STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

Hoping for an Encore

***"We are cautiously optimistic [on the market's prospects for 2012]. The resilience we discussed earlier is a very good sign and, in our opinion, reflects the market's underlying strength. It seems to be suggesting that the U. S. economy will improve and that the European debt problems will not result in the collapse of the European Union and a global economic crisis."*-- <u>Sterling Capital Management client letter</u>, February, 2012.**

It always feels good when we get the market's direction right. It feels even better when our clients do well. We experienced both feelings in 2012.

<u>A Quick Look at Last Year</u>

The S&P 500 produced a total return of 16.0%, and the equities in most of our clients' accounts did better than that. We attribute this out-performance to a steadfast adherence to our value-oriented stock selection philosophy, which has proven itself over the long term. For comparison purposes, we note that 88% of all hedge funds trailed the S&P 500 in 2012, according to Goldman Sachs. The average return for these funds was around 8%. According to Lipper, Inc., the average return for U.S. diversified mutual funds was 13.9%.

Your account's overall return, of course, will be lower than the return of the stock component of the portfolio because of the miserly returns on bonds and cash. In general, the bond portion of our clients' portfolios increased slightly, around 1%. Because of the great risk to principal at these depressed interest rates (which we discussed last year), we limited the duration of our bond holdings, which in turn limited returns. Money held in cash equivalents continued to return only a fraction of 1% as the Fed made good its pledge to keep short-term interest rates at barely measurable levels.

In our opinion, the stock market did well last year because investors' fears—that the sputtering U.S. economy would slip into another recession and that the European debt crisis would spiral out of control--were already factored into the valuation of the stock market by the end of 2011. As the likelihood increased that these fears would not be realized, the market moved up, bolstered by the solid 8% growth in corporate profits during the year.

Not every aspect of our outlook was correct, however. You may remember that we suggested that stock prices were poised to benefit from an expansion of forward price/earnings multiples, which reflect the amount investors are willing to pay for $1 of a company's estimated earnings over the upcoming 12 months. In fact, although the total returns of stocks went up, there was very little expansion of the forward stock multiple of the S&P 500. Even with January's rise, the multiple remains under 14, lower than its average multiple of 15 to 16. So there is still room for multiple expansion. Will we get it in 2013?

<u>The Storm Clouds</u>

There are still plenty of worries out there. First, the European banking system may not have collapsed, but most European economies remain weak. This weakness will continue to reduce demand for U.S. exports, as was reflected in the Commerce Department's January 30 economic report: exports fell more in the 4th Quarter than in any other quarter of the last four years. Second, the return to the 6% payroll tax rate will have an impact on the spending of the U.S. consumer. A household with earnings of $50,000 will now find about $1,000 less in its pockets by the end of the year.

Moreover, the battle over the mandatory sequestration of federal revenue and the clash over the debt ceiling will likely re-intensify as we move closer to the new self-imposed deadlines in March and May, respectively, creating a climate of uncertainty among investors and businesses alike. Finally, because of the aggressive money-creating policies of the world's central banks, rumblings of inflation, which could spook the market, are possible.

The Sunny Side of the Street

But we also see many encouraging developments. Perhaps topping the list is the improvement in the housing market, which has a substantial impact on GDP. The National Association of Home Builders compiles an index, the HMI, to measure the strength of the single-family housing market, and it has been on the move, recently posting its highest reading since April of 2006. This could be particularly good news for the economy since strength in residential housing investment tends to lead to employment gains a year to a year and a half later. And not surprisingly, the HMI is often closely correlated with the stock market, which usually reacts about twelve months after the HMI.

There are other indications that the economy is trying to accelerate. The ISM Manufacturing Index, perhaps the most widely followed barometer of U.S. manufacturing strength, closed the year on an upbeat note with a reading over 50, which is considered a sign of growth. December's reading is the third in the last four months over 50, following 3 months in a row of sub-50 readings, which led to concerns that the economy was stalling. Just as important, the ISM Non-Manufacturing Index, which measures the strength of the nation's service sector, popped to over 56 in December, the highest reading since last February. In addition, the nation's durable goods orders, those orders for products expected to last over three years, have been strong the last few months, and auto sales continue to grow, up 13% in 2012.

Although these growth indicators are encouraging, the Federal Reserve Board still believes the economy is vulnerable and remains committed to keeping interest rates low. The world's other key central banks--the European Central Bank, the Bank of China, and the Bank of Japan--maintain the same or similar views about their own economies and have joined the Fed in flooding the globe with money. In the long run, this strategy may end very badly, but it will likely continue to inflate the prices of paper assets, including stocks, over the short term.

Another positive development for stocks is the recent change in the money flows to mutual funds. From 2009 through the end of last year, hundreds of billions of dollars flowed ***out of*** stock mutual funds and ***into*** bond mutual funds. This month, however, the flows out of stock funds appear not only to have subsided but actually to have reversed as investors have deposited a net of several billion dollars into stock funds during the first three weeks of January. If this trend is sustained, it could provide fuel for a prolonged market rally, especially since money is still flowing into bond funds. If interest rates begin rising, investors will likely pull money out of bond funds and purchase stock funds, which would give an additional boost to stock prices.

Putting all of this together, we think there is a pretty good chance that the market will be up again in 2013. The long-term returns of your stock portfolio, however, will not hinge on our ability to forecast the swings in the stock market as much as on our ability to select stocks whose value is not being reflected in the prices set by the market. This takes diligence, patience, and faith in our value-oriented philosophy, which has served our clients well for many years.

Indeed, stock selection may be even more important in the upcoming years than in the recent past because the correlation between the movements of individual stock prices and changes in broad market indices such as the S&P 500 is beginning to ease. (We noted the impact of correlation in our October, 2011 letter. According to one study, only 25% of an individual stock's performance, on average, has been attributable to the performance of the market throughout the history of the S&P 500. It has been far higher than that during the last few years and was over 50% at the end of 2012.) The easing of this correlation means that many individual stocks will diverge from the movement of the market as a whole, either in magnitude or even direction. In our opinion, this development will provide greater opportunities for money managers to outperform the market, and we welcome it.

As you probably remember, we have been extremely cautious on bonds for the past few years. When interest rates are extremely low as they are now, even a moderate rate increase would erode the value of the bonds in your portfolio. And the longer the bonds' maturity, the greater would be the loss. If the economy does accelerate and/or there are signs that the tremendous expansion of the Fed's balance sheet, which occurs when the Fed purchases Treasury bonds and mortgage-backed securities to increase the money supply, is beginning to cause inflation, interest rates could spike and the price of longer-maturity bonds collapse. As a result, we will remain very cautious in the fixed income arena.

Please do not hesitate to call if you have any questions about our outlook for 2013 or our investing philosophy. Please know that regardless of the economic environment or market conditions, we will work hard to find promising long-term opportunities for your portfolio as we continue to monitor your existing positions. As always, we appreciate your continued trust and confidence.

02/05/2013

12300 Old Tesson Road • Suite 100C / Saint Louis, MO 63128-2245 / 314.843.9999

www.scmstl.com