ADDING VALUE

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It was the best of times…..

Steve Forbes recently interviewed John Mauldin, an economist. Here is what John said about the QE program: "We're talking eight years of artificially low, financially repressed interest rates. That is theft. And what it is, is a theft of time. Because we have a generation of people who have played the game by the rules. They've saved their money. And now they're saying "you're not going to get enough return unless you move out the risk curve."

As the old adage goes, it was the best of times, it was the worst of times. As the year draws to a close, the S&P is approaching 1850, a total annual return of almost 32%, one of the best returns since the early 1990's. No one forecasted such a stupendous, exhilarating, and heady performance result.

The downside of this wonderful year is that history shows that starting valuations have a **strong** impact on future returns. That means taking your cash and investing it all tomorrow in an S&P 500 index fund (or equivalent) does not guarantee you'll receive the same past performance result. In actuality, it is likely you will experience a return that is much less. As the following chart developed by Robert Shiller indicates, enjoy today's results while you can, because future returns probably will be anemic.

Starting valuations have demonstrated a strong impact on future returns

Subsequent nominal returns (annualized)*

Starting Shiller P/E	5-year	10-year
<10x	15.1%	14.8%
10-15x	9.3%	10.6%
15-20x	6.2%	5.6%
20-25x	4.2%	1.7%
>25x	0.4%	2.6%

Current level: 23.6x

As of 30 September 2013
SOURCE: Robert Shiller Online Data; PIMCO
**Median of the annualized subsequent returns calculated at each month end, using Shiller P/E and S&P 500 monthly returns from 31 December 1927 to 30 September 2013*

In addition to being excited about the 2013 returns, many clients are asking us: "what is happening?" The economic news (high unemployment, low sales, anemic GDP growth, etc.) does not seem to be correlating with these stock market results. The culprit of this disconnect is the Federal Reserve's Quantitative Easing (QE) program. Simply put, quantitative easing impacts stock prices by creating a mountain of zero-interest cash that must be held by **someone** at each point in time. Those holding cash or CDs and earning zero percent interest are meant to feel very uncomfortable. The hope and mechanism behind QE is to force those cash

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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holders to feel so distressed that they reach for yield in speculative assets that they would otherwise not hold. As the economist John Hussman explains: “The process ends at the point where investors are indifferent between holding zero-interest cash and more speculative securities such as long-term bonds or stocks. At this point, every speculative security is priced to achieve the lowest possible risk premium that investors are willing to accept.” Presumably, when investors move from zero-return cash to 20%+ total returns for stocks, they feel richer and are more willing to spend some of their investment profits. This is known as the “wealth effect”.

Will the Fed’s current policy have unintended adverse consequences? Time will tell. In the meantime, there is a quote that recently appeared in the Wall Street Journal from Friedrich A. Hayek, a well-known economist. Upon accepting the Nobel Prize in economics in 1974, he stated: “To act on the belief that we possess the knowledge and the power which enable us to shape the processes of society entirely to our liking, knowledge which in fact we do not possess, is likely to do much harm.” He goes on to say: “Even if such power is not in itself bad, its exercise is likely to impede the functioning of those spontaneous ordering forces by which, without understanding them, man is in fact so largely assisted in the pursuit of his aims. We are only beginning to understand how subtle a communication system the functioning of an advanced industrial society is based – a communications system which we call the market and which turns out to be a more efficient mechanism for digesting dispersed information than any man has deliberately designed.” Hmmm…

“Buy low, sell high. Aren’t there any other eternal truths?”

We’ll see how well reality plays out this wholly academic and unproven theory. Meanwhile, most of the return in 2013 is due to margin expansion through cost cutting rather than sales growth. At the time of this writing, the S&P 500 price to earnings (P/E) ratio rested at 24x, a level not seen in an expansion since late 2007. Moreover, other valuation metrics such as price to cash flow, price to book, and price to earnings are starting to, or already have, surpassed their long-term averages. What this indicates to us is that now may not be the best time to be fully invested. If starting price is the most important factor for long-term, average beating results, then we generally feel the prices the market is giving us do not warrant the underlying value purchased.

We are NOT saying the market is in imminent danger of collapse. We are NOT and have NEVER been market timers. We are suggesting that a little breather might be in order for the market to absorb the ramifications of the Fed’s QE program as well as the run-up in price as compared to underlying, fundamental values. Sometimes a sports analogy helps. If we think of the market cycle as a baseball game, where the first inning is a low point and the ninth inning is a high point, and we’re somewhere in between, then we gauge the market to be in the later innings. Though it’s nearly impossible to foretell the exact inning, we believe it is necessary to be prepared for the end of this game (“read:cycle”) and for the start of the next one. In a nutshell, we believe the most prudent investment action may be to hold cash as uncomfortable as it may be in the short-term.

While we wait, the following is a list of some of the actions we are taking in your portfolios. (Please keep in mind that we do not create one size fits all portfolios, so all of the following actions are not being taken in each portfolio.)

1. <u>Rebalancing to managers that are increasing cash levels</u>

   Some managers that are holding high cash levels at the time of this writing include:

   - Yacktman Focus Fund – 22% in cash
   - FMI Common Stock Fund – 21% in cash
   - Longleaf Small Cap Fund – 40% in cash
   - First Eagle Overseas Fund – 22% cash

- Weitz Partners Value Fund – 28% in cash
- Goodhaven Fund – 17% cash position
- FPA Capital – 35% cash

These managers are not predicting an Armageddon, they are just being conservative. Cash is a by-product of their investment style. Therefore, if there are no attractive investment opportunities, then they hold cash and wait for those opportunities to appear. Most are very comfortable with the 60-80% that is invested. They just want to be able to buy new securities without having to sell others at depressed prices.

Here is what the portfolio managers of Goodhaven Fund, as written in their 05/31/2013 shareholder letter, have to say about cash:

"Just how much cash the Fund holds is a function of three factors. First, cash rises or falls with shareholder subscriptions and redemptions – and inflows have been significant, particularly in recent months. Second, cash ebbs and flows depending on the extent to which we are able to find investments that we believe are compelling in terms of both potential profit as well as a limited risk profile. A briskly rising market (such as occurred earlier this year) usually results in a slowdown of new purchases. At times of general distress, it is easier to invest and we are capable of moving fast under such circumstances. Lastly, our experience argues that a certain amount of liquidity in a mutual fund structure is desirable. Cash helps to meet redemptions under stress, to invest in new securities without having to sell other inexpensive holdings, and to maintain optionality in highly volatile environments. Under truly panicky conditions, the value of liquidity is greatly multiplied by the ability to pick off unsustainably cheap securities, though such extremes are infrequent and hard to predict."

2. <u>Verifying that there is sufficient liquidity to meet the cash needs of those investors in withdrawal mode for at least a 2 year period.</u>

While many of our equity funds may hold large cash positions at given points in time, we do not view this liquidity as cash available for withdrawal by our clients. Clients in withdrawal mode will find they hold funds that are typically of lower volatility than younger clients with growth objectives. We, Wright Associates, then manage the cash in the portfolio. This enables your investments to have a longer time frame to recognize value without having to worry about selling at loss, during low points, in order to meet spending needs. It is, and always has been, our goal to make sure no client experiences a permanent loss of capital. Liquidity, also, does not always mean cash. In many instances we are using FPA New Income as a highly liquid cash alternative. After 30 years of investing they have never had a down year, and while the fund holds very short term highly rated government debt, the stability and yield it returns is better than most other cash alternatives.

3. <u>Rebalancing to managers who focus on the developing or emerging world.</u>

The developed world, which basically consists of the roughly one billion people residing in North America (ex. Mexico) and Western Europe are facing several headwinds. The three major headwinds, as described by Rob Arnott, are demographics, deficits, and debt. Cutting deficit spending, servicing costs for debt and an aging population are all factors which will lower GDP potential in the developed world in the future. These factors as well as a rapidly increasing stock market are causing us to look to other areas of the world for value and opportunity.

While the developed world is facing several headwinds the developing world has those same factors as tailwinds. To implement this idea we are using the Thornburg Developing World Fund. The fund managers are looking to invest in local, emerging market companies that deliver goods and services to those residing there. In other words, they are looking for attractively priced companies selling to the five billion people living in the developing world. The base assumption is that as these five billion people industrialize and increase their purchasing power they will spend more and more money on leisure goods and services, thus increasing the value of the companies that Thornburg owns. Finally, the overall emerging market space has faced a tough year. They are still experiencing negative returns, year to date. With lower beginning P/E's than in the developed world as shown in the beginning chart, we find this as a good time to make some initial investments.

We are working hard to ensure our clients' portfolios are invested in a safe, prudent and opportunistic manner. Above all else, the most important investment guideline to follow is to have patience. Reaping investment rewards takes time. We feel if we can safely compound our clients' money at an average real rate of 7-10% per annum, clients will all be better off in the very long-term.

It has been an exciting and exhilarating year. We will remain cautious going forward, since rising prices indicate lower future expected returns. We promise to remain vigilant in buying the right assets at the right prices.

We hope everyone had a wonderful Holiday Season filled with the blessings of family and friends, good health and continued prosperity.

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Sincerely,

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