August 15, 2012

Dear Friends & Family,

Entering 2012, Roundview Capital considered equities reasonably valued in light of ongoing concerns about the global economy. Record low yields in fixed income investments like cash and bonds enhanced the relative appeal of stocks, and central banks around the world continued to provide a short-term backstop through monetary easing programs. In this environment, equities delivered solid gains in the first half of the year, as the major U.S. market indices advanced between 6-9 percent.

With U.S. stocks close to five-year highs, market participants continue to be wary. The media continues to deliver a steady stream of bad news, and we are bombarded with dreary accounts of the Eurozone crisis, economic slowdown in Asia, the U.S. fiscal cliff, and war in the Middle East. Your Advisor continues to uncover attractive investment opportunities amidst this backdrop. As Joe Rosenberg, the longtime Chief Investment Officer of Loews, astutely observed, “You can have cheap equity prices or good news, but you can't have both at the same time.”

In our mid-year letter, we discuss why the 24-hour news cycle is perhaps our greatest enemy, and also draw on history to provide context for the current Eurozone mess. We have also included an appendix which outlines information and potential action items regarding the “U.S. fiscal cliff,” which is a set of potential tax increases and government spending cuts scheduled for enactment in 2013.

WHY THE NEWS IS HAZARDOUS TO YOUR WEALTH

My life has been full of terrible misfortunes, most of which never happened.
- Michel de Montaigne

What can a cult teach us about investing?

In 1954, cult leader Dorothy Martin predicted that the world would end in a great flood on December 21 of the same year. When the day of reckoning passed without consequence, her group of followers initially struggled for an explanation. Yet after a short time of contemplation, the remaining loyal constituents changed their story and said that the world was saved because the group had spread so much light into the world.

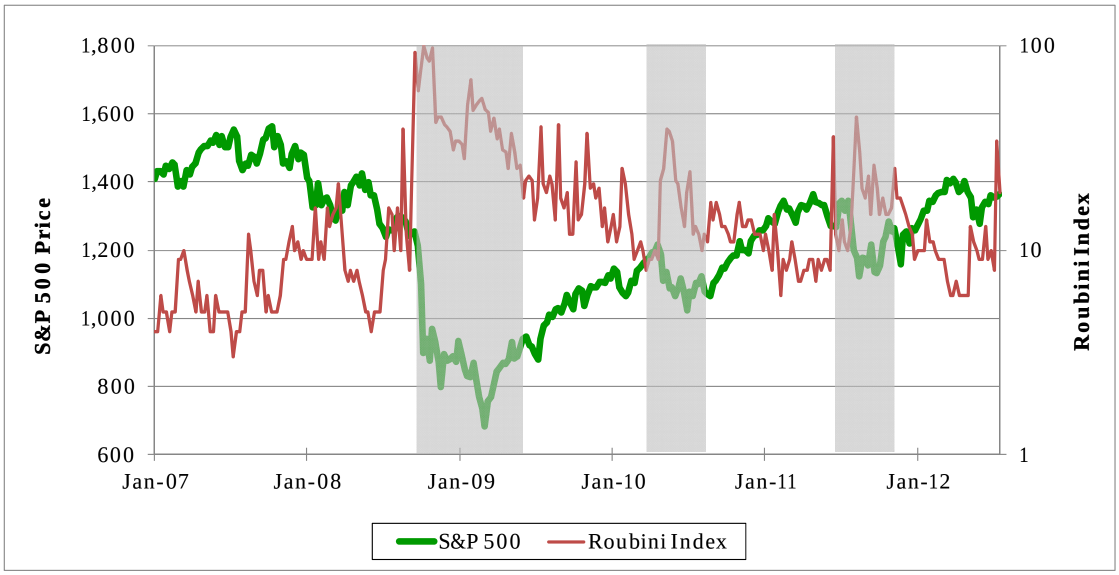
Psychologist Leon Festinger coined the term “cognitive dissonance” to describe how Martin’s cult rationalized what happened so that the outcome made sense. Cognitive dissonance theory warns that people often engage in irrational behaviors to lessen discordant elements, or in other words, “I’d rather ignore reality and be wrong than change my mind.”

Does this sound crazy? While Martin’s faction lies at the far end of the spectrum of self-delusion, this psychological bias is widespread among very normal people. Research demonstrates that our preexisting beliefs, far more than any new facts, can skew our thoughts and even influence what we consider our most logical conclusions.

We see this bias at work in today’s market environment. Much of the investing world is paralyzed by fear, believing that something dreadful is about to happen. Their perceptions of the economy and investment landscape are shaped by a continuous barrage of pessimistic headlines and fresh memories of the 2008 financial crisis.

In the midst of a market downturn – when prices are low – the media seems to reinforce the bad news by highlighting negative stories and bearish commentators. This point is illustrated by press coverage of New York University Economics Professor Nouriel Roubini, whose consistently bearish economic forecasts have earned him the nickname "Dr. Doom."

We've observed that media attention of "Dr. Doom" increases whenever there is a market sell-off. Over the past five years, we can see that the market as measured by the S&P 500 has traded almost inversely to the number of mentions that Dr. Roubini gets in the press as measured by Google Trends (Roubini Index).



Sources: Google Trends and Bloomberg

When investors experience the pain of a market sell-off and ensuing barrage of negative news in the media, cognitive dissonance theory explains why many people sell during market lows. Conversely, it helps us to understand how companies like Groupon, Zynga and Facebook were driven to relatively high valuations prior to their IPOs because of glowing media coverage. Market participants are influenced by what they consume through the media, and this is manifested through their actions. Just as members of Martin's cult were trapped in their misguided views, it is easy to be ensnared by the popular wisdom of so-called experts we follow in the media.

A FOUNDING FATHER'S TAKE ON EUROPE

"In Europe, it is particularly important that we build good relations to everyone who holds political responsibility, because Europe can only be built together."
- German Chancellor Angela Merkel

The Euro experiment began in 1999 as European countries sought to strengthen monetary cooperation by sharing a common currency. Seventeen nations now share the same official currency. However, in joining this union, each individual member gave up its ability to take independent monetary actions like devaluing its currency, lowering interest rates, or printing money in order to help resolve a crisis. In addition, each country also agreed to certain fiscal compacts, such as balancing their budget and setting borrowing limits.

With these limitations and hurdles, debt-laden member nations like Greece and Spain have struggled to remain solvent in the midst of a severe recession without support from the European Central Bank or from financially stronger countries like Germany. Complicating the problem is the lack of a viable decision-making process for the Euro region. As they face the current crisis, European political leaders must overcome their vast cultural and financial differences and agree on complicated decisions.

The original thirteen colonies of the United States also faced a great challenge of overcoming massive liabilities. Additionally, the level of debt varied dramatically from state to state, with Virginia and Maryland owing far less than their Northern neighbors. Before the U.S. Constitution was ratified in 1788, the thirteen colonies operated under the Articles of Confederation which had created a weak central government that was unable to properly finance itself.

Ultimately, the United States was able to consolidate state obligations and create a centralized system under the leadership of America's first Treasury Secretary Alexander Hamilton. As an author of the U.S. Constitution and the architect of the U.S. financial system, Hamilton was instrumental in uniting the original 13 colonies and creating a strong federal government. It's no wonder that his portrait graces the front of the ten-dollar bill.

Although there are clearly differences between the original thirteen colonies and the seventeen European countries that comprise the Eurozone, your Advisor would like to share some passages from Ron Chernow's acclaimed biography of Hamilton that provide some interesting historical perspective and insight.

Insight	**Excerpts from Ron Chernow's <u>Alexander Hamilton</u>**
Governments have dealt with financial woes that once seemed insurmountable.	Money problems pervaded all others under the Articles of Confederation. America was virtually bankrupt as the federal and state governments found it impossible to retire the gargantuan debt inherited from the Revolution. On European securities exchanges, investors expressed skepticism about America's survival by trading its securities at a small fraction of their face values. Many Americans were as debt-burdened as their legislatures.
Things are only clear in hindsight.	That the thirteen states would someday coalesce into a single country was far from a foregone conclusion. George Washington doubted that the new federal government would survive twenty years.

Change is never easy.	The aftermath of the Constitutional Convention turned ugly and divisive, polarizing the populace. At a Fourth of July parade in Albany, a riot broke out when a copy of the Constitution was publicly burned and federalist and antifederalist contingents collided, leaving one dead and eighteen wounded.
Congress has always been structured to move slowly and partisan politics is nothing new.	Jefferson long remembered the sour mood that hung like a miasma over New York that spring: "Congress met and adjourned from day to day without doing anything, the parties being too much out of temper to do business together."
Bankers have always aroused suspicion and been demonized.	"Holding banking to be no more than the prostitution of money for illicit gain," historian John C. Miller has written, "one Virginia planter swore that he would no more be caught going into a bank than into a house of fame."
Worries about credit are not new.	Hamilton wasn't blind to the speculative hazards of creating credit. He warned that "the superstructure of credit is now too vast for the foundation."

Your Advisor is aware that Europe faces very significant challenges, and does not claim to know exactly how the Euro experiment will end. However, our historical perspective tells us that political struggles, fiscal uncertainty, and "unprecedented" change are a part of our civilization, for better or worse.

As we perform our due diligence, we are always mindful of potential hazards and risks, but we also have strong conviction that the best investments are made when the market's outlook is quite gloomy. After all, the problems that encumber Europe are well known, have been analyzed in great depth, and are largely reflected in market valuations.

CONCLUSION

Actions are always more complex and nuanced than they seem. We have to be willing to wrestle with paradox in pursuing understanding.
- Harold Evans

Three and a half years ago, with the financial system teetering near failure, it seemed unlikely that equities would stage such a strong recovery. Similarly, given all of the current global uncertainty, it is easy for some investors to remain on the sidelines even when market opportunities remain attractive.

While the path forward may seem paradoxical and daunting, your Advisor's philosophy can be summed up quite simply. Live frugally, invest in a disciplined manner, and remain focused on valuation across all assets (disregarding the popular press for the most part!). We are honored to be your guides as you continue on this journey.

At Roundview world headquarters, we continue to make the firm as environmentally friendly and efficient as possible. As an example, many of you are enjoying our new paperless report delivery system. The reduced number of paper cut injuries for our staff has already paid off!

We thank you for your continued confidence and enthusiasm for our efforts and wish you a wonderful autumn.

With Best Regards,

Howard Alter

Stephen Shueh

Andrew Lieu

George Andresen

Janet Chen

Janice Puccio

APPENDIX: THE FISCAL CLIFF

Merle Hazard, who was dubbed by the New York Times as the "great musicalizer of economic dysfunction," recently wrote a Beach Boys-style song that aptly summarizes the much talked about "fiscal cliff."

"The fiscal cliff is a danger zone.
It's where grown men go when budgets are blown.
When our Congressmen cannot agree,
Taxes go up automatically!

Starting January 2013, several major tax increases and government spending cuts will automatically be implemented unless there is a political compromise. This has been dubbed the "fiscal cliff," as the prospect of fiscal contraction is a significant challenge to an already shaky economy.

- The Bush tax cuts of 2001 and 2003 expire, increasing tax rates across the population and raising the top marginal rate to 39.6% from 35%.
- The payroll tax, which funds the Social Security fund, increases from 4.2% to 6.2%.
- The top rate for capital gains taxes rises from 15% to 20%.
- Dividend income will be taxed as ordinary income instead of at 15%.
- Also, higher taxes due to the Affordable Health Care Act increase investment income taxes by an additional 3.8% for individuals or married couples that earn over $250,000 or $500,000, respectively.
- The estate tax exemption would be reduced from $5 million to $1 million, and the estate tax rate would be increased to 55% from 35%.
- Government spending cuts would be enacted, including reductions to unemployment benefits, decreased payments to physicians who treat Medicare patients, and a $65 billion decline in defense and domestic spending in 2013 alone.

Your Advisor expects many of the aspects of the fiscal cliff to be moderated by congressional action. For example, both Democrats and Republicans are in favor of extending the Bush tax cuts. However, Democrats want to keep lower tax rates for lower- and middle-income families, while Republicans favor lower taxes for the whole population. Also, President Obama's budget suggests that the estate exemption should be lowered to $3.5mm with a top rate of 45%, as opposed to the scheduled $1mm exemption and top rate of 55%.

While the results of the fiscal cliff will be unclear without resolution from Washington, the takeaway from this debate is quite clear: **taxes are likely to increase.**

With this in mind, it is advisable to accelerate taxable income so that it is received while marginal tax rates are lower to the extent possible. Similarly, one should consider delaying tax deductions, such as charitable contributions, in order to reduce taxable income in the future.

In addition, while the capital gains tax remains at 15%, it may be sensible to sell assets with long-term, unrealized gains if those assets might otherwise have been sold in 2013.

While the estate tax exemption is under a cloud of uncertainty, the IRS very recently released guidance for new legislation that was passed late in 2010. Fortunately, most couples will now find it much easier to maximize federal estate tax savings without needing extensive advanced planning. One of the requirements, though, is that estate tax returns will have to be filed within a short window of nine months after a partner's death. Proper preparation is still necessary to protect assets against state taxes.