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Mid-Quarter Outlook

By John M. Silvis, CFA

Director of Investments

As we embarked on the third quarter, the capital markets finally succumbed to all the political wrangling over deficits, debt ceilings, downgrades and defaults. Both in Washington and in continental Europe, concern has risen over how each will deal with their structural issues. The solution here domestically, while dramatic, has been mostly discounted by the equity markets. The debt ceiling was raised by \$1.2 trillion, avoiding a last minute shut down, and a committee was formed to find another \$1.4 trillion of savings extending the ceiling until after the election in 2012. As a result, S&P downgraded the sovereign debt of the United States pushing an already shaky market to decline -14.9% so far this quarter.

The issues in Europe are more severe and structural in nature. The sovereign debt issues in Greece continue to add stress to the 17 nation Eurozone as their combined economy slows and edges towards another recession. A long term solution on how to fund the ongoing needs of the peripheral countries remains unanswered and has now drawn in both Spain and Italy. The ECB has expanded its program to purchase government debt, which now includes Italy and Spain, in an effort to avoid a large scale default of sovereign debt or an intensifying banking crisis. The fear within the domestic equity markets is that the ongoing contagion in Europe could spread to the United States and stall our already fragile economic expansion.

The fundamental picture, while battered over the last few weeks, has not broken and remains in place for potentially better returns in the equity markets in the months or quarters ahead. As we deal with the aftermath of the debt downgrade and the ongoing correction in the markets, it should be expected that the markets need to take some time to consolidate and build a better base in the coming weeks or months. The technical trend has shifted from positive to more balanced, and the expected returns are more muted. The economy, while disappointing, should continue to expand in the second half of this year. Corporate profits remain a bright spot, with second quarter earnings growing over 15% versus last year. Balance sheets remain strong, further driving M&A activities (the most recent example was the purposed purchase of Motorola Mobility by Google for \$12.5 billion in cash), stock buybacks and higher dividend payouts. Valuations remain attractive and monetary policy remains firmly accommodative supported by the most recent statement by the Federal Reserve to keep rates low until mid 2013.

Fairport Global Asset Allocation

Since the cyclical high in the S&P 500 Index back at the end of April, Small and Mid Cap equities have come under pressure as investors continue to de-risk and move towards safety. The biggest beneficiary has been high quality, multinational Large Cap stocks. The international Developed Markets, lead by the crisis in Europe, have come under pressure. We remain underweight Europe and have been cautious in general towards investing new funds overseas with the exception of Canada. The international Emerging Markets remain a long term investment; however the growing global concerns, along with rising food costs continue to hinder the equity markets of the BRIC countries. Commodities prices, with the exception of crude oil, remained firm so far this quarter led by the rise in precious metals such as gold and silver.

Fairport Large Cap

The current dividend yield of the S&P 500 Index is 2.1%, roughly the equivalent of the yield on the U.S. 10-year Treasury note. The continued flight to quality has driven investment funds into the higher quality, dividend paying, multinational companies. Health Care and Consumer Staples, two sectors we are overweight in, have outperformed on a relative basis during the correction. Technology, a sector we have reduced but remain overweight, has also held up well during the last few weeks. Financials, led by the banks, have come under renewed pressure as investors remain concerned with the potential fallout from Europe.

Fairport Fixed Income

With the Eurozone sovereign debt crisis unresolved, Treasury yields fell below QE2 lows, with 2-year and 5-year yields dropping to record lows. Weak economic data along with extreme market volatility also chipped away at consumer confidence, further contributing to the decline in yields. While current yields appear appropriate for an environment of negative growth and zero inflation, this economic environment appears more indicative of a slow growth, low inflation recovery.

By historical measures, government bonds appear to be unattractively priced relative to stocks. For example, the ratio of the 10-year Treasury note yield to the S&P 500 earnings yield dropped to .40 last week, registering the lowest reading since 1958. In early August, the Fed also signaled its intention to keep rates low for two years until mid-2013. Following the announcement, the front end of the Treasury curve flattened considerably, as 3-year maturities yielded only 30 basis points. As a result, we continue to remain overweight spread product, as the Fed's latest action will likely encourage investors to move further out on the yield curve or take on more credit risk (for example, high yield, emerging markets debt).

Happy Birthday Fairport

This September we're celebrating our tenth year under the Fairport Asset Management banner in a couple of special ways. We're producing a short video that reflects on the firm's roots dating back to 1963, as well as our current successes and bright future. The video will feature words of wisdom from the founders of the firms that preceded Fairport—Roulston and Company founder Thomas Roulston, II and The Hickory Group founder Paul Abbey—as well as reflections by current co-Managing Partners Ken Coleman and Heather Ettinger. The video will premiere at a birthday party-themed, Fairport Night event for clients, employees and friends at the end of the month at the House of Blues.

In this fickle industry, we understand that our longevity is due to the support of our loyal clients. Whether you're a long-time client or you've joined us this year, it's our privilege and honor to serve as your trusted financial advisor. From our partners and the entire Fairport team, sincere thanks and cheers to the next decade!



Client Question

More and more frequently, our clients are inquiring about “alternative investments.” As Manager of Investments, Rick D’Amico oversees the implementation of the firm’s fixed income models and is responsible for the review and oversight of Fairport’s alternative investments and strategies. Below he answers some frequently asked questions about the subject.

*By Richard P. D’Amico, CFA
Manager of Investments*

“What are alternatives?”

Fairport uses alternative investments as a way to build more diversified portfolios and help manage risk for clients. An alternative investment can be broadly categorized as an investment that is not one of the three traditional asset classes (i.e., stocks, bonds, and cash). More specifically, alternative investments are often divided into two sub-categories; alternative assets and alternative strategies. Alternative assets, also called "hard assets" or "real assets," are tangible items that hold inherent value—that is, their value is not derived from other sources (e.g., Commodities, Currency, Real Estate). Alternative strategies are tactics or tools used to create value through investments in traditional and nontraditional asset classes (e.g., Long/Short Equity, Managed Futures, Event Driven, Global Macro).

“What are the potential benefits?”

Adding alternative investments to a traditional stock and bond portfolio helps to maximize risk-adjusted returns while also providing a degree of downside protection. This can be achieved due to the historically low-to-negative correlation of alternative investments with traditional asset classes. In general, alternative investment strategies also tend to have a lower volatility relative to equities. One trade-off which should be considered is that alternative investment strategies are unlikely to keep pace with equities in periods of strong equity outperformance.

“How can alternative investment strategies be utilized in my Fairport portfolio?”

Fairport offers diversified exposure to alternative assets and strategies through our Liquid Alternatives Model, which currently consists of seven mutual funds and one exchange traded fund (ETF). Once available mainly to institutional investors, alternative investments have become widely accessible in a mutual fund or ETF format. These formats offer some distinct advantages over traditional “hedge fund” or LP structures in the form of lower fees, and increased transparency, liquidity and regulation. On the flip side, mutual funds and ETFs face more constraints in terms of the amount of shorting and leverage that can be employed.

If you’d like to learn more about alternative investment strategies, please contact a member of your Fairport team.

Fairport News

Fairport believes in supporting the community as a company and through encouraging employees to participate and hold leadership positions in charitable, professional and community organizations. Read about our most recent community involvement.

Ken Coleman was re-elected as chairman of MidTown Cleveland Inc. Board of Trustees. MidTown Cleveland is an economic development corporation that serves the two-square mile district between downtown Cleveland and University Circle in which Fairport’s office is located. The organization is funded by members with a focus on business retention, economic development, safety and creating a visually appealing urban district.

Peter DeVito was appointed as Treasurer of the Merrick House Board of Directors for this upcoming year. Merrick House is a Settlement House neighborhood center located in Cleveland's Tremont neighborhood that provides community services from infants six weeks old to seniors in their nineties.

Heather Ettinger was honored with the 2010/11 Exceptional Service Award by the Estate Planning Council of Cleveland for her recent work on the FWAC national women’s survey/white paper and long-time commitment to financial literacy and advocacy for women. The Exceptional Service Award is not necessarily given out annually; it is awarded only when the committee identifies someone providing outstanding service that merits significant recognition. Heather was honored at the Estate Planning Council Annual Meeting and Awards Luncheon in June (she is pictured on the following page with Award Committee Co-Chairs Ginger Mlakar and Lisa Michel).



Emily Shacklett has joined the Board of the Autism Family Foundation (Akron). The Autism Family Foundation strives to help parents of children with Autism through fundraising, advocacy, support and resources.

John Silvis was appointed to the programming committee for the CFA Society of Cleveland. The mission of the CFA Society of Cleveland is to provide opportunities for professional development and fellowship among Cleveland-area investment professionals, consistent with the ideals of excellence, integrity and education as set forth by the CFA Institute.

Fairport Continuing Education

Fairport employees frequently attend conferences, continuing education seminars and informational webinars to keep up-to-date with new strategies and industry trends relating to the wealth management needs of our clients. From investment management to client service to technology, read more about the conferences we've recently attended.

Rick D'Amico attended the Innovative Alternative Strategies Conference in Chicago in June. The conference offered attendees a look beyond traditional alternative investments and strategies into the "new breed" of alternatives, how they are perceived by the investing public and how they are being utilized by successful advisors.

Heather Ettinger attended the Schwab EXPLORE conference in June and met with the members of the Family Wealth Advisors Council (FWAC) in Boston in August.

Rachel Margulis is taking the first of six of The American College financial planning courses, with the ultimate goal of obtaining her Personal Financial Specialist (PFS) designation. The PFS program allows CPAs to demonstrate their knowledge and expertise in personal financial planning.

Paul Zappala attended the Schwab SOLUTIONS 2011 Conference in Columbus in August. The annual SOLUTIONS workshop trains attendees how to best utilize Schwab technologies and tools to streamline workflow and help deliver exceptional client service.

Newsletter Disclosures

This newsletter represents an assessment of the economic and market environment at a specific moment in time and is not intended to be a forecast of future events or any guarantee of future results. It is for informational purposes only and should not be relied upon as research or investment/financial planning/tax advice. It should not be considered as a solicitation or recommendation by Fairport to buy, sell or continue to hold securities or other investments. Past performance is not a guarantee of future results, and is not indicative of any specific investment. It should not be assumed that the investment process and strategy discussed herein has been or will prove to be profitable. Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

