CUMBERLAND

Strategy Review
July 2011

Fear of Fear Itself

"The only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance."

- Franklin D. Roosevelt from his 1933 Inaugural Address

Almost eighty years ago, a newly elected President of the United States, Franklin Delano Roosevelt, took the stage to give his Inaugural Address. The nation was just over 3 years removed from an unprecedented (at that time) stock market and banking system collapse, millions of Americans were unemployed, a precipitous decline in housing had vaporized the wealth of families, foreclosures had skyrocketed and business confidence evaporated. Federal, state and local budgets were under immense pressure as tax revenue declined and markets had lost trust in the currency. Sound familiar? To be sure, the situation then was much more difficult than what we face today. Poor policy choices by the previous Hoover administration are widely believed to have exacerbated an already very bad situation. By the time FDR took office in 1933, the U.S. economy had suffered three straight years of cascading economic decline with real GDP down by 25% over that period. There was an overwhelming malaise hanging over virtually everyone's expectations for the future. It appeared hopeless.

Yet in one simple phrase, FDR summed up the essential underpinning of economic theory: the self reinforcing feedback loop. That is, if you expect things to get worse, you will make spending and investment decisions which actually do make things worse, causing you to further lower your future expectations. If you expect conditions to improve, you will make spending and investment decisions which will improve economic conditions, causing you to raise your expectations further. In short, FDR understood that the key to getting the nation back on its feet was simply to help them believe they COULD get back on their feet. He promised that not only was a better future possible, but that he could lead them to it. That took Leadership (with a capital "L"), something we appear to be sorely lacking today. FDR gave his address in March of 1933 and real GDP growth had turned positive by the second half of the year and stayed positive through the next four years. If you are interested in reading his entire address, we have posted it on our website under Insights, or you can watch it on YouTube.

The economic situation today bears many resemblances to the situation faced by FDR. Now as then, the U.S. is about three years removed from an "unprecedented" stock market and banking system collapse. Unemployment, housing, foreclosures and business confidence are also the key hangovers affecting confidence this time around. More recently, escalating fear over the very solvency of major nations and their currencies has become mainstream, as it was back in 1933. Now as then, a lack of confidence in leadership and fresh memories of a frightening systemic collapse three years earlier engender fear, bordering on panic.

Cumberland Capital Appreciation Model Performance (Net)[1] as of July 31, 2011

	1 Month	YTD	1 Year	2 Year	3 Year	5 Year	10 Year
Cumberland	-2.1%	1.0%	15.8%	14.1%	6.4%	4.0%	5.1%
SP500/TSX (50/50)	-2.8%	-1.3%	12.2%	11.2%	1.2%	2.1%	3.0%

Asset Allocation

Equity	74.8%
Bonds	12.1%
Cash	13.1%

1. All returns are presented net of transaction costs and management fees. Performance for periods greater than 1 year is annualized. Cumberland model portfolio performance is utilized for monthly performance reporting; composite performance is available on a quarterly basis. Past returns do not guarantee future results.

Strategy Review

Importantly, there are also major differences. The U.S. economy declined only 2.5% in 2009 and has gained pretty much all of that back already. Although the economy has been slowing, actual economic data on the ground is not indicating a pending recession. What is indicating recession are people's expectations for the future. Retail sales data for July came in ahead of expectations but the consumer sentiment reading a week later (immediately following the debt ceiling debacle and S&P downgrade of the U.S. credit rating) is *among the lowest ever recorded*. Lower than anytime in 2008 or 2009. Only the Iranian hostage crisis and the oil embargo in the 1970's managed to register readings below the most recent consumer sentiment poll. Industrial production in July came in well ahead of expectations with particular strength in manufacturing, but recent surveys of future expectations for manufacturers (once again taken just after the S&P downgrade) were nothing short of abysmal. The experiences of 2008 remain fresh in everyone's mind and as a result the threshold to move from worry, to fear, to panic has been compressed far beyond what would have been normal a few years ago. "Shoot first; ask questions later" is the rule of the day.

So what keeps us up at night? Quite simply, we're worried that poor leadership has allowed uneasiness over long term problems to morph into panic about the immediate future. Make no mistake about it, panic about the immediate future can create very real and very negative outcomes whether they were deserved or not. Absent panic: equities are a bargain relative to bonds. Absent panic: opportunity abounds to earn attractive dividend yields and capital appreciation. Absent panic: we think the economy could continue to grow at a modest rate and over time this would improve the housing market, the consumer balance sheet and even government finances.

Unfortunately, the first half of August has demonstrated that we are NOT absent panic - and there isn't any FDR in sight. Who will step up and demonstrate the courage and leadership needed to tackle difficult issues with unpopular solutions? The leaders in Europe? Congress? President Obama? The current slate of Republican hopefuls? Now that is depressing. In the end it appears it will be left up to the Fed (and to a lesser degree, the European Central Bank) to act as the emergency panic relief valve. Not because they want to but because nobody else appears up to the challenge and they are the last resort. Look for more Fed and ECB action to be announced over the coming weeks, starting with the annual Fed conference in Jackson Hole Wyoming this weekend.

Within our clients' capital appreciation accounts we continue to hold significant levels of cash and gold (through senior gold mining stocks) and are unlikely to lower either unless we see signs that the current elevated levels of fear are subsiding. Should the economy hold on and markets calm down, we see plenty of opportunity to put more capital to work. On the other hand, if panic continues, we will not hesitate to further lower our clients' allocation to equities unless we see meaningful progress putting concerns over sovereign debt and the banking system to rest.

John Wilson
Chief Investment Officer
August 22, 2011