Education

Equity Partners for Companies Primed to Become Public®

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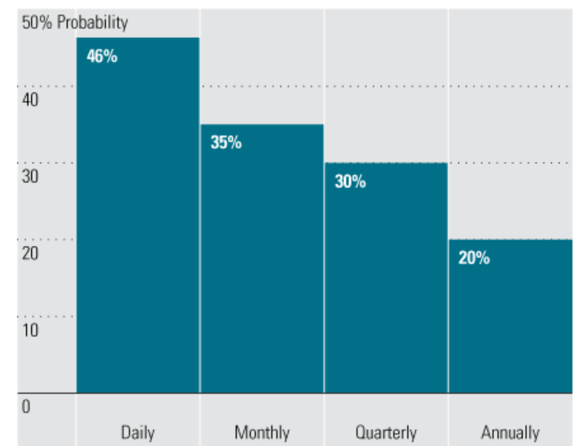
Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market
1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

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About Keating Capital

Keating Capital, Inc. is a business development company that specializes in making pre-IPO investments in innovative, high growth private companies that are committed to and capable of becoming public. We provide individual investors with the ability to participate in a unique fund that invests in a private company's later stage, pre-IPO financing round — an opportunity that has historically been reserved for institutional investors.

Keating Capital shares are traded on Nasdaq under the ticker symbol KIPO.

Portfolio Companies:
*Agilyx
*BrightSource Energy
*Corsair Components
*Harvest Power
*Kabam
*Livescribe
*MBA Polymers
*Metabolon
*NeoPhotonics
*Solazyme
*Suniva
*Tremor Video
*TrueCar
*XTime

Economic Outlook for 2012

The U.S. economy grew in 2011, but at a slower rate than everyone expected. Even more surprising than the overall growth rate was the pattern of that growth rate throughout the year. Growth plunged to 0.4% in the first quarter and accelerated throughout the year, with the fourth quarter now likely to produce annualized growth well in excess of 3%.

More Upside than Downside (Though the Downside Is Scary): Morningstar economists' overall forecast for 2012 sees slightly higher growth than the consensus of other economists, but not by a lot. However, the odds of an upside surprise are substantially higher than those of a downside surprise. Potential sources of an upside surprise include increased U.S. oil production, a sharper rebound in automotive and aircraft production, and a stronger housing market.

Corporations Are Scared Even as Consumers Accelerate Spending: It looks like U.S. corporate managers are far more scared about Europe and the economy in general than the U.S. consumer is. Recent reports seem to suggest at least some precautionary spending cuts by corporations in the software arena. Managers also seem to be paring inventories to the bone. However, it appears that U.S. consumers are accelerating spending; they seem to be "thrifted out" and can no longer delay certain purchases, especially autos. This leads Morningstar economists to predict greater production both in the U.S. and in other world economies that export to the U.S. in 2012.

Europe Remains at the Top of the Worry List: The main concern here is the potential of the European sovereign debt crisis to wreak havoc on the worldwide financial system. U.S. exports to Europe represent just 3% of U.S. GDP, and a lot of that is for basic necessities that can't be bought elsewhere. However, with a web of lending in which European banks lend to sovereign governments, and those governments lend the money back to the undercapitalized banks, the failure of any one link could bring down a healthy chunk of the European banking system.

China Slowing Is an Issue for Some, but Potentially Good News for the U.S.: China certainly remains an issue, too, as growth there slows modestly and the construction industry pulls back from its breakneck pace. Slowing there is bad news for a lot of high-profile capital goods manufacturers in the U.S but, overall, China is an even smaller part of U.S. GDP than Europe. Furthermore, slowing growth in China could mean significantly lower commodity prices, especially in the U.S., which would be good news for low-end U.S. consumers, who were particularly crippled by rising commodity prices in 2011.

A Savvy Consumer May Limit Profit Growth: Corporate margins could begin to shrink in the future as consumers start to gain the upper hand. Consumers are fighting every price increase tooth and nail, with the possible exception of the very high end of the market. The most recent example comes in the banking industry, where a pushback by consumers forced several major banks to cancel proposed increases in debit card fees.

Europe Will Hurt Big Firms More Than U.S. GDP: Although U.S. GDP growth may escape the worst of the effect of a slowing Europe, U.S. multinationals may not. Many of these firms derive 20%-40% of their revenues from Europe. Since many of those goods are produced in Europe or in other non-U.S. markets, they are not counted in the U.S. GDP calculations, and they don't directly add to U.S. employment. Therefore, a weak Europe could significantly affect U.S. companies even if it doesn't make a dent in the U.S. GDP growth rate.

Looking forward to 2012, the U.S. economy is probably better positioned than most of the rest of the world economies, showing accelerating growth even as Europe falls into a recession and as growth in Asian economies slows to a more modest pace.

What Is an Economic Moat?

Commentary

Historical data shows that stocks might be the best investment to help you build wealth over time. However, with so many stocks available out there, how do you decide which one to pick? What makes a stock a good or a bad investment? The answer lies in carefully scrutinizing the company.

A company's stock is likely to generate attractive returns if the company outperforms its competitors. The advantage a company builds over its rivals in the marketplace is called competitive advantage. Morningstar has developed a rating to measure this competitive advantage, the "economic moat." There are four main types of economic moats, examined below.

1. Intangible assets: Intangible assets like brands, patents, and regulatory licenses can provide a company with a unique position in the marketplace and a significant advantage over its competitors. A powerful brand like Apple or Nike can bring in more revenue and increase customer retention. Patents are especially important for technology companies and companies in industries where innovation is critical (pharmaceuticals, for example). Regulatory licenses provide a competitive edge in the sense that they can prevent competitors from entering a market.

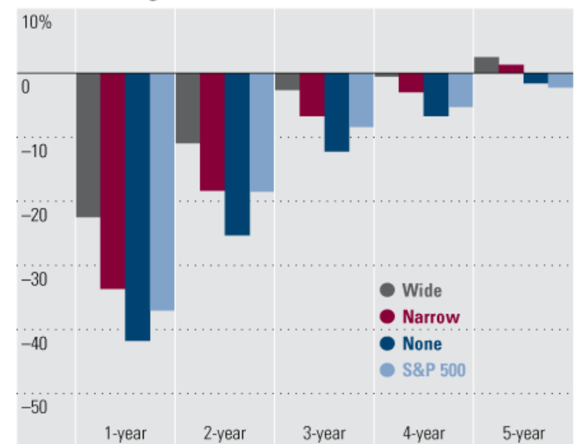
2. High customer switching costs: Basically, if a company makes it difficult (and, ideally, impossible!) for customers to switch to a competitor, that company will have a much easier time growing revenues and expanding. Examples of industries with high switching costs include banks and software companies.

3. The network effect: The network effect is based on the simple premise that the more users a product or service has, the higher its value will be. The most popular example of this type of moat is Microsoft: its success is highly dependent on its enormous user base. In fact, this network effect occurs mainly in businesses based on sharing information and connecting people (eBay is a good example).

4. Cost advantages: This type of competitive advantage is probably the simplest, and yet the most difficult to achieve. Companies can build a cost-based economic moat by improving their business processes (Dell and Southwest Airlines), optimizing their supply chains (Wal-Mart), or by outsourcing in order to reduce labor costs ("made in China," anyone?). Cost-cutting can be a two-edged sword, however, and, once the competitive advantage is achieved, it may prove difficult to maintain.

In Morningstar's database, stocks are assigned an economic moat rating: wide (denoting a strong competitive advantage), narrow (weaker), or none (no competitive advantage). The image shows that wide-moat stocks have outperformed narrow- and no-moat stocks, as well as the S&P 500 index, over the five time periods analyzed.

Total Return by Morningstar Economic Moat Rating, Year-End 2008



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. References to specific securities should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell such securities.

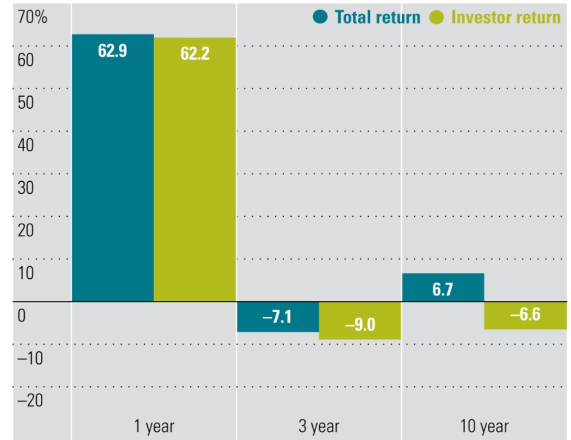
Source: Wide-, narrow- and no-moat stocks from Morningstar. The S&P 500® index is an unmanaged group of securities and considered to be representative of the stock market in general.

Chasing Performance

Investors often endure poor timing and planning as many chase past performance. They buy into funds that are performing well and initiate a selling spree following a decline. This becomes evident when evaluating a fund's total return compared with the investor return. Overall, the investor return translates to the average investor's experience as measured by the timing decisions of all investors in the fund.

The image illustrates the investor return relative to the total return for a given fund. Over the short term, both the total and investor returns were positive, with the investor return ending slightly lower. Over a 10-year period, however, total return greatly exceeded investor return. Investors who attempted to time the market ran the risk of missing periods of exceptional returns.

Comparison of a Fund's Return Performance Over Time



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Returns and principal invested in stocks are not guaranteed. Morningstar investor returns measure how the typical investor in that fund fared over time, incorporating the impact of cash inflows and outflows from purchases and sales. It is not one specific investor's experience, but rather a measure of the return earned collectively by all the investors in the fund. Total return measures the percentage change in price for a fund, assuming the investor buys and holds the fund over the time period, reinvests distributions, and does not make any additional purchases or sales. Investor returns are not a substitute for total returns but can be used in combination with them. Data as of February 2010.

Source: The fund illustrated in this example was selected from Morningstar's open-end database.

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