KPF GLOBAL
INVESTMENT STRATEGIES LLC

Second Quarter of 2012

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KPF GLOBAL INVESTMENT STRATEGIES LLC

Executive Summary

- Equity markets relinquished a portion of their strong Q1 gains last quarter, with cyclically-sensitive sectors (commodities and international equities) suffering the largest losses. Investors are again fearful of a synchronized and self-reinforcing global downturn, triggered by recession in Europe, a policy-engineered slowdown in China, and growing evidence of spillovers from these developments into the US economy.

- We do not believe that a recession is inevitable, given the increasing focus and coordinated efforts of global policymakers to support demand. However, the missing ingredient for sustained growth is a credible and pragmatic strategy for medium-term fiscal adjustment in *all* the developed economies. Even though budgetary restraint will, in principle, be deflationary, the boost to confidence from a credible strategy could more than offset the contractionary effects of deficit reduction over the longer term.

- In this regard, the upcoming US elections will be an important bellwether for markets. We believe the most likely scenario is that Republicans will gain control of both houses of Congress. If so, they will seek to advance their agenda of deficit reduction, primarily through spending cuts. Whether and how tax policy will evolve in the near term depends on who wins the Presidential election. If Romney is elected, tax rates will likely remain the same (or possibly decline, although this would imply implausibly large spending cuts). Regardless of who wins, progress in deficit reduction, with a focus on entitlement reform, would be the most market-friendly outcome.

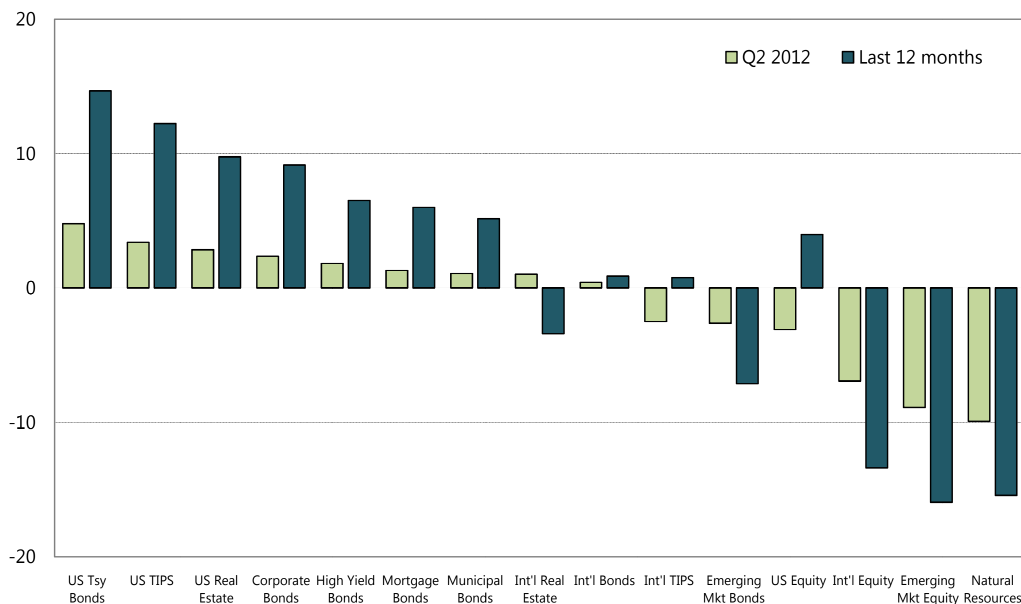
- We are in a period of unusual uncertainty and latent volatility. In such circumstances, we are focusing on a two-prong strategy that balances steady income from high-quality investments with exposure to market sectors that are attractively valued and which offer considerable upside as/when economies and markets normalize. We believe that this patient approach will allow dividend and coupon payments to accrue and compound effectively, while we await capital recovery in undervalued market segments.

- Our low-volatility income equity strategy has performed well since inception. We are increasing our clients' investments in dividend-paying stocks and high yield, low-volatility fixed income sectors.

Introduction

Last quarter, equity markets relinquished a portion of their strong Q1 gains, with cyclically-sensitive sectors (commodities and emerging market equities) suffering the largest losses (Figure 1). As is typical in a risk-averse market climate, the US dollar rallied, compounding declines on foreign investments. Investors are yet again fearful of a synchronized and self-reinforcing global downturn triggered by recession in Europe and a policy-engineered slowdown in China. There is growing evidence that slower growth abroad is spilling over into the US economy. In the United States, manufacturing activity has slowed, retail sales have softened, and job creation has stalled. Although policymakers around the world have responded to evidence of weakening demand with additional monetary easing—most notably in the emerging markets—many market participants doubt that such measures can do more than cushion an inevitable recession.

Figure 1. Relative Asset Class Performance

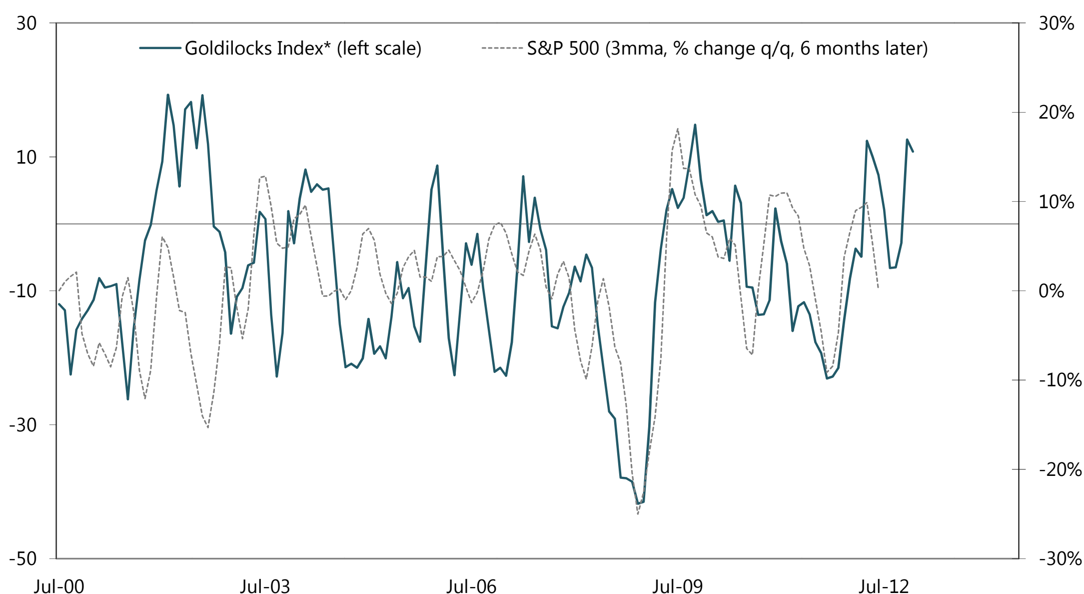


Source: Bloomberg

We do not believe that a recession is inevitable, given the increasing focus and coordinated efforts of global policymakers to support demand. However, the missing ingredient for sustained growth is a credible and pragmatic strategy for medium-term fiscal adjustment in *all* the developed economies. Businesses and households don't want to spend when they are so uncertain about the trajectory of tax (and regulatory) policy. Progress is being made in Europe, and we believe that the coming US election will be a referendum on budgetary sanity.

In the meantime, there are positives to sustain the US economy. The housing market is stabilizing. Job growth, though tepid, is keeping growth at a just-below-trend pace. Lower commodity prices are supporting household spending and corporate earnings. As the chart below illustrates, the margin relief afforded by lower input prices is—so far—more than compensating for weaker sales, supporting corporate earnings. That's why the stock market held up pretty well in July, despite the slowing economy. Households too are benefiting from lower energy prices.

Figure 2. United States: Goldilocks Index vs S&P 500



** Institute for Supply Management New Orders Index/Prices Paid Index*

Fiscal Reform: The Time is Now

We expect the global economy to remain sluggish for the remainder of 2012, while avoiding a full-blown recession. Continued monetary stimulus from central banks, along with widespread short/underweight investor positioning, should create a floor under risk assets. However, these are not a sufficient catalyst for sustained growth and asset price appreciation. What is needed is comprehensive fiscal reform, in all the mature economies. Although budget cuts and tax increases are, in principle, deflationary, the boost to confidence from a credible strategy could boost private spending and more than offset the contractionary effects of deficit reduction over the longer term.

In this regard, the upcoming US elections will be an important bellwether for the economy and markets. Although there is tremendous uncertainty regarding the outcome, we believe the most likely scenario is that Republicans will gain control of both houses of Congress. If so, they will seek to advance their agenda of deficit reduction, primarily through spending cuts. This is not entirely realistic, given the magnitude and political sanctity of entitlement spending—and for the Republicans, of defense spending. Although entitlement reform is at the heart of credible fiscal reform, there will eventually need to be tax increases as well.

Whether and how tax policy will evolve in the near term depends on who wins the Presidential election. The table below summarizes the various tax proposals that are on the table. If Romney is elected, tax rates will likely remain the same (or possibly decline, although this would imply implausibly large spending cuts). In principle, there could be more rapid progress on deficit reduction under a unified Republican government, since it would be harder to blame the Democrats for obstructing the process. Progress in deficit reduction, with a tilt toward spending cuts, would be the most market-friendly outcome.

	Figure 3. Tax Proposals for Households With Income > $250,000			
	Capital Gains	**Dividends**	**Top Income Rate**	**Estate Tax**
Current Law	15.0%	15.0%	35.0%	35.0%
Romney Budget	15.0%	15.0%	28.0%	Eliminated
Ryan Budget	15.0%	15.0%	25.0%	Eliminated
Simpson-Bowles	26.8%	26.8%	24.0%	45.0%
Obama Budget	23.8%	39.6%	39.6%	45.0%
“Fiscal Cliff”	23.8%	43.4%	43.4%	55.0%

If Obama is reelected, while the Republicans take control of Congress, a more balanced approach to deficit reduction, one that combines spending cuts with modest tax increases, is likely. This would be more desirable over the long term, from the standpoint of efficiency and equity. Unfortunately, given the political gridlock that would likely ensue, the process could be contentious and protracted, with adverse consequences for markets. In our view, it would be better to put in place a credible strategy for medium-term deficit reduction—even if that strategy suffers from some flaws—than to waste more time as the fiscal crisis intensifies.

Regardless of the outcome of the election—or the odds-making that precedes it—we believe there is little risk that the economy will fall off the "fiscal cliff." It is all but certain that, before the end of 2012, the Bush-era tax cuts will be extended, in some form, through 2013. Neither party stands to benefit from allowing draconian spending cuts and tax increases to take effect—least of all now, while the economy is still so fragile.

Balancing Income and Appreciation Potential: A Strategy for Patient Investors

We remain in a period of unusual uncertainty and latent volatility. When financial markets take one-and-a-half steps back for every two steps forward, it is important to take the long view. We do not think it is prudent (or even feasible) to attempt to trade every swing in the market. We are focusing on a two-prong strategy that balances steady income from high-quality investments (i.e., our low-volatility equity income strategy, preferred stocks, non-agency mortgages, emerging market debt, etc.) with exposure to market sectors that are attractively valued and which offer considerable upside as/when economies and markets normalize (i.e., international and emerging market equity). We believe that this patient approach will allow dividend and coupon payments to accrue and compound effectively, while we await capital recovery in undervalued market segments.

Since we launched our low-volatility equity income strategy in February (it was described in detail in our Q4 2011 quarterly letter) its performance has been creditable. This segment of the stock market has been outperforming both bonds and broad US equities, on both an absolute and a risk-adjusted basis (Figures 4-6). US equity dividend yields are at multi-generational highs vs. US Treasuries, and valuations remain attractive despite increased capital flows into the sector. Although there is some risk of higher dividend tax rates in the future, we do not expect this to occur anytime soon, given the political backdrop described above.

Figure 4. KPF Global Equity Income Strategy Performance Since Inception (February 1, 2012)

	KPF Equity Income	**Russell 3000**	**S&P 500**	**DVY**	**SDY**	**Neuberger Berman**	**Barclays Agg**	**Barclays 10YR Treasury**
1M Return	3.4%	2.3%	2.1%	2.8%	1.1%	3.7%	1.1%	1.0%
3M Return	5.4%	-3.4%	-3.3%	2.1%	-1.0%	1.7%	2.5%	5.0%
Since Inception	6.2%	1.1%	1.7%	5.2%	0.4%	1.8%	2.4%	3.9%
Annualized Vol.	8.9%	14.4%	13.7%	10.3%	11.8%	9.1%	2.6%	5.9%
Sharpe Ratio	0.69	0.07	0.13	0.50	0.03	0.19	0.93	0.66

Figure 5. KPF Global Equity Income Return vs Equity Funds

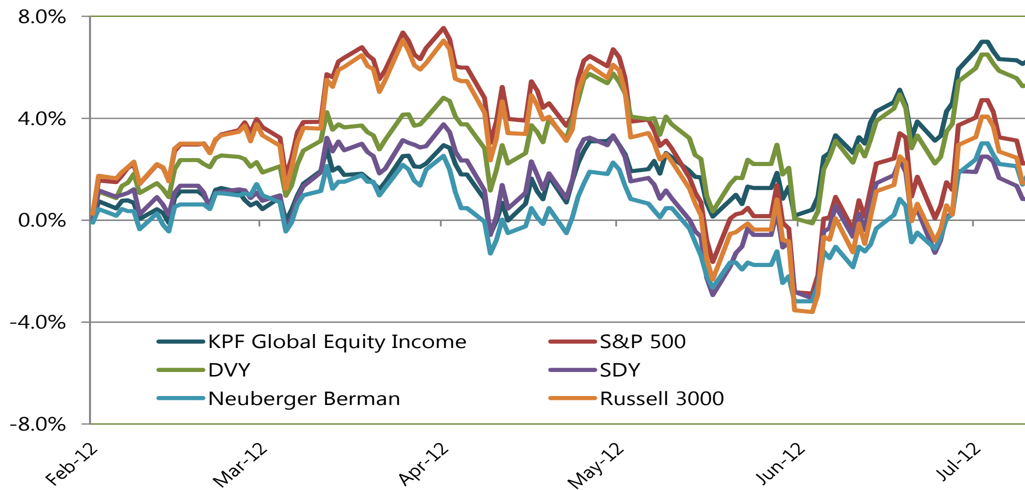
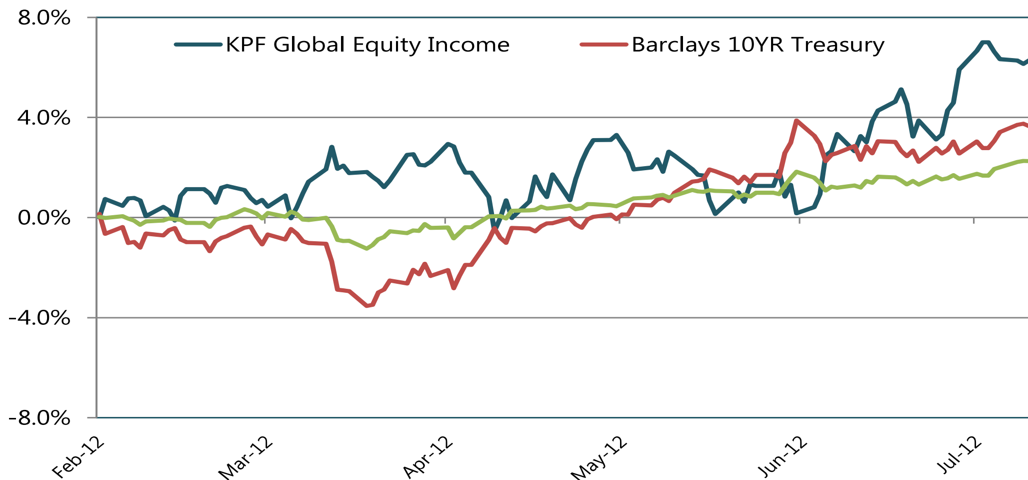


Figure 6. KPF Global Equity Income Return vs. Bond Funds



Most mutual funds and ETFs that are geared toward dividends tout a more consistent return profile. However, the reality is that these funds are only slightly less volatile than their broad US equity benchmarks. By contrast, our approach specifically seeks to control risk, and has been delivering a volatility (annualized standard deviation of daily returns) that is just two-thirds that of the broad market. More consistent returns significantly improve the compound rate of return on the strategy over time.

In addition to our equity income strategy, we have been gearing client portfolios toward other market sectors with yields that are high relative to the volatility of returns—again, with the goal of improving the compound return on the portfolio. These sectors include US real estate, corporate & high yield bonds, mortgage bonds, US$ denominated emerging market bonds, and preferred stock. The risk-reward profile of these and other asset classes is shown in Figure 7.

Figure 7. Asset Class Valuations & Yields
As of end-June 2012

	Valuation* (Percentile)	Current Yield**	Volatility ***	Yield/ Volatility
US Treasury Bonds (10-year)	99	1.46	5.08	0.29
US Inflation-Protected Bonds	100	0.91	6.29	0.14
US Real Estate		4.40	7.30	0.60
Corporate Bonds	69	3.60	4.82	0.75
High Yield Bonds	83	5.85	4.10	1.43
Mortgage Bonds (5-year agency)	98	3.11	3.15	0.99
Mortgage Bonds (non-agency)	50	6.17	3.52	1.75
Municipal Bonds (5-year)	99	3.12	2.20	1.42
Internatonal Real Estate		5.68	24.14	0.24
International Bonds		2.26	7.48	0.30
International Inflation-Protected Bonds		3.42	9.55	0.36
Emerging Market Bonds (US$)	73	6.18	4.89	1.26
Emerging Market Bonds (local currency)	10	4.40	9.47	0.46
Preferred Stock		7.20	5.77	1.25
KPF Global Low-Volatililty Income Equity	54	4.00	8.40	0.48
Other US Equity	52	2.30	19.99	0.12
International Equity	26	6.60	23.25	0.28
Emerging Market Equity	45	2.13	23.23	0.09
Natural Resources		0.00	19.86	0.00

** For equities, data range begins in 2003; for fixed income, 1977 and 1997
** Current SEC yield of KPF Global preferred investment vehicles
*** Annualized standard deviation of KPF Global preferred investment vehicles over past three years

Of course, future investment returns are influenced not only by the level of income an asset generates, but also its potential for appreciation—which depends in large part on its initial valuation (price). Therefore, we are wary of asset classes that are highly valued (US Treasury bonds, agency mortgage bonds, and high-quality municipal bonds) regardless of their apparently low volatility. Conversely, we are willing to allocate our clients' capital to asset classes that are clearly undervalued (emerging market equity, foreign currency debt and international equity) even if they are volatile. What matters is that an asset's *expected total return* (of which yield is one key component) be commensurate with its volatility.

The appropriate balance between income and capital appreciation, as sources of portfolio return, depends on a client's needs and preferences, as well as the market environment. Given the high degree of uncertainty and latent volatility of financial markets, we believe that a more stable return profile, and the enhanced compounding of returns that results, is beneficial even for clients who do not need income from their portfolios.

KPF Global Portfolio Strategy

We retain a cautious posture with regard to investment risk, holding cash for our clients in the 5-10% of portfolio range. Our equity investments are at or slightly below clients' dynamic targets, with a tilt toward value (both US and international) and dividend-paying stocks. Our clients' fixed income allocations are below their strategic targets, with almost no exposure to US Treasuries, and a focus on higher-income sectors such as mortgages, emerging market debt and high-yield bonds. Municipal bonds remain a mainstay of our clients' fixed income portfolios, but we are emphasizing premium callable bonds (so-called cushion bonds) to achieve an acceptable balance between yield and duration risk.