HUTCHINSON
CAPITAL
MANAGEMENT

October 2012

INVESTMENT PERSPECTIVES

Uncertainty

"It's tough to make predictions, especially about the future." Yogi Berra

There are many events that have caused investors to be concerned about the future of the U.S. and global economies. These current global issues seem more serious than they have been in the past and make people fearful of making investment decisions. Since uncertainty always exists, living with uncertainty is not the issue; it's how we *respond* to uncertainty that is important. We believe it is not within our ability to predict the future; however, it is within our means to profit from uncertainty. In this Investment Perspective we try not to predict the outcome of each of some of the current uncertainties investors face, but instead focus on the opportunities that these uncertainties may provide.

What is Uncertainty?

It is important to recognize that uncertainty is ubiquitous in our world, but we must also acknowledge that uncertainty doesn't always have to yield negative outcomes. Uncertainty is best defined as "a state of having limited knowledge where it is impossible to exactly describe the existing state or the future outcome(s)."[1] The current state or the future state in the presence of uncertainty could result in either a positive or negative outcome. At Hutchinson Capital, we believe it's critical to focus on the range of possible outcomes—both positive and negative—and the most likely outcomes. We certainly don't pretend to walk around with a crystal ball, but we do try to frame the opportunity set. Uncertainty is what offers investors real opportunities to earn excess returns in the marketplace, because if the world had perfect information of the current state and future outcome(s) this would simply not be possible.

Current Uncertainties

While we don't know the outcome of the issues listed below, we believe it is important to look at the potential for both positive and negative outcomes.

[1] Hubbard, Douglas. How to Measure Anything: Finding the Value of Intangibles in Business. Hoboken: Wiley, 2010

Fiscal Cliff

There is a great deal of concern surrounding the willingness of Congress and the Administration to find a compromise to the coming fiscal cliff. If the automatic tax increases and spending cuts are allowed to go into effect on January 1, 2013, the Congressional Budget Office (CBO) estimates that Gross Domestic Product would decrease from a growth rate of 1.7% in 2012 to a negative 0.5% in 2013, sending the economy into a recession[2]. Unemployment would grow from a projected 8.0% to 9.1%. While extremely painful, one positive outcome of these tax increases and mandated cuts would be a decrease in both the federal deficit and the federal debt.[3] Currently in the Senate, there is a bipartisan group that is trying to reach a compromise to mitigate the full impact of the automatic tax increases and budget cuts that are set to take effect. Often these extreme events fail to materialize and a compromise tends to be more likely.

Unemployment

There is considerable uncertainty regarding the high levels of unemployment and the pace of the reduction in the unemployment rate. According to the Bureau of Labor Statistics there has been a noticeable drop in unemployment from a high of 10% in Oct. 2009 to 7.8% reported for September of 2012 and the trend is clearly down. Another way of looking at it, that doesn't get as much attention, is that 92.2% are employed. With the backdrop of a falling unemployment rate, the number of individuals seeking employment is reaching new highs. This could be a good sign that discouraged individuals are more optimistic that they will be successful in finding a new job.

Housing

Housing remains an important component of the U.S. economy. While mortgage rates remain near record lows, many existing homeowners are not able to take advantage of these attractive rates because an estimated 11 million Americans still owe more than their homes are worth. Also, many potential home buyers face the hurdle of more stringent lending standards since housing's peak in 2006.

Nonetheless, recent improvements in the housing sector represent a positive development which appears to be underappreciated. Evidence to support the view that housing perhaps has finally turned the corner includes the following: housing starts increased +29.1% year-over-year in August;[4] building permits, a forward looking indicator, increased 24.5% year-over-year in August, near a four year high;[5] the National Association of Home Builders index, an index surveying home builders' confidence, rose to its highest level since June 2006; [6] new-home inventories are lower than at any time since the U.S. census began tracking them in 1963.[7]

---

[2] From CBO Publication 43539, Update to the Budget and Economic Outlook
[3] From CBO Publication 43539, Update to the Budget and Economic Outlook
[4] U.S. Department of Housing and Urban Development
[5] U.S. Department of Housing and Urban Development
[6] Wall Street Journal 9/26/12
[7] Wall Street Journal 9/14/12

Europe

Europe's major debt problem is threatening its monetary union and straining the global economy. In order to resolve its debt crisis, Europe has pushed for austerity measures that require massive government spending cuts, which have contributed to slowing economic growth in the region. The material economic slowdown in Europe is in turn negatively impacting global economic growth. While further deterioration in Europe is certainly possible, there is also the potential for a sustained recovery over time. A solution to the European debt problem would likely involve a combination of additional fiscal discipline, bailouts, debt restructurings, and central bank intervention(s). Once Europe remedies its serious debt overhang, we should expect that its underlying economies will start to grow again and should lift the broader global economy.

China's Economy

There is evidence in China over the past nine months of a slowdown in manufacturing and domestic spending as well as build up in capacity in many industries. The deceleration is creating a great deal of uncertainty for many economies worldwide, especially the countries dependent on shipments of commodities such as iron ore, copper, etc. A major question is "can China manage production for anything other than boom-year breakneck growth".[8] In our opinion, China's very high growth rates over the past few years were unsustainable and could have resulted in severe inflation. We believe that the world will adjust to a more moderate and sustainable growth rate in China, which is healthy for both China and the rest of the world. However, China is still expected to grow this year at a 7.8% pace, the fastest of the 43 countries tracked by *The Economist*.[9]

Dealing with Uncertainty

Memorable events impact our decision making. Today, in addition to the uncertainties listed previously, many investors are still recovering (both emotionally and financially) from the 2008/2009 financial crisis. For most people, this has resulted in risk-averse investing behavior. For example, since the end of 2007 there has been $500 billion in outflows from stock mutual funds and $800 billion into bond mutual funds, a record spread.[10] The preference for near-zero returns on cash investments and a 1.63% yield on the 10-year Treasury note in exchange for safety suggests that perhaps many have assumed an overly cautious stance. Indeed, the Federal Reserve and other central banks around the globe intend to keep interest rates low for an extended period of time as an enticement for investors to move out on the risk spectrum. In our view, the perception of risk should not paralyze investors from taking advantage of long-term opportunities.

Like a pendulum, as economic and emotional uncertainty wanes, confidence rises. This confidence pervades individual investor's and business owner's psyche. Just like a cycle in the economy, money moves from the sidelines (cash and bonds) into growth-oriented assets. Business owners stop looking to "hunker down" and refocus on growth and expansion. This confidence leads to a self-fulfilling recovery through hiring and investment.

---

[8] Financial Times article 09.04.12
[9] Economist 09.29.12
[10] Schwab Market Snapshot, July 2012

Conclusion

Like a surfer, we must not focus on the wave that went by, but start paddling for the wave ahead. We believe that those still concerned with the 2008/2009 financial crisis, which is now well behind us, are overly focused on the negatives of today's current uncertainties.

Since uncertainty is omnipresent, it is imperative we not be frozen by it. What is important is how we respond to uncertainty through our investment choices. At Hutchinson Capital Management, we prefer to look for opportunities at the company level based on fundamental analysis. During periods of uncertainty, by staying with high quality investments (stocks and bonds), we believe that they we will provide attractive returns during bull markets and limited downside during bear markets. We believe a consistent investment discipline is the solution to investment uncertainty.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.