



PACIFIC GLOBAL
Investment Management Company

Message *from the Chairman*

“A Rewarding Journey”

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Several years ago while on a business trip to Ireland I went on a hike in the countryside. A tourist guide touting this particular trail noted the extraordinary beauty of the area but indicated that a portion of the trail went through a bog. I knew what a bog was but I had no real idea of the challenge of hiking through it. The afternoon was overcast and misty but the beauty of the area lived up to its description. Quickly, however, I discovered the difficulty of hiking through a bog; with each step my boots were swallowed up in the muck. Plodding forward was difficult and quite different from my expectations. I was relieved to reach firm ground. The mud on my clothing left a permanent reminder of this outing. Once on firm ground, I quickly picked up my pace only to come upon another bog. What a disappointment! I wasn't quite sure how difficult the remainder of the hike would be, but I knew turning back would be difficult so I continued slogging ahead on my journey. Looking back, the hike covered only a couple of miles; nevertheless, it was one of the more difficult and memorable hikes I have taken.

The journey through the equity markets over the past three years seems to parallel this Irish trail. Many knew the sub-prime debt market was due for a correction; however, anticipating its magnitude and severity was hard to imagine. The fall of 2008 and winter of 2009 created great anxiety as investors tried to navigate the credit crisis and its toll on institutions and individuals. The spring of 2009 brought a relief rally as banks were recapitalized and businesses began to stabilize and recover. The economic recovery has been anemic compared to past recoveries. Nevertheless, in our experience, portfolios for those individuals who maintained their investment discipline and strategy generally recovered and began to grow again.

Fast forward to the summer of 2011 and a challenging market has reemerged. The European sovereign debt crisis has taken center stage. With it comes the renewed concern that a double dip recession might be imminent. The severe pull back in August and again last week have no doubt created anxiety. Investors are once again reflecting on the emotional and financial toll of the “Great Recession.” Those who are near or in retirement may be especially troubled by the potential impact on their finances.

The European sovereign debt crisis is real; however, this crisis differs in many respects from the financial crisis of 2008. The European debt crisis is manageable but the lack of clarity within the European Union as to how it will resolve its problems has increased. The EU seems to lack the sense of urgency and collective agreement as to the steps to be taken with individual countries as well as the banks which hold their debt. At this point, most investors believe that Greece will have to default on some portion of its debt; the only questions seem to be when and how the default will be packaged. It appears the current negotiations, including new proposals to stimulate private sector growth while reducing the government's dominant economic role, are necessary to achieve a more realistic resolution. The problem facing Greece is essentially behavioral; they have borrowed heavily with little fiscal discipline to support entitlement-rich social policies.

In contrast, Ireland, Spain, Portugal and Italy, while facing significant challenges seem to be taking the necessary steps to reduce debt and slowly recover. The most recent GDP data for Ireland indicate that economic growth, an important catalyst to achieve a meaningful recovery, is underway. This progress is notable as many economists believed Ireland's austerity program would inhibit growth and lead to an eventual default. Spain, Portugal and Italy are all pursuing similar strategies but it is still too early to comment on their progress.

Emerging economies in countries such as China, Brazil and India continue to see impressive growth. The challenge facing these countries is to manage their growth without allowing inflationary pressures to overwhelm their economies. For this reason, these governments will seek to periodically take corrective action to slow their growth. Recent increases in interest rates in both China and Brazil reflect this practice. **Longer-term, these developing economies are creating consumer demand at home to reduce their reliance on exports.** The long-term outlook remains positive even as they deal with the growing pains of a developing economy.

The U.S. economy continues to plod along. Our anemic recovery is creating concerns that sluggish economic growth and the European contagion will result in a double dip recession. The severity of the last recession was created by the collapse of the sub-prime housing market and the resulting near meltdown of the credit markets. **The housing collapse, while still a drag on the economy, is not the threat it was three years ago. Likewise, the credit markets are now highly liquid** thanks to the monetary policy of the Federal Reserve. Lending capacity is near an all-time high. Additionally, consumers and businesses have been paying down debt. The credit demands by consumers and businesses have been low. **This lack of demand has created the illusion that banks are not lending.**

Today, unlike the "easy money" period in the run-up to the sub-prime crisis, consumers and businesses with poor credit quality are having trouble getting credit. Importantly, we are not hearing of companies with creditable balance sheets unable to obtain appropriate financing. In recent conversations, for example, auto dealers have indicated that credit is readily available and the problem is the lack of autos due to the Japanese earthquake. Furthermore, we have seen banks quite willing to work with companies to cover temporary setbacks.

The housing market continues on the long road to recovery. Nevertheless, housing prices in certain parts of the country are rising and rental rates are increasing in most areas. In addition, the formation of new families is on the rise for the first time since the recession. **These factors, along with the low levels of new housing construction, should enable the housing market in many areas to bottom out and begin to grow.** Mortgage financing is also improving for qualified homeowners. The bigger problem has been buyers; they have been reluctant to enter the market on concerns that they might buy too soon only to see the value of their home depreciate.

Many current homeowners continue to be underwater on their mortgages. They, therefore, have limited mobility to trade up or move to other parts of the country for new employment opportunities. Home values will likely not recover for several years; in the meantime, many homeowners are remodeling to upgrade their current homes.

Consumer spending, which historically accounts for approximately two thirds of the economy, has been a significant area of concern. Here too are notable signs of improvement: luxury retailing has been strong and auto sales in 2011 will probably exceed 12 million units which is the highest level since the recession. If auto manufacturing had not been paralyzed by the Japanese earthquake, sales would likely have been even greater. The scrapping of older cars

continues to outpace new sales. **The average age of autos in the U.S. has grown to 10.5 years from the historical average of 8.5 years; the pent up demand should continue to spur auto sales for the next few years.** The earthquake-related pullback in auto sales has been a significant factor in consumer spending reports since April of this year. This area of the consumer market is critically important as autos represent the single biggest purchase for most individuals. Spending in other areas has been somewhat uneven but this can be attributed, in part, to consumers paying down debt and the gradual easing of credit for less credit worthy buyers.

Unemployment continues to be the one area in which little progress has been made. **Historically, employment rates begin to improve as GDP growth reaches 2½%.** Given the severe impairment of the housing industry, this growth rate has been hard to achieve. Additionally, States, counties and municipalities have laid off government workers due to budgetary cuts. Further, consolidation in many industries has also led to layoffs as companies right-sized following acquisitions. **Absent any significant long-term policy to spur economic growth, the pace of an employment recovery will be slow.**

The partisanship in Washington politics has been another source of investor concern. The tug-of-war between those who wish to increase spending to stimulate the economy and those seeking austerity has dominated the headlines. Corporations considering new investment opportunities face the added uncertainty of increased regulation and the introduction of costly new programs. In our view, much of the stimulus spending over the past two years was used to plug state and local budget deficits. Other spending was oriented towards infrastructure projects that were longer-term; many carried a potentially high cost for local and state governments to absorb. The potential increase in jobs, if undertaken, is probably years away. This uncertainty will continue to be a drag on economic growth until a more sound economic growth policy emerges.

The road to a sound strategy for U.S. economic growth will require a combination of budgetary restraint and pro-growth policies for individuals and corporations that are more equitable and predictable. Even though many voters are sending a message to legislators that fiscal responsibility is paramount to prosperity, progress seems unlikely until after the 2012 elections. Only time will tell how much progress will be made in implementing a well-thought out growth strategy for the U.S. economy.

The U.S. economy faces many challenges; yet many companies are seeing resurgence in their business operations. The future remains bright as they navigate the slow economic recovery. This may sound counterintuitive but the contraction in many industries has rewarded well-managed companies and expanded their growth opportunities. As a result of this phenomenon, companies in many industries have improved pricing power as demand, while weakened, is greater than supply. We believe that, as the slow economy takes its toll on weaker companies, this trend will continue. Struggling businesses will be unable to generate sufficient revenue to pay down debt, invest in new equipment or take advantage of strategic acquisitions. Business leaders remain vigilant to changing economic conditions but believe that growth opportunities will continue to develop over the next several years. In reality, the sluggish growth, while it negatively impacts the overall U.S. economy, will help certain companies.

In recent years, equity investing has been difficult. Investors fear that as new concerns emerge, the hope of recovery is fading and along with it, the ability to meet their investment objectives. **Many are advising investors to go into cash to protect principal until the markets improve.**

Unfortunately, with cash investments providing a negative return when considering inflation, this will ultimately be a losing proposition. This logic also assumes that investors will accurately time their reinvestment into the equity markets. Historically, most investors wait to reinvest until a market recovery is well along; they re-enter the market after it has experienced significant growth.

Even though the pace of economic growth may ebb and flow, high quality companies still offer attractive investment opportunities for long-term growth. It is important to be selective and have a good understanding of each company's business model and ability to execute its growth strategies. Not all companies in a portfolio will achieve the anticipated success; nevertheless, maintaining an investment discipline that is focused on fundamental value provides a strategy that looks for dominant well-capitalized companies. Over time, and even in a slow growth economy, this strategy should reward the patient investor.

There are, and there will always be, good reasons not to invest in the equity markets. **More importantly, there will also be attractive opportunities to invest in even when economic conditions are unfavorable.** I have highlighted some of the challenges facing the economy and yet, even now, I can see some signs of progress. There are many attractive investment opportunities in the midst of the pessimistic headlines and the differing opinions in the business media. **In contrast to the 2008-2009 recession, inflation and interest rates are low; credit markets are liquid; and the Federal Reserve continues to maintain a high level of liquidity in the economy.** Then, our focus was evaluating the ability of companies to scramble in managing the "Great Recession." **Today, many companies have embarked on growth strategies that are well-thought out, opportunistic and disciplined; company managers in many areas of the economy are optimistic as they move forward.**

While it was difficult to appreciate the beauty of Ireland while slogging through the bogs, the journey was both challenging and rewarding. I was able to appreciate the beautiful countryside and the accomplishment of completing the journey. Similarly, investing is a long-term journey. Investors begin the trek with great enthusiasm. They anticipate their portfolio growing to meet the financial objectives they have established. But, just like the Irish trail, investing has its own bogs which are challenging and, at times, seem to never end. **During these periods, investors become easily discouraged and often confused by conflicting advice and media commentary. The equity markets can generate times of great enthusiasm as the markets move higher and periods of pessimism as the markets retreat.** Unlike a savings account, which provides a small but steady return, **success in equity investing requires a focused investment approach that is adaptive while maintaining a strategic buy-sell discipline through all phases of the market cycle. History demonstrates that equity investing can be one of the most rewarding investments for those willing to continue their journey through the market's ebbs and flows.**

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