SEPTEMBER 2013 INVESTMENT COMMENTARY

GROWTH ORIENTED PORTFOLIOS HAD A VERY GOOD SUMMER -- WHAT WE ARE THINKING NOW

WHAT WE DID OVER THE SUMMER

The U.S. stock market indices ended down in August between 2-3% after a very good advance in June and particularly July. Our Core Equity Strategy, which many of our clients have a variation of, was running positive for most of August, only to drop approximately 1% during the last couple days of the month.

As we enter September, many market moving storylines are vying for our attention as we gauge how to position portfolios after such a strong advance over the summer. As we remind clients regularly, we do not overtly attempt to side-step corrections or otherwise time the market. However, our process at times will inadvertently lead to us accumulate larger cash positions when we are harvesting profits at a time when we are not finding ample attractive opportunities.

We are currently beginning to experience this situation currently and we have begun to selectively reinvest some equity profits, within balanced accounts, into some carefully selected bonds. Bonds now look much more attractive than they did a just few months ago. We continue to research equity opportunities, but they are certainly not as prevalent as they were at the beginning of the year.

U.S. STOCKS HAVE COME A LONG WAY; WHAT'S NEXT?

We recently read an insightful article by Ukarlewitz, the author of the Fat Pitch blog, who went through an exhaustive analysis of the bull market in U.S. equities that has taken place since March, 2009. He then attempted to rationalize what can be expected from the broad market over the next couple years. This article was titled "What Will Drive Equities Higher In the Next 12 Months?".

The blog began by breaking down the bull market by stages as follows:

STAGE ONE

Stage One ran from 2009 to late 2011 and was driven primarily by fundamentals: strong sales growth and strong earnings growth. In Stage One, fundamentals outpaced the appreciation in the indices.

STAGE TWO

The second stage has run from late 2011 to the present. Fundamentals have slightly improved but Stage Two was overwhelming about the indices becoming revalued upwards. Since the end of 2011, less than 20% of the gains in the SPX can be accounted for by EPS growth; the remaining 80% has been multiple expansion.

Next, Ukarlewitz delves into the process of attempting to rationalize what Stage Three will look like over the next 12 months or so. He states the following and provides a summary:

If fundamentals drove Stage One and valuation drove Stage Two, what will drive the next leg higher?

To simplify, think of the market as being driven by three primary variables: sales, margins and valuation multiples. For the market to go higher, some combination of higher revenue growth, higher profit margins or higher multiples will be needed.

We will look at each in turn below, but here are the main conclusions:

- *Sales growth, like economic growth, has been slow for the past two years. The good news is top-line growth might increase in the next year. The bad news is that sales growth has the least leverage on future returns.*

- *Margins, on the other hand, are already at the top of their long term range and are unlikely to expand further; in fact, they may well contract as interest expense and labor costs rise. Moreover, margins have a very large impact on future returns; even a small drop in margins can negate a large increase in sales growth.*

- *Valuation multiples are also already at the top of their range based on a number of measures. A substantial expansion in multiples would be an outlier event. Multiples, like margins, also have a highly leveraged effect on future returns.*

Expecting the double digit returns of the past several years to continue over the next 12-months is not odds-on. The best-case realistic assumption is that equities appreciate no faster than the growth rate of their revenues (2-4%); there is also a reasonable likelihood equities decline.

THE STOCK MARKET IS A MARKET OF STOCKS AND WHAT IS GOING RIGHT IN THE WORLD

Although we try to pay the least amount of attention possible to broad market prognostications, we did find this blog post very well written and logical in the conclusions that were drawn. This does not mean that we are tempted to sell out of our high conviction portfolio names. The equity positions that we hold for clients still appear to us to have attractive risk/return opportunity. However, given where we are in the market cycle, we are not inclined to assume that we will have the benefit of a strong cyclical bull market wind at our backs going forward, without a meaningful correction.

Now that we have addressed reasons to be cautious, we turn our attention to what is going right. From a global perspective, the U.S. is once again the shining city on the hill. Our economy has shown remarkable resilience over the last several years and that has been particularly noteworthy when viewing the multi-year trends in U.S. auto sales, job creation, industrial production, home sales, and the Purchasing Managers Index (PMI). The U.S. economy has grown steadily over the last four years in spite of a persistent fiscal drag, a recessionary European Union, stagnate Japanese economy, and decelerating growth in many of the world's largest developing nations. The world economy is a complex inter-related web of global trade and the drivers of the expansion of global trade are continually shifting. In spite of growth challenges in Europe and the developing markets over the last couple years, the U.S. economy has weathered these headwinds well. Over the last two years, greater Europe has been a negative force in global trade. This negative growth in Europe has reduced growth in the U.S., Chinese, and Japanese industrial sectors. Looking ahead, a European economy that emerges from recession will conversely be additive to growth in our economy and other large economies around the world.

There has been much written about the negative impact on global growth of China's GDP slowing down from 10% a few years ago to close to 7% today. We believe that those who are using this inevitable reduction in Chinese economic growth to foster worries about a Chinese influenced global slowdown are not entirely intellectually honest. The reality is that China's absolute contribution to global GDP at 7% growth, given the current size of the world's second largest economy, is essentially the same as it was just three years ago when China's year-over-year growth was closer to 10%.

The reason that this is the case is that China's GDP in 2010 was $5.9 trillion versus $8.2 trillion in 2012. Because of the increased size of the Chinese economy, it can now experience gradual slowing GDP growth without providing a negative shock to the global economy.

As we view the U.S. and world economy, we feel that for the foreseeable future, the major drivers of economic growth are reasonably well balanced and poised to continue to produce modest global economic growth. That modest growth should remain reasonably consistent. With that said, we do not currently view shifting global-macro economic forces as a significant risk to the capital markets. However, there are always present geo-political risks (e.g. Syria, Iran, and North Korea) that can very quickly introduce volatility and fear into the markets. These events are unpredictable and therefore we believe that it is foolish to attempt to side-step the associated market volatility.

POLITICS AND THE MARKET -- WE WON'T GET FOOLED AGAIN

On the subject of upcoming political showdowns regarding the debt ceiling and budget, we do not want to waste too much ink speculating what will happen. Based upon similar confrontations over the last several years, we believe that there is again far more smoke than fire. Enough said.

We always look forward to any comments or questions on anything written in our monthly commentaries. We hope that this month's relatively brief comments provide a valuable insight into how we are viewing the investment landscape that lies ahead.

CURT R. STAUFFER
Partner, 717 877 7422

JONATHAN M. WILLIAMS
Partner, 717 810 6705