Talbot Asset Management Quarterly Report

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The Election Is Over, Now What...

I woke up on November 7th and nothing politically had changed. The President won and Congress is still divided. So what does that mean for investors? In the short run, we're going to see portfolios being adjusted since capital gains will likely be going up next year. The "fiscal cliff" (or more of a fiscal slope), takes effect at the end of the year and along with the return of the U.S. debt ceiling in early 2013.

Although my X's and O's have still been positive, the market sold off dramatically the day after the election. Many investors across the country threw in the towel. "Sell me out, I'm done" was heard across the country. Investors capitulated for psychological reasons. Unfortunately, knee jerk reactions to political events are not usually fruitful. America will go on, but there will be differences in what companies roll on and which companies buckle under the weight of repressive government and government regulations. In general, overall economic growth will be muted and in fact will probably decline into a possible recession in the first half of 2013. Unemployment could get worse and probably remain high for quite some time.

Should President Obama compromise on the fiscal cliff, stocks could have significant upside. I'm not optimistic he will compromise but even if he doesn't, many equities are cheap and many bonds are expensive.

According to a recent research report from highly regarded economist, Brian Wesbury of FT Advisors, there is probably a 25% change of a recession in 2013. He believes the European situation improves along with a substantial depreciation of the Euro. He believes we will have slow economic growth and the burden of bigger government. However, most companies have restructured and are quite profitable right now. FT Advisors used a profit model to find the fair value of stocks. They divided corporate profits by the current Ten Year Treasury yield (1.7%) and compared the ratio of the index to each quarter for the last 60 years. At current profit levels vs. interest rates it estimates the fair value of the Dow at an absurdly high 51,500 or four times the current level.

Obviously, that's crazy and the result of artificially low long term interest rates. So they adjusted their model using a more appropriate Ten Year Treasury yield of 4.5%. Using this 4.5% rate, it gives a more reasonable fair value of 19750. But what if we have the recession next year and profits fall 25% and interest rates rise to 4.5%? They still estimate the fair value of the Dow at 15,500, if that happens. What this means is that the upside still appears to be much greater than the downside especially when factoring the low interest rates and easy money floating in our economy.

So what sectors look good (or bad) based on the election? I still believe blue chip stocks that pay dividends will do fine.

Energy

The election gives the President the ability to implement a number of environmental actions without Congressional approval. This will include ozone regulations and controls on coal.

Potential Winners: Biofuels, Energy efficiency companies, vehicle efficiency companies, waste water efficiency companies

Potential Losers: Coal, Hydraulic Fracturing companies

Financials

With the President's re-election, all of Dodd-Frank's mandated rules will be enacted. The biggest beneficiaries are the exchanges that trade derivatives.

Potential Winners: Exchanges, Clearinghouses

Potential Losers: Agency Real Estate Investment Trust, Payday Lenders, Money Center Banks, Homebuilders

Healthcare

Obamacare takes effect. This is a big positive for pharmaceutical and biotech companies as they see a significant number of new patients. Other big beneficiaries will be Medicaid HMO's and cost containment contractors. Biggest losers will be companies tied to Medicare Advantage.

Potential Winners: Pharmaceutical, Biotechnology, Medicaid Health Management Organizations, Medical Device companies, Hospitals, cost containment companies

Potential Losers: Medicare Advantage Insurers, Health Care Providers

Defense

The Obama strategy is to pay more for technology as opposed to modernizing ground warfare systems.

Potential Winners: Cyber-security, Intelligence, Surveillance

Potential Losers: The broad Defense Industry

Other Potential Winners

Gold: due to the inevitable monetary debasement we will probably continue to experience since the odds of the government reigning in the deficit is near zero.

Firearms and ammunition manufacturers: If you've been to a gun shop lately, you'll know why.

In summary, with interest rates so low, it is prudent to be cautious but not too bearish.

Trends in Education...

I've been on the Board of Directors of Tau Kappa Epsilon Fraternity for the last seven years, the last three as the International Treasurer. I've spent a lot of time in strategic development with the fraternity along with working directly with the today's college students. In higher education, I see some positives and negatives developing that parents of children under the age of 18 need to be aware of. This is a global economy. Employers are shopping for graduates worldwide and you have to have the skills that compete with kids from Taiwan to London. Therefore, degrees have to be useful in a global economy. I've told kids for years the best thing they could do is learn Mandarin Chinese. In a few years, 60% of the world will speak Chinese. Last year, the Chinese were teaching 30 million people how to speak English while we were teaching 10,000 people Chinese. More universities are emphasizing applied sciences degrees in anticipating the global economy as opposed to Fine Arts Degrees.

The biggest issue and threat to higher education is coming from the internet. Harvard and MIT have just launched edX, a platform to deliver courses online. MIT had one of their professors open up his lectures for free and over 350,000 from all over the world signed up for it. Most universities are not worried about it - yet. They still believe that personal interaction is the best way to learn. I agree, IF you are a Notre Dame or USC. But what about Western Illinois University or the University of Arkansas at Monticello? The threats to these schools are huge down the road. I mean, why take a science class at Western Illinois University when you can plug into one from a professor at Harvard or MIT? Why would parents pay high fees to sit through mediocre lectures when you can go online and watch world experts, even if it's in another country?

With this trend on the horizon, costs at small to midsize institutions should begin to decline. Besides the aforementioned scenario, state and federal budgets are tight and will probably not be increased anytime soon. For the younger generation, the gap between online and real life is blurred (they would much rather text you than talk to you). Therefore, the transition to online universities could come faster than some people think.

With that being said, how do parents plan for this? First, you do need to save for it and the 529 plan is an option. A 529 plan allows you to save money tax deferred with qualified withdrawals for education expenses tax free. If the cost associated with college is less than anticipated or your child doesn't go to school, you can transfer the plan to another child or relative or you can recapture the assets (special terms apply). I would encourage all parents to fund a 529 plan to the best of their abilities.

The reason I would encourage the use of 529 plans is the disastrous scenario involving student loan debt. The worst thing parents can do is saddle their kids with debt after college but that is what is occurring. When I first got on the Fraternity Board, it was not uncommon to see every kid with 5 - 10 different credit cards all at their maximum limits. They were living for the day. After the 2008 financial crisis, it was much harder for kids to get credit cards so they opted for the next available piggy bank - student loans. The average student has more than $24,000 of student loans. Coupled with the fact that most parents had under saved for college and you have a real problem down the road. Most kids will be 35 - 40 years old before they are out of their student loan debt and on their way to saving. Please call us, if you haven't already set up a 529 for each of your children or maybe for your grandchildren.

I have seen a few other disturbing trends in high school education. Kids today can land F-15 fighter jets on their computers but can't solve elementary algebra problems. Therefore, I'm seeing several college students forced to pay for classes in math that they should have learned earlier. I would strongly encourage parents to utilize computer added education to assist their students in math and science. It will save you money down the road along with making them better prepared for degrees which are more applicable to todays economy.

I had another disturbing trend confirmed to me by a Dean at one of the area high schools. I had an honor student at West Orange High School ask me what the difference was between capitalism and socialism since that was what he was seeing all day long with these political ads. I asked him why his economics teacher didn't explain that to him. He said they don't offer economics or any finance classes anymore to high school students. I was stunned. High schools are more worried about standardized testing and preparing their students to pass these tests. It's no wonder that kids have no concept of money when they aren't taught the value of it early on in life.

The New Retirement Income Model...

Over the last 30 years, interest rates have plummeted to historic lows. The Ten Year Treasury Note was 14% when I got into the business in 1981 and it's 1.70% now. We have been in a bond bull market for 30 years. The average annual returns on government bonds over the last ten years has been 9.0% a year vs. 2.0% for stocks.

Look at the trend of interest rates vs. dividend yields in the S & P 500 over the last 30 years.

	Ten Year Treasury* Note Yields	S&P 500 Dividend Yields
1980	12%	6%
1990	8%	3%
2000	6%	1.1%
2010	4%	2%
2012	1.70%	2.10%

Historically, financial planners would use a rule of thumb that suggested subtracting your age from 100 and that would be the percentage you should allocate towards equities. Therefore, a seventy year old would have 30% invested in stocks and 70% in bonds. (100 - 70 = 30% stocks and 70% bonds).

With interest rates this low and the S & P 500 yielding more than bonds, this historical allocation model (and several models created by using past performance) is no longer valid. The returns on bonds that we have experienced over the last three decades are impossible to duplicate. In fact, the risk in owning fixed income assets at this point are larger and retirees need to plan accordingly.

Health of Investors...

A recent article in Advisor One magazine suggest that CNBC is **detrimental to the health of investors**. It didn't single out CNBC, it was applicable to all financial news. Kansas State University Financial Planning Research Center led by Sonya Brett and Dr. John Gamble wrote a recent paper, "Financial News and Client Stress," which said this about financial news and the resulting stress:

They found that contrary to what you might think, stress goes up when **watching** financial news and hearing the market went up causes stress levels to rise even **higher** than if the market went down. Specifically, 67% of people watching CNBC Bloomberg and Fox Business News showed increased stress, while 75% of those who watch only positive financial news showed increased levels of stress.

WHY? "Financial news was found to increase stress levels particularly among men" they wrote. Surprisingly, they said that positive news created higher levels of stress suggesting that people feel regret for not taking action. The authors felt "people tend to feel remorseful when they look back at a situation and realize they failed to take action." The authors concluded: turn your TV off to become better investors.

Late Night Revelations & Useless Information...

- LEGO is a Danish company that patented those classic LEGO pieces in 1958. LEGO is a combination of the Danish words LEg GOdt which means "play well." Since 1958, there have been over 600 billion LEGO bricks produced.

- In 2012, over 40%of babies in the United States have been born to single mothers.

- There is probably no better indication that America is in decline than when you watch the new TLC show "Here Comes Honey Boo Boo." Enough said.

- There are approximately 10 million bricks in the Empire State Building.

- Did you ever wonder what the WD-40 stands for? Researcher Norm Larsen was trying to find an anti-corrosion formula while working on the principle of displacing water. On his 40th try he got it right! Therefore, WD-40 literally means water displace 40th try. (source: WD-40 website)

- According to Dorsey Wright and Associates, if Apple Computer had been added to the Dow Jones Industrial Average in 2009 instead of Cisco Systems, the Dow Jones Average would be close to 16000!

- Taco Bell was founded in San Bernardino, CA in 1946 by Glen Bell who was 23 years old when he opened a hotdog stand. Six years later he sold the hotdog stand and started selling tacos. Thus Taco Bell!

- I was talking to a foreign exchange student from China recently. She told me the funniest thing she has seen in America is when people take pictures. People say "cheese" when they take pictures. In Chinese, chie zi sounds like cheese but means "**go die.**"

Notes from Nancy…

RMD: I'm pleased to introduce a new IRA account feature that automatically calculates and pays out your required minimum distribution (RMD) for the year – whether you select monthly, quarterly, semiannual or annual payments. The distribution amount is calculated at the beginning of each year, and payments from your retirement account will remain in effect for as long as you wish – simplifying the process for you.

Assuming sufficient funds remain available, your payments will go out like clockwork on the scheduled date. If you like, we can also adjust the frequency and pay date to suit your needs. Should you opt to take an additional distribution outside the scheduled payments, any remaining RMD payments will be adjusted to ensure you receive only your RMD for the year.

If you are required to take a minimum distribution from your IRA, you can begin to take advantage of this convenient periodic payment feature at any time. I will be happy to help you establish a schedule that makes the most sense for you.

IRA: For 2012 contributions, individuals who have "earned income" may contribute 100% of their earnings to an IRA up to $5,000 per year. An additional "catch up" contribution of $1,000 may be made by those who are age 50 or older by year-end.

REMINDER: our address for the new world headquarters is **32 S. Main St., Winter Garden, FL 34787**. Please remember this when sending correspondence and checks.

REFERRALS: If you have a friend or relative you feel would benefit from our services, please feel free to refer them to our website or have them call the office. We are so thankful for the referrals we obtain from clients, it is the best compliment we could receive!

With Thanksgiving approaching, we wanted to take a moment to thank you for placing your trust in us during these challenging times. We value each of you as a client and as a friend and look forward to continuing to meet your investment needs. Happy Thanksgiving to you and your family from all of us here at Talbot Asset Management!

You can view our newsletters on our website, **www.raymondjames.com/talbotassetmgmt**, in addition to receiving it in the mail. Our website includes articles regarding hot financial topics, stock quotes, access to related financial links, and an overview of Talbot Asset Management, Inc., as well as the products and services we offer.

* Yields are interpolated by the Treasury from the daily yield curve. This curve, which relates the yield on a security to its time to maturity is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market. These market yields are calculated from composites of quotations obtained by the Federal Reserve Bank of New York. This method provides a yield for a 10 year maturity, for example, even if no outstanding security has exactly 10 years remaining to maturity.