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QtrNotes

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FIRESTONE CAPITAL MANAGEMENT

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In this Issue

Market Summary:

The markets finished the quarter with a flourish, recovering most of the losses suffered in May and June.

The Dow ended the quarter up just under 1%, while the S&P 500 gave up 0.4%. The small-cap index fell 1.9%. International stocks, pressured by Greece's financial crisis and geopolitical uncertainty in the Middle East, eked out a 0.3% gain.

New Website:

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New Brochure:

We are about to go to press with a beautiful new company brochure. Call if you want a copy.

Recovery Continues Despite Headwinds

The pace of the recovery has slowed, but there is no doubt that it continues. We do not expect a double-dip recession, although the recovery is going to take longer and be less robust than anyone would desire. First quarter GDP came in at only 1.9%, causing lowered expectations for the balance of the year. On the positive side, consensus outlook for the second half of 2011 is stronger, with expected growth topping 3%.

Index	6/30/2011	% YTD
Dow Industrials	12,414.34	7.2%
S&P 500 Index	1320.64	5.0%
Nasdaq Composite	27,773.52	4.5%
Russell 2000	827.43	5.6%
MSCI EAFE	1708.08	3.0%
10 Year Treasury	3.16%	

The second quarter began with a few headwinds three weeks after the tragic events in Japan. We believe the resulting interruption in the global supply chain was temporary; nonetheless, it did dampen second quarter worldwide growth. Focus has now returned to the ongoing troubles of high unemployment, weak housing, and European debt woes.

After three months of solid job creation, with the US averaging 220,000 jobs per month, in May only 54,000 jobs were created. Some of the drop is attributable to the problems in Japan. Another factor affecting unemployment is layoffs as state and local governments are forced to balance their budgets; however, state and local tax revenues are now recovering.

The housing market appears to have reached bottom in several parts of the country, and prices have actually stabilized in some areas. Nationwide, housing inventory continues to improve. There is only a six-month supply of newly constructed homes, in line with the 48-year average. This represents a 25% improvement over last year. In a few distressed areas housing prices could fall further. However, mortgage rates remain below 5% and housing continues to become more affordable. We feel this market is at or near a turning point.

Not all indicators are grim. Recent declines in oil, gas, and other commodity prices should provide relief in a number of ways. Lower energy prices free up spending for other goods and services. Lower commodity prices mean less expensive raw materials, which will lower production costs, allowing for strong profit margins to continue. These are signs that inflation is still not an imminent threat.

Currently, with unemployment still high and housing prices low, US demand for goods and services remains weak. Consumers, worried about their jobs, homes, and debt levels, just don't have the capacity or the enthusiasm to spend freely. Without demand from customers, businesses feel no pressure to hire, thus hurting employment prospects and stunting job creation. Painful though it has been, unemployment and its downward pressure on wages might be what is necessary to make our workforce more globally competitive. Lack of wage pressure also helps keep inflation in check.

The markets have shown faith in the continuing recovery. The S&P 500 rose 28% over the last 12 months. Analysts expect second quarter S&P 500 earnings to increase by 9% over the first quarter. Earnings have remained robust as US companies have been able to sustain record profit margins and high productivity. Firms have also taken advantage of record low interest rates by borrowing heavily, knowing they can generate returns greater than the cost of the debt. US companies are sitting on $2 trillion in cash. Once they see an increase in consumer demand, they will be ready to begin hiring more workers.

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Other Notes

End of QE2:

The Fed's second round of Quantitative Easing, known as QE2, ended June 30. Although critics of the policy say it failed to stimulate growth and employment, the main objective of QE2 was to prevent deflation. Judged by that goal, it appears to have been a success. The Fed has committed to holding on to the Treasuries it now owns and reinvesting the proceeds as the bonds mature, so the unwinding process will probably take several years.

The effects of the end of QE2 are likely to include a modest uptick in interest rates. However, the debt crisis in Europe and a slowing domestic recovery may cause investors to continue to prioritize safety over returns, mitigating the push on interest rates. As rates rise, we may see a mix of positives and negatives: a rising dollar, lower commodity prices, and perhaps increased market volatility.

Quotes:

"Inflation is the only form of taxation that can be imposed without legislation."
- Milton Friedman

"I'm not worried about the deficit. It's big enough to take care of itself."
- Ronald Reagan

"Any man who is a bear on the future of this country will go broke." *- J.P. Morgan*

When It's Time to Retire

As Baby Boomers approach retirement, their most frequent question is "How do I convert my assets into income, and not run out of money?" Many investors believe the answer is to own income-producing assets, spend the income, and preserve the principal. This methodology is flawed and can lead to poor investment results as well as an insufficient retirement income stream. To improve upon this "rule of thumb" reasoning we recommend the following:

First, distinguish between *income* and *cash flow*. We like to tell clients "All dollars are green." Ultimately your spending in retirement is a function of how much cash flow you have available. Cash flow can come from both dividends and interest earned from your portfolio, as well as a harvested share of growth or capital appreciation. In order to optimize cash flow, we manage portfolios for total return, the concept of maximizing both growth and income.

Second, be sensitive to the location of the assets. Most clients have both taxable accounts and retirement accounts. Many retirees' instincts lead them to draw on non-retirement assets first, until they have to begin taking Required Minimum Distributions (RMDs) from their retirement accounts at 70½. But caution should be exercised with this approach. Once non-retirement assets have been depleted, every future expense triggers a taxable event: if you have to replace a car or a roof, paying for it out of an IRA can cost up to 35% more once you figure in the tax liability incurred by the IRA withdrawal. Make a distribution analysis and use your non-retirement funds to help preserve your flexibility by managing the tax treatment of withdrawals.

Third, focus on maintaining a sustainable distribution level throughout retirement by looking at the aggregate value of your financial assets. Clients can reasonably expect to take a draw of approximately 4.5% annually on their total assets without exhausting the principal.

For each $1 million in assets, you can withdraw $45,000 each year and still have a high degree of confidence of never running out of money. For this rate of withdrawal to be sustainable, you must maintain a balanced portfolio with both stocks and bonds to provide long-term growth of the principal. By targeting a growth rate in excess of the withdrawal rate, the purchasing power risk of inflation is mitigated.

Finally, ignore market volatility and focus on enjoying retirement. Markets will rise and fall. Your stock investments will fluctuate in value. In order to be comfortable with your retirement cash flow, think of your portfolios as having two components generating funds for withdrawal: income and growth.

Think of the pie chart of your diversified portfolios and visualize a 'cash bucket.' As we rebalance, we replenish your money market and other liquid accounts so that your monthly distribution checks are secure and not subject to the ravages of swings in the markets. We have lived through the worst of what the markets can deliver in the last three years. Clients who used this strategy and were able to stick with it have recovered nicely.

Hitting the Debt Ceiling

The news has been dominated by worries over the debt ceiling. Allowing the US to default simply is not an option. What the debates fail to highlight is that at 58%, the US public debt as a percentage of GDP is not out of line with other major developed countries. While manageable in the short term, given the size of our economy and the vast wealth of the US, this amount of debt is not sustainable.

Despite all the posturing and political rhetoric, the bond markets and interest rates reflect an assumption that Congress will eventually act as it must, and will negotiate a deal to cut spending and increase revenues. We agree that politicians will act, but it's painful to watch them squabble. If Congress does play "chicken" with the debt ceiling, the markets are likely to send Congress a message no one wants to receive.

As a nation we can ultimately get our balance sheet in order. Expenses will be cut, entitlements reformed, and revenues increased. The goal should be to move us toward a more sustainable fiscal position over a reasonable time period, so as not to jeopardize the recovering economy.