Strategy over Tactics

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> *"All men can see these tactics whereby I conquer, but what none can see is the strategy out of which victory is evolved."*
> *–Sun Tzu, Art of War*

Are We Almost There?

Investors traveled a long way in 2013. Interest rates fell to historical, never-seen-before lows and have since risen to more normal levels. Gold, the ultimate safe asset, started the year within range of record high levels, only to fall by more than -25% for the year. Cautious stock investors were surprised by a market that climbed over +30%. Finally, the Federal Reserve's pump was set at full speed to infinity-and-beyond, but in late December outgoing Chairman Bernanke announced that Tapering has officially begun. Are we almost there?

Compounded Annual Rate of Change

	Stocks (S&P 500)	Gold	Oil	Food Inflation	Consumer Price Inflation	Nominal* GDP Growth
1950s	18.9%	-1.4%	0.8%	-0.4%	2.2%	6.6%
1960s	7.7%	0.0%	1.0%	2.1%	2.5%	6.9%
1970s	5.9%	32.2%	22.4%	7.7%	7.4%	10.0%
1980s	17.1%	-2.8%	-3.1%	4.4%	5.1%	7.9%
1990s	17.9%	-4.0%	-1.0%	2.7%	2.9%	5.5%
2000s	-0.7%	14.2%	12.4%	2.8%	2.5%	4.3%
2013	32.1%	-28.1%	7.2%	1.0%[1]	1.7%[1]	3.0%

*Not adjusted for inflation. [1]BLS through Nov '13.

First Things First – Strategy over Tactics

There, of course, partly depends on one's asset allocation. For those sitting on the stock market sidelines, for example, *there* likely refers to a market correction – a good time to get in. For those heavily invested in gold, *there* refers to a bottom in gold prices. And so on.

The *ultimate* destination for investors, however, relates to goal attainment. Investor goals are broadly grouped into three categories: 1) capital preservation, 2) growth, and 3) income. To varying degrees, investors have a combination of one, two, or all three of these goals. Interestingly, these three goals are perpetual in nature – as much associated with the journey as the destination.

- A goal of wealth enhancement (growth) argues for a long-term strategic allocation to investments that participate in economic growth over the long run, such as equity ownership in business (i.e. stocks);
- A goal of income argues for a long-term strategic allocation to a range of reliable income producing securities (i.e. preferred stocks, dividend payers, MLPs, bonds, etc.);
- Finally, a goal related to capital preservation argues for a commitment to investments that are focused on providing a predetermined value contractually or otherwise (i.e. bonds, CDs, money-markets, etc.).

As a result, the investment journey primarily establishes long-term *strategic* investment policies that cater to investment goals and secondarily considers shorter-term tactical decision making. Distinct from goals, tactical adjustments to portfolios result from the identification of opportunities and concerns in various investment markets.

When Strategy takes a Back Seat to Tactics

When this order is reversed, and tactical decision making becomes primary, an investor is more likely burdened with a desire to know if we are almost *there*. From the perspective of anyone who has successfully navigated major turns in markets, there is nothing wrong with such an approach. However, when a majority of an investor's assets are in cash or gold, for example, fear is often the leading driver behind such an allocation – rather than commitment to longer-term strategy priorities. Likewise, conservative investors who get caught up in stock market rallies often assume undue risks counter to their strategic goals.

To be clear: There is nothing wrong with tactical changes to exposures to any asset class. The challenge for those making tactical allocation decisions as the primary approach to investing is that investment decisions must be correct *twice* to be successful (as in superior to a longer-term strategic allocation). Consider fictional investor Mike Brady who has a growth long-term objective but is holding mostly cash on the sidelines due to a concern that the market will fall. Initially, for cash to be successful the market must fall; otherwise the cash allocation will lag the market. Subsequently, for Brady's overall tactical decision to be profitable, the market needs to go up after re-deploying the cash back into stocks. If Brady is not correct on both of these decisions (the timing of both getting out and getting back in), it is likely that simply staying invested whole time would be the more profitable – even if a pullback were to occur.

So what are the chances of being right twice in a row? The folks from Wall Street who make market forecasts and provide tactical advice for a living are ironically called *strategists* (they should probably be called *tacticians*). The best known strategists tend to be right approximately 50% of the time[1]. Consequently, if we assign a 50% probability to being correct on any given tactical decision, then the chances of being correct twice in a row is a paltry 25% (50% times 50%). Let's suppose our fictional friend Mike Brady follows the top-ranked market guru. In this case, we assign a 68% chance of being

[1] Study by CXO Advisory Group (www.cxoadvisory.com/gurus/) analyzed over 6,500 market predictions by 68 experts from 2005 to 2012, and found the typical strategist correct 47% of the time (and a range of 22% to 68%).

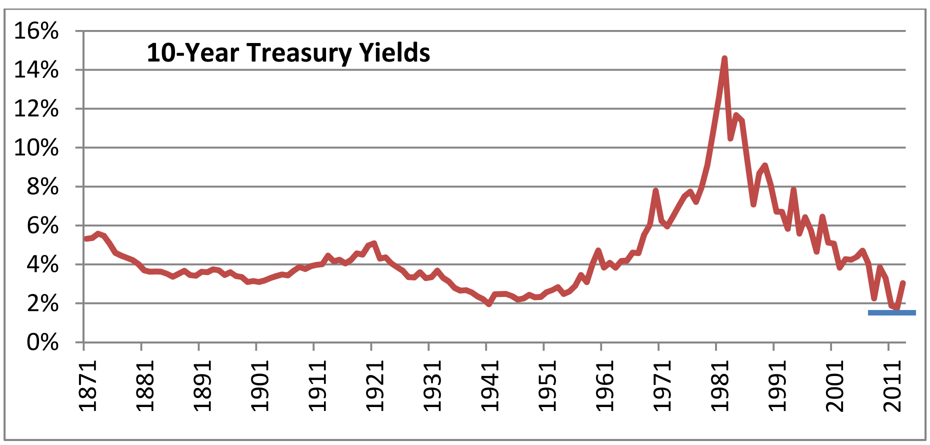
correct on any given tactical decision. Brady's odds of success on a round-trip tactical move now shoot up to a moderate 46% (68% times 68%).

This challenge applies to all investment asset classes. As a result, investors who continually subject a majority of assets to tactical investment decisions have a lower probability of success than those who invest primarily with a goal-oriented, strategic framework.

Market Analysis – Identifying Risks and Outliers

While it tends to be quite challenging to make consistently accurate predictions on markets (be it stocks, bonds, or otherwise), it makes absolute sense to identify and respond to risks and outliers, such as the historic low interest rates at the start of 2013. It was not a bold call to say that rates would climb, and it was further relevant to advise investors towards a reduction in bonds sensitive to interest rates. Many bonds indeed had a challenging 2013. Similar historic outliers were seen in price-to-earnings ratios in 1999 or bank-leverage in 2008.

In the end, we believe the best approach to market analysis helps investors reduce exposure to undue risks and takes advantage of the significant outliers of the day, if any.

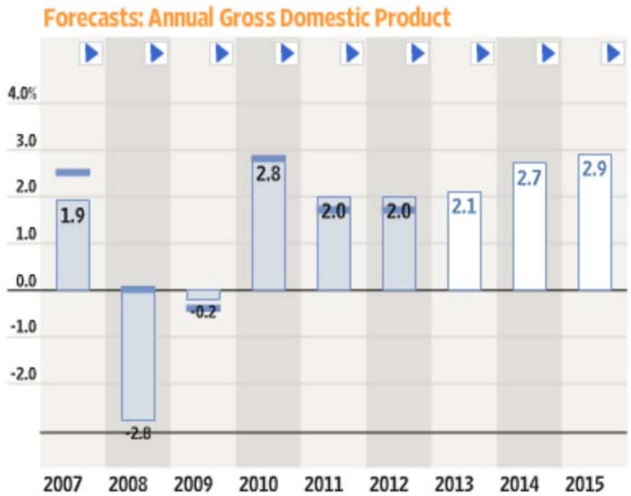


2014 – Risks and Outliers

Economy

Both economic growth and unemployment have been gaining positive momentum over the past year. Consensus expected *Real* (after inflation) Gross Domestic Product growth for 2014 is 2.1% according to the Wall Street Journal. We fall on the optimistic side of this consensus and would not be surprised to see growth closer to historically normal levels (3% +) this year. Our view is based on the following:

1) Easing of fiscal constraints at the local and federal level
2) Strong real-estate market based on pent up demand
3) Slowdown in debt reduction / increase in consumer credit → spending
4) Rising consumer and small business confidence
5) Continued decline in the unemployment rate
6) Growth in domestic energy production



Source: WSJ.

Interest Rates and Inflation

Long-term government bond yields (10-year US Treasury bonds) started 2013 at approximately 1.8%. As the Federal Reserve continued its bond-buying program, rates fell to 1.6% in May – representing the lowest level in our nation's history. Bonds sold off as concerns that the bond-buying program would taper off (as bond prices fall, bond yields rise). By the end of 2013, rates climbed to 3.0%, and indeed, the Fed reduced purchases from $85 billion/month to $75 billion.

Today, the Fed is still purchasing bonds at hefty levels. This continues to artificially suppress yields. As the Fed continues to taper the purchasing program, we believe rates will rise further.

History tells us that long-term government bonds typically yield more than inflation by 1% to 5%. Today, inflation expectations are 2%, and long-term yields are 3% - meaning inflation-adjusted yields are at the low end of the normal range.

Given our view that economic growth will pick up, we believe inflation will rise, and the Federal Reserve will discontinue its bond buying program by mid-2015. As a result, increasing interest rates continue to pose a higher level of risk than normal over the next 18-months; meaning risks remain elevated in the bond market.

Stocks

The total return from stocks consists of three factors: dividends, valuation changes, and growth. Consider the following example:

1. When a company pays dividends that equate to, say, 3% per share (a 3% dividend yield), its total return for the year will be stronger by that amount.
2. When a company's price-to-earnings ratio increases from 15 times to 16 times over a year, the valuation (and total return) has improved by 6.7% for the period.
3. When a company grows its earnings by 3% per share over the course of a year, the total return is improved by that amount.

Now consider if the company in our example does all of these things in the same year: 3% dividends + 6.7% valuation adjustment + 3% earnings growth. In this case, the total return for company stock would be in the neighborhood of 13%. The stock market can be analyzed in the same fashion.

We use the S&P 500 as our proxy for the broad market.

- Dividends: Currently stocks are yielding 2.0%.
- Valuations: Last year valuations based on price-to-earnings (using operating earnings) expanded from 14.7 times to 17.2 times – an increase of +17%. Currently, at 17.2 times, valuations are in line with the 25 year average. Similar fundamentals tell a similar story. Since valuation does not seem to be an outlier, we do not assign a particularly high risk (or opportunity) to it. Consequently, the base case is that valuations remain at normal levels.
- Growth: Last year, operating earnings for the S&P 500 grew by 11.8% (from $98.35 to $109.91). Earnings growth can be volatile, but earnings normally grow between 5% and 10% annually. Since margins (earnings as a percent of sales) are historically high right now, we assign a conservative growth estimate of 5%.

Putting it all together, our base case for stocks is a total return of 7% (2% dividends + 0% valuation change + 5% growth). This argues that investors do not need to stray too far from their long-term strategic asset allocation of equities in 2014.

Summary

In our identification of risks and outliers for 2014, we believe both the economy and inflation will pick up to historically normal levels, which is a bit higher than the consensus view. This, along with a winding down of the bond-buying program instituted by the Federal Reserve, means interest rates pose a risk of rising further. Fixed-income investors should continue to play it safe in 2014 – avoiding unnecessary interest rate risk when possible but not broadly avoiding the asset class.

On the stock market side of the universe, a growing economy should help business revenues increase. However, with a rising economy comes rising input prices (including a more competitive wage environment). This along with abnormally high margins leads us to believe that earnings growth will be modest in 2014. We also view valuations and dividend yields as normal; leading us to a base case that the market is likely to rise modestly this year.

As a result, adhering to a long-term strategic asset allocation continues to be optimal for 2014.