



SECOND QUARTER MARKET COMMENTARY ***JULY 2012***

EXECUTIVE SUMMARY

The U.S. equity markets followed a strong first quarter of 2012 with a moderate correction in the second quarter, as we anticipated in our first quarter market commentary. At the end of the second quarter, the S&P 500 was up 8.3%, the Russell 1000 value index was up 7.27%, and the Dow Jones Industrial Average was up 5.39% for the year. The yearly return of the RDM Capital composite portfolio was 7.47% at the end of the second quarter.

The three main forces driving the market correction were continued uncertainty in Europe, declining growth in emerging markets, and a stalled recovery in the United States. The equity markets behaved like a true “trader’s market,” as rumors about the Fed’s monetary policy and Europe’s debt crisis drove stock prices to a greater degree than fundamental stock valuations. This volatility is likely to continue in the third quarter of 2012 with the November elections, the Supreme Court decision upholding “Obamacare,” and the so-called “fiscal cliff” at the end of the year all causing investor uncertainty.

Despite the uncertainties, we are bullish on the outlook for the U.S. equity markets over the long-term. Companies are fundamentally stronger than they have been in years and are waiting to deploy large amounts of cash. The housing market and employment appear to have stabilized and are slowly improving. U.S. equities are especially attractive considering their high dividend yield levels compared to yields from U.S. treasuries and other fixed income investments. The dividend yield for stocks in the S&P 500 is 2.12%, which is higher than 10-year treasuries and only slightly lower than 30-year treasuries. By most estimates, stocks are the cheapest they have been relative to treasuries since the early 1950s. We recommend that our clients stay invested in the U.S. equity market as the U.S. and worldwide economies improve, slowly but surely. We will continue to look for equities that are currently undervalued, consistent with our contrarian investment strategy. We emphasize investments in energy, financials, healthcare, and pharmaceuticals.

I. The European Debt Crisis Continues To Dominate Headlines

Like the past several quarters, investors’ eyes were on the European debt crisis in the second quarter of 2012.

The most noteworthy development in the European debt crisis last quarter was the Greek elections in June, pitting the ruling conservative and socialist parties against the

radical left Syriza party. If Syriza had won, Greece likely would have reneged on the previously-agreed bailout package and left the Euro zone. As we predicted in our May 2012 client note, the “pro-bailout” conservative and socialist parties won a majority of seats in the Greek parliament and formed a governing coalition. We believe this outcome was favorable for the U.S. financial markets, as a Greek exit would have reverberated throughout the international financial system. Despite this favorable outcome, the Greek crisis is far from resolved. Syriza made a strong showing and likely will further increase in power if the current coalition fails to put Greece on the track to a recovery. As a result, many commentators believe it is inevitable that Greece will leave the European Union in the near future. For the reasons stated in our May client note, we do not believe in this inevitability.

The second quarter also brought renewed worries about Spain, which suffers from a burst housing bubble and undercapitalized banks. Spain’s borrowing costs increased rapidly and the country with the fourth largest economy in Europe ultimately requested a European bailout of its banking sector in June. Italy also faces similar financial headwinds. In short, the European financial crisis is likely to be a significant issue affecting the global economy for some years to come.

However, there may be light at the end of the tunnel. A late June summit among European leaders has given the markets hope that Europe is on the road to a single banking supervisory mechanism for the region, combined with tighter fiscal controls and the issuance of bonds backed by the entire European Union. If implemented, we think these measures will go a long way towards resolving the crisis, as it confirms that the financially stronger northern European countries will continue to back the weaker southern European countries. While these recent statements are encouraging, the markets have been encouraged before by positive statements from European leaders that did not result in effective changes, so we remain skeptical until convincing steps are taken.

The recent crisis is forcing European countries to confront the reality that the current European monetary union is unsustainable without major structural reforms, such as an integrated fiscal union, the joint issuance of “Eurobonds” and a single European banking supervisor. For decades, Europe has had stagnant private sector growth, high unemployment and massive entitlement programs, which have led to soaring deficits in European countries. European leaders have struggled to develop a more integrated fiscal and banking union, along with a practical, long-lasting resolution to break up their entrenched entitlement state and strengthen their feeble GDP. Ultimately, the threat of a catastrophic break-up of the EU may be the spark needed to implement fundamental changes to the European financial system.

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In the meantime, we will look for investment opportunities in equities that may be undervalued because of their exposure to Europe. The price/earnings ratio for the MSCI Europe index is under 10 and the dividend yield is 4.5%. This suggests that investors are generally bearish on European stocks today, but there may be opportunities to invest in

undervalued equities in this region. While we avoid companies with heavy exposure to Europe due to the uncertainties discussed above, we see buying opportunities in companies that have a low to moderate exposure to Europe, as we believe these companies will out-perform when the European debt crisis subsides.

II. Large Emerging Markets, Especially China, Have Faced Declining Growth

Another international development that impacted the U.S. financial markets in the second quarter was slowing growth in China, India and other large emerging markets. Emerging markets have been drivers of international growth over the past decade, but these export-driven markets also tend to be especially sensitive to global slowdowns. China in particular has been a significant leader in stimulating the world economy, with double-digit GDP growth in recent years. The strong growth in China has been replaced by more moderate growth estimates of about 7%, due in part to Europe's debt crisis and weaker demand at home. In response, China's central bank recently lowered interest rates for the first time since 2008 in an effort to spur growth.

The slowdown in the developing world has been a drag on the U.S. financial markets. Manufacturing and construction-related companies in particular have been hit the hardest, as companies in these industries relied on growing Chinese demand to replace weakening demand in the U.S. and Europe. We expect China to continue to grow only at a moderate pace while the European debt crisis continues with a corresponding effect on U.S. companies with exposure to China.

III. Growth In The United States Has Been Sluggish In The Face Of Uncertainty At Home And Abroad

The U.S. economy in general was resilient in the second quarter, with analysts predicting that GDP grew between 2-2.5%, slightly below the average 2.7% U.S. GDP growth since 1970. While this growth is not particularly impressive, it demonstrates that the U.S. economy has muddled on in the face of the headwinds from the European debt crisis and slower growth in China, as discussed above. Part of the reason is that U.S.

Slow international growth presents a significant impediment to the U.S. economy.

exports to Europe comprise about 2% of U.S. GDP, and U.S. exports to all countries comprise just 14% of U.S. GDP, which is lower than almost any other advanced country. That being said, international growth (or lack thereof)

presented a significant impediment to the U.S. economy in the second quarter and likely will continue to hinder growth for the foreseeable future.

U.S. financial markets also continue to be sensitive to any suggestion that the Fed will (or will not) act to implement "QE3" or otherwise act to spark the financial system. This caused swings in U.S. equity markets last quarter as traders took long positions in anticipation of Fed action and then sold if the Fed did not act as hoped. The Fed ultimately continued the "Operation Twist" program, which is intended to lower long-term interest rates through the sale of short-term treasuries and purchase of long-term treasuries. The Fed's announcement disappointed traders, and the market responded with

a short-term decline. This decline was no more than a short-term trader's reaction and, at most, presented a buying opportunity for temporarily depressed equities.

Uncertainty about legal and regulatory changes also has taken a toll on the U.S. economy. Regulations for two pieces of legislation that will significantly impact the U.S. economy – the Dodd-Frank Act and the Affordable Care Act (aka Obamacare) – have yet to be fully implemented. The election in November will have broad implications for capital gains, dividend, estate and income taxes. The U.S. also faces the prospect of a return to recession if Congress fails to reach an agreement to avert the so-called “fiscal cliff” at the end of 2012. In the absence of an agreement, the U.S. will face increased taxes and decreased spending that could have a draconian effect on the U.S. economy. These legal and regulatory uncertainties have caused many companies to sit on their cash, rather than proceed with the type of investments – such as expanding into new business lines or facilities and hiring new employees – that would spark the economy.

IV. There Are Values In The Healthcare, Energy, And Financial Sectors

Healthcare/pharma, energy, and financial stocks presented some of the best values in the second quarter, as well as going forward, and we are overweight in these sectors.

Healthcare/Pharma: The most discussed topic in the healthcare industry in the second quarter was the Supreme Court decision upholding Obamacare. The decision did not have a significant immediate impact on most healthcare and pharmaceutical stocks, as the effect of the law was largely priced into stock values already. To the extent there was an impact, medical device manufacturers generally were seen as short-term losers. Regardless, the jury is still out on whether the financial benefits from the 32 million people who are expected to gain insurance as a result of the law will offset the increased fees and costs that the law imposes on the healthcare sector. That also assumes that the law is fully implemented: Republicans have committed to repeal and replace Obamacare if they gain control of Congress and the Presidency.

Ultimately, we are bullish on healthcare and pharmaceutical stocks. This sector has been an anomaly in that it has been less risky while providing strong returns in recent quarters. Companies in this sector remain cheap on a valuation basis, have high net cash flows, and pay good dividends, while staying largely immune to business cycles and volatility. We believe these returns will continue to rise as Americans live longer and the number of senior citizens grows. Indeed, it is estimated that more than 20% of the country's population will be 65 years old or older by 2030. In short, we believe the sector is attractive even if Obamacare turns out to be a net negative for the industry.

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Energy: The second quarter brought low oil prices, with prices down approximately 20% in the second quarter. The decline was due to a combination of a boom in U.S. supply due to new drilling techniques, such as horizontal drilling and fracking, and decreased demand caused by the European debt crisis and slower growth in China. Natural gas prices also are down over 5% for the year due to the oversupply, but they did bounce back significantly in the second quarter. As a result, the aggregated second quarter return from stocks in the energy sector was -8.79%.

We believe that energy companies stocks are undervalued, and their prices will turn around as energy prices improve. The energy sector historically has tended to perform well in the expansionary phase of the economic cycle, particularly in the late-stage of an economic expansion when inflation causes commodity prices to rise. In the long-term, the U.S. economy will expand from its current sluggish pace and the massive monetary stimulus of the past five years will undoubtedly lead to much higher inflation. Therefore, we continue to look for investment opportunities in this sector.

Financials: Financial stocks are trading at a discount as regulatory uncertainty, the Europe financial crisis and low interest rates have weighed on the sector. There also is concern that U.S. banks have not adequately reduced risk taking by their trading operations. As a result, the markets are overly skittish to any bad news from U.S. banks. A perfect example of this hypersensitivity is the drop in J.P. Morgan's share price after the disclosure of a \$2 billion-plus trading loss. There was reason for further analysis of J.P. Morgan as a result of the loss, but the 25% stock price decline in May was unjustified considering the amount of the loss relative to J.P. Morgan's total size and expected earnings. Not surprisingly, the stock recovered about half of this decline in June.

Again, we see financial stocks as relatively cheap. The price/earnings ratios for U.S. commercial bank stocks are significantly lower than their historical rates.

Tangible equity to assets for U.S. banks is higher than at any time in the last 70 years.

Additionally, current prices are much less than tangible book value, and the tangible equity to assets ratio is higher than it has been at any time in almost 70 years. We acknowledge that investing in the financial sector today requires

that the investor assume the regulatory, interest rate and headline risks that currently exist in the sector, as well as the risk of contagion from Europe's banking system. But, we believe that many financial stocks are attractively priced due to these risks and that stock prices are due to out-perform over the long-term when these risks subside.

V. Projections

The U.S. economy eventually will see better days, but we believe this will occur only through a combination of low taxes and more efficient regulations that facilitate responsible private sector growth. For the past few years, the U.S. economy has been buoyed by temporary fixes that stimulate moderate, short-term growth that eventually dissipates. Any fundamental changes to the regulatory and financial structures are unlikely until next year with the upcoming Presidential and Congressional elections precluding any real reforms from Washington. We believe that the results of the election

will have a significant impact on the U.S. economy for years to come. We will be writing about the November elections and the impending “fiscal cliff” in the coming months.

All of this uncertainty means we likely will see choppy results for much of this year. We remain optimistic that, as we forecasted, the S&P 500 will finish 2012 at 1,425 and the Dow Jones Industrial Average will reach 14,025. We will continue to monitor and report on events in the U.S. and world market as they affect our clients’ accounts.

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We are pleased to announce that David LaRocca has joined RDM Capital as vice president. David is a graduate of Cornell University and Cornell Law School, cum laude. He was an attorney with Simpson Thacher & Bartlett LLP from 2000 through 2008 where he specialized in insurance and securities law and a senior legal counsel with MetLife from 2008 through 2012 where he worked with MetLife’s investment advisors and broker-dealers. David is admitted to the bars of New York, New Jersey, and North Carolina and holds the Series 65 Investment Advisor Representative license.

As usual, all comments are welcome.

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