



HIGHTOWER

AN UNOBSTRUCTED VIEW

THE MORGIA GROUP

Semi-Annual Update

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Back Where We Started:

The fact that most U.S. stocks ended 2011 pretty close to where they started, disguises an extremely turbulent and busy year. From last January to July the market hopped back and forth between break even and a reasonable +6%. Then came August, posting one of the most violent back and forth actions I have seen in my 24 year career. That month turned out to have one of the worst starts for any August on record and would close out as the worst in a decade.^{1,2} Fear created by the debate on raising the government debt ceiling was quickly followed by the European debt crisis, worries over a Chinese economic slowdown and ultimately, questions of a possible double-dip recession for the U.S. economy.

We had our typical defenses in place, including a relatively high amount of cash in the stock portfolios, which we used to do some bargain hunting in early October. Like we have said in past updates, if we take Fed Chairman Bernanke at his word we can be reasonably certain that when the economy is threatened, “Uncle Ben” will do his best to prop it up; i.e. print more money. How long he can keep this up, however, is anyone’s guess.

With this high level of market volatility, investors invariably get sucked into short-term thinking. This kind of focus on the day-to-day gyrations of the stock market, however, can do serious damage to one’s portfolio as well as one’s mental health. Here is a quick listing of the manic- depressive headlines during the past six months:

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August 3, 2011 – Bear Stalks Stock Market

“...setback in Greece’s financial crisis sent major stock market indexes to lows for the year”³

August 26, 2011 – DJIA, Stock Market Jumps after Bernanke Speech

“...Chairman Ben Bernanke... said the central bank remains focused on revamping the nation’s economy...”⁴

October 3, 2011 – Market Sell-off Starts Fourth Quarter on a Down Note

“...the market fell nearly 3% on fears that Greece may not get its needed bailout funds to avoid default...”⁵

October 27, 2011 – S&P 500 Extends Best Month Since ‘74

“...Stocks surged, extending the biggest monthly rally...since 1974.”⁶

November 16, 2011 – U.S. Stocks Drop after Fitch Warns of Debt Contagion

“...the market fell nearly 3% on fears that Greece may not get its needed bailout funds to avoid default...”⁷

November 30, 2011 – Stocks, Euro Rally as Central Bank Moves to Boost Liquidity

“...Stocks surged, extending the biggest three-day rally in global equities since 2009.”⁸

I am always dismayed about the wasted emotional energy that many investors (including myself) subject themselves to during volatile sessions such as witnessed over the last few months. From the “Oh no!” feeling during those 400 point down days in the Dow Jones Average to the “Oh yes!” feeling during the snap backs, market participants put themselves through an emotional wringer. Yet, at the end of the day, we are simply back where we started.

The true long-term investor (a breed that I am quite certain is on the endangered species list) thinks of stocks as pieces of real businesses, not trading cards. And although we may never quite be able to detach our emotions from our investing, it is something for which we should certainly strive.

Case in point: According to Bloomberg, 81 year old, legendary investor Warren Buffett invested \$23.9 billion during this troubled timeframe (the most in 15 years). It is always comforting to see Mr. Buffett step in as a buyer in the midst of panic. It was also comforting to see that one of his largest purchases was \$10 billion worth of IBM stock, one of the larger holdings in our Morgia Group Core Stock Accounts.⁹

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A Tale of Two Futures:

A little over two decades ago during the 1990 recession, the market was in great turmoil and most bank stocks had been beaten down into the single digits as the U.S. struggled with the Savings & Loan crisis.

At that time, I had just finished reading a very disturbing prediction, by a credible expert, that the crisis would certainly turn into another economic depression, pushing both the economy and the stock market to much lower levels than already seen. Being a “seasoned” stock-pro with a full two years of experience, I knew it was time to act and I scrambled into Tony’s office with the pressing news of doom in hand. “Yeah I read that” he dismissed. “I read this one too” he said, and tossed me another report. That second report turned out to be a very bullish piece (also by a credible expert) that predicted an eventual large recovery in the beaten down financial stocks and the market as a whole.

I found myself with a headache after having been immersed in the negative premise for an hour and a half, only to be whipsawed around 180 degrees to the counter argument. Tony talked about seeing these extreme predictions throughout his career and that if I looked, I could find a so-called expert to back up *any* opinion I might have at any given time. He counseled that investors are much better off taking a moderate approach and ignoring both extremes – the world tends to revert back to the norm.

I wrote myself a reminder that year that I still reference today. The instruction says “*Never try to predict the stock market direction, you will only wind up with a headache – there will always be so-called “experts” on both sides of every argument.*” It wasn’t particularly profound, or well-worded for that matter, but it was important.

In the twenty years that have followed there have been countless times that I have failed to heed my own warning. I still can get caught up in listening to elaborate and detailed predictions of the future course of the financial world, both positive and negative. In each case, without fail, I have come away frustrated by the equally compelling, equally logical, yet totally opposing conclusions of the country’s leading economists and market strategists.

So why am I about to subject you to the mental pain of listening to contradictory forecasts? Besides the fact the misery loves company, I want to accomplish two important things: First, to drive home the fact that it is extremely difficult trying to invest by predicting the future course of the world

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financial markets with any kind of precision. Second, I wish to show how misguided, shortsighted and just plain wrong the popular conceptions of the future can be. And “misguided” should be a term never mixed with your finances.

Don't get me wrong – we are big believers in keeping an eye on macro-economic and cultural trends affecting stocks and bonds. For those clients who were with us back in 2005, you may remember our warnings prior to the housing bust. But markets can be very unpredictable in terms of timing, intensity and ultimate destination. The human tendency toward emotional behavior is one of the main drivers of this unpredictability. As investors, we must strive to never become too stubborn with our view of the world. As we become inflexible, risks have a tendency to mount.

So take an aspirin and let's continue:

The Glass is Half Empty:

At the Morgia Group, we tend to focus on risk first. As we often say, we believe that the best way to build a portfolio is by attempting to strip out as many risks as can be found. Watching out for potential disasters is what keeps us up at night. So let me start with what might go wrong with the world.

As we all know, the governments of the Western world are spending more than their incoming tax receipts. To make up the difference they have been borrowing, and borrowing, and borrowing. This has been going on for many years. Like Greece, Portugal and Italy are now discovering, there comes a day when lenders start to question a country's willingness to give them back their money. Cuts in government payrolls and services (austerity) must be implemented in to order “stop the bleeding,” but this can lead to a drop in economic activity as higher unemployment affects consumer spending. This, of course, can cause tax receipts to drop even lower, and a vicious cycle can ensue where it becomes more and more difficult for a country to make good on its obligations. Europe is finding this out today, with pressure mounting on the more fiscally sound Northern Europeans, to bail out the Mediterranean countries.

How long before California becomes our Greece? Will the U.S. states that are in better fiscal shape have issues with being asked (or forced) to pay the bills for the chronic overspending states? What

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about our national debt problems? What would happen if the Chinese decided that they were done financing the U.S. budget deficits? Might our interest rates need to rise dramatically to entice other buyers? And what would that do to our economy?

When viewed from the perspective of the over indebtedness of many of the world's countries, it is easy to speculate that global spending might need to be sluggish for quite some time as the world deals with paying yesterday's tab. Many worry about a long drawn-out period of stagnation, similar to that which Japan has been mired in for two decades, or worse stagflation with lackluster or negative economic growth but increasing prices. Luckily, corporate America at least, has cleaned up its collective balance sheet in the last decade and is in fairly strong financial shape ...oops I am supposed to be focusing on only the negatives for now.

Even plain old cash itself has many investors worried. Is it worth the paper it's printed on if world governments can't or won't pay their bills (Greece) or *can* pay their bills by simply printing more money (U.S.)?

Lastly, there is a theory that the aging U.S. baby boomers may slow down their consumption habits, as they pass their peak spending years. The thought of the "me" generation slowing their buying habits, at least willingly, strikes me as a stretch. However, I *could* see them selling down their stock portfolios to fund their spending needs and wants – which could keep a lid on stock prices.

So ... now that we all want to crawl into a hole with our gold bars and army rations, let's brighten things up a little. Let's look at what could go right. But before we discuss a possible rosy future, let me first go back several decades for some perspective on how investors of the past viewed their future. In the mid 1970's, our country was in the middle of one of the worst recessions in a generation. The Arab Oil embargo and skyrocketing fuel prices were jeopardizing our ability to move the nation forward (literally), with gas lines and rationing being the norm. Nixon resigned in August of '74, Saigon fell in April of '75 and the stock market had been on a rollercoaster ride for the previous ten years. In summary: bad stuff. Needless to say, the common perception of the future course of the stock market was bleak. Imagine for a moment that you could speak to an investor of that time. Your goal being to assure him that the world would eventually be just fine and that he should simply relax and hang on to the stocks that he had not already sold.

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The conversation might go something like this:

1970's Investor: This market's a drag, how am I ever going to retire?

You: Don't worry, the market will be fine, there will be many stocks over the next few decades that you will be able to make some money on.

1970's Investor: Like what? The world is in big trouble. All the major industries like Steel and Automobiles are not doing so hot.

You: Well... there will be a lot of newer industries with very solid companies ... like Google for instance.

1970's Investor: What will they do?

You: They'll build the world's best search engine.

1970's Investor: What's a search engine?

You: Well, when you are looking for some information on the web...

1970's Investor: What's the web?

You: Ok... when you are using your PC and want to find...

1970's Investor: Hey man... I have no idea what a PC is.

You: Oh I give up! Just buy some stocks.

The preceding exercise serves only to show how futile it can be even imagining how the economy and markets might shape out in the next decade or two. Investors would be totally wasting their time in trying to peer too far ahead with too much detail. What appeared to be a bleak future back in 1974 turned out to be the dawn of the information age. Investors were on the verge of a technology revolution that would touch or change almost all aspects of life and launch the stock market on a run-up seldom seen in history – and they had no clue.

So can we, as today's investors, possibly have a high degree of confidence that we *know* what the winning industries will be in the next few decades? I think that we cannot; not with any true detail at least. But perhaps we can detect some broad themes or trends:

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The Glass is Half Full:

It seems ironic, with oil over \$100 per barrel, Iran looking to join the nuclear club and the Arab Spring not quite working out as planned, that the United States still has no real energy plan.

The famed oil-man T. Boone Pickens gave a CNBC television interview a few weeks ago where he said, *“If you look at the last ten years we have paid OPEC...for our oil... \$1 trillion. If we go forward ten years we will pay, at \$100 barrel, \$2.5 trillion”*. He went on to say, *“We have the cheapest energy in the world in this country. Our oil is cheaper by \$15 a barrel than the global price and our natural gas is cheaper... Why isn’t someone saying we have the cheapest energy in the world? We can bring industry back into the country.”*¹⁰

With unemployment at 9% and energy imports adding daily to our national debt, we seem to be acting extremely foolish and lazy by not developing our own resources. If there is any doubt that merely embarking on a path towards energy independence would help our economy, we need only look to Alberta, Canada. This landlocked province is witnessing an economic boom due to the development of its oil-sand resources. It has seen its population jump 37% in ten years as its economy and employment have soared and its GDP has climbed to C\$70,824 per capita (a huge 75% greater than that of Quebec’s).¹¹

Eventually, the U.S. could embark on a similar path to economic growth with the rising stock prices that usually follow. But there’s a problem. It seems our leaders have decided that Albertan oil is just not green enough for us. Not only aren’t we working on developing our own vast unconventional oil resources – we are actually refusing to allow that Canadian oil to flow our way. The proposed Keystone XL pipeline project that would carry Alberta oil down to the southern U.S. coast for refining is being blocked.¹²

According to Pickens, *“I met with one of our congressmen and he said I’m not going to be for anything that emits CO² like they do at Fort McMurray in the oil sands. I said, you’re not a congressman in Canada, you have no influence over that country. They are going to develop their oil sands and we’re either going to get the oil or China is – now where do you want it to go? And it’s insane... Historically when they go back and look at us, we’ll be the dumbest people that ever came to town”*.¹³

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Our country is also blessed with vast quantities of off-shore oil, which after the BP spill is much harder to come by. Yet last month, the Spanish company Repsol was floating their deep sea drilling rig, Scarabeo 9, towards its new home in Cuban waters just 70 miles from Key West.¹⁴ The Cubans have also invited PetroVietnam and Petroleos de Venezuela to join the oil hunt. Yes, someday soon, Hugo Chavez could be helping himself to undersea oil fields that are just too environmentally dangerous for Exxon to tap, but I'm sure he will be very careful not to spill anything.

Ok... I can hear everyone reading this update asking, *so how the heck does this lead to a positive future?* Well... because one way or the other, it seems very probable that our country will *have* to let the U.S. energy genie out of the bottle. We either do it proactively or we wait until our U.S. dollar gets beat up enough that we can't afford foreign oil. I believe it will be the former, as this hot-button issue is just too easy of a target in the 2012 presidential race. Any candidate risks looking foolish if they don't at least pay lip-service to some form of real energy plan. That debate should highlight the energy issue sufficiently enough to get the ball rolling. But either way, I believe we will develop our own oil and gas resources – and that could be a very big boom to the engineering and construction industries in the near term and a God-send to our national debt problem in the long term. Yes, we need to develop as fool-proof a safety system as possible, but that too could put people back to work. Imagine the economic boom that could develop with a full-out national effort to become energy independent. Between the cheap and clean natural gas of the Marcellus shale field in the Northeast, to shale-oil development in Colorado, to the expansion of offshore exploration, our country and economy could see much brighter economic days. Why should the Canadians have all the fun, eh?

Other potentially very positive trends include the following:

- The steady growth of the Chinese and Indian middle class: This surge in potential consumers could help many different companies, from airline manufacturer Boeing to consumer product companies such as P&G or Johnson and Johnson. This trend could also lead to more food consumption and thus put pressure on food prices, especially meat, as the emerging markets increase their protein intake. As a major food exporter, the United States could find itself in a very prosperous farming environment.
- Productivity moves to yet a higher level: The worldwide adoption of social media and smart-phone technology is driving a new way to interact. Google has made finding information as easy as posing a question on the web or watching a YouTube video. But society is only scratching the surface as far as worker productivity goes. Every industry and company can

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benefit from working smarter, from collaborating better and from automating drudgery out of the workplace. This can free up employees to do more important work. It could also displace workers as well, but overall I think this change will largely be for the better. As productivity generally does, it will drive economic efficiency as well as a higher standard of living.

- The robotics revolution: Five years ago, with little fan-fare, Bill Gates wrote an article in *Scientific American* that predicted we were in the early stages of the age of robots. He saw robotics as having high potential to be the next important area in the technology sector. Last August, Reuters reported that Taiwan's Foxconn Technology Group, which assembles electronics (including the iPhone) in Mainland China, plans to use perhaps a million robots in the next three years to help them cope with rising labor costs. It seems that sick-days, vacations and pension benefits are not as common for machines. Also, advanced voice recognition technology from companies such as Nuance Communications (a holding in the Morgia Group Opportunity Accounts) is bringing the interface between humans and machines to another level. This software is being embedded in everything from Apple's iPhone to Ford's cars and trucks, letting machines begin to understand the spoken language – any spoken language. As consumer goods and manufacturing companies turn more and more towards robotics, China's cheap-labor advantage starts to dwindle and U.S. factories become more viable. Some analysts have started speaking of an American manufacturing renaissance because of this trend. The Morgia Group has begun buying equity positions for client accounts in one of the world's leading robotics companies. This Asian manufacturer of factory automation equipment has perhaps one of the best software operating systems for robotic platforms.

The Opportunist:

So which is it? Should we fret the future or embrace it? Is the glass half empty or half full? My answer is simply – yes. There are important arguments to listen to on each side. Why not let the Bears insist that the glass is half empty and let the Bulls insist that it is half full... we should be opportunists and drink up while they argue. Mr. Buffett seems to be just such a role model, often lecturing that investors should not even attempt to guess the market's next direction. He simply waits for an opportunity to develop and then he acts – either buying or selling accordingly. It's hard to argue with living proof.

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As always, please do not hesitate to call with any questions, comments or suggestions. On behalf of Tony, P.J., Mark and the rest of the Morgia Group, thank you for your continued confidence.

Sincerely,

Michael Morgia, CIMA®

Managing Director, Partner

The Morgia Group at HighTower Advisors

Tony Morgia

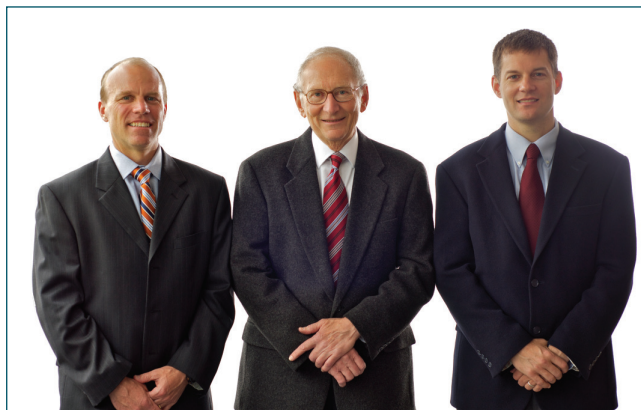
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From left to right: P.J. Banazek, Tony Morgia and Michael Morgia

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