



SAN ANTONIO CAPITAL MANAGEMENT - QUARTERLY INSIGHTS

Investing Side by Side

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Please welcome Dr. GP Singh to our Advisory Board

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In This Issue

Stormy Quarter Ends on High Note

While people fret over the 2nd quarter "soft patch," we see underlying strength in corporate fundamentals, and look forward to a more robust second half of the year.

Partners Flagship Portfolio Update

With the end of QE2 looming, we have been defensively positioned throughout the 2nd quarter, but are looking for brighter skies ahead as we turn to fall.

Digging for Gold

Gold has long been seen as a store of value. With global printing presses spitting out money, see why we think it makes sense as a piece of one's portfolio.

Understanding 529 Plan Distributions

Parents looking to take advantage of the many benefits of saving for college with a 529 plan will want to know the full details on which educational expenses qualify for tax-free distribution status -- and which do not.



Stormy Quarter Ends on High Note

In a quarter marked by a global economic slowdown, an awful May jobs report, high oil prices, and continued crisis in the Eurozone, stocks ended the quarter on a high note. The S&P 500 rose 4% in the quarter's last four days, regaining most of the ground that was lost earlier in the quarter. Overall, the Dow ended the quarter up 0.8%, while the S&P 500 and Nasdaq finished about 0.3% lower.

Most of the problems encountered during the last three months had roots in previous quarters. We believe that the economy hit a "soft-patch" in the 2nd quarter in large part because of the after-effects of the March Japanese earthquake and tsunami. Since the economy came out of recession in 2009, manufacturing and exports have been by far the largest contributor to economic growth in the United States. However, manufacturing slowed worldwide in May. The Institute for Supply Management's monthly index tumbled from 60.4 in April to 53.5 in May. Manufacturing figures also weakened in China, Germany, and the UK. A big reason for the weaker numbers in the U.S. is that imports of auto parts fell 13% in April. Manufacturers simply did not have the necessary parts on hand to make cars, and production and sales showed marked declines because of it. Toyota's unit production in the U.S. fell from 111,000 in February to a mere 31,000 units in May.

While we feel that the 2nd quarter soft-patch was temporary, fears were rampant during the quarter that the slowdown was more permanent in nature. High oil prices and unemployment helped to contribute to these fears. We feel that it is not a coincidence that the S&P 500's peak for the year was on April 29, the same day that oil prices peaked at \$114 per barrel. High gasoline prices act as a tax on consumers and businesses alike. Oil prices started the year at \$91 a barrel, but the loss of Libya's 1.8 million barrels a day of oil as well as strong global demand from the emerging world brought about significantly higher prices during the quarter. As a result, the \$20+ increase in oil prices effectively wiped away any stimulus for the American consumer from the 2% payroll tax holiday instituted in December. As tends to happen when there is inflation, consumers began to change their spending habits and started to drive less. As oil prices dropped due to lower US consumer demand and economic data weakened from the Japanese hangover, investors began to interpret the drop in oil prices as a sign that the economy was weakening significantly.

The 2nd quarter soft-patch also showed up in the May unemployment figures. The US economy added only 54,000 jobs in May, much less the 150,000 jobs needed to keep up with the growth of the labor force. Real hourly wages continued their slide, moving into negative territory in May as well. As would be expected, the S&P 500 fell more than 2% in the two days after the release of the report.

And of course, there are our friends in Europe. Throughout the month of June, a cloud hovered over the head of Greece and the global economy as a result. After providing Greece with a loan of 110 billion Euros (\$149 billion) only one year earlier, Greece was forced to ask for another lifeline from the European Central Bank and core Eurozone governments. With public bond markets demanding over 20% yields on their debt, Greece simply could not afford the financing costs to refinance maturing debts. Eurozone finance ministers were forced to go back to the drawing board once again to find a way to rescue Greece. But after having gone through this same process a year ago, political unity showed signs of fracturing this time. On one hand, you see Greek citizens marching the streets in

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protest of continued austerity measures, which have helped to bring about a 16% unemployment rate in the country. On the other side stands Germany, a nation undergoing an economic renaissance in large part due to their sound fiscal policies. German citizens became tired of financing Greece's problems, and a dispute formed within Germany's political hierarchy as to whether German and French banks should be forced into purchasing new Greek debt. Fears of a disorderly Greek default and a replay of the Lehman Brothers crisis of 2008 spread throughout the world.

But as the quarter came to a close, the European banks agreed to "voluntary" purchases of Greek debt, and the Greek Parliament approved further austerity measures. Europe appeared to successfully "kick the can down the road" once again.

Despite all of the persistent negative headlines in the US economy, some positive signs emerged in the last week. FedEx Corporation, traditionally a good bellwether for the global economy, described recent economic weakness as temporary and forecasted fiscal 2012 earnings well above expectations. According to Chief Executive Fred Smith, based on "actually talking to hundreds of thousands of customers," FedEx projected 3% U.S. GDP growth in 2012. Other companies like Nike began to report strong earnings, and manufacturing began to pick up noticeably. Positive reports from Japan also contributed to the optimism. After plummeting, due to reduced demand and the announced future release of 60 million barrels from the Strategic Petroleum Reserve (SPR), oil prices began moving in lockstep with stocks and rose 5% from their lows of only a few days earlier. Investors began to realize that stock prices aren't driven by headlines, but by real corporate profits, and US corporations continue to be in great shape in that regard.

Looking ahead, we see the economy accelerating in the 2nd half of the year in comparison to the weak growth of the 1st half of 2011. GDP growth of 3% should be expected, driven partly by motor vehicle output, which is expected to be 18.5% higher in the third quarter compared to the second quarter. Corporate profits should also continue to grow at near double digit rates, as profits continue to grow much faster than GDP due to strong global demand from the emerging markets, and in particular China. Valuations remain attractive, with the S&P 500 trading at a PE ratio near 14 based on expected earnings. Retail sales, excluding autos were actually solid this quarter, and we expect that trend to continue with gasoline prices down from their highs and low interest rates keeping consumer's financial obligations at relatively low levels. The unemployment picture should be better in future months, as a later Easter and some particularly bad weather made for tough comparisons in the May numbers. Should all this happen as expected, and assuming that Europe (our biggest remaining concern) has truly "kicked the can down the road" successfully until its next crisis a year from now, we would expect equities to outpace bonds for the foreseeable future.



Partners Flagship Portfolio Update

As you may recall, we spent most of the 1st quarter poised for a market pull back, only to receive it all at once in the middle of March. The markets brushed themselves off in April as commodity prices eased, sending the S&P 500 to 1363 on April 29th and allowing emerging markets to breathe a sigh of relief. This brief goldilocks period resulted in a seven week slide beginning in May and continuing into June, retesting the March 16th lows several times, but not breaching them. The market has appeared to be resilient, despite the ongoing Greek debt crisis, congressional disputes on raising the US debt ceiling, and the hard vs. soft Chinese landing debate that seems to flip flop daily depending on the source. Throughout this period, we have tried to remain focused on our long-term views and not be distracted by short-term fire drills and political posturing.

In addition to the end of QE2 and the aforementioned global problems, we believe that much of the recent volatility has been caused by the markets' inability to truly foresee the effects of the Japanese crisis. The global markets seem to have not properly discounted the aftershocks of the global super power, touting that the country only made up 6% of global GDP. However, just like the money multiplier, the Japanese "input multiplier" had exponential consequences on manufacturing and employment numbers across several continents. These numbers will primarily be felt in the second quarter, and our belief is that 3rd quarter earnings, manufacturing, inventory and labor numbers will be much stronger as Japan comes back to full production over the coming months.

Throughout this period, we have been defensive in our equity positioning, slightly reducing our mid cap exposure in favor of dividend producing large caps. In addition, we added an overweight to industrials during the May lows based on the sector's favorable valuation and growing export demand from emerging markets. Along with Technology, Energy, and Materials (which we have overweights to in the portfolio), Industrials have the highest percentage of domestic foreign sales. Our current weak dollar make these goods even more attractive to international buyers, as the companies benefit from the currency appreciation by selling to non-US purchasers.

We continue to be long-term bearish on the dollar, and while we saw a resurgence in May as US equity markets faltered and commodity prices retreated, we have again seen the dollar turn and retreat from its highs. As we have said time and time again, we constantly search for ways to diversify our dollar exposure and protect our clients' purchasing power. We see gold as one solution to diversifying our currency exposure (Please see article: "Digging for Gold"). While we have had exposure to gold in the portfolio since inception, we did make a strategic decision in late April to change our positioning by rotating out of gold mining stocks and into physical bullion. This was due to the fact that we'd begun to see a decoupling of the two assets, as investors feared increased commodity prices would eat away at miners' profits, as well as the potential for decreased stimulus and access to credit caused by the end of QE2. This turned out to be quite timely, as we've seen almost a 1200 basis point difference in the performance of the two assets, with gold up roughly 5% for the quarter and mining stocks still in the negative.

The 2nd quarter has definitely been a rocky ride, however, we believe we see light at the end of the tunnel. The Summer will still continue to hold uncertainties, especially as we reach the August 2nd deadline for the US debt ceiling to be raised, but overall we feel confident about companies' ability to make money and therefore we should see a much improved 3rd quarter on the horizon.

Partners Flagship Core Strategies
A Globally Diversified Dynamic Asset Allocation Portfolio
Performance Net of Fees (12-31-09 to 06-30-10)

2010													
Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2010
Return	-1.68%	1.11%	2.61%	0.82%	-4.30%	-0.93%	3.89%	-0.97%	4.92%	2.36%	-0.97%	2.94%	9.84%
S&P 500	-3.60%	3.10%	6.03%	1.58%	-7.99%	-5.23%	7.01%	-4.51%	8.92%	3.80%	0.01%	6.68%	15.06%
MSCI EAFE	-4.44%	-0.88%	5.81%	-2.10%	-12.06%	-1.16%	9.41%	-3.34%	9.49%	3.55%	-5.03%	8.02%	4.90%
MSCI World	-4.11%	0.58%	5.56%	0.94%	-9.78%	-3.37%	8.01%	-5.97%	9.37%	3.65%	-2.18%	7.39%	4.60%

2011								
Month	Jan	Feb	Mar	Apr	May	June*	YTD*	ITD*
Return	0.19%	2.08%	0.77%	2.63%	-1.59%	-1.40%	3.00%	12.73%
S&P 500	2.37%	2.87%	0.04%	2.85%	-1.13%	-1.70%	6.00%	23.26%
MSCI EAFE	2.36%	1.85%	-2.19%	6.02%	-2.80%	-1.40%	3.00%	10.23%
MSCI World	2.28%	2.38%	-0.95%	4.02%	-1.97%	-1.54%	5.62%	10.63%

*Performance for June, Year to Date, and Since Inception are estimated.

By: Whitney E. Solcher, CFA

Digging for Gold

At San Antonio Capital Management, we realize that when our clients hire us, we have one primary job: Not to lose their money. In order to accomplish this, we look both at the short term and the long term, in order to best preserve the purchasing power of our clients' capital.

Traditionally, investors (both domestic and foreign) have achieved this goal by purchasing United States Treasury bonds, the perceived global "risk-free asset." In the past, many US investors built "diversified" portfolios by simply purchasing a selection of blue-chip U.S. stocks and complimenting those positions with the safety of treasury or municipal bonds to limit risk or volatility. The fact that we have had a 30 year bull market for bonds greatly helped returns during this time period. In 1983, the average interest rate on a 10-year constant maturity Treasury note was 13.91%. As we stand today, the 10 year rate is barely over 3%, making the next 30 years very uncertain for this asset class.

The Fed's \$600B bond purchase program ended on June 30, with no plans to reconstitute it any time soon. However, the Fed has stated it will reinvest the proceeds of maturing bonds until they feel that the economy is on firmer footing. With Japanese automobile production returning to full capacity shortly and gasoline prices likely to drop due to oil's \$20 fall in the last two months, we expect economic growth in the U.S to be higher in the 2nd half of the year than the 1st half. If this occurs, the Federal Reserve will start to shrink their balance sheet by no longer investing the maturing Treasury bonds into new bonds, and interest rates should begin to rise as the largest recent buyer of Treasuries exits the market.

Due to the possibility of yields rising from their current level, we at San Antonio Capital Management feel that Treasuries present "return-free risk" to our clients. The current yields simply are not enough to compensate for the risk of interest rates rising, which lowers the underlying value of existing bonds. For a 10 year treasury bond, a 1% rise in interest rates could cause as much as a 10% drop in the value of the bond. A 1% rise in interest rates is more realistic than you may think, as recently as April 2010 the 10 year treasury yielded above 4%. For 5 year bonds, the prospects are no better. The current yield is less than the rate of inflation, which means that an owner's "real return" (nominal yield less inflation) is actually negative.

So the question becomes, if we don't want to own treasuries, how do we best protect our clients' capital to withstand all of the potential market scenarios? After all, traditionally in times of crisis, Treasuries have performed very well. Just look at 2008, as an example.

One method is by owning some gold in our portfolios. Gold has long been known to be a store of value. In fact, it has reached some of its peak real values over the last century during times of systemic distress. When Northwestern Mutual Life Insurance Co., a AAA-rated life insurance company, purchased gold for the first time in company history in 2009, they pointed to how well gold held its value during the Great Depression. In more recent times, gold prices rose 14% from September 2, 2008 to March 9, 2009, a period when the S&P 500 tumbled 47%.

We also look at gold as a hedge against the modern-day system of paper fiat currencies. For hundreds of years, gold has served as a form of money and/or paper currencies were valued at a fixed ratio to gold, as in the Bretton Woods system. When Bretton Woods was effectively abolished in 1971, the dollar was no longer backed by gold, and the price of gold was allowed to float freely. Gold prices then soared in the turbulent 1970s decade, only to crater in the 1980s and 1990s during the "great moderation." But over the last decade, as the US suffered through two recessions, gold prices increased nearly five-fold.

One reason for the price increase is the printing of money done by the Federal Reserve, Bank of Japan, European Central Bank, and China. There is a nearly identical relationship over the last decade between the growth in global currency reserves and the price of gold. As more currency floods the global economy, the value of each unit of currency drops, and global purchasing power is diminished. Gold provides a hedge against this cycle, as it is one of the few forms of currency that simply cannot be printed. As Alan Greenspan said in 1967, "Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights."

While gold has increased in value every year over the last decade, we do not feel that it has reached bubble territory. For an investor who purchased gold at its peak in 1980, gold prices would need to rise another 50% just for him to keep up with inflation over that 30 year period. That is because gold appreciated by 16x during the 1970s. Gold reached a peak of 3% of total investors' holdings in 1980, while just last year, gold only made up .7% of total holdings.

Global central banks were net buyers of gold last year for the first time since 1980. So far this year, central banks have bought about 151 tonnes of gold, led by Russia and Mexico. Currently, central banks are holding

"the cost of gold (adjusted for inflation) would be roughly \$6300 in order for it to back all of the dollars in circulation"



roughly 31,000 tons of gold, a significantly lower amount than the 38,000 they held in reserves as far back as the 1960s. Due to the United States' \$14 Trillion deficit and expansion of the Federal Reserve's balance sheet, there has been much talk among central bankers and economists about the US dollar losing its reserve currency status. With the Eurozone in distress, and the Chinese yuan limited in its use beyond Chinese borders, the problem is that there is no global currency of significant size to take the dollar's place. Recently, Robert Zoellick, president of the World Bank, has proposed a new monetary system utilizing several of the world's major currencies, but also including gold. While it may be unlikely that the world returns to the Bretton Woods system whereby the dollar is fully backed by gold, if that were to actually happen, the inflation adjusted price of gold would be roughly \$6300 in order for it to back all of the dollars in circulation.

Part of the reason for such a high price is the lack of supply of gold. *Global gold production is down 1% per year over the last decade, despite the fact that exploration budgets tripled since the start of the decade.* In late 2009, the president of Barrick Gold, the largest pure gold mining company in the world, stated that the world may be reaching a 'peak gold' stage. Whether that is true or not, we feel that supply will have a hard time keeping up with demand, leading the price of gold higher. Just in the last year, China has deregulated its gold market, causing imports of gold to rise four-fold, as China surpassed India (where gold has traditionally been a form of savings) as the world's biggest consumer of gold. Chinese citizens are likely buying gold for many of the same reasons that we are, there simply aren't many safe places in the world to put your money and get a return higher than inflation.

In summary, a confluence of factors is driving the price of gold higher, and we feel this will continue for the foreseeable future. And even if that is not the case and gold falls from its recent highs, that will likely mean that stock prices are higher, and our clients' purchasing power will be maintained.

By: Stephen A. Palmer

Understanding 529 Plan Distributions

Parents looking to take advantage of the many benefits of saving for college with a 529 plan will want to know the full details on which educational expenses qualify for tax-free distribution status -- and which do not.¹ In Publication 970, the IRS gives detailed guidance on qualified expenses. Here are a few important points.

What's Covered

- Tuition and fees are covered in full.
- Room and board, if the student is enrolled at least half time. But such expense must be not more than the greater of (1) the allowance for room and board, as determined by the school, that was included in the cost of attendance; or (2) the actual amount charged if the student is residing in housing owned or operated by the school.
- Food. If you spend a certain amount for a meal plan, that entire amount can be deducted, even if used for coffee or ice cream and not a full meal. Weekend meals can also be included if the dining halls are not open.
- Books and supplies. Any fees associated with purchasing school textbooks are considered qualified, as are required equipment or supplies such as notebooks and writing tools.
- Computers/laptops, but only if required by the school. If required, Internet fees and PDAs or "smartphones" may also qualify. The Savings Enhancement for Education in College Act (H.R. 529) that is currently being considered by Congress would expand this definition to apply to all computer technology used by the student.
- Special needs services required by special-needs students that are incurred in connection with enrollment or attendance at school.

What's Not Covered

- Student loans. Interest on or repayment of student loans is not considered a qualified expense by the IRS.
- Insurance, sports or club activity fees, and many other types of fees that may be charged to students but are not required as a condition of enrollment.
- Transportation to and from school.
- Concert tickets or other entertainment costs, unless attendance is requisite to a course or curriculum.

Note that expenses must apply to a qualified college, university, or vocational school for post-secondary educational expenses. Also keep in mind that taxes and a possible 10% penalty will apply to all distributions that are not considered qualified educational expenses by the IRS, so be sure to check first.

¹By investing in a 529 plan outside of the state in which you pay taxes, you may lose the tax benefits offered by that state's plan. Withdrawals used for qualified expenses are federally tax free. Tax treatment at the state level may vary.

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Any fees associated with purchasing school textbooks are considered qualified, as are required equipment or supplies such as notebooks and writing tools.



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