MAINSTAY INVESTMENTS℠

MARKETFIELD ASSET MANAGEMENT

December 31, 2012

MainStay Marketfield Fund

Fund Overview

Objective

The investment objective of the Fund is capital appreciation. We endeavor to accomplish this by seeking low-volatility absolute returns in excess of broad equity indexes.

Strategy & Process

The Fund attempts to provide returns on capital substantially in excess of the risk-free rate rather than matching any particular index or external benchmark. The Fund has a broad investment charter that allows it to utilize equity securities, fixed-income instruments, commodities, futures and options. Additionally, with respect to 50% of the Fund's net assets, the Fund may engage in short sales of index-related and other equity securities to reduce its equity exposure or to profit from an anticipated decline in the price of the security sold short.

The use of short selling could result in increased volatility of returns.

Fund Facts

Fund Statistics

CUSIP:.....Class A: 56064B878
..... Investor Class: 56064B886
..... Class C: 56064B860
..... Class I: 56064B852
..... Class R2: 56064B845
Inception Date.....7/31/07
Benchmark.....S&P 500 Index
Net Assets $4,407M
Number of Holdings 89

Top Ten Long Equity Holdings

(As of 12/31/12)

BASF SE (Germany) 2.83%
iShares Dow Jones Transport Avg. ETF...2.54%
SPDR S&P Regional Banking ETF 2.48%
iShares MSCI Mexico ETF.....2.32%
Eagle Materials Inc. 2.30%
USG Corp. 2.08%
CRH PLC (UK) 2.00%
iShares MSCI Italy Index ETF.....1.87%
Wolseley PLC (UK) 1.86%
General Electric Co. 1.83%
TOTAL: 22.11%

Portfolio Allocation (As of 12/31/12)

Equity Long 86%
Equity Short 35%

★★★★★ OVERALL MORNINGSTAR RATING™ (CLASS I)

AMONG 96 LONG-SHORT EQUITY FUNDS AS OF 12/31/12

Ratings are based on risk-adjusted return. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its 3 year Morningstar Rating metrics.*

Fund Performance

Monthly Average Annual Total Returns as of 12/31/12 With Sales Charges

	Tickers	One Year	Three Year	Five Year	Inception
Class A (10/08/2012)	MFADX	7.06%	8.09%	7.49%	7.60%
Class INV (10/08/2012)	MFNDX	7.06%	8.09%	7.49%	7.60%
Class C (10/08/2012)	MFCDX	11.43%	9.32%	7.90%	7.91%
Class I (07/31/2007)	MFLDX	13.50%	10.40%	8.97%	8.99%
Class R2 (10/08/2012)	MFRDX	13.06%	10.00%	8.58%	8.60%
S&P 500	N/A	16.00%	10.87%	1.66%	1.90%*

*Inception date used was for Class I (07/31/07)

Class A & INV: 5.5% maximum initial sales charge. Class C: 1% CDSC if redeemed within one year.

Total Annual Fund Operating Expenses: Class A: 2.70%, Investor Class: 2.86%, Class C: 3.61%, and Class I: 2.45%; Effective October 5, 2012, New York Life Investment Management LLC ("New York Life Investments") has contractually agreed to waive fees and/or reimburse expenses so that Total Annual Fund Operating Expenses (excluding taxes, interest, litigation, extraordinary expenses, brokerage and other transaction expenses relating to the purchase or sale of portfolio investments, and acquired (underlying) fund fees and expenses) for Class I shares do not exceed 1.56% of its average daily net assets. This agreement will be in effect for a two-year period unless extended by New York Life Investments and approved by the Board of Trustees.

Average annual total returns include the change in share price and reinvestment of capital gains and distributions. Effective 10/8/12, Marketfield Fund was renamed MainStay Marketfield Fund. At that time, the Fund's existing no-load shares were redesignated Class I shares. Performance for Class A, Investor, R2 and C shares, first offered 10/8/12, includes the historical performance of Class I shares from inception through 12/31/12, adjusted to reflect the applicable sales charge (or CDSC) and fees and expenses for such shares. Class I shares are generally available only to corporate and institutional investors.

Performance reflects the reinvestment of dividends and other earnings and is net of advisory fees. Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data to the most recent month end may be obtained by calling 800–MAINSTAY (624–6782).

The S&P 500 Index (SPX) is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The securities holdings and volatility of the Fund differ significantly from the stocks that make up the SPX.

Top five sectors—net

Industrial.....32.08%
Consumer Discretionary.....16.55%
Basic Materials.....6.99%
Consumer Staples 2.75%
Financial.....2.64%

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security. Current and future portfolio holdings are subject to risk.

There can be no guarantee that investment objectives will be met.

Management Team

Michael C. Aronstein
President, Chief Investment Officer,
and Portfolio Manager

Michael C. Aronstein is Portfolio Manager of MainStay Marketfield Fund. In 2004, Mr. Aronstein joined Oscar Gruss & Son Incorporated, where he held the position of Chief Investment Strategist. Prior to joining Oscar Gruss, Mr. Aronstein was Chief Investment Strategist at Preservation Group, a provider of independent macroeconomic and strategic advice to professional investors. Mr. Aronstein began his investment career in 1979 at Merrill Lynch, serving positions as Senior Market Analyst, Senior Investment Strategist, and Manager of Global Investment Strategy. Mr. Aronstein spent six years as President of Comstock Partners, a diversified investment advisor, and left to found West Course Capital, a discretionary commodity management firm. Mr. Aronstein graduated from Yale College with a Bachelor of Arts in 1974. His views on macroeconomic and strategic issues are regularly sought by and disseminated through the financial print and visual media. Mr. Aronstein manages $4,407 million in MainStay Marketfield Fund and $509 million in The Marketfield Fund, Ltd.; total assets under managment are $4,916 million.

Myles D. Gillespie
Principal, Senior Trader

Myles D. Gillespie joined Marketfield Asset Management in 2007. Myles is a graduate of The Hotchkiss School and holds a Bachelor of Arts degree from Franklin and Marshall College (Class of 1983). From 1983 to 1986, he worked as a stock index futures trader with Henderson Brothers and in 1986 became a NYSE Specialist at Quick & Reilly. He was appointed Executive Vice President of JCC Specialist Corp., the successor firm to Quick and Reilly, in 1989. In 1999 he became President of Fleet Specialist, Inc., the successor firm to JCC Specialist Corp., retiring from this position in 2004. During his time at the NYSE, Myles served as a NYSE floor Official (1993-1999) and NYSE floor Governor (2001-2004).

Michael Shaoul
Chairman and CEO

Michael Shaoul also serves as Chief Executive Officer of Oscar Gruss and Son Incorporated, a position he has held since December 2001. He joined Oscar Gruss in 1996 as Chief Operating Officer. Between 1992 and 1996, Mr. Shaoul ran Park Square Associates, a Manhattan-based real estate investment and management company. He was awarded a Ph.D. in Accounting and Finance in 1992 from Manchester University (UK). Mr. Shaoul has written articles on behalf of *Barron's* and has been regularly quoted in The *Wall Street Journal* and Dow Jones Newswires regarding his opinions on the investment markets.

David C. Johnson, Jr.
Principal, Director of Research

Mr. Johnson joined Marketfield Asset Management LLC as Director of Research in April 2011. Mr. Johnson is a graduate of the University of North Carolina at Chapel Hill. He received his MBA in 1984 from Darden School of Business, University of Virginia. Prior to joining Marketfield, Mr. Johnson was an investment analyst, portfolio manager, and head of business development at Wilkinson O'Grady & Co., Inc. He spent the first 10 years of his career in the fixed-income department of Salomon Brothers, where he managed one of its primary sales groups. Mr. Johnson was president of Preservation Group, where he worked closely with Mr. Aronstein.

Before You Invest

Mutual fund investing involves risk. Principal loss is possible. The Fund invests in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for investments in emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the Fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Investments in asset-backed and mortgage-backed securities involve additional risks such as credit risk, prepayment risk, possible illiquidity and default, and increased susceptibility to adverse economic developments. The Fund regularly makes short sales of securities, which involves the risk that losses may exceed the original amount invested. However, a mutual fund investor's risk is limited to the amount invested in a fund. The Fund may also use options and futures contracts, which have the risks of unlimited losses of the underlying holdings due to unanticipated market movements and failure to correctly predict the direction of securities prices, interest rates and currency exchange rates. The investment in options is not suitable for all investors. Investments in absolute return strategies are not intended to outperform stocks and bonds during strong market rallies.

 For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ (based on a Morningstar Risk Adjusted Return measure that accounts for variation in a fund's monthly performance, including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) MainStay Marketfield Fund Class I received 5 stars among 96 Long-Short Equity Funds for the three-year period & 5 stars among 56 Long-Short Equity Funds for the five year period ending 12/31/12.

MainStay Marketfield Fund is subadvised by Marketfield Asset Management LLC and distributed by NYLIFE Distributors LLC, 169 Lackawanna Avenue, Parsippany, NJ 07054, a wholly owned subsidiary of New York Life Insurance Company. NYLIFE Distributors LLC is a Member FINRA/SIPC.

MainStay Investments is a service mark and name under which New York Life Investment Management LLC does business. MainStay Investments, an indirect subsidiary of New York Life Insurance Company, New York, NY 10010, provides investment advisory products and services.

Neither New York Life Investment management LLC, its representatives or affiliates provide tax, legal or accounting advice. Please consult your own advisors on these matters.

The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

Obtain the Prospectus

For more information, call 800-MAINSTAY (624-6782) for a prospectus or summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus or summary prospectus contain this and other information about the investment company. Please read the prospectus or summary prospectus carefully before investing.

Year End 2012 Commentary

As we enter year five of the bull market in U.S. equities, recognition is beginning to dawn while additional markets in the developed world join the trend. The process by which the domestic capital markets and the economy were saved from calamity in the fourth quarter of 2008 is finally being repeated in the European area and possibly even Japan. The latter has been burdened by false starts toward a more expansive monetary policy for twenty-two years. Perhaps they have finally learned that monetary quantity matters.

Our immediate views about macroeconomic and market conditions are not remarkably different from those expressed at the end of 2011. Several important trends have progressed farther, with a few new ones appearing to have arisen.

Among the incipient trends that we are involved with, the potential downturn in "safe haven" asset prices, including high-grade government bonds is the most pivotal. It is connected with a secular decline in the relative fortunes of governments in general, and is likely to be a feature of the macroeconomic environment for the remainder of this decade.

Global credit expansion is a longstanding trend that has been in the process of reversing for more than a decade. With trends of this magnitude, the exhaustion phase is necessarily prolonged and inconclusive. The underlying behavioral correlates are so embedded that they take many years, if not decades to change.

In most of the developed world, the process of deleveraging has progressed through much of the private sector. Industrial companies and most commodity producers began the restructuring of their operations and balance sheets in response to the collapse of emerging market currencies and commodity prices during the final years of the twentieth century. For many U.S. and European industrial companies, the choice was to radically restructure their costs and balance sheets or fail.

The corporate restructuring that has taken place over the last ten or fifteen years has been evident in companies' ability to withstand the pressures of 2008 and 2009 and emerge with unusually robust profitability and cash flow. Corporate balance sheets are as strong as they have been in several generations.

Households and the banking system that enabled their adventures in real estate speculation during the decade past have also gone through extensive balance sheet restructuring. Both are now on much sounder footing, and the main collateral form on the asset side of their balance sheets–residential real estate–is in recovery.

The element within developed market economies that has yet to restructure their affairs and overburdened balance sheets is government. By government we are referring to units of political authority across the spectrum, from Athens, Cairo and Paris to Chicago, Detroit, Albany, Sacramento and Washington.

The fiscal pressures on governments of all sorts are not accidental. They are part and parcel of the dynamics of long-term credit cycles, whereby the underlying collateral forms are overwhelmed by the demands of debt service after years of increasing leverage. Every element of a broad upturn in the use of credit has its own particular collateral form. For businesses it is their asset base and the profitability thereof. The favored commercial asset used as collateral varies from cycle to cycle, and has included commodity reserves, commercial real estate, forests, ships, communication networks and various forms of intellectual property.

The surge in household indebtedness during the first decade of this century was almost entirely collateralized by single-family housing. This marked radical departure from long standing assumptions that based household solvency on a combination of income and savings. The leverage from the adaption of a consumption good (owner occupied housing) as a favored form of collateral was mirrored in the banking system and among the quasi-official mortgage agencies.

When the cycle of appreciation and capital gains halted and then reversed, all sectors involved in the leveraging process entered the emergency phase of balance sheet restructuring. In the ensuing five years, great, albeit painful progress has been made.

In every long cycle of credit excess and its eventual deflation, there are several distinct phases. Their general characteristics are universal. The particulars of each vary with the specific nature of the collateral form involved.

At the peak stage of credit expansions and the asset price inflations (aka bull markets) that are their normal correlates, the most visible indication of an impending reversal is the emergence of new and extensive sources of supply. This is true in every asset class and in every long cycle of inflating price.

Commentary Cont.

Discerning the exact nature of the new supply is not always as simple as it sounds.

The analysis begins with identification and understanding of that aspect of the favored collateral form that has come to be thought of as invaluable, unique and beyond serious question. The analytic process almost always involves wading through a swamp of pedantry in academic and popular commentary that has arisen in order to justify what common sense recognizes as excess. A Google search of the phrase "Japanese business superiority 1989" yields 214,000,000 results. It is worth reading a few and noting the august institutions and commentators from which they emanated.

The appearance of new sources of supply is not, from an investment perspective, sufficient to declare the exhaustion of a trend. The process of supply rising up to meet the extraordinarily enthusiastic demand that is characteristic of late stage, credit enhanced price advances can take years.

In technical terms, one of the characteristics of a late stage bull market is a marked rise in transaction volume as the advance persists. Think of the sales rate of houses in 2004 and 2005. The growing transactional volume is a sign that supply is rising to meet more of the elevated demand.

To the extent that demand remains the prevalent force, prices continue to rise. The crucial phase, during which the first signs of a major trend reversal are visible, is characterized by continuing enthusiasm on the part of buyers, high turnover and the absence of any further price increase. In securities markets, the flood of new issuance continues far beyond the high point in price. In markets for non-exchange traded assets, supply from new and atypical sellers often persists well into the first stage of the ensuing long-term bear market as prices remain at levels too good for sellers to pass up, even after an initial decline.

As we have mentioned in several past commentaries, bull markets never end because buyers lose enthusiasm for the assets in question as the advance progresses. If anything, the enthusiasm increases as prices move higher and higher. The terminal phase is always and everywhere marked by the response of actual and potential sellers to the inducements of elevated prices.

Incentives to produce, sell and, in the case of tangible assets, conserve, substitute and restrain consumption eventually yield enough supply to overwhelm any given level of demand. A parallel market dynamic emerges, wherein every dollar rise in price is another dollar of value on the supply side that must be met by an equivalent increase in buyers' purchasing power if the price trend is to continue higher. In other words, supply grows from more than the simple addition of units to the offer side. Increased prices have exactly the same effect. Unique items with strictly limited unit supply can also reach a point at which they overwhelm demand solely from the market price mechanism. Even the Mona Lisa, should the French government reach that level of desperation, would likely run out of bids before the auctioneer hit a trillion dollars.

Popular market manias that drive prices to unsustainable levels are always supported by conceptual and intellectual analogues. There is never a shortage of good, plausible arguments as to why the excessive behavior and its resultant price distortions are justified.

As we have asserted that the current macroeconomic landscape is and will be influenced by a continuing bear market in "government", it is important to define the practical and theoretical aspects of that trend and how it might shape the investment environment.

In the simplest terms, governments are being involuntarily weaned from their dependence on credit as a means of sustaining privilege. As is the case when watching waning advances in capital markets, the weakest participants give way first. It is why, at meaningful tops in price, the breadth of advance narrows as more and more of the demand is funneled to fewer and fewer high grade and seemingly impervious instruments.

At the peak of the technology stock mania in 2000, the low quality names broke early in the year, while many of the established leaders (Cisco, Intel, IBM, Microsoft) remained at or near historic highs for another year or more.

In the present case, governments with impaired balance sheets presiding over regions with the weakest underlying fundamentals have fallen first. Greece, Detroit, Egypt and other leaders in the parade of management failure are harbingers of a more widespread problem.

Central to this general trend is a mistaken body of theory regarding the nature of wealth, its sources and the proper role of government in allowing its development.

Commentary Cont.

One of the nicer parts of our approach to managing money consists in our not having to participate in academic debates or contrived argument sessions in financial media in order to get our points across. Markets will eventually prove or disprove any theoretical case that we make within the fund.

Our investment approach begins with identifying what we believe to be invalid macroeconomic hypotheses. To the extent that these have been incorporated into investment decisions and asset prices, there will be a large scale and long-term opportunity to exploit the mispricing born of misconception. This, of course, assumes that we are right.

The improper adoption and application of macroeconomic data is the last area where we see important inefficiencies in capital markets. The efficient market hypothesis which, from our perspective merely states that the available data concerning elements affecting a specific set of prices will be reflected fairly accurately in those prices, fails to take into account circumstances wherein there is a lack of understanding about how certain exogenous data bear on markets. The market does have the facts, but participants are at a loss to reckon how they should be incorporated into pricing.

It is as though early twentieth century life insurance actuaries were convinced by the contemporary scientific thought that cigarette smoking was not a factor in health or life expectations. Their policy prices would have efficiently reflected prevailing thought, but would have been wildly inaccurate and poorly predictive of differentials in mortality.

The fact that markets are largely efficient does not mean that they are largely correct. Efficiency only implies rapid incorporation of the available data and the prevailing beliefs about what it implies. Insofar as the discussion applies to specific securities, the lines of causation between the data and prices are clear. There is not a lot of argument that a leveraged cyclical company with building receivables and diminishing current assets presents a greater credit risk than a cash-rich counterpart. The bonds of such a company will normally reflect the risk. It is highly unlikely that more assiduous study of the accounts will reveal an overlooked number. It is particularly so in the case of large, public companies. It is why the verdicts of ratings agencies are at best superfluous, and at worst, highly misleading and drastically off base.

This is the strong form of market efficiency, and goes a long way to explaining why managers relying entirely on security selection are having a harder and harder time exceeding the return of some arbitrary index as communications technology and data access become ever more widespread.

There has been a great deal of criticism from academic sources regarding the validity of market efficiency as a basic concept. This trend has accelerated since the panic of 2008 and the subsequent depression in housing activity and finance. The fact that markets seemed to miss the events and were, in retrospect, wildly mispriced before hand, is cited as an argument against markets.

We would argue that markets were perfectly efficient in incorporating the most widely accepted opinion regarding housing. The problem was that the opinion, academic, institutional and market related was largely incorrect.

Markets are accurate expressions of established facts and expectations, even when the latter are wrong. As is the case of markets for goods and services in a free society, people buy and sell according to rational expectations of what they believe will benefit their circumstances. Often times they turn out to be wrong. That does not illustrate the frailty of free markets, but of we humans.

The efficient incorporation of flawed macroeconomic hypotheses into capital asset prices continues to be a feature of the current bull market in risk assets. The most prevalent topic of error is a big one, involving the role of governments in economies. This question broadly pertains to the role of central banks, currencies, fiscal conditions, taxation and all of the dramas involving the apparent paralysis of political and legislative processes. The broad, philosophic and economic issues resonate from Washington to Brussels, Tokyo, Beijing, Sacramento and Detroit. The basic issues are similar, but the probable forms of resolution are widely disparate.

We made the point earlier that the current macroeconomic climate is being shaped by the ongoing confrontation between governments and the credit markets upon which many of them have come to depend.

Commentary Cont.

A vast body of modern mythology has underpinned the destructive trend among many governments toward profligacy and intemperate accumulations of debt. Like the invulnerability of house prices or the inevitable triumph of the Japanese or, at present, the Chinese approach to business and economic management, the arguments highlighting the benefits of government spending are embedded deeply in parts of academia and hence within the extensive and influential community of academically trained economists.

One of the core assumptions in current economic thought that is, we believe, severely hampering the decision making process among investors is the presumed equivalence between GDP growth and wealth creation. The former is a broad measure of output that comprises activity in three important sectors of the economy i.e., households, businesses and government. It is an invention of the post-war era, enabled by greatly expanded data collection by government agencies.

The wealth of a society, which consists in the corpus of productive capital assets that it has accumulated, has its origins in that portion of output that is saved (not consumed) and invested. In this broad sense, output measures like GDP are important, as they provide some gauge of the product from which savings can originate and be directed toward an increase in the capital stock i.e., wealth.

The problem with present measures of national output is the inclusion of governments' deficits as a net contributor to reported GDP. Because a systemic accounting must acknowledge the increase in private sector incomes that results from the portion of government spending financed solely through credit creation, there exists an illusion that deficit spending is a form of economic stimulus. It is a stimulus to statistics regarding GDP, but stimulating statistics is not the point of economic interchange.

Deficit spending by governments accomplishes, at best, a temporary increase in the level of consumption. Because this additional consumption is artificial and transitory, it is questionable whether it will spur incremental investment (additions to the productive apparatus that constitute wealth) by those addressing the additional demand. Often, the only market response to the demand stimulus will be an increase in real prices. This has been the clear trend in our health care system, and is likely to accelerate as more subsidized demand is brought into the market place.

Private sector investment is the source of wealth in a free society and consequently the long-range objective of economic effort. The idea that projects undertaken at the behest of political authorities can be thought of as a form of investment is mistaken. As stated earlier, the wealth of a society exists in its productive capital stock. The capital stock can be held in either financial or physical form, with the proviso being that it is intended for use in the production of goods and services.

As such, the output of capital assets, normally organized in the form of a business, must realize sufficient revenue to sustain operations and provide its owners with some benefit in the form of return for allowing the use of their savings. Failure to meet these criteria will result in the eventual demise of the enterprise and the redeployment of what ever capital that remains to endeavors better able to satisfy the demands of the economy as a whole.

An important descriptive element in discussions of the accumulated capital stock as the basis of wealth is the term 'productive'. In this sense, productive refers not only to capital assets that are capable of output, but are capable of output that meets demand in sufficient volume and price to be self-sustaining. The problem with expenditures by government on projects that might satisfy some form of demand is that there is no way of ever knowing whether that demand produces revenues sufficient to perpetuate the enterprise without an ongoing extraction of resources from the private sector. In instances where there is a revenue stream that can be measured against costs, it is almost always inadequate, meaning that the enterprise operates at a loss. Amtrak, the postal service, various public transit authorities, publicly owned utilities and even public monopolies in gambling are primary examples. In each case, they persist in spite of the fact that they fail to provide something that people are willing to purchase at prices and in quantities that cover the costs of production and depreciation. They survive because they can force involuntary transfers from those same prospective customers who, when faced with calls from the taxman, have no choice but to reach into their pockets.

A report card in the form of a profit and loss statement is the only way of checking whether or not a particular good or service is sufficiently popular at a certain price level to allow it to be self-sustaining. High-speed trains, public hospitals, overnight postal delivery, and government supported radio and television channels all sound like wonderful, life-enhancing elements of any society. They might well be, but we will never know unless we see whether sufficient numbers of free citizens are willing to spend enough of their resources to make them economically viable i.e., able to produce enough revenue to sustain their operations.

Because the unique powers granted to government allow the threat of force to be used to undertake its economic adventures, access to capital for even the most harebrained schemes is normally not an issue. The government undertakings that we listed in the preceding paragraph all sound beyond reproach. And that is exactly the problem.

Commentary Cont.

No political leader has ever said that he or she needs more tax revenue to waste on silly, useless projects or to pay off political cohorts. Even if this is the case, every call for increased government revenue is always justified by invoking the most profoundly virtuous plans for its use. Health care for poor children, universal pre-school, protection of endangered animals, rescuing the entire planet from the effects of sunlight—how could any decent human being be against any of these? That is the political calculus, and it is generally very effective in casting anyone who expresses doubts about the use of government's coercive power to accomplish these noble objectives as a vicious misanthrope.

Good politics and good economics are often diametrically opposed, and when the two are at odds, it is unfortunate that the political imperatives normally prevail over sound economics. It is doubly unfortunate that the consequences are borne mainly by those who most need a fully functioning economy to escape the burdens of misfortune and privation.

With no way of measuring the economic viability of any government directed infrastructure schemes, there is a very good chance that the finite resources of a society will be squandered and overall wealth diminished by their undertaking. The economic problem arises because even the most wasteful expenditures by government (or, for that matter, members of the private sector) will add to GDP as they are undertaken. We would guess that, had such statistics existed, Egypt would have had one of the highest GDP growth rates in history during the construction of the Pyramids. If that GDP growth was truly a measure of general prosperity, we could calm all of their present troubles by simply suggesting that they build a few dozen more. Come to think of it, why not include Greece and Detroit?

The advantage of having these activities take place in the private sector is that normal accounting will clearly reveal the wasteful and mistaken projects, and they will stop, either voluntarily or in a bankruptcy court. The capital will have been squandered, but the process will end and discretion over the deployment of capital will be out of the hands of those entities that have proven incompetent in its use.

Because political leaders have virtually unlimited access to the resources of their citizens through compulsory measures that are not available to private sector entities, their uneconomic expenditures can persist indefinitely. Every dollar that they are able to obtain and deploy is a dollar less that is available to be utilized within the private sector, where markets provide checks and balances to assure that there is sufficient voluntary demand to label the expenditure productive.

Both public sector and private sector expenditures on, for example, improvements to railroad track beds will have about the same additive effects on GDP. For many with a quantitative, statistically driven view of economics, there is nothing to choose between the two. The fact that one needs to satisfy actual demand at a satisfactory combination of price and volume and the other only has to satisfy the political imperatives of a small group of officials is enormously consequential in the overall accumulation of wealth.

Acknowledgement of this distinction runs up against the vanities of those unwilling to accept the free markets' reflections of the voluntary actions of their fellow citizens as they engage in the constitutionally assured pursuit of happiness. The fact that someone chooses to live on beer, bacon and cigarettes demands no response from government or its agents. I will quickly acknowledge, alongside those with the professional qualifications to back their judgments, that this regimen is unhealthy. That said, it is critical to remember that the strength of this country and its economy stems from the proposition that everyone is entitled to life according to their own, subjective design. I may think that I know better, but I have no right to impose my opinions about nutrition or anything else on my fellows. Even in matters where we feel professionally qualified, we would not think of petitioning the government to enforce our beliefs about proper asset allocation or risk management.

If government officials do not like the judgments of markets, they likewise, by extension, do not like the personal preferences of their fellow citizens. To the extent that they are willing to use the threat of violence underlying their authority to change the outcomes, they are engaging in a form of tyranny. If it persists, the result will be an economy that is unable to satisfy the particular, personally chosen needs of its citizens. Yes the government can ban beer, bacon and cigarettes (and reality TV, we would hope) but that would thwart the pursuit of happiness upon which this nation has thrived.

At present, the cycle of deficit spending and increased taxation by governments is reaching its theoretical limits. It has two weak points, both of which are beginning to be exposed. The first is obvious i.e., capital markets unwillingness to continue to provide credit to official entities that are clearly not creditworthy. The clearest examples have arisen in Europe, and require no further discussion.

Commentary Cont.

The second structural flaw in the cycle of governments' arrogation of a greater share of economic output to its own purposes is the migratory problem. There is some point at which the citizens whose productive efforts are being converted to government use will up and leave. In the U.S., most of this traffic is interstate, while in most other parts of the world where less onerous restrictions on emigration are in place (as compared with those in the U.S.), the migratory paths are international.

Along these lines, it will be extremely interesting to see whether the tax regimes introduced recently in California will prove to have gone too far.

The overemphasis on GDP (and a host of other statistic measures of the overall economy) has important investment implications. Our investment approach begins with our trying to identify macroeconomic misperceptions that are reflected in large scale asset mispricing. It is why we spend so much time and effort on seemingly pointless academic and theoretical analysis of economic systems. Theoretical applications in any science are eventually manifest in practical consequences. Economic science is no different.

There has been a large body of opinion suggesting that because GDP growth is and might remain restrained, equity investment is a fool's game. We have taken the other side of the trade, and thus far have benefitted from the outcome. As of this writing the four-year annualized total return for the Vanguard All Stock ETF is 20% (as of 1/10/13). For the equivalent S&P 500 based fund it is 19% (as of 1/10/13). This has taken place against a commentary backdrop that has suggested that investors would be lucky to see mid-single digit portfolio returns. The fact that domestic stocks have provided returns at between three and four times expected rates has been little remarked upon by some of the most vocal proponents of a "lost decade" for investors.

During the past year, German equities have returned more than 30%. German GDP growth was below 1%. Much of Europe is in or near recession, and yet their equity markets have been strong performers.

We cannot guess how long it will take before people understand that GDP is neither a measure of prosperity nor a predictor of equity returns. To the extent that diminishing government spending holds GDP statistics back, the process is bullish for the private sector and overall standards of living. The opposite is also true.

China has reported the highest rates of GDP growth on earth for years and yet their equity markets have been among the worst performers. They are a large scale example of how elevated output statistics driven by the whims of government officials rather than individual's preferences are misleading indicators of real prosperity.

The seeming contradiction between a slow GDP growth rate and the bull market in stocks over the past four years has provoked a great deal of hysterical outcry by people who have chosen to avoid investing in equities. Their caution is rationalized by a host of statistics showing how elevated corporate results and stock prices are relative to GDP.

Any analysis that compares the private sector to GDP will show unusual relative strength in the former. This is simply a result of the forced retrenchment of government at all levels and the consequent drag on reported GDP.

Economic forecasting that hopes to add value in the investment process cannot rely on quantitative econometric models. They do not work.

The only avenue available to an investor who wishes to incorporate big picture, macroeconomic factors into the capital allocation process is one that leads to an understanding of the processes and system dynamics that produce the economic statistics. Taken in isolation, any group of quantitative measures can be extremely misleading if the processes behind their generation are not understood. It is why the most expensive risk management systems on earth failed before the 2007-8 crises, along with ratings agencies, regulators and many very sophisticated investors, including the endowment managers of the most respected educational institutions on Earth.

As we continue down the path of confrontation between governments and the credit markets that they rely upon, the principal danger is that some governments will attempt to remedy their fiscal imbalances by extracting a greater share of private sector output. This will diminish the visible income streams subject to taxation as people and business flee the most intrusive jurisdictions and rearrange their affairs to shelter or defer more of their earnings.

Commentary Cont.

To the extent that increased taxation succeeds in wresting control of more resources from their private sector owners, there will be that much less available to build up the productive capital base that constitutes society's wealth. Less capital formation in the private sector leads to less employment and activity in enterprises that are subject to the constant discipline of their fellow citizens' free choices about what is worth paying for and what is not. Government officials deploying assets generated by others' efforts have no such worries. They can produce GDP without producing real value.

We have moved nearly a quarter of the fund's equity holdings into European shares during the past year, beginning with companies in the more stable northern economies a year ago and adding exposure in certain of the more troubled nations during the past two quarters.

Europe is another example of recovering private sector fundamentals and governments displaying various degrees of distress and ineptitude. We have made the point in past letters that it is a mistake to equate a national government with that nation's economy. Governments influence economies, but the fortunes of the two can diverge. Good businesses can exist alongside terrible governments. In parts of Europe, private companies can borrow at lower rates than their governments.

Our domestic equity holdings have shifted from emphasis on consumer spending to business investment. Most of the burden imposed by the recent tax changes will fall upon consumer rather than business incomes. Consumer discretionary sectors have led the bull market for the past four years. We sense that a change is in the works.

The question of whether a shift to an environment led by business investment requires a meaningful correction in the overall markets is difficult to answer. Thus far, we have seen a fairly seamless transition.

A final, crucial issue reflected in our current portfolio concerns the point at which strength and credit demand in the private sector begins to crowd out government borrowing and prompts a rise in interest rates. We have established meaningful short positions in long duration government bonds during the past six months in response to this risk.

From a cyclical, timing perspective, the danger point for credit markets appears close at hand. Housing activity continues to accelerate, business investment is turning up, the Federal government is resisting expenditure cuts and the Federal Reserve Board is continuing with policies that seem appropriate for the summer of 1932.

The only mechanism that might change cavalier attitudes toward spending is the bond market. If government remains on its current heading, fiscal discipline is going to be imposed rather than chosen. When we reach that stage, the volatility now associated with equities may migrate to fixed income markets. Like teenagers running into the basement at the beginning of a horror movie, investors who have looked to government bonds as a refuge from market risk may be in for some surprises.

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The information provided herein represents the opinion of the Portfolio Manager and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.