

A Q3 Client Letter Drawing on Buffett's Optimism 'The U.S. is coming back now' - and why three investment veterans are bullish on stocks

By Dan Richards
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Since 2008, each quarter I have posted a template for a letter to clients; these are consistently among my most popular articles.

This quarter's letter provides clients with perspective on the recent market turmoil. I hope that you find this useful as a starting point for your own client letter. The letter currently runs long, so eliminate quotes that don't resonate for you. Alternatively, you could construct your letter using just quotes from Warren Buffett – the link to his interview is at the end of the letter.



And a reminder as always to spend the time to make this letter yours by incorporating your own point of view and language.

A third quarter letter: Warren Buffett: “The U.S. is coming back now” ... and why three investment veterans are bullish on stocks

“This country comes back we came back from Pearl Harbor and we're coming back now.”

Warren Buffett
Charlie Rose Show – Friday September 30

Each quarter, I attempt to provide perspective on the last 90 days. This letter draws from two sources. One is a 30-minute interview with Warren Buffett on PBS on Friday September 30. The other is a September panel discussion with the title “The End of America?” moderated by CNBC's Maria Bartiromo and featuring three participants with long experience and outstanding track records:

*Larry Fink, CEO of Blackrock, the world's largest asset manager
Pierre Lagrange, a highly respected hedge fund manager based in London
Meredith Whitney, an investment analyst who was among the first to identify the looming problems for US banks*



Before focusing on the themes emerging from Buffett’s interview and the panel discussion, here’s a recap of the last 90 days.

Market performance in the third quarter

This has been a year of contrasts, starting with a first quarter that saw strong increases, with the second quarter flat.

The third quarter was ugly with a capital U, with extreme volatility and the sharpest decline since the first quarter of 2009, when we were in the throes of the global financial crisis. The main drivers of this decline were sovereign debt worries in Europe, a dramatic downgrading of growth forecasts for the global economy, a slowdown in China and mounting talk of a double-dip recession.

Below are results for key markets. These are in local currencies, so the effects of swings in the dollar are not reflected here.

2011	US	Europe	Japan	Emerging Markets	World Markets
First Half	+6.4%	+2.6%	-4.1%	-2.0%	2.6%
Third quarter	-15.2%	-17.9%	-9.6%	-14.8%	-15.3%
2011 to date	-9.8%	-15.7%	-13.3%	-16.5%	-13.1%
12 months to September 30	+0.7%	-10.8%	-5.7%	-11.6%	-5.6%

Source: MSCI, All cap stocks, local currency

So that’s what’s behind us; the key question is what’s ahead. Four themes emerged from Warren Buffett’s interview and the September panel discussion – the real challenges facing the US and Europe; confidence in America’s ability to respond to those challenges; the cost of risk avoidance in investing; and the opportunities for solid companies in the period ahead.

Theme one: Challenges for Western economies

The first theme relates to some of the troubling issues facing the United States and Europe. None of the experts sugarcoated the real challenges ahead.

Warren Buffett on the challenges for Europe:



"It was clear well over a year ago that we were headed towards a cliff (Europe) tried a grand experiment where the imperfections in it are becoming manifest and the numbers are big ... the solvency of the banks is intertwined with the solvency of sovereigns and vice versa ... while they melded the currency for 17 countries, they didn't meld the culture, they didn't meld the fiscal policy"

Larry Fink on the role of government:

"I don't think this environment is any different than the 1970s. In the 1970s, the United States was worried about Japan, we really questioned the vitality of this country, we were questioning the kinds of things we were manufacturing, we had Watergate, the oil crisis, and during those ten years the S & P was up 1.5% a year and yet corporate earnings were up 12% a year during those ten years.

The same thing is going on now where we're seeing earnings growth but we're obviously seeing a flat market and a lot of it has to do with the uncertainty around government, very similar to the 1970s. As investors in the 1980s and 1990s and the first part of this past decade, government was not part of our thought process and now we're trying to get rebalanced , today we don't even know what the foundation is."

Meredith Whitney on US housing:

"What really powered the US economy for the past 20 years was housing, the biggest structural unemployment problems are in those states like California and Florida that were wed to housing, housing's not coming back and it's hard to imagine housing becoming a driver of the US economy going forward"

Theme two: The end of America ... or a new beginning?

Despite the issues facing it, there was broad consensus about America's ability to make the changes needed to compete.

Warren Buffett on a double-dip recession

" I don't buy that we're going into another recession ... I'm looking at 70 plus companies, they're not galloping but there has been no downturn except for construction, which is on its rear.

We have a wonderful economy in the US ... this country comes back, it came back from Pearl Harbour and it's coming back now."

Larry Fink on opportunities for US companies



“Today we have opportunities that our corporations never had.... At a time when our country is not doing as well, our corporations are doing quite well by building and manufacturing products, selling products to the emerging world....people forget that we are still the largest exporter in the world, we just happen to be the largest importer in the world by a little more.

And so having a stronger world actually is stabilizing this economy, it's not hurting this economy, it's providing the engine for stronger corporate growth... in most cases when selling products overseas creates jobs here too, and it is a myth that all of these jobs are being exported overseas”

Meredith Whitney on emerging markets within America:

“You have incredible opportunities that are created outside the US that actually help the US get out of its morass ...

Every generation the US recreates itself economically ... we're doing that now, even though it's a painful process ... if you look at the strength in America, agricultural rich states, what I call the emerging markets of the US, which also have the cleanest balance sheets, you have 22% plus growth dynamics ... what they're really doing now is attracting businesses, attracting jobs, you've got incredible job opportunities, growth within these markets.”

Theme three: Understanding the price of avoiding risk

One topic that got a number of comments was risk avoidance as the paramount objective for many investors.

Larry Fink on the biggest risk for investors:

“I would avoid 2% treasuries, other than fear it's very hard to make a living earning 2%

So if I had to look where to invest I would own a core amount of treasuries just for liquidity purposes, and I would be looking towards dividend stocks, I would be looking towards credit opportunities especially with the European banks selling assets there are going to be some great credit opportunities for investors in Europe. The greatest worry I have is under-investing and destroying your foundation, and I think that will be the greatest risk in the next few years.”

Pierre Lagrange on being ruled by fear:



“There are quite a few sectors like the Swiss franc that make no sense where you’re only there because you’re scared of everything else and that always backfires”

Theme four: Opportunities in global markets

Another area on which experts agreed was that valuations make US and European stocks exceptionally attractive

Warren Buffett on buying back Berkshire shares

“When we buy back our own stock we are intensifying our interest in mostly American companies ... each shareholder will own a greater percentage of Burlington Northern, a greater percentage of GEICO”

Pierre Lagrange on the upside for European companies:

“Europe is making adjustments at the political level structurally which is very good. What’s less accepted is the return on capital employed is really very strong.

Since 2008, (companies) have really had the license not to spend money. And you have had an extraordinary drive to productivity increases and cost rationalization, so we have a lot of companies which have an extraordinary operating leverage, now in some areas of the most cyclical nature it is going to be eaten away by raw material increases, but in other areas you are going to be very strongly surprised positively by the earnings of these companies which is sort of defying expectations in quite a few industrial and consumer stocks.”

Larry Fink on European multinationals:

“We’re of the view that European companies are probably a good place to invest, they’re benefiting like US companies, the Siemens, the Nestles, we’re talking about companies with incredibly low valuations now that are benefiting from the world, they’re being harmed right now because of the instability in Europe but I do believe that over a longer cycle you will benefit from owning those companies.

“Investors worldwide are diversifying. I think that is one thing we have to accept as a nation, the world going forward because of the successes of South America and China and India, the world has a greater ability to diversify than ever before, there’s going to be a bias towards more global investing , less dollar oriented investing.”

What this means to you



The key points that emerged from Warren Buffett's interview and from the panel reinforced the conversations my team and I have been having with clients over the past year: Clearly we should be cautious given the policy challenges ahead, but for those investors who need growth to achieve their long term goals, we also need to take a longer view on outstanding companies available today at inexpensive prices.

The panel's consensus that the best opportunities are in high-quality multinationals that pay substantial dividends is one that we hold as well. We also subscribe to Larry Fink's suggestion that for investors with cash on the sidelines, now is the time to start putting some of that money to work, and we are planning to do this in stages over the period ahead.

One final point pertains to anyone who doubts America's ability to compete. Each year, Britain's *Financial Times* ranks universities around the globe on quality and reputation. In its last ranking, the U.S. had the each of the top five and 15 of the top 20 of the world's universities. For all of its challenges, the best and the brightest talent is still clamouring to come to the U.S. – and that gives us confidence about America's ability to do what it takes to compete and to maintain its global lead.

In the period ahead, I or one of my team will be in touch to discuss how your portfolio is positioned. In the meantime, should you have any questions about your portfolio, the contents of this note or any other issue, please give me a call – I'd be happy to answer your questions on the phone or at our next meeting.

In the meantime, here are links to Warren Buffett's [interview](#) and to the [panel discussion](#).

As always, thank you for the opportunity to work together.

Best regards,

Name of advisor

Dan Richards is a top-rated presenter at advisor conferences and an award winning instructor in the MBA program at the University of Toronto, as well as author of Getting Clients Keeping Clients: The Essential Guide for Tomorrow's Financial Advisor. To learn more about his conference keynotes and workshops, email dan@clientinsights.ca.

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