StaufferWilliams
ASSET MANAGEMENT · LLC

JANUARY 2014 INVESTMENT COMMENTARY

LOOKING DOWN ON STOCK MARKET SKEPTICS FROM ON TOP OF THE WALL OF WORRY

During this time of the year, many people set New Year's resolutions that they hope will positively impact their health, wealth, and/or happiness. For some, these resolutions will come and go within a matter of weeks or months as old habits prevail. However, others will successfully stick to their goals and will be able to measure their progress over time.

Resolutions, goals, aspirations, targets, and benchmarks are all descriptive words associated with comparative evaluation. As we enter another new year, many people will think about their goals and will evaluate if they are satisfied with the progress. When it comes to personal financial goals, particularly those surrounding the accumulation and/or preservation of wealth, these goals are typically long-term in nature. Unique to each investor, personal financial goals are determined by an individual's willingness to take risks in order to accomplish their objectives.

When it comes to the topic of goals or benchmarks in the context of evaluating one's investment portfolio, it is very common to use market indices as a measuring stick. However, this tendency can be very risky, and for most individuals, largely irrelevant. Market index risk and return characteristics have very little to do with an individual's unique financial goals. These goals are typically very dynamic in nature due to life's uncertainties unfolding in ways that require a customized response. A market index has no regard for when an investor is retiring or needs to reallocate in order to generate more income, thus leaving investors exposed to significant market performance uncertainty.

2013 -- STOCK MARKET SKEPTICS THROW IN THE TOWEL

I look forward to discussing our clients' 2013 account growth. These discussions typically will not focus on how much an account surpassed a market benchmark, but instead, these reviews will focus on how much excess return was generated versus the amount of risk assumed and where that level of return falls relative to a long-term goal. As I have mentioned on many occasions, our portfolio management process does not attempt to generate performance relative to any particular market benchmark. Contrary to this common practice, we manage portfolios based upon target long-term return objectives and near-term risk/volatility considerations that we deem more vital to our clients' goal attainment.

When a client's portfolio is reviewed, we often will show a very broad "blended" index for the period being measured in order to place an account's performance within the context of a broad asset allocation. However, we also illustrate the "expected" long-term performance target along with the associated range of returns on both sides of the risk continuum, thus demonstrating where the subject period's performance falls within this expected range of returns. By keeping the concept of "reversion to mean" in mind, we will be able to intelligently discuss risk exposure in the context of how much excess or below mean returns the portfolio has generated over a period of time. Therefore, this awareness of excess returns and reversion to mean at the macro level, combined with active management around relative valuation considerations, will tend to drive our tactical asset allocation shifts and security selection.

2013 certainly exemplified the concept of excess returns for most equity investors. Over the last year we have discussed the factors that drive stock appreciation, including earnings growth and multiple expansion. Although 2013 delivered modest earnings growth, earnings multiples expanded after being capped for a number of years due to persistent economic, monetary and geopolitical uncertainty. After several false alarms regarding debt ceiling and budget battles, European sovereign defaults, and Middle East flash points, the market seemingly resolved that it was time to stop pricing in the worst case scenario and instead, focus on company fundamentals. For the last three years I have been investing based upon the non-consensus view that the crisis was over and that corporate America was once-again creating durable shareholder value.

STOCK MARKET PRICED FOR PERFECTION - AGAIN

That being said, earnings growth has slowed over the last 12 months and multiple expansion cannot reasonably continue at the 2013 pace. Investor sentiment has significantly improved compared to this time last year, which should also put a cap on another year of material multiple expansion. What was a relatively easy market for us to find attractive investments has now become a market where the majority of equities are priced for perfection. Perfection pricing denies us a margin of safety from a valuation standpoint that we seek. Thus, we are forced to search out those increasingly rare equity opportunities where market valuation reflects future expectations that are viewed pessimistically.

During other periods where the market reflected stretched valuations, such as the late 1990's and 2006-07, optimism limited investing opportunities. I have stated before that I do not see any prevalence of large equity bubbles like the late 1990's. However, being someone who weighs relative valuation very heavily in stock selection, the bull market advance in equities following the financial crisis has finally eliminated much of the low-hanging fruit that had existed since 2009. Using a popular blue chip stock such as Proctor and Gamble as an illustration of valuations coming full circle from 2007 to 2013, one can see, by using a price-to-cash flow multiple, that today's valuation is significantly higher than it was in 2009 and slightly higher than where it was in 2007:

Proctor & Gamble Company (PG)

2007 P/CF	2009 P/CF	2013 TTM P/CF
16.1	11.0	16.7

Likewise, a very similar picture is produced by applying the same valuation ratio to the S&P 500:

S&P 500 Index

2007 P/CF	2009 P/CF	2013 TTM P/CF
11.6	9.1	11.2

While we do not rely exclusively on any one valuation metric and we view valuation with respect to expected growth rates, the above comparison is a worthwhile exercise to help validate our view that the market is once again fully valued. This exercise is intended to demonstrate how stock valuations have now come full circle and just how inexpensive stocks were in 2009 when most investors were too frightened to recognize the opportunity that existed.

While the price-to-cash flow ratio is a consistent measure of value over a market cycle, another metric that can be more nuanced is the PEG ratio or a PE ratio that is divided by forward expected earnings growth. This rule of thumb typically calls for purchasing stocks whose PEG ratio is less than 1 and avoiding those whose PEG ratio is greater than 2. In the case of Proctor & Gamble's stock, its PEG ratio currently sits at 1.9.

Now that I have made it clear, for illustrative purposes, that we will not be purchasing Proctor & Gamble stock in portfolios any time soon, one can be certain that we are finding opportunistic investments for our clients going into 2014. We are selecting attractively valued and special situation equities, identifying unique fixed income, and allocating additional assets to non-traditional investments. By creating dynamic asset allocations that include non-traditional investments such as private equity funds, real estate investments, and specialized mortgage debt investments, we have the luxury of not having to force all investment assets into traditional stocks and bonds.

LOOKING DOWN FROM THE WALL OF WORRY

I have already been asked several times in this New Year what will likely happen in the markets during 2014. On that subject, I can only state that stock opportunities are scarcer today than they were 12, 24 or 36 months ago. Additionally, today's interest rate backdrop threatens to add an additional headwind for the equity markets. Lastly, on the subject of what else may affect 2014's equity market, the economy and unemployment rate have unquestionably improved substantially over the last 12 to 18 months. Most economists expect the economy to remain stable and improving throughout 2014. Counter-intuitively, this better economic outlook may present a challenge for broad domestic equities because the contrarian investor, who has aggressively bought the market dips over the last several years, may be less inclined to buy those dips as enthusiastically. This "buy the dip" contrarian tendency is what allows markets, during uncertain times, to "climb the wall of worry". Conversely, as uncertainty fades away, those same contrarian investors become less enthusiastic about the dips, and instead, are inclined to sell the peaks.

Entering 2014, I am more cautious than I have been since 2007. However, I am proud to say that our portfolio design process has become more flexible over the last year as we have recognized the need to offer clients quality growth and income generating opportunities, regardless of stretched equity valuations and rising interest rates. As the investment industry embraces passive investing, which asks investors to rely exclusively on a broad exposure to markets by utilizing ETF's and index funds, we find it increasingly important to offer flexible and dynamic active portfolio management that can be crafted to meet each client's situation.

CURT R. STAUFFER
717 877 7422