HUTCHINSON
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INVESTMENT PERSPECTIVES

Turning The Corner

As we start 2012, there is continued uncertainty in the minds of many people regarding the direction of the economy and the stock market. The Great Recession in the United States ended in June 2009[1], but there is still significant unemployment in the country and anemic economic growth.

Throughout the history of our country, there have been many negative events that have caused us to stop and wonder if we could ever recover. In the last 100 years, we have experienced the Great Depression, two world wars, the oil embargo in the early 1970s, the oil price collapse in 1986, the Savings and Loan crisis in the late 1980s, the collapse in real estate prices in 1991, the technology bubble in 2000, the September 11, 2001 terrorist attacks, and more recently, the Great Recession. We have always recovered from these events because of our entrepreneurial spirit and resilience (see our Investment Perspective April 2011).

Contrary to the opinion of many people, there is good reason to have hope at this stage of the economic recovery. Notwithstanding the European debt crisis and other global economic challenges, we believe that significant amounts of liquidity worldwide along with improving consumer, government and corporate sectors, will be the catalysts for better economic conditions and increasing stock prices over the next three to five years. However, let's first review investment behavior after significant downturns in the stock market and the economy.

Behavioral Finance

History is replete with examples of irrational investment behavior after there have been significant decreases in the value of stocks and bonds, farm land, commercial real estate, major commodities, and after each of the major events mentioned above. After enduring a significant negative financial event, we believe that individuals are often impacted by psychological biases that may impair sound judgment. One such psychological bias occurs when more recent events tend to remain more prominent in decision-making than events that occurred further in the past[2].

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[1] National Bureau of Economic Research, September 20, 2010
[2] In behavioral finance, this is commonly referred to as the "recency bias". *Behavioral Finance and Wealth Management (Michael Pompian, Wiley Finance, 2006)*

We can observe irrational behavior today as individuals make investment decisions that continue to extrapolate negative trends from the recent Great Recession into the future, largely ignoring the market's cyclical nature and the progress made so far.

We see the following investments as flights to safety resulting from this psychological bias:

1. Bond mutual funds continue to post large weekly net inflows totaling nearly $800 billion since the end of December 2007 (compared to net outflows of nearly $400 billion in equity funds).[3]

2. The SPDR Gold Shares exchange-traded-fund has more than $60 billion in assets (from nothing at inception in November 2004), and it was briefly the world's largest exchange-traded-fund (ahead of the SPDR S&P 500 exchange-traded-fund) in August 2011. [4]

Increased volatility[5] in the financial markets recently has only exacerbated this flight to safety after a difficult period by encouraging investors to fear more uncertain times ahead. In the remainder of this letter, we hope to show that individuals should avoid this psychological bias, move beyond their fear, and recognize the cyclical nature of markets. Importantly, we believe that investors simply may be ignoring some clear evidence of a promising recovery ahead.

Liquidity

Liquidity plays a central role in the functioning of financial markets. Liquidity can be described as the availability of short-term loans or the ease with which institutions can borrow. Currently, there are large amounts of liquidity or "cheap money" throughout the financial system in part due to global measures by Central Banks. We can measure this liquidity in interest rates and credit spreads or the difference in yield between corporate bonds and U.S.Treasury bonds. For example, the difference in spread between a commonly used interbank lending interest rate and treasury bills stands at 0.55 % – this is much lower than the 4.0% spread during the 2008/2009 financial crisis.[6]

As Central Banks globally have lowered interest rates effectively to zero, they are pushing profit-minded investors to borrow and take risk. As investors slowly realize that U.S. Treasury Bonds provide them with very modest yields, they may look to other assets to provide a more attractive rate of return. We have seen this in home foreclosure sales where investors are pleased to purchase a home and then rent it if they can make a decent return on their investment.

Currently, banks have returned to a more traditional lending model – they are issuing long-term bonds and CDs and then lending these proceeds to their clients. In times of financial turmoil, this provides banks with more secure funding and markets with more liquidity. Banks are now sitting on large amounts of available cash to lend; however, lending standards are more stringent, which is a good thing! As banks capital requirements become better defined, banks should look

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[3] Investment Company Institute
[4] State Street Global Advisors, January 4, 2012, SPDR Gold Shares
[5] Measured by the Chicago Board Options Exchange's volatility index (VIX)
[6] Bloomberg L.P.TED Spread, 1/5/12

to lend more as the large amounts of cash they hold at the Federal Reserve Bank are currently earning just 0.25%. We are starting to see increased lending in the following chart:

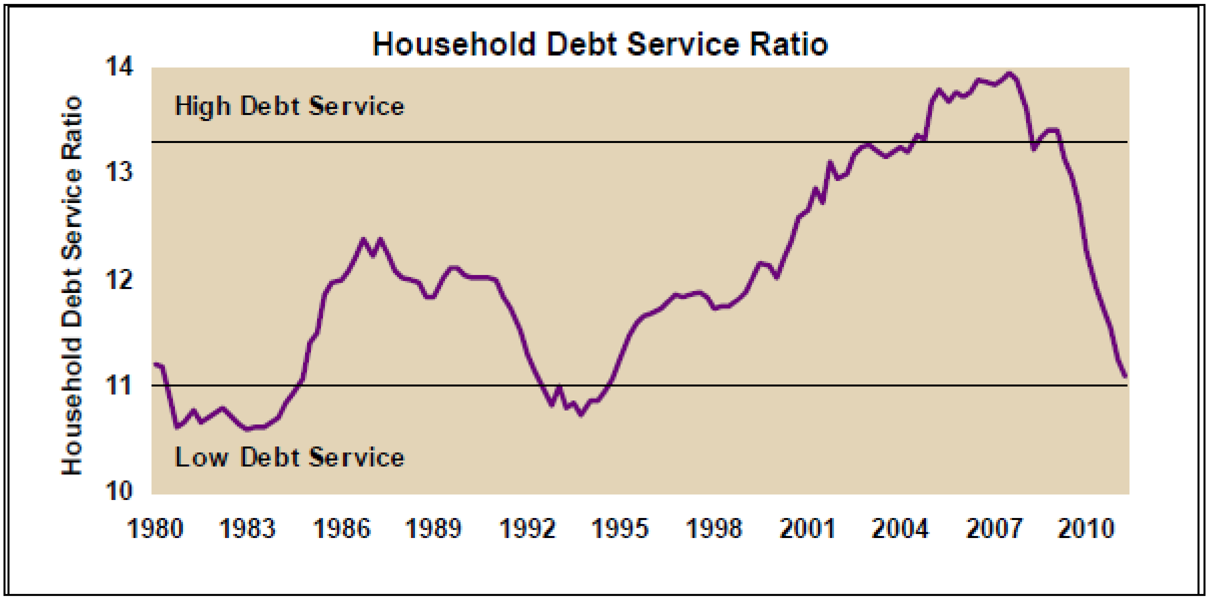
[7]

Today, investors and companies are able to borrow money very inexpensively and invest in projects and investments that have the potential to return a handsome profit. We believe these profits, as well as an increased willingness to take risk, will drive stock prices higher.

Consumer

It is widely known that consumer spending represents about two thirds of economic activity in the U.S. Unsustainable levels of spending and debt (on new homes, remodels, cars, credit cards etc.) are well documented in the media and were driving factors in the 2007-2009 Great Recession. What has not received as much widespread recognition, however, is the notable progress that the consumer has made in the past few years. In our view, the consumer has indeed "turned the corner" in improving their financial condition. The chart below shows the household debt service ratio (or debt payments as a share of after-tax income). This ratio reached an all-time record high in 2007 but has declined for four consecutive years and is now at its lowest level since 1994.[8]

[7] Schwab Market Perspective; Liz Ann Sonders. Factset, Federal Reserve, as of 12/23/11
[8] Wall Street Journal, December 19, 2011



Used from Market Snapshot presentation, Liz Ann Sonders, Charles Schwab & Co., Inc., November 2011. As of 2Q11. Household Service Debt Ratio is an estimate of ratio of required debt payments to disposable personal income. Required minimum payments of interest and principal on outstanding mortgage and consumer debt are included. Source: FactSet, Federal Reserve, N*ed Davis Research (NDR), Inc.*

Other evidence of an incrementally more positive backdrop for the consumer includes:

1. Retail gasoline prices, which act like a tax on the consumer, peaked last May at close to $4 a gallon but have declined about 17% and currently average $3.26 a gallon.[9]
2. Mortgage rates have declined: 30-year fixed rate mortgages have dropped about 1% in the past year and are currently at record lows below 4%. [10]
3. After several years of saving more and spending less, there is "pent up" demand from consumers eager to spend more on postponed purchases of cars, gadgets, vacations, furniture etc. The most recent retail sales figures showed a solid 6.8% year-over-year increase.[11]

In our view, general doubts about the health of the consumer will eventually be replaced with a wider acceptance of the progress the consumer continues to make and this change could represent a pivotal shift in sentiment and psychology – not just for consumers themselves but for other economic participants such as investors, businesses, and government policy officials – and lead to increased confidence in the sustainability of the economic recovery.

[9] U.S. Energy Information Administration
[10] Bankrate.com
[11] Census Bureau

Government

After a severe economic downturn, it is typical for deficits at both the state and federal levels to be high. It is normal for governments to attempt to mitigate recessions through stimulus programs to encourage consumer spending, to enable corporations to have a chance to recover, and to alleviate the conditions of the unemployed. The government is especially hard hit during economic downturns since not only do they try to stimulate the economy, they also experience significant downturns in revenue from taxes.

To adjust to this downturn in revenues, state and local governments try to cut expenditures by reducing the number of employees, and by reducing pension and health care benefits of current employees. Three examples follow:

1. Rhode Island[12] – Lawmakers voted to suspend cost-of-living adjustments for state pensions and to raise the retirement age. To fully fund its pension system, the state would need $7 billion, about as much as its annual budget.

2. Minnesota and Colorado[13] – Judges in each of these states have thrown out lawsuits challenging recent cuts to certain retiree benefits. The judges said that legislatures in these states had the right to reduce cost-of-living adjustments for retirees, saying the benefits were not contractually protected.

3. Marin County, California[14] – The 2011 Civil Grand Jury called for a host of changes, including "prohibiting any retroactive pension benefit increases that create an unfunded pension liability" like San Rafael did in 2004. The grand jury noted that "pension plans are designed to accumulate sufficient funds during an employee's working career to pay the employee's pension during retirement".

Additionally, there are typically strong efforts undertaken to reduce the benefits of new hires. Reductions occur in health and pension benefits while the amounts that employees contribute to these plans increases. In many instances, starting pay is reduced for new hires. Retirement ages may be raised and the length of time that employees must work to obtain benefits may be increased.

We believe that federal, state, and local governments are now starting to move in the right direction and that we will see continued improvement in tax revenues and reductions in expenditures.

[12] Associated Press, November 11, 2011
[13] Wall Street Journal, July 2, 2011
[14] Marin County Civil Grand Jury, from the Marin IJ, June 12, 2011

Corporate Situation

Fundamentally, there are many reasons why now is a good time to invest in businesses. Balance sheets of U.S. companies are currently very strong – for example, S&P 500 non-financial companies are sitting on approximately $1.1 trillion in cash, according to Capital IQ. That's up 70% from 2007 and 200% in the past 10 years.[15] This means that companies are less susceptible to a credit crisis as they can fund their operations internally or make large investments without the need for bank funding.

Due to the downturn, company labor costs are much lower which has led to higher profitability. Companies quickly reduced headcount in the downturn, and have asked more of their current employees which has sharply increased productivity.

In addition, low interest rates mean it's very inexpensive to issue debt. For example, Procter & Gamble recently issued three year notes at 0.7% yield, the lowest corporate bond coupon in recorded history.[16] Issuing debt more inexpensively lowers companies cost of doing business, thus making investing in new projects more attractive since the returns they receive are potentially larger.

Conclusion

We believe that today is an attractive time to invest for the long-term (three to five years or longer) since we believe that we are at the beginning stages of an economic recovery. Our approach is to look continuously for and to invest in high quality businesses that are selling at very attractive valuations. We also believe that investing a portion of most portfolios in laddered, high quality bonds is a viable approach to reducing overall volatility. This is how we have invested our clients' assets and our own retirement plan assets over the past sixteen years, and it is how we intend to continue investing all funds entrusted to us in the years to come.

[15] Barrons, Jacqueline Doherty, 12/10/2011
[16] Bloomberg L.P., Zeke Faux, 8/10/11

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.

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