October 15, 2013

"The most important thing to realize is that we haven't been here before and that we haven't had this degree of experimental policies before by central banks."

Mohamed El-Erian, the CEO and co-chief investment officer of Pimco (the $2 trillion global asset manager known for its expertise in bonds) in a *Barron's Magazine* interview, 09/28/2013.

Time Horizon

Being a long-term investor means living a double life. A long-term investor lives in the day to day world, meeting current needs, participating in relationships, work and play; and a long-term investor lives in the future, envisioning what investments could be when short-term emotions and short-term cycles are removed, seeing beyond current worries such as Federal Reserve policies, federal government shut downs, debt ceilings and stock market squalls. (Ah, what a life!)

I use *10 years plus* as my basic definition of a long-term time horizon when investing in the stock market. Historically, that has been the amount of time required to remove the risk of material principal loss in the stock market. From 1901 to now, there have only been two 10 year periods (measured from calendar year end) when the U.S. stock market has had a negative return. From 1928 to 1938, the stock market had a negative (-1.6%) annualized return, and, more recently, from 1998 to 2008, the stock market had a negative (-1.4%) annualized return. In periods shorter than 10 years, the risk of loss in the stock market climbs significantly higher. Just in the last 13 years we had two 50% drops from top to bottom! It took approximately 5 years for the stock market to recover from each of those drops. A 10 year plus time horizon allows a long-term investor to focus on quality and value and ignore short-term risks and emotions.

In a financial planning framework, using the 10 year plus benchmark for low-risk stock market investing, an investor can begin to build a portfolio allocation by estimating income and cash needs from the portfolio in the next 10 years. By subtracting the estimate of income and cash needs from the total portfolio (and/or adding estimated additional savings), a potential amount of assets that could be invested in stocks from a long-term perspective can be calculated. From there, other elements of planning -- such as personal goals, requirements and risk tolerance -- can be used as inputs to help further define the long-term stock allocation vs. other risk assets. Diversification among different asset classes (U.S. stocks, international stocks, U.S. government bonds, corporate bonds, municipal bonds, commodities, etc.) can be utilized to help manage overall portfolio objectives in terms of needs, goals, taxes and risks. Once an allocation to stocks is determined, the focus shifts to opportunities and the long-term horizon.

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Back in the short-term, as the table of various asset class returns on the next page indicates, U.S. stocks have been the place to be so far in 2013. Diversification is a wonderful tool for managing objectives and risk over time, but diversification outside of U.S. stocks this year has materially hurt relative and absolute performance. While the success of diversification is built partially on non-correlation between asset classes (or the fact that different asset classes do not move in tandem with one another) and partially on mean reversion, the current breadth of divergences between asset classes is historically extreme. It is interesting to note that U.S. stocks have continued to do well despite the fact that revenue and earnings growth have slowed to the +2% range over the past couple of years. So why are investors willing to pay more for revenue and earnings today than they were a year ago? Here are a few possible dynamics at play:

1) Some investors are anticipating an acceleration in growth of revenues and earnings;
2) Many have been forced to accept the higher risk in stocks because they need to earn more than the less than 1% available in low risk assets;
3) Some investors are finding the risk/reward in bonds less attractive and are allocating more to stocks;
4) Some are chasing stock market returns;
5) Others got out of stocks in 2008 and 2009 and have started to buy back in; and/or
6) Some investors believe the systemic risks to the global economy -- from the U.S. and Europe -- have been reduced to a level where they are comfortable with new or more stock exposure.

My guess is that all of these dynamics, as well as other variations, have been playing a role in the stock market's move higher this year, and they could certainly continue to drive stocks upward. In the long-term, however, growth in revenues, earnings and free cash flow, along with balance sheet strength, are the metrics that determine underlying stock market valuations.

2013 Asset Class Returns through 09/30/2013

S&P 500	+19.79%	US Aggregate Bond Index	(-1.98%)
EAFE International Stocks	+16.41%	7-10 Year US Treasury Bond	(-4.18%)
Emerging Market Stocks	(-4.86%)	S&P National Muni Bond	(-3.51%)
High Yield Bond Index	+2.50%	Dow Jones/UBS Commodity	(-6.10%)

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I opened this letter with a quote from a *Barron's* interview with Mohamed El-Erian from Pimco on our Federal Reserve's current policies. Here is a related quote in the interview:

"Hyperactivist and experimental Fed policies have resulted in a disconnect between fundamentals and the prices of financial assets. The policy view is relatively simple: Artificially elevate financial asset prices in order to trigger the wealth effect, animal spirits, and financial engineering, which in turn help lift fundamentals and validate the high asset prices. It's a win-win situation—or that's the hope. The reality is that the Fed has repeatedly succeeded in lifting asset prices, but it hasn't succeeded in getting the economic fundamentals to "escape velocity." So, with such a persistently large gap, the markets have become more sensitive to every indication of whether Fed support will remain strong for asset prices."

It is clear to me that our Federal Reserve has continued on its aggressive policy course (0% short-term interests rates and $85 billion plus purchases of bonds/mortgages a month) because it believes, rightly or wrongly, the risks from our economy stalling out or rolling over are greater than the risks of asset bubbles, inflation or other market distortions. I believe the Fed's policy responses coming out of the 2008 financial crises were both appropriate and effective. It definitely helped buy some time for our economy to start healing (particularly given the ongoing dysfunction on our federal government's fiscal side). At this point, I think it is more difficult to assess the risks vs. the rewards, and I see the potential risks in policy missteps growing. At a minimum, the fact that our economy is growing at such a relatively sluggish rate (roughly 2%) with the Fed's unprecedented support is indicative of real structural issues that have yet to be resolved. As a portfolio manager and an investor, it makes me think of one thing over and over: time horizon, time horizon, time horizon…

If you know someone that could use our assistance in long-term investing, please let us know. We would be happy to contact them. We appreciate your business.

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