

# HARMAN INVESTMENT ADVISORS

January 15, 2012

## Quarterly Letter

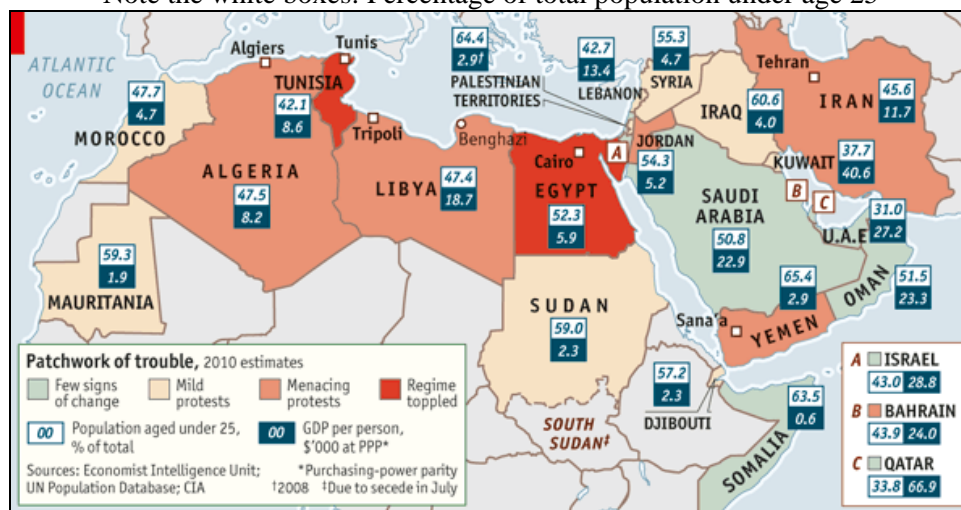
Clients seem to start conversations with “What I’m concerned about is.... We often share the same concern. Recognize, however, that there are two sides to every story and money to be made going long or short. (While we can’t short stocks *per se*, we can take opposing positions through stock selection and / or sector rotation.)

Today, we’re confronted with concern about the US economy (debt / entitlements, housing, unemployment), Europe, the Mideast, and China (among other things!). We can adopt a pessimistic or optimistic viewpoint. And can only predict, position, and react to events as they unfold.

Before discussing our current outlook, let’s look at some long-term trends. There are, in our opinion, several themes to current global events: credit, demographics, and energy. They’re important because geopolitical events have been driving the market recently. We believe:

- Sovereign debt won’t be paid off. It will be repudiated by default, legislation (e.g., a reduction of unfunded entitlements / promises), or inflation.
- The battle for resources between the young and old will be won by the young. Simply put, the old die. Nassim Taleb, author of *The Black Swan*, co-authored an article in *Foreign Affairs* entitled “The Black Swan of Cairo.” He states “What the world is witnessing in Tunisia, Egypt, and Libya [the overthrow of dictators] is simply what happens when highly constrained systems explode.” The same dynamic is unfolding in Europe and the US. In Europe, the sustainability of the welfare state is being challenged. In the US, state and federal finances are strained by entitlements. As the population balance shifts from old to young, as in the Mideast, the rules are being re-written.

Note the white boxes: Percentage of total population under age 25



Courtesy of The Economist, February 17, 2011

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- North America will become energy independent (sooner than later). While politicians continue to push “green energy” alternatives, a quiet revolution is occurring. Natural gas is slowly replacing gasoline and diesel in fleet vehicles—and there’s no reason it can’t power your car. (There is, in fact, a Honda Civic model that only runs on compressed natural gas.) According to Chesapeake Energy, we now have a 200-year supply of natural gas. And because of supply and demand, natural gas prices are now considerably cheaper on an energy equivalent basis than oil; hence, the commercial fleet conversions. We expect the rest of the transportation fleet to rapidly follow. (Another positive: The loss of oil revenue will generate further change in the Mideast. We expect the Mideast to follow the development course of Japan / Korea / Taiwan and China over the next several decades. The Arab Spring may become the Arab Renaissance.)

Current outlook: The economy and stock market have been “cycling” through inflation / deflation, risk on / risk off, optimistic / pessimistic swings of roughly six months duration since 2008. We attribute the cycles to competitive devaluations / monetary policies of the central banks.

The economy is currently improving. Manufacturing, employment statistics, and consumer confidence have improved. We interpret rising commodity prices, including energy and copper, as a sign of strengthening demand. Fourth quarter GDP growth may be as high as 3%.

The issues that could derail the economic expansion are widely known (and debated). Here’s our current viewpoint:

- China will not have a hard landing. Authorities are taking steps to reinvigorate growth. In the last few weeks, bank reserve requirements were reduced, higher bank capital requirements deferred, and the renminbi yuan devalued. The major difference between China’s housing bubble and ours is that China’s was driven by excess savings and limited investment alternatives, not fraud and overextended consumers. They need the housing. The *Wall Street Journal* reports China has “a crash program to build 36 million subsidized apartments by the end of 2015—enough units to house the entire population of Germany. The goal is to head off social unrest by ensuring decent places to live for low wage workers, but also to cushion an expected fall in high-end construction—the result of policies to tame property speculation.” (*Wall Street Journal*, December 31, 2011)

- Europe. The EU will remain intact and the Euro survive. Greece will default; time’s passed and everyone’s prepared. Spain is taking the steps necessary to restore fiscal balance. Italy hasn’t (although they posture as having done so). Germany and the EU may be entering a recession. It will speed the re-structuring process and probably be short-lived (if our read of central bank management is correct). We will be the short-term beneficiary—until they grow and we stagnate.

- Iran is bluffing; however, the risk of a mistake is high. Iran’s threats to oil transport and the US Navy are designed to raise oil prices, deflect attention from the emerging, domestic economic crisis, and protect an unpopular regime. Recent actions by the US and Europe to deny Iran oil revenue are working. Since the US sanctions law was signed on December 31st by President Obama, the Iranian Rial has fallen by 17% (as of January 6<sup>th</sup>). Official interest rates have been raised, reputedly to 20%, to fight emerging hyperinflation. Iranians are liquidating assets (financial and hard) and investing the proceeds in foreign currencies.

The “people” know the regime’s end is near. Following fraudulent elections last year, the Green Revolution spontaneously erupted. It’s the unpopular government that’s at risk. Armed conflict with the US and other countries would cause a “spike” in oil prices. However, we don’t think the Iranian military will initiate a conflict they can’t win. More likely, they’ll either (a) guide events as in Egypt or (b) abandon their uniforms as in Iraq. And any rise in oil prices will be temporary.

We assign a low probability to a Chinese hard landing, a break-up of the EU / Euro, and armed conflict in the Mideast. We, in fact, assign a higher probability to (managed) Chinese growth, a recovery in Europe in 2H:2012, and an Iranian revolution.

Worse case, low probability scenarios always exist. Unfortunately, doom and gloom make good headlines. And with neighbors out of work, we pay attention. As events unfold, we’ll re-position as we deem appropriate. We manage money based upon the most likely scenario. Today, that’s the economic expansion reflected in improving economic statistics.

On behalf of the firm,

Douglas K. Harman, CFA, CPA  
President and Chief Compliance Officer

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## Core Equity I – 4Q:2011

**STRATEGY:** The Core Equity I is a value-oriented, all-capitalization, and concentrated portfolio.

S&P 500 - 4Q:2011	11.82%
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We all know that risk and return are related and that, over the long term, risk is rewarded—witness the upward bias of the Dow and S&P 500. Risk, however, is two-sided and 2011 was one of those years when risk taking didn't reward. During 2011's bear market (April 29<sup>th</sup> to October 3<sup>rd</sup>), the S&P 500 fell 19.4%. Cyclical sectors, e.g., materials, fell more, and defensive sectors, e.g., utilities, fell less.

We believe a new cyclical bull market (within a secular bear market) began in September / October following the mid-2011 cyclical bear market. Unfortunately, we can't predict its duration. We expect the market to "run" into late January / early February, just as it has the last several years. We (and others) will then re-evaluate our expectations for the year. Wall Street analysts have been lowering earnings estimates for 2012. Management guidance during "earnings season" will be closely watched.

The past several years have been characterized by high correlations within and between asset classes. Thus, as the economy moves from risk on to risk off, the market switches from pro-cyclical to defensive. "Themes" rather than sector rotation or stock selection drive returns. That may be changing.

When the consumer deleveraging cycle is complete, we expect that a "normal" economic cycle will re-emerge. That is, one driven by interest rates and sector rotation. Some economists believe we're about two-thirds of the way through the de-leveraging cycle. Thus, it's encouraging to see housing stocks participate in this expansion; a move validated by recent building permit, housing start, and pending home sales data. Consumer deleveraging, while not complete, may have reached a point where low interest rates are having an impact on consumer behavior.

We remain over-weight industrial, energy, and material stocks because they operate globally (i.e., they benefit if any country is expanding), and secular growth in demand is straining capacity. While this "theme" didn't work in 2011, cyclicals have been outperforming since the market turned in early October. .

We also continue to look for individual securities that warrant purchase. Value investors rely upon sector rotation and "trouble," e.g., an earnings "miss," to create opportunity. Since 2008, opportunities of that nature have been limited. That's why thematic investing remains the primary tactic. We are, though, starting to see more companies with 50% profit potential, particularly smaller ones, pass our screens. Last year was unusual in that large capitalization, particularly high yield securities, outperformed. Small- and mid-capitalization companies are being overlooked.

Based upon what we're seeing—specifically, widening divergences in capitalization and sector performance—we suspect that a better investment environment is starting to develop.

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## Telecommunications and Utility Approach – 4Q:2011

**STRATEGY:** The Telecommunications / Utility Approach is an actively managed equity-income portfolio that strives for above-market (S&P 500) dividend income as well as incremental capital appreciation attributable to individual common stock selection.

S&P 500 - 4Q:2011	11.82%
S& P Telecom. Sector	7.90%
S&P Utilities Sector	8.28%

We introduced the Telecommunications and Utility Approach, an equity-income portfolio, during the second quarter of 2011. Since inception, the T/U portfolio is out-performing the S&P 500. As of December 31, 2011, the current yield of the portfolio is 5.40%.

During 2011, Telecommunication companies underperformed and Utility companies outperformed the S&P 500. Other things being equal, Telecommunication companies are now undervalued and Utilities overvalued. Telecommunication companies tend to be “pro-cyclical” and utilities’ “defensive.” The Telecommunication companies’ relative investment performance recently started improving—just as you’d expect when the economy begins to improve. While utilities’ revenue and earnings are tied to the economy, their stock performance is, in large measure, driven by interest rates. Thus, they perform relatively well when interest rates decline, i.e., during recessions (and bear markets—as occurred in 2011).

Despite economic improvement, we don’t expect interest rates to rise substantively. Utilities are likely to stay overvalued: (1) The Federal Reserve has signaled that it will maintain low interest rates until mid-2013. And (2) utility company yields—at year-end, about 4%—exceed the yield of most common stocks and bonds. To get the same yield, investors have to “stretch,” i.e., commit for the long-term or take substantively more risk. At year-end, the S&P 500 yielded 2.1%, the 30-year US Treasury yielded 2.89%, and the Bank of America Merrill Lynch Corporate Master effective yield was 4.24% at 7-10 years, 4.84% at 10-15 years, and 5.13% at 15+ years. The BofA Merrill Lynch High Yield Master effective yield was 8.29%.

Several companies raised their dividends during the fourth quarter: Ameren Corp. (from \$1.54 to \$1.60 per year, a 3.9% increase); American Electric Power (from \$1.84 to \$1.88, a 2.2% increase); and Vectren Corp. (from \$1.38 to \$1.40, a 1.5% increase). In December, Progress Energy declared a special dividend of \$0.259 payable January 9<sup>th</sup> in order to align its payment schedule with that of Duke Energy. (The regular quarterly dividend of \$0.62 was paid November 1<sup>st</sup>.) The companies’ merger is awaiting regulatory approval.

On November 1<sup>st</sup>, NTELOS Holding spun-off Lumos Networks thus becoming a pure wireless company. NTLS reduced its dividend from \$2.24 to \$1.68. LMOS established an initial dividend rate of \$0.56 per year. Thus, investors (like us) holding both positions still receive \$2.24 per year.

Because of their relative valuations, we’ll be incrementally moving funds from utilities to telecommunication companies. We’ll do it in a manner designed to enhance and not reduce dividend income, i.e., to the extent feasible, positions will only be reduced after a dividend “ex-date.”

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