# Third Quarter 2014

## Quarterly Letter to Clients

### By Scott A. Wendt, CFA

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I recently had a client ask me "Could this finally be the moment of truth?" After exchanging a nervous laugh, we agreed that it was impossible to forecast the almost inevitable correction that could happen anytime in the near future. Instead, we should make sure that her portfolio is customized to meet her needs first, and then also structured to weather any of the seemingly capricious threats that the markets might present us. Of course we also want to take advantage of any opportunities that a price reduction in stocks might also give us in the foreseeable future. However, that phrase, "moment of truth", continued to ring in my ear and got me thinking about what *really* is a moment of truth.

The American Heritage® Dictionary defines the moment of truth as "a critical or decisive time on which much depends; a crucial moment."[1] The period of change in markets is more akin to the mathematical idea of an inflection point – the point when the direction and magnitude of a trend reverses itself. However, historically it is extremely difficult to spot beforehand a single moment in time when a market makes a turn. The oft quoted phrase "no one ever rings the bell at the top of a bull market" was meant to capture this idea. Never was the difficulty of hearing that metaphorical bell more challenging than in the quarter just passed. The 3rd Quarter of 2014 came to a close amidst headlines of rising Mideast tensions due to the rapidly rising threat in Iraq of the Islamic State in Syria (ISIS), increased nervousness regarding the Ebola outbreak in Africa which has found its way onto U.S. soil, and a stock market that may be showing signs of fatigue in its 5 ½ year marathon run.

Likewise, the economic scorecard continues to be fighting the headwinds of a global economy exhibiting slowing economic activity, which was most recently seen in European and Asian economies that reported softer GDP growth. Here in the USA, the latest indicators show that the current economic expansion is well below the average of prior growth rates experienced during a post recessionary period, with the first-half of 2014 rollercoaster dip and subsequent recovery appearing to be mostly related to the

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peculiar first quarter weather pattern. The economic expansion is now approaching its 6th anniversary, and remains remarkable in both its duration and irregular pattern when compared to historical recoveries.

The labor market continues to be the lynchpin in the quest to have a self-sustaining level of economic growth. While the nation's unemployment rate dropped to 5.9% in the September labor report, the lowest level since July 2008, wage growth is still lackluster. This reflects the combined effects of high under-employment and the above average numbers of job seekers who have dropped out of the labor force, as demonstrated by the low labor participation rate. It appears that the Federal Reserve is also looking for a healthier job market, and is focusing on more than just targeting an unemployment rate at a specific level. At the most recent Jackson Hole Federal Reserve Conference, Janet Yellen commented on the Job Openings and Labor Turnover Survey, or JOLTS report, highlighting the "quits rate" as an important indicator of an improving job market. The Chairwomen explained that:

> "The quits rate has tended to be pro-cyclical, since more workers voluntarily quit their jobs when they are more confident about their ability to find new ones and when firms are competing more actively for new hires. Indeed, the quits rate has picked up with improvements in the labor market over the past year, but it still remains somewhat depressed relative to its level before the recession."[2]

In other words, more folks walking into the boss and giving notice would be an indicator of the availability of competing jobs, and give the Federal Reserve Open Market Committee (FOMC) a higher level of confidence that the job recovery is on a viable trajectory.

Two other factors are important in providing additional support for a sustainable expansion. The first factor is businesses making capital investments for the future. Business spending on plant and equipment has been lackluster for most of this economic recovery. It appears there is adequate current capacity to meet ongoing demand, which has meant that businesses have kept a lid on most capital expenditures, except for those that reduce costs or provide productivity enhancements. However, the key to providing more jobs and having the ability to manufacture more goods for growing world demand (think China) will be in making new investments in infrastructure while continuing to purchase equipment that will improve plant efficiency.

[2] "People Are Quitting Their Jobs" by Rob Garver The Fiscal Times August 28, 2014

The second factor in sustaining economic activity will be securing affordable energy sources for the future. Given the improved United States oil and gas production profile, we have a good start in meeting this goal. Affordability will be helped by enhanced production and supplies around the world. Moderate or lower oil prices due to the twin effects of improving United States production profiles and the recent announcement of Saudi Arabia lowering its official selling prices for its crude oil could provide a boost to economic activity in the near term. With plentiful global supplies, prices have retreated, reducing Brent Crude below a $100 a barrel for the first time since 2012. OPEC is reacting by cutting production to try and maintain prices near the $100 per barrel level.

Despite a long list of worries, the domestic economy continues to demonstrate its resilience with gradual improvements on the labor front and rebounds in both the housing and auto sectors. In general, corporate managements have done a great job of managing through a severe recession and uneven recovery, while maintaining profitability. Inflationary pressures remain muted, allowing the Federal Reserve to focus on the labor side of their dual mandate.

The bond market has witnessed a myriad of changes over the past quarter. The U.S. Treasury Yield Curve flattened somewhat, as shorter maturities of less than five years saw yields increase, while the maturities over 10 years saw yields decline. Despite a bounce back in September, long-term treasury yields continue to be below the levels where they began the year. In addition, credit spreads for higher quality corporates widened during the quarter, although not enough to return to levels that would be considered attractive for purchase. Demand for higher coupon alternatives remains above average, as many investors continue to ignore the risks of higher coupon bonds in their search for improved cash flows from their investments.

Concerns over the conclusion of the Fed's Quantitative Easing (QE) program, and expectations of higher rates, caused a price selloff in the U.S. Treasury Market in early September. This in turn boosted the yield on the 10-Year treasury to 2.65%. However, a spike in geopolitical risks in the Ukraine and Mideast, caused a rush back into the safety of U.S. Government bonds, pushing yields back to almost where they began the quarter. After three months of churn, the 10-year treasury ended the 3$^{rd}$ quarter at a yield of 2.53%, just slightly higher than its June 30 print of 2.49%.

We continue to focus our bond strategy on purchasing higher-quality credits, while maintaining our bias towards capital preservation. By maintaining a targeted average maturity between 3 to 5 years, we minimize the potential adverse impacts from unexpected increases in interest rates. Should rates begin to rise, we would anticipate that average maturities would be extended, allowing us to capture higher coupons while being compensated for the additional risks of holding longer-duration securities.

Heighted geopolitical risks and the delinking of global central banks appeared to have been a minor wakeup call for equity markets around the world that have, for the most part, been fixated on global Zero Interest Rate Policies (ZIRP) and their benefits to financial assets. The result was a downdraft in stock prices, which resulted in the retracement of the major indices from their recent highs. The divergence in performance was of particular interest this quarter. While the general stock market has not seen a 10% pullback since October of 2011, many stocks have declined by a far greater amount. For instance, almost half of the NASDAQ stocks were down greater than 20 percent, which puts them in bear market territory.

However, a quick perusal of the NASDAQ Composite would lead one to believe that the tech-laden index performed in line with the other major averages. During the quarter, the NASDAQ Composite saw a *price only* increase of +1.9 percent, which was slightly better than the Dow Jones Industrial Average, which posted a *total return* of +1.9 percent, while the S&P 500 Index increased +1.1 percent. The divergence in performance is also demonstrated by the wide range of returns shown in the Lipper Performance table below. According to the Lipper report, the average U.S. Stock fund declined 2.0% during the quarter, reducing its year-to-date return to 2.8%. Generally, smaller but higher-quality companies performed worse than the larger, riskier stocks.

## LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

**MONDAY, OCTOBER 6, 2014**

| | Qtr | 1 year | 5 year | 10 year |
|---|---|---|---|---|
| S&P 500 | 1.0 | 19.1 | 15.1 | 7.6 |
| S&P 500 Index P | 0.6 | 17.3 | 13.3 | 5.9 |
| Dow Jones Ind. Average | 1.3 | 12.7 | 11.9 | 5.4 |
| Equity Income | (1.1) | 15.0 | 13.8 | 7.8 |
| Large-Cap Core | 0.4 | 17.4 | 14.2 | 7.5 |
| Large-Cap Growth | 1.3 | 16.9 | 14.7 | 8.1 |
| Large-Cap Value | (0.1) | 17.0 | 13.6 | 7.0 |
| Mid-Cap Core | (3.3) | 11.9 | 14.6 | 8.7 |
| Mid-Cap Growth | (2.3) | 9.9 | 15.3 | 9.2 |
| Mid-Cap Value | (3.7) | 13.6 | 15.4 | 8.8 |
| General Equity | (2.0) | 12.0 | 13.4 | 7.6 |

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

The divergence in performance is both a blessing and a curse. Of course for currently invested funds, a downdraft in performance can provide those investors who are not psychologically prepared a bit of anxiety. For those who are prepared, it provides an opportunity to purchase quality companies at lower prices. Our work on stocks and our estimation of their fair value continues to put us in the camp that would say (for the stocks we follow) that we are closer to fully valued, rather than at the bargain end, of the valuation spectrum. In addition, our work would anecdotally confirm the following, according to Morningstar:

> "…the S&P 500's Shiller P/E of nearly 26.5 – is above the 70th percentile relative to the past 25 years and points to the poor expected returns and an elevated risk of a material drawdown."[3]

Irrespective of what the market pundits proclaim, our stock strategy will continue to focus on constructing and maintaining well-diversified portfolios, which consist of companies with a history of earnings, dividends, and cash flow growth. While we continue to find numerous companies that fit our qualitative standards, many of them do not yet meet our required margin-of-safety for purchase at this time. Nevertheless, we will continue searching for and buying those stocks that meet our purchase criteria, while selling those stocks that exceed our estimate of fair value, regardless of the general stock market trends.

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[3] "Stock Market Outlook: Keep Your Expectations in Check" by Matthew Coffina, CFA Quarter-End Insights September 29, 2014.