to restructure. Unfortunately it seems unlikely that the ECB will have the moxie to take such a step until the crisis has reached full chaos levels.

The maelstrom created by this lack of leadership in Europe has indeed created the type of violent dislocation referenced earlier. We've seen preferred securities of financial issuers who have balance sheet buffers that put them billions of dollars above Tier 1 capital requirements as mandated by Basel 3 get beaten up as if they were on the verge of insolvency. This has made yields very attractive in an environment in which yield is obviously difficult to come by. For names where the balance sheet strength is complemented by a business model with little to no proprietary trading risk, we've made purchases for portfolios that we think represent the type of prudent investment accumulation that serves a client well.

In the US, concerns continue to abound that a variety of factors, jobs chief among them, are going to tip us into recession. From our perspective, a) we're not certain this is the case, and b) we don't believe the potential should cause dramatic alterations in portfolio strategy. On the former, we at PCA systematically track a series of data points on a monthly basis that have historically been leading or coincident indicators of economic fates. These factors include measures of employment, credit spreads, Fed policy targets, and the shape of the yield curve among others. Only credit spreads are on the verge of pointing to a recession, and again, we think this presents as much opportunity as danger. Spreads for high yield bonds are now nearly nine percentage points above Treasuries, and with default rates running at 2% annually and not expected to go significantly higher, we think there continues to be real value in this market. One interesting technical factor that is rumored to have widened spreads is selling by Japanese "double decker" funds. These funds which are sold to Japanese retail investors, combine high yield bonds with a high yield currency exposure, often the Brazilian real. With the real falling off of a

cliff in September, these funds which may account for 6-9% of the buyers in high-yield, have fallen as much as 25% and have seemed to be forced sellers.[i] On the latter, if we do tip into recession what becomes important from an investing perspective is what additional impact will the announcement of recession, as opposed to the current anticipation of one, actually have. There is no recession playbook; duration, magnitude, and impact on equity markets can vary dramatically. In the Great Recession markets fell 57% from their October 2007 peak. In the 1990 recession markets fell just 20%. From the end of April high to the early-October low, this possible recession if it becomes one will already have knocked equity markets down almost 17%.

As of September 30, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	-7.0	-8.7	1.1	-1.2
Russell 2000	Small Cap Equities	-11.2	-17.0	-3.5	-1.0
Russell 3000 Growth	US Growth Equities	-7.7	-7.9	3.4	1.6
Russell 3000 Value	US Value Equities	-7.8	-11.8	-2.2	-3.5

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
INTERNATIONAL EQUITY					
MSCI World ex US	Global ex US Equities	-10.4	-17.3	-11.7	-5.5
MSCI EAFE GR	Developed ex US Equities	-9.5	-14.6	-8.9	-3.0
MSCI Europe GR	European Equities	-11.0	-15.1	-11.3	-3.6
MSCI Japan GR	Japanese Equities	-1.6	-10.8	0.1	-4.8
MSCI EM GR	Emerging Mrkts Equities	-14.6	-21.7	-15.9	5.2

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

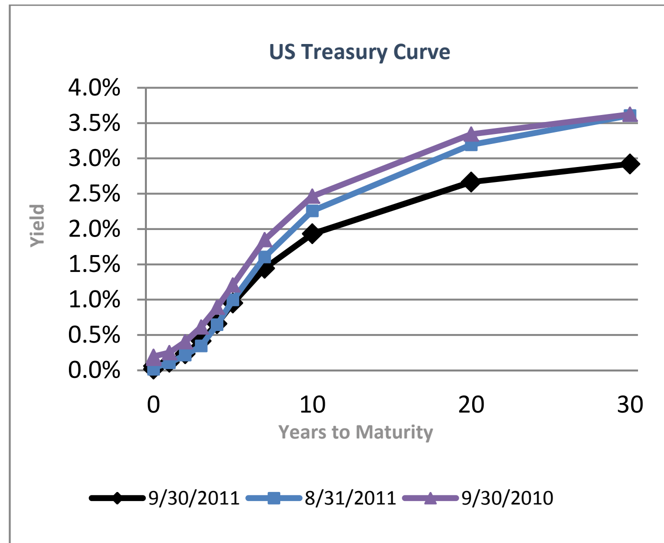
Within equities we continue to believe that domestic large cap, particularly quality stocks that provide a measure of yield, are relatively attractive. Fundamentals for businesses remain strong, as the second quarter was the best quarter in history for operating earnings and the third quarter reports are expected to be down only slightly. Again, fear has gripped both businesses and investors and wreaked havoc with markets. On the part of businesses the fear is causing them to hold stockpiles of cash, and is also preventing them from providing much forward guidance about earnings. On the part of investors, the fear is keeping them from putting money into the market regardless of positive earnings releases. An awful third quarter ended with an abysmal September. Down over 7% in September and over 14% for the quarter, the latter figure was the worst since the fourth quarter of 2008 when the S&P 500 was off 22.56%. Breadth for the quarter was frighteningly bad – in the S&P 500 there were 53 advances and 447 declines. The average change for up names was 5.68%, for down names it was -20.78%. Two stocks were up by more than 25% while a staggering 156 were down by more than 25%.[ii]

Despite this destruction there continue to be signs worthy of optimism, particularly as they pertain to stocks paying dividends. Of the approximately 7,000 publicly owned companies that report dividend information, 350 increased dividends while only 23 decreased. Both figures are improvements over the same period last year. Yields for paying issues moved up to 2.99%, a 60 basis point jump in just two quarters. The dividends appear safe, if not poised to increase, as the maintenance of that cash on balance sheets has payout ratios sitting at under 30% relative to an historical average of 52%.[iii] All of this bodes well for dividend paying, high quality equities. Particularly relative to many sectors of fixed income.

As of September 30, 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	1.6
BarCap US Agg Bond	**Broad US Investment Grade Bonds**	0.7	6.6	5.3	6.5
BarCap Municipal	**Municipal Bonds**	1.0	8.4	3.9	5.0
BarCap Treasury	**US Treasury Bonds**	1.7	8.8	6.0	6.8
Citi WGBI USD	**Global Sovereigns**	-1.9	6.5	4.6	7.5
arCap US HY Interm	**US High Yield Bonds**	-3.3	-1.7	1.6	6.8
JPM EMBI Plus	**Emerging Market Bonds**	-4.1	3.7	1.4	7.9

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



Beyond high yield bonds we also think municipals have become attractive. Across the curve, ratios relative to Treasuries have soared back to nearly 140%, levels seen at the height of the Great Recession. This is due more to the flight to quality trade in Treasury markets than any factor endogenous to municipal bonds. That is not to suggest that the economic peril facing the nation as well as states and municipalities doesn't represent potential risks to the municipal market, but we feel that they can be managed through appropriate security selection. To wit, fiscal consolidation at state and local governments continues, as governments face an aggregate budget gap of $91 billion in the current fiscal year and $32 billion next year.[iv] We think we mitigate this risk by focusing on issuers with strong tax support or revenue streams, and avoiding issues with mandatory extraordinary redemption features which could lead to indiscriminate principal loss.

While hedge funds as measured by the Dow Jones Credit Suisse Hedge Fund Index were down for the quarter, their loss of 1.77% when compared to the MSCI All Country World Index loss of 17.42% lends credence to their role as shock absorbers in a portfolio when markets plummet and money makers when times normalize. We've been beating the drum for the managed futures sector for some time, and true to form they were up 4.29% in the quarter. Another alternative asset class that we feel is getting attractive again is commodities. The space got punished in September as the dollar got pushed up and assets like commodities that are priced in dollars suffered. There are of course risks in commodity positions today, including the potential continued appreciation of the dollar and a hard landing in China, but we think on balance the value and diversification benefits outweigh them.

As of September 30, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
ALTERNATIVES					
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	-2.8	-4.7	0.4	3.4
MLM Index	Managed Futures	-1.4	3.6	5.6	4.2
DJ UBS Commodity	Commodities	-14.7	-13.6	0.0	-1.1
Wilshire US REIT	REITs	-11.1	-5.4	2.1	-3.1

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

	Latest Month End (9.30.11)	Latest Yr End (12.31.10)	One Year Ago (9.30.10)	Five Years Ago (9.30.06)
CURRENCIES				
US Dollar Index Value	78.55	79.03	78.72	86.03
USD vs. Yen	77.06	81.12	83.53	118.18
Euro vs. USD	1.34	1.34	1.36	1.27
GBP vs. USD	1.56	1.56	1.57	1.87
COMMODITIES				
Gold ($ / ounce)	1623.97	1420.78	1308.35	598.30
Crude Oil ($ / barrel)	79.20	91.38	79.97	62.91
Copper ($ / ton)	6998.00	9650.00	8006.00	7568.00
Corn - Generic (Usd/bu)	592.50	629.00	495.75	262.50

A potential hard landing in China in fact is one of the bigger risks across many asset classes. We are of the belief however that policy makers there will recognize that their tightening has gone too far before they reach the precipice. Evidence to that end is mounting, as property developers who have been squeezed by draconian efforts to tighten credit have suffered, and widespread reports of bankruptcies and defaults among this group are spreading. The bigger risk that China represents to global growth may indeed be sparked by policy makers on our shores, as threats of a trade war are again cropping up. There is a theme here, as the leadership, or lack thereof, in developed countries largely holds the fate of the global economy in its hands in a way that supersedes their traditional impact by a significant order of magnitude. This doesn't necessarily give us peace of mind. The Economist last week ran the following warning on its cover- *Until politicians actually do something about the world economy….Be Afraid.* They went on to describe the two greatest risks to this grim assessment. The first is an overemphasis on near-term austerity. The second went as follows:

"The second failure is one of honesty. Too many rich-world politicians have failed to tell voters the scale of the problem. In Germany, where the jobless rate is lower than in 2008, people tend to think the crisis is about lazy Greeks and Italians. Mrs. Merkel needs to explain clearly that it also includes Germany's own banks-and that Germany faces a choice between a costly solution and a ruinous one. In America the Republicans are guilty of outrageous obstructionism and misleading simplification, while Mr. Obama has favored class warfare over fiscal leadership. At a time of enormous problems, the politicians seem Lilliputian. That's the real reason to be afraid."

While we don't disagree with The Economist's sentiment, we do continue to look for ways to take advantage of that widespread fear amongst market participants. This is accomplished by finding value for our clients with the margin of safety and soundness of fundamentals required to hit those singles and doubles that allowed Steve Jobs to create one of history's most successful businesses.

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.

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.

---

[i] Barron's, It's Time to Talk Trash- October 10, 2011
[ii] Standard & Poors Index Research- September 2011
[iii] Standard & Poors Research- US Companies Add $9.6 Billion to Dividend Payments in Third Quarter
[iv] BCA Research, US Bond Strategy- October 7, 2011