PARAGON CAPITAL MANAGEMENT, LLC

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What Now? (Part II)

Last quarter we wrote, with some degree of amazement, about the resiliency of the financial markets even as underlying economic fundamentals continued to languish. We cited low interest rates, rising corporate earnings, historically high corporate cash reserves, and robust security prices in the face of stubbornly high unemployment, sluggish economic growth, and worldwide financial crises *de jour*.

Not surprisingly, the riskier the market, the more outsized the return during 2012. U.S. Treasury bonds were up roughly 2% as a group, the Dow Jones Industrial Average was up just over 10%, while speculative grade U.S. High Yield bonds returned over 15%, Italian bonds were up 21%, and Portuguese and Greek bond markets were up 57% and 97%, respectively.

Of course, we do not believe that speculating in the teetering sovereign debt markets of Europe is in the best interest of our clients. We do believe that there is a lesson to be learned (perhaps before we become a teetering bond market ourselves); **Responding to a crisis is painful, but immanently better than ignoring it.**

Apparently, Congress does not agree with us. Did the U.S. avoid a crisis by skirting the “fiscal cliff”, or did it just prolong the process and postpone any meaningful solution?

Our analysis of the situation is less than sanguine. We believe that by finalizing the deal to avoid the fiscal cliff, Congress simply kicked the can farther down the road. This is ironic, because it all began in 2001 when the Bush tax cuts were written to accomplish the very same objective – let someone else deal with the deficit problems in the future.

What was really accomplished in the 11th hour? First, the political goal of raising taxes on “the top 1%” was met. This will neither take food off of their tables, nor will it make a dent in the deficit. Although this tax hike is expected to raise $60 billion in new revenue, Congress also voted to award another year’s extension of unemployment benefits (approximate cost, $30 billion).

The other $30 billion raised by the tax hike has been spent to prevent a scheduled reduction of Medicare physician payments. Since Congress mandated a reduction to Medicare physician payments at the end of the Clinton administration, it has postponed these “mandated” cuts for 13 consecutive years.

Second, by delaying the budget sequester (the device by which mandated spending cuts were to take effect if no deal had been reached) by three months; Congress adds about $27 billion to the national debt. Finally, the list of new tax cuts to special-interest groups and campaign donors smacks of cronyism, not fiscal discipline.

So, to summarize: the 2001 tax cuts which were set to expire after ten years were extended an extra year with the promise that spending cuts would be made (by law) if Congress could not reach agreement by the end of 2012. However, at the end of 2012 they simply agreed to postpone any real decision for another three months while everyone could claim political victory. Congress, and the administration, assumes that the status quo can continue indefinitely while they dance around the edges of the problem.

Eventually the problems of outrageous budget deficits, high unemployment and slow economic growth must be addressed. Unfortunately, not all three problems share a common solution. What will solve one, will exacerbate the others. This is not “gloom and doom”, it is simply reality.

As we so often write, “we try to make reasoned, rational decisions based on the information at hand”; “we try to “expect the unexpected”, and “we never try to forecast economic recoveries, sovereign defaults, or next quarter’s earnings report”. However, it would be foolish of us to ignore the possibility of further short-sighted, irrational, and even counter-productive measures being proposed, and implemented, by the powers that be.

When all is said and done, we will not try to predict what will happen, but rather will try and be prepared for all possible eventualities.

In that light, we continue strive to identify industries and companies that are profitable in all kinds of economic environments. We attempt to determine appropriate values for those companies, and invest in them when the stock price is materially below what we believe the true value to be. There is no magic in that, and there is no timetable, there is simply work.

As always, thank you for your continued trust and support.

Craig, Howard, Elizabeth & Ward

In the ongoing effort to continue to give our clients the most detailed, and meaningful, data available, you may have noticed that your Schwab statement now includes, within the detail sections, cost basis information on your individual securities.

Although this is information which we provided to you on an ongoing, quarterly basis in the past, it is now available on your custodial statements. We trust that you find it useful.

A copy of our SEC Brochure (formerly Form ADV Part II) is available to you at anytime. This document describes who we are, what we do, and how we do it. Also, our Proxy voting policy is available to you at any time. If you would like to receive either of these documents, or inquire as to how your shares have been voted, please contact us at a phone number, or e-mail, listed below.

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