Robshaw & Julian Associates, Inc.

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Investment Matters

For the quarter ended September 30, 2011

Consider Dividends

At current prices, the expected real return from holding a 10 year Treasury bond to maturity is approximately zero. While these bonds pay 1.9% cash interest each year, that is about the same as the expected annual rate of inflation for the next 10 years. The net result is no increase in purchasing power, or no real return.

This situation reflects extraordinary pessimism about the prospects for the U.S. economy. Historically, real expected returns from 10 year government bonds have approximated the real growth rate of the economy, about 3% per year in the post WW II era. Today's bond buyers are not only betting that inflation stays well below historic averages but that the economy generates no real growth over the next ten years, something which has never happened before not even during the Great Depression.

Stocks appear to offer better returns with relatively low risk. First, stocks in general are attractively priced at about 12 times current earnings. This is well below the long term historical average of 15 times. Other value measures such as price in relation to book value or price to cash flow also suggest that stocks are cheap.

U.S. stocks also have the advantage of high exposure to the faster growing global economy. Companies in the S&P 500 Index generate 40% of their sales from outside of the U.S. A growing portion of these foreign sales are from fast growing economies in Asia, South America and Africa.

But the biggest advantage stocks have over bonds is dividends. The average dividend yield for a stock in the S&P 500 is 2.3% and many high quality stocks such as Chevron, GE, Home Depot, Johnson & Johnson, Proctor & Gamble and Pepsi pay 3% or more.

Over the last half century dividend payments have grown about 1% faster than inflation.

Dividends usually hold up even during recessionary times. There were only five years in the history of the S&P 500 Index when dividend payments declined. And because firms today only pay out about 30% of their earnings to shareholders, the risk of a decline is low.

In fact, dividend payments are likely to grow. Over the last half century dividends payments have grown about 1% faster than inflation. In the past two years they are up 20%. Over long holding periods some stocks may end up with annual dividend payments which approach or even exceed the original cost of the shares to the investor.

Investing in stocks always takes patience and often requires a strong stomach. At this point, cheap, high quality dividend paying stocks are very likely to provide good long term returns with tolerable risk.

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Tiny Greece Is A Big Problem

According to the IMF, Greece's economy ranks 32nd in the world with total 2010 output of $305 billion, about the same as the State of Maryland.

Despite its small size, Greek financial troubles are depressing stock markets around the world. Last year when Greek debt was downgraded to junk status, U.S. stocks fell 16% in two months. This year the crisis is again being blamed for further depressing stock prices.

The real problem is not Greece itself but that Greece may be the canary in the European coal mine. A Greek default on their national debt would signal a threat to the very existence of the European Monetary Union and the economic advantages of a single European currency. The effect on the world economy would be severe.

Seventeen countries now use the Euro in place of their own currency. By eliminating the need to convert currencies each time products are sold across international borders, the Euro has resulted in large savings and helped establish the euro-zone as an economic rival to the U.S.

But when countries adopt the Euro they cede power to control their monetary policy to the European Central Bank. Individual government power to tax, borrow and spend, is the only means left to them to control their separate

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Greece: continued

economies. In place of the discipline forced on governments by a currency which fluctuates in value as national policies become more or less prudent, member countries pledge to keep debt levels within sensible limits.

Predictably, this arrangement makes it tempting to cheat, which is exactly what happened. When Greece adopted the Euro in 2000 they were already in violation of the rules, a fact they managed to keep secret until 2003. Now that the debt problem has worsened, they are not strong enough to grow their way out of it. Instead of the natural austerity which would be forced on them by a national currency with less buying power, they are resisting the austerity which European Union leaders are trying to force on them by political means.

If the political will and fiscal discipline required for the Euro to function is not sufficient to prevent a Greek financial collapse, Europe will be picking up the pieces for many years to come.

The Population Bust

In the frenzy to lay the blame for our current economic malaise on greedy bankers and incompetent political leaders, we may be overlooking a fundamental social shift which is depressing economic growth. The recent financial crisis and slow economic recovery may be partly a consequence of slower population growth.

Although we have always experienced strong population growth, the growth rate has been slowing for years. In parts of the world it has reversed: Japan's population peaked out years ago; Germany and Russia have birth rates below their mortality rate and little or no immigration; China is discouraging further growth with its one child policy. Although the U.S. population is still growing, the rate of increase has fallen to less than 1% per year, including immigration.

Slower growth results in a population with a higher average age, a condition which is exacerbated by life-extending medical advances. An older population generates less economic activity. There are relatively fewer young people who want to accumulate houses, cars and electronics and more old people who feel they have enough. Older people also tend to save and invest while younger people are more inclined to borrow.

Thus, as populations age, more money becomes available for making loans at the same time that the loan demand declines. This drives down the cost of borrowing (i.e. interest rates). The rate of return from all investments declines as banks and businesses have more money to invest but fewer opportunities for return.

Slow population growth also depresses economic growth more directly. The total output of an economy is defined as the product of the number of people working times the amount of work they each produce. When the U.S. workforce was growing at about 1.5% per year, real economic growth was bolstered by that amount every year. With workforce growth expected to average about half that rate over the next decade, a significant decline in real economic growth is almost inevitable.

A dynamic system like we have in the United States is particularly well suited to meeting the deflationary challenges of a population slowdown. First, unlike other developed economies, our population is still growing. This is in large part due to growth by immigration, an advantage we enjoy over almost all other countries. Second, as a democracy, we are better able than others to adapt our public policies to new realities. Third, as a free market economy, our private sector business leaders have plenty of experience at meeting and overcoming new economic challenges.

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The Bottom Line: 9/30/2011

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1132	0.7%
Small company stocks *(S&P Small Cap Index)*	355	0.9%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	1.9%	From 2.5%
Inflation *(Consumer Price Index)*	224.8	3.4%
Energy *(West Texas Intermediate Crude Oil)*	$78.90/bbl.	-1.3%
The economy *(Inflation adjusted GDP)*	$15.0 trillion	1.6%

QUOTABLE

"Chains of habit are too light to be felt until they are too heavy to be broken"

Warren Buffett

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