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Balanced

It has been a very rewarding time for equity investors. From the dismal trough four and a half years ago in March of 2009 at 666, the index advanced to a recent high on September 18th of 1,725. **Remarkably, the market recovery and breakout beyond the highs of five and 13 years ago has merely brought stocks back to the median price to earnings valuation since 1957** (The Leuthold Group). This is a tribute to the outstanding earnings performance of corporate America.

After a bull market run of this duration and magnitude, it seems logical that we should scale back our expectations for future equity returns. In fact, one of the best predictors of prospective rates of return in stocks has been the starting valuation of the market. Since the market is at an average price to earnings valuation, it would argue for average rates of return over the next five to ten years. However, we would adjust that expectation down for two reasons. First, corporate margins are at record highs, which should make it increasingly difficult to grow earnings faster than sales. Secondly, US economic growth is below historical levels and growth in the rest of the world is also well below par. Even with a modest pickup in global growth, it will be difficult for companies to grow sales at historic rates and earnings growth will be further constrained. Still, the prospect of equity market returns consisting of 2% dividend yields, plus appreciation in line with mid-single-digit earnings growth is better than most alternatives in this environment.

Though we are not in the early innings of this cycle, we do not see any near-term threats to its longevity. We don't see the precursors of a recession nor an inflationary threat. We expect the economy to continue to muddle along with short-term interest rates repressed by the Fed for several more years. Longer term interest rates have only just begun to ascend towards market levels and will represent a modest headwind to the economy and to stocks. We expect that subdued inflation, elevated global liquidity and the Fed's lockdown on short rates will generally limit the increase in long-term rates over the next couple of years.

Yet, there are certainly risks and there will certainly be bumps along the way. The risks emanating from Washington, the Middle East, the weak economies in Europe, China, etc. have not abated. Nor have "left field" or more subtle risks dissipated. For instance, with the threat of the Fed pulling back on its purchases of Treasury bonds, emerging market countries with trade deficits saw their currencies weaken precipitously. In response, countries such as India, Indonesia and Brazil increased short-term interest rates to defend their currencies. The disruption to international flows of capital and the response are but one example of largely unanticipated consequences that may lie ahead as the Fed begins to reduce their impact on our credit markets. In other words, artificially low interest rates have introduced some distortions to the markets. Only in hindsight will we fully understand where and to what degree.

There is also the possibility of an overshoot to the upside for stocks as public enthusiasm grows. Finally, after five years of net outflows, cash started to trickle and then pour into US equities this year. With the S&P 500 breaking above the highs of 2000 and 2007 in the first quarter of this year and continuing to gain ground, inflows into equity funds accelerated to a record monthly level in July and a record weekly level in September. As a Merrill Lynch strategist recently put it, "a rising market lifts all flows." However, over the five years when

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US equities experienced outflows, trillions of dollars flowed into bond funds, emerging market and international equity funds, commodity funds and hedge funds. We view these as potential sources of new cash for stocks in the months and years ahead as investors chase past performance and bond funds show a lack of returns. Thus, stocks may also see reasonable valuation upside that we are not counting on, or go on to levels that we are not comfortable with.

The point is, that **at this stage in the market cycle, potential returns and risks are more balanced and we should all be thinking along those lines.** We see further opportunities in equities for fruitful stock picking, but it is not a time to swing for the fence. As always, we trim positions as they become oversized and sell stocks outright as they reach our targets. If we are not able to find new stocks with attractive risk/reward characteristics, our cash reserves will build. In the past, this discipline has eventually protected us when expensive markets roll over and allowed us to have fire power to deploy into weakness.

We have fully participated in the strength of the market this year and it is an excellent time to review objectives, scale back expectations, rethink asset allocations and make sure that there's a comfort level with a range of scenarios. A portfolio tailored appropriately for risk tolerance and income needs coupled with solid execution are the keys to riding through turbulence.