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Running of the Bulls

We don't recall any strategists predicting a 32% return for the S&P 500 in 2013 and we certainly weren't expecting the best year for US stocks since 1997. But it happened, and it raises the obvious questions of why and what does this tell us about the next several years? Some of the factors contributing to the past year's results may be intuitive while others are anything but that. We will try to put some of these variables in perspective and think about what that implies going forward. Unfortunately, the interaction between independent economic/financial variables and human emotions makes shorter term guesses just that, as this past year has proven!

The glib answer to the question of why stocks were up is always that there were more buyers than sellers. Some of the variables that influence that balance include liquidity, positioning, relative returns and consensus themes. Liquidity has been abundantly provided by global monetary authorities and by the prolific cash flow of the corporate sector. Positioning reflects where investors are currently invested. Relative returns draw investors toward or away from various asset classes. Consensus themes give investors the confidence to make purchase and sale decisions. In short, three important variables in the supply/demand balance relate to where investors are concentrated and what they are moving towards.

One consensus theme has been that if diversification is good, more must be even better. Enter the broadly employed investment consultant model which utilizes a wide range of asset classes to "optimize positioning on the efficient frontier." In more simple terms, the theory is that owning non-correlated assets can reduce risk while providing competitive returns. The seeming sophistication of the theory illustrated by glossy pie charts has proven to be an effective sales approach and there is usually something working in the mix that makes for a good discussion point. Our view is very different. **By, in effect, partially hedging for every scenario, returns on the whole portfolio are diluted**. Some of the asset classes employed, such as commodities, have not generated positive inflation-adjusted returns over long periods of time and represent a long-term performance drag. **Most importantly, in times of duress, it turns out that enough of the asset classes are highly correlated that investors are not protected.** This was certainly the case in the last bear market where a "fully diversified" portfolio performed substantially worse than a classic portfolio of stocks and bonds. Still, investors with trillions of dollars have bought into this approach.

Now what happens when you have another period where "the more colorful your pie chart, the worse you did (*Winners of 2013: Boring Investors,* WSJ 12/31/13)." Gold fell 28% (GLD) in 2013, ending a 13 year bull market. Commodities slid 9.6% in 2013 and 22% over three years (DJ UBS Commodity Index). Investors in TIPS, Treasury Inflation Protection Securities, overpaid for that protection and the 10-year issue lost 11.7%. The MSCI Emerging Markets index was down 2.4% in 2013, with Chinese stocks off 5.2% (Shanghai Shenzhen 300). Europe had healthy returns of 21.6% (Stoxx Europe 600), but lagged the US. Lastly, bonds generally posted negative total returns after receiving inflows of over $1 trillion from 2009 through 2012. In other words, after two horrifying bear markets in stocks in less than a decade, trillions of dollars have poured out of US stocks and into alternative asset classes. Some of these dollars started to flow back into US stocks in the second half of this year for the first time in five years.

Not only were there $156 billion of inflows into domestic equity mutual funds and ETFs (electronically traded funds), companies used their prolific cash flows to repurchase some $450 billion of their own shares. New supply of stock from IPOs was roughly offset by the shrink from corporate mergers and acquisitions. Very simply, the underperformance of other asset classes (relative returns), the heavy exposure of many investors to those asset classes (positioning), the excitement of the bull market in stocks (consensus theme) and a relatively benign environment, led to a flow of capital into US stocks at a time when supply was shrinking**. Increasing demand and shrinking supply is the formula for a bull market in anything.** Given this set up and the fact that investors typically chase performance and run from negative returns, there are likely more equity inflows ahead.

It is also worthwhile to consider the variables that did not drive the advance in stocks to new highs. It wasn't that earnings were growing sharply; they were up only 5% and estimates were repeatedly cut through the year. It wasn't that longer term bonds were becoming less attractive; yields were increasing. It wasn't that we had solved any of the long-term fiscal issues confronting the US or reformed our tax code. It wasn't that we had successfully weaned the economy of monetary stimulus. It wasn't that sound economic policy was being implemented around the world. It was enough that nothing else looked appealing and some confidence returned to a battered, undervalued asset class: US stocks!

What does that imply going forward? **We are comfortable that valuations on stocks are reasonable in a low inflation environment with an improving economy. With a better backdrop, inflows into funds and ongoing share repurchases, stocks could post another good year. Our concern is that the mood may become too ebullient, followed by heightened volatility.**

We are keenly aware that we are four and three-quarter years into an equity bull market, capped by a 32% year, without a correction in over a year, with short-term interest rates near 0% and with Fed policy beginning a slow inflection. We are no longer in the early innings of this advance, equity risks eventually increase with prices, bond prices are susceptible to higher interest rates and many policy risks remain. Our playbook for this year is unchanged; find opportunity and protect capital, one security at a time.

- Make sure that all of our clients are comfortable with their current asset allocations. With a run in stocks, equity exposure increases. While that fits in with the long-term strategy for many, others may be candidates for rebalancing.
- Trim or sell stocks as they reach our targets. Last year, for mature portfolios, we outright sold four stocks and had roughly a half dozen trims. This is a key discipline to limiting portfolio risk and for securing gains.
- Find new stocks with attractive risk/reward characteristics with a catalyst in view that will elevate the company's performance and earnings. This is becoming a larger challenge as prices and valuations rise. This past year we initiated new positions in seven stocks and added to three positions. We likely will need a bout of weakness in the market to restore it to a target rich environment and to match last year's level of purchase activity.
- Find ways to generate income in fixed income vehicles while limiting duration risk. Thus far, we have been able to add significant value in a range of fixed income categories by being opportunistic, flexible and understanding corporate credits. By owning higher coupon instruments this past year, we were able to generate positive returns in a challenging environment. The range of appealing options has narrowed and as defense becomes more important, cash becomes a part of an overall fixed income strategy.

We are energized and looking forward to the challenges of a new year.

Happy New Year!