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Special points of interest:

- **Obstinance Pays No Dividends**
- **For 2012 Copper is Our Favorite Base Metal**
- **S&P Downgrade Shows Stunning Ignorance**
- **Outlook for Equities Remains Positive**
- **Bond Duration Increased to Five Years from Three**
- **Alpha—The value a Portfolio Manager Adds**

Breaking the Circle of Anxiety and Incapacity

The perception that Washington does not have the capacity to govern has severely depressed confidence. A stalled US recovery, renewed market turmoil, and the downgrade of US government debt have been contributing factors. The US Federal Reserve Bank has and will continue to shoulder much of the load, but fiscal policy must not be written off. A demanding challenge is for Republicans and Democrats to find common ground. Casting every dispute as a battle for the

larger war is bad for the country, militates against compromise, and is delusional. There are certainly areas of potential compromise. For example, the Congressional “super committee” must find \$1.5 trillion of deficit reductions in the next several months. Perhaps the easiest way to win both parties’ support would be a proposal to simplify and create a flatter tax system. Countless panels believe tax rates could be cut and revenues raised at the same time. Everybody wins. Debating

big competing ideas in a democracy is good if it doesn’t cause mutually-assured paralysis. Perhaps at the moment, vision needs to be throttled down and common sense accelerated. Obstinance in defense of core principals pays no dividends, as proven by the fiasco around the handling of the debt ceiling. The outrage that followed will hopefully cause Washington to tactically adjust and become more effective. As bad as the current state is, it’s not hopeless.

Thoughts on Market Volatility

The extreme volatility of 2011 began in August. The largest intra-day swing in the Dow industrials was 640 points, or 6% on August 9. So far, volatility this year has not approached levels of 1987 (DJIA fell 22% on one day) or 2010 (DJIA swung 1,010 points or 10.2% in the one day flash crash). Since after the recent gyrations share prices were only down a moderate amount, investors have been left to wonder whether there was any meaning to the volatility. As is always the case when market gyrations become excessive, we search to know why. Are the gyra-

tions due to market imperfections rather than fundamental economic problems? In the past, the former has been more palatable to politicians and sometimes, even correct. If it is not due to real economic problems, it must be people who seek profit from declines and market innovations. In the 1920s, targets of scorn were Wall Street pools - thought to have manipulated stock prices higher and then dumping overpriced shares on speculators. In 1987, the strategy of offsetting long futures contracts with short sales became the target. In 2010, high-

frequency trading firms were in the fore. In the past and now, volatility increased when markets were already under stress. Most recently, it has been the domestic and European debt crisis. One could further argue that with the markets already nervous, new financial and technological innovations turned what might have been an orderly decline into a crisis. Given that markets do recover and ultimately move higher, it’s like the line from William Shakespeare: “It is a tale told by an idiot, full of sound and fury, signifying nothing.”

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Short-term Expectations for Commodities

Commodities, as a group, have had a good run. Precious metals, in particular, have traded higher as nervous investors have sought safe haven investments. As a result of recent buying, gold, at nearly \$1,600, could be ahead of itself and may see a short-term contraction. For 2012, we estimate gold to average \$1,540. We have taken some profits in the metal and anticipate additional sales in 4Q 2011. Base metals have seen recent profit-taking. Copper (\$8,934) peaked near \$8,990 per metric ton. Assuming a rebound in global growth momentum, we expect copper prices to average \$10,930 during 2012. We anticipate adding to long positions. Platinum and palladium are also likely to benefit as global auto production recovers. Energy

prices are expected to move sideways, yet remain vulnerable to supply shocks. Brent crude trading near \$113 per barrel is likely to average \$108.40 for 2011 and could move to \$100.50 in 2012. The result could be positive for US consumers who may benefit from lower gasoline and heating oil prices. One commodity that may show improved relative strength is US Natural Gas. For a long period of time, natural gas has performed poorly as supplies have continued to increase. The fundamentals may be improving and natural gas, currently trading under \$4 per MMBtu, could rally to \$5.00 next year. Thermal coal and iron ore prices are likely to stabilize near current levels. We expect grain prices to move sideways to slightly lower, but supply shocks could alter

our view. Wheat, while off its high above \$8 per bushel, is still trading north of \$7. Our best guess is for wheat to average around \$6.60 (2012 est.). Over all, our preferred sector for near-term relative strength is base metals. Prices are likely to rebound as China's growth improves. Weaker-than-expected Chinese demand would obviously alter our view. We prefer platinum, palladium, copper and aluminum to energy and grains. Copper remains our favorite base metal. Keeping with our strategy, we will continue to allocate funds to all three commodity sectors (energy, metals, and agriculture) rebalancing as valuations warrant. Currently, Conservative Growth portfolios are 21% allocated to the sector; Moderate Growth portfolios 30%, and Growth portfolios 26%.

S&P Downgrade Raises Numerous Questions

US Debt Downgraded to AA+ from AAA

Under the oligopoly of Nationally Recognized Statistical Ratings Organizations, bond credit rating firms Standard & Poor's ("S&P"), and Moody's and Fitch are for-profit companies that are legally sanctioned to function as quasi-regulatory authorities. These companies attempt to assess the credit worthiness of a corporation's or government's debt issues. It is analogous to credit ratings for individuals. The credit rating assigned is supposed to be a financial indicator to potential investors of debt securities. However, at the heart of the 2008 financial crisis were the disastrously flawed ratings of these agencies. During August, S&P downgraded the debt rating of the US from "AAA" to "AA+" for the first

time ever. The agency took this action after the worst week in US equity markets since 2008. It was a week which not only saw stocks fall, but witnessed an escalation in the European debt crisis. The decision, not shared by Moody's and Fitch, showed tremendous ignorance and disregard for the potential consequences of the currently fragile global financial system. In the opinion of many, the action was unnecessary and the timing could not have been worse. It could also be argued that S&P's reasoning was flawed and that both short and long-term consequences are uncertain. Since these companies are legally sanctioned, they can determine what securities financial institutions can

hold, have an impact on an entity's borrowing costs, and can even impact the amount of capital financial institutions will need to maintain. There was no need for S&P to rush to judgment just days after a bruising political battle that resulted in a bipartisan agreement to raise the debt ceiling. In fact, some have seen the agreement as "a turning point in fiscal policy." It is incredible that S&P believes the US is less credit worthy now than before the downgrade. It also appears that S&P gave no weight to the unique role that the US plays in the global economy. Lastly, the market is saying S&P is wrong. The US enjoys among the lowest interest rates in the world and when investors look for safe assets, they buy Treasuries.

Equity Strategy

Worries that the Euro-area sovereign crisis was turning into a systemic crisis and worsening debt problems both here and in Europe triggered a slide in stocks in July that intensified into August and resulted in a near 18% fall for the Standard and Poor's 500 (1,119.46 closing low). Despite the fact that earnings for the S&P have been growing, the index has yet to return its 2007 high of 1,576. During 2007, the 500 S&P companies earned a combined \$82.56. Analysts project that earnings for the S&P will exceed \$90 this year and \$100 during 2012. Despite the increasing earnings, the average S&P stock is trading 22% off its 2007 high. Stocks obviously have been trading on fear, not fundamentals. The battle between the bulls and bears will continue into the fourth quarter. The bears will focus on the Euro-area crisis, remain concerned about slowing growth in China and speculate that a double-dip recession

may be developing within the US. We are more in the bull camp. We expect a modest growth re-acceleration as a result of additional monetary policy easing, strong corporate balance sheets, and gradual improvement in US employment. The US recovery may continue sub-trend as there is still excess leverage in the economy. However, emerging economies, now 50% of global GDP, are resilient. We continue to be constructive on equities. Earnings are growing, price-to-earnings ratios are close to 2009 levels and, relative to bonds, equities are abnormally cheap. Fear has caused many investors to be underweighted in equities which has led to short-term oversold conditions. Underweighted investors may prove to be a source of buying should the train begin to leave the station without them aboard. There are events that could derail our view. First, the US could implement excessive fiscal

tightening. Guidance from the US Federal Reserve leads us to believe this is unlikely. We would view as a negative either the European Central Bank or the US Federal Reserve Bank failing to provide additional easing measures in the face of weaker US and European economies. Perhaps the biggest risk that could derail equities would be the Euro-area sovereign crisis turning into a deeper systemic event. We'll also keep an eye on corporate hiring and investment. Should companies begin to cut back on hiring, or fail to begin investing the cash now on their balance sheets, this would be a sign of a slowing economy. A sharp acceleration is soft and hard commodity prices would trigger monetary tightening. There is no current evidence of this. Finally, should China overheat and be forced into a policy change, this would be a negative for world growth. For now, our 2012 S&P 500 index target is 1300+.

***The S&P 500
Index has
yet to return
to its 2007
high.***

Interest Rate Strategy

The United States Gross Domestic Product (GDP) expanded 1% in the second quarter of 2011 over the previous quarter. Little improvement is expected for the third quarter. The inflation rate in the US was reported at 3.6% in July. Fear of deflation has caused the US Federal Reserve Bank to maintain a policy of an extraordinarily easy monetary policy. Despite this easing, the inflation rate is just above the historical average of 3.38% (since 1914). Now that QE II has ended, it's uncertain what, if any, additional actions the central bank may take. With the uncertainty surrounding possible additional easing, fear of contracting asset prices has once again been rising.

While economic fundamentals remain disappointing and inflation expectations falling, US interest rates are likely to remain low. Since March, the yield curve has begun to flatten (short rates remaining near unchanged and long rates falling). The 3-month Treasury bill recently yielded 0.01%. The benchmark 10-year note has fallen in yield close to 1.8% while the 30-year bond has dropped in yield from over 4% in March to 3.35%. The flattening of the yield curve is due largely to the Federal Reserve Bank's Open Market Committee announcing it would leave short-term interest rates at current levels for an extended period of time (probably into 2013). We expect the Fed, ultimately, to

implement more asset-side easing, most likely in the form of an extension to the duration of its Treasury holdings. In response to recent fundamental changes, we have (where possible) been extending the duration of fixed income portfolios to five years from three years. The typical Conservative Growth portfolio is 37% invested in fixed income. To target the five year duration for this sector, portfolios have been diversified between one to three year Treasury notes (11%), seven to ten year Treasury notes (16%), with the balance in high yield corporate bonds. The projected yield to maturity for an optimized, five year duration portfolio is 3.02%.

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*"Helping Clients
Balance Risk and
Return"*

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We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information and a complete performance history, please visit www.starkadvisers.com.

Pursuant to Rule 204-3 of the Investment Advisers Act of 1940, we are required by the Securities and Exchange Commission to offer each client a copy of Form ADV Part II that describes our firm and methods of operation. To receive a copy, please call our Managed Account Services Department at (800) 410-0704.

Understanding Alpha

As you recall from the last Commentary, beta tells you how much you can expect a fund's return to move up or down given a gain or loss of its benchmark. In a nutshell, alpha is the difference between a fund's expected returns based on its beta and its actual returns. Alpha is sometimes interpreted as the value that a portfolio manager adds. If a fund returns more than you would expect, given its beta, it has a positive alpha. If a fund returns less than its beta predicts, it has a negative alpha. To

calculate alpha, first subtract the return of the 90-day Treasury bill, for whatever period you wish to measure. The T-bill serves as a proxy for risk-free investment. From that, subtract the fund's excess return based on its beta. What's left over is the alpha.

*"An investment in
knowledge always
pays the best
interest"*

Benjamin Franklin

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**As always the professional staff at Stark
Financial Advisers thanks you for your
confidence and business**

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