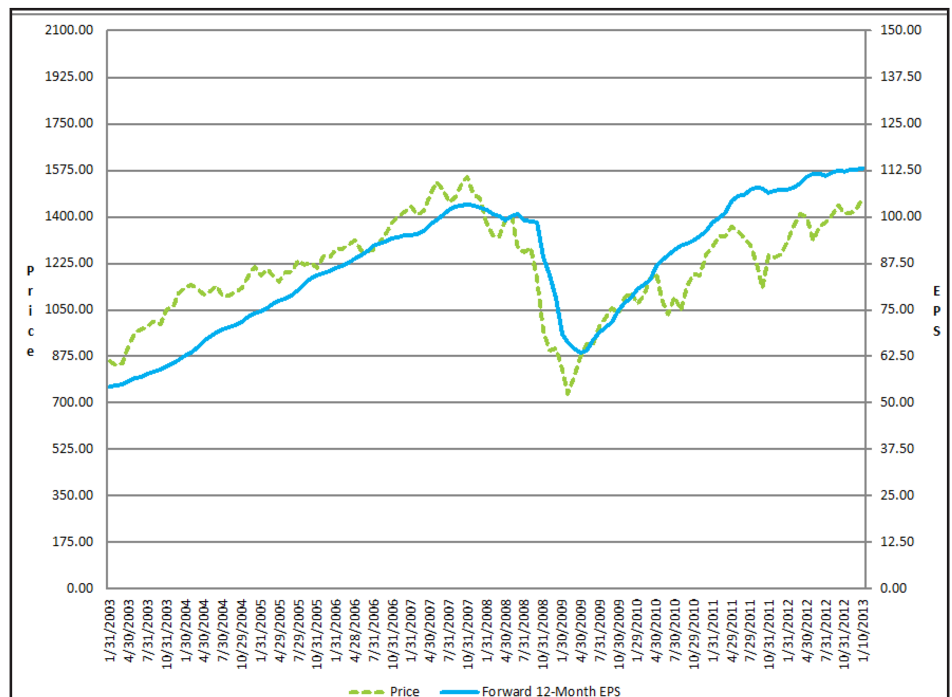
MARCH 2013 INVESTMENT COMMENTARY

SAVING FOR A RAINY DECADE THAT HAS PASSED

Over the last four years the U.S. stock market has risen approximately 100% with a backdrop of slow economic growth, stubbornly high unemployment, a massive Tsunami in Japan, revolutions in Egypt and Libya, rolling self-induced political flashpoints in Washington, and sovereign debt crises in Europe. It's no wonder that many equity investors continue to plow money into bonds or savings accounts yielding virtually zero. Looking backwards reveals a hostile risk taking climate. This fear of a hostile investment climate has persisted since the financial crisis hit its nadir in the fall of 2008.

As this commentary is being written, the Dow Jones Industrial Average has crossed into record high territory last seen in October 2007. Over the last 12 months net funds have moved out of equity mutual funds and into bond funds. That fact leads us to wonder whether people are truly investing or are they merely employing a form of "sophisticated saving?" We believe investors are those who invest money today in assets that they reasonably anticipate will be worth more over a long period of time. Fundamentally altering a long term investment strategy due to current events in the market—such as moving assets from equities to bond funds— is not what we would define as "investing." The naysayers can list a myriad of reasons, ranging from high unemployment to quantitative easing by the Federal Reserve as to why the stock market should not be rising. For many fundamental investors, the most essential determinant of market valuations—and the only thing that really matters—is the expectation of corporate earnings forecast into the future. This fact is very effectively illustrated in the FactSet Research Systems, Inc. chart below.

S&P 500 FORWARD 12 MONTH EPS VS. PRICE LEVEL



Forward earnings estimates over the last ten years have been upwardly biased and have not been particularly volatile, with the very obvious and notable exception being the period between September 2008 and March 2009. This period featured a global financial crisis of the likes not experienced since the Great Depression. The crisis, triggered by the failure of Lehman Brothers and compounded by political indecisiveness, reverberated globally. The inability of governments and Central Banks to prevent the collapse of one of the largest investment banks in the world set-off a crisis of confidence and domino effect of debt instruments being rapidly re-priced by a mark-to-market accounting system that was rendered dysfunctional in an environment when the gears of our capital markets were rapidly grinding to a halt.

Within a matter of months governments and Central Banks acted to inject massive stimulus and accommodative monetary policy, and virtually infinite backstops, in order to resuscitate confidence in a badly damaged financial system. Four years later stimulus is waning and those backstops have been largely removed from the system. In the meantime, corporate profits have recovered from this crisis period and equity multiples are back to the low end of a valuation range indicative of a healthy market.

So why today are there so many investors and corporations still sitting on an unprecedented level of savings and credit instruments which would normally be associated with a crisis level of fear and uncertainty? Now that major U.S. Stock indices are above or nearing record highs, is a correction looming? We would say yes, at some point. We do not know why when investors look backwards for guidance on what's working and what's not, they tend to ignore the remarkable market performance between 2009 and 2012, and instead fixate on the pain of the sell-off that occurred after the last peak in late 2007, culminating with the market bottom in early 2009. We advise anyone concerned about a correction to recall that we have had at least one 7% plus correction each year for the last four years on the way to reclaiming record market highs.

These new highs are not particularly surprising to us as we have kept our focus on the drivers of capital appreciation in equities – corporate earnings growth. We have not allowed market corrections over the last several years to distract us from our focus on the fundamentals that really matter in the long run. What constitutes an important fundamental, when it comes to investors, is a matter of perspective. Many investors confuse economic fundamentals and arcane measures of monetary policy, such as the employment rate the size of the Fed's balance sheet, with investment fundamentals. Being a successful investor over the long-term is not significantly different than being successful in answering one of those long SAT math questions that asks how long it takes a train to travel from point A to point B. These questions tend to contain one or two long paragraphs of background information including how many railcars the train was pulling, the weather conditions, and the name of the relevant cities, even though all that is necessary to get the right answer is the distance and average speed. In order to get the right answer and not waste time, one must know what information is important and what a distraction is.

A common theme of ours over the last couple of years has been that the noise in the markets tends to get a disproportionate share of investors' attention because the financial media is prone to sensationalize issues such as Greece's sovereign debt problems, the Federal Reserve's "money printing", debt ceilings, and fiscal cliffs. Anyone reading this commentary should be familiar with us pointing out these examples of market noise, but only a few readers are likely to have seen a similar illustration to what is presented in graph on page 1.

We know we will never be successful in convincing the media to change the way it reports on the financial

markets because talking about something as simple and boring as the chart on page one is not as exciting as making a bet on tomorrow's economic release using a put/call spread strategy. So we will be satisfied using our knowledge of what makes the market go up to grow our clients' assets and we will continue to block out the noise. From our perspective, the aforementioned "sophisticated saver" would be well served to focus attention on a longer-term perspective and to re-join the ranks of investors. Savings are earmarked for a rainy day, but today many "sophisticated savers" are seemingly prepared for a rainy decade. Our outlook is supportive of long-term investing in assets that appreciate in value based upon well understood fundamentals.

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