After several billion dollars in campaign expenditures the U.S. elections are finally over. Its now back to governing as the Democrats and the Republicans must deal with the impending "fiscal cliff." This so called fiscal cliff refers to the drastic public-sector spending cuts and the expiration of large tax breaks affecting the wealthy, middle class and small businesses that are due to take effect in January of 2013. Unless a compromise is reached before year end, these spending cuts and tax increases are expected to have serious economic consequences. The non-partisan Congressional Budget Office predicts that "going over the fiscal cliff" would cause unemployment to rise to 9.1% and push the U.S. back into recession. The International Monetary Fund has warned of a "recession with large international spillover."

The pundits are now starting to focus on this issue and are using words such as catastrophic, dire and doomsday to describe the effect that the impending government budget reductions and tax hikes are expected to have. In turn investors are starting to get fearful and equity markets have started to sell off.

We are not as concerned about the situation; we believe that in one form or another there will be a solution that brings us back from this cliff. Despite the partisan bluster, politicians historically tend to compromise and solve critical issues.

Should an agreement not be reached, the consequences would not be as calamitous as predicted. Growth would certainly slow and a small recession might ensue for a short period of time but this outcome would not pose a systemic risk like the one we faced in 2008. Ever the contrarians, we would consider this scenario as an opportunity to buy companies that meet our criteria at attractive valuations.

We agree with Warren Buffett. As CNN reports:

> ***Buffett shrugged off the Congressional Budget Office's warnings that failure to address the fiscal cliff by Dec. 31 could lead to a recession. "We have a very resilient economy," he said. "The fact that [lawmakers] can't get along for the month of January is not going to torpedo the economy."***[1]

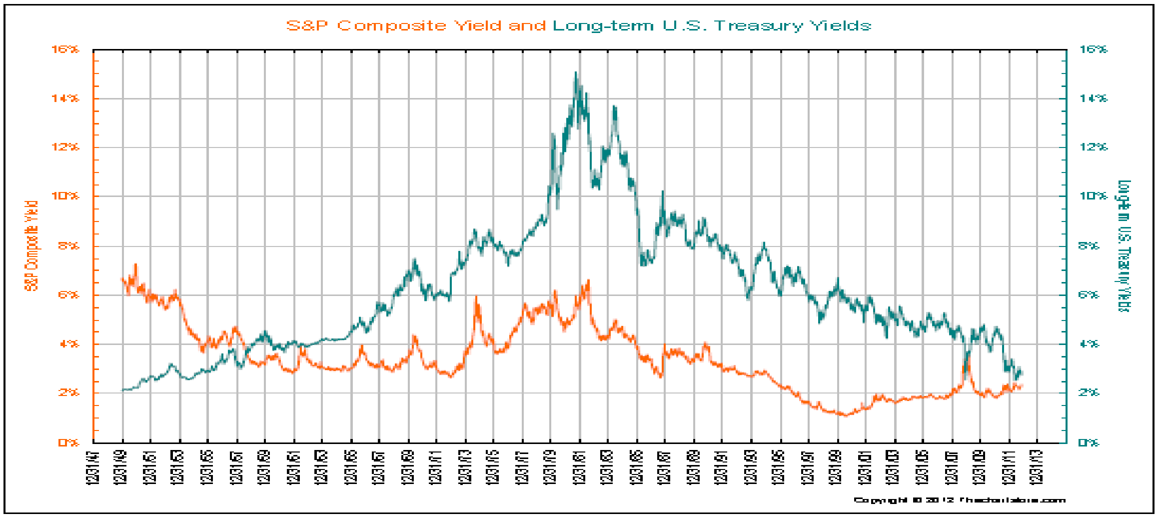
Investors are also concerned about the impact that the proposed higher dividend and capital gains tax will have on equity prices. The fear is that investors will sell their equity investments prior to December 31, 2012 in order to avoid paying higher capital gains taxes in 2013. While this may be true over the very short term for taxable investors there is no evidence that suggests that in the long term equity market are impacted by tax rates. For example, in the fifties and sixties tax rates were at much higher rates than they are at today and equity markets enjoyed strong returns during those decades. To quote Mr. Buffett again:

> ***"Never in 60 years of managing money have I come up with an idea and had someone say 'I'd do it but the tax rates are too high'."***[2]

A decline in equity prices as a result of the "fiscal cliff" or worries over tax rates would solve a very serious problem for investors seeking income. With interest rates at all-time lows, money has flowed into dividend-paying stocks causing their respective prices to rise and yields to drop. Chart 1, courtesy of The Chartstore.com, highlights the historically low levels of both interest rates and dividend yields.

[1] CNNMoney.com Wednesday, November 14, 2012
[2] CNNMoney.com Wednesday, November 14, 2012

Chart 1



With interest rates and dividend yields at lows on both historical and absolute levels investors looking for income are in a very difficult situation. At current interest rates, the probability of losing money on all but the shortest term government debt instruments, after taxes, fees and inflation is a near certainty. Dividend paying stocks provide a slightly better alternative relative to today's interest rates largely due to some inflation protection and a more favorable tax treatment. We estimate that after taxes and fees a dividend portfolio will likely provide a three to four per cent total return from current valuations. This modest expected return is better than fixed income but still not enough to meet most investor's requirements.

Under these circumstances we have seen those who truly need income take risks that we think are imprudent. They either "reach for yield" or purchase high yielding securities that are either a <u>return of capital</u> or change their asset mix to a more aggressive stance. Occasionally, we have seen some use debt in an attempt to enhance returns. In all of these cases the risk of permanent capital loss is extremely high.

We occasionally meet with potential clients who tell us that they need a certain level of income from their investment portfolio. In most cases we find that at current expected rates of return that the value of the portfolio cannot generate enough absolute dollars to meet their expectations. For example, recently we met a couple who had a portfolio of approximately one million dollars. In order to meet their expected lifestyle they needed to generate approximately $100,000; an annual net after tax portfolio return of ten per cent. This requirement translates into a return before fees and taxes in the range of fifteen per cent! This annual expectation is difficult to achieve in any market and almost impossible to obtain in today's environment.

In such scenarios we pull no punches. We present our modest return expectations and advise that expenditures be reduced and/or that the "income gap" be made up through the use of a small portion of their capital. Most prospective income seeking clients are not receptive to this message and do not engage PCM. However, we strongly believe that this approach is far more prudent than incurring the potential for substantial losses.

PCM does not have an "income product" as the vast majority of you have long term capital appreciation as your primary investment objective. However, we can foresee a time when many of you may need to transition to income oriented portfolios. Hopefully at that point fixed income and equity markets will have reverted to more normal levels and we will be comfortable providing an income product that meets your expectations and ours for an acceptable rate of return with a very low level of risk.

Our assets and client base continue to grow. We now have more than three hundred and fifty million dollars in assets under management. To our long standing clients we offer our deepest gratitude and we enthusiastically welcome our new clients. We very much appreciate all of your continued confidence and support.

We often talk about how blessed we are at PCM. We have an incredible client base, a great team, family and many friends. We are now literally blessed with our own in-house saint as Domenic was recently proclaimed St. Domenic by his priest for all of his parish work. Mary, Domenic's wife, would beg to differ with the saintly label! We agree with …

Vito Maida

November 14, 2012