March 2013

You Need to Be Right Twice in This Market, and This is One of Those Times

As we wrote in our last note, the first few months of 2013 have witnessed the continuation of a four year bull market that has surpassed even the most optimistic expectations ($11 trillion of wealth has been recovered since March 2009). Depending on one's entry point, the stock market is viewed as a black hole of dead money for more than a decade or an unbelievable wealth building machine that has helped many investors more than double their money in a short four-year run.

However, we are reaching a short-term peak in the cycle which should give all of us pause; pause to take some profits and adjust our allocations more defensively as we think a minor correction could be in the cards. This would be healthy and something that is to be expected. While we aren't in the business of "trading" in the markets, the current environment has created both risks to mitigate and opportunities to take advantage of with a little proactive, thoughtful planning.

Recent highlights:

As we emerged from the fiscal cliff resolution at the beginning of the year, it became clear the global equity markets had a reason to surge. The S&P 500 was up over 7% in January and now is up 9% for the year, yet there wasn't a significant change to the underlying economic fundamentals. We also still faced the artificial crises of the sequester and the debt ceiling debate looming as potential catalysts for a real correction (just think back to last year). Here is what we did:

- We bought the VXX, the Volatility Index ETF which appreciates when volatility goes up (in essence, a hedge against equity exposure) - we sold it for an approximate 12% gain. Reason: volatility was at near-term lows and it was clear the sequester and events in Europe would elevate the fear in the markets - once that happened, we sold it and took our profits.

- Sold our exposure to financial stocks which were up over 7% this year. Reason: we felt financials would get hit the hardest during a pull back and wanted to reduce our risk. We still like financials longer term which is why we added the preferred stock ETF which is largely comprised of financials, but has less volatility since it is preferred stocks and not equities. This yields 5.84%.

- Sold our ETF in mortgage REITs which was up over 12% this year. Reason: the strategy appreciated significantly and we wanted to take profits.

- Sold our technology ETF in Q4 2012 which subsequently declined over 8%. We recently repurchased it after its underperformance. We feel this is a longer term holding. Reason: AAPL is down almost 40% from its highs and is 14% of the index. While there might be some additional near-term pain, the underlying cycle is in our favor.

- Recently added floating bank loan exposure yielding 4.8% whose yield will rise as rates increase (over time). Reason: the Fed will continue to create liquidity and these have very good yields that won't collapse like fixed income bonds when rates eventually move higher.

- Shifted (slightly) our strategic equity exposure from the US to Emerging Markets. Reason: we feel emerging markets are much more attractively valued right now given they haven't moved up as much as the US and aren't as prone to the dysfunction in Washington.

Hopefully these highlights provide some additional insight into our thinking and how we effectively manage risk by being proactive in our asset allocation. We want to emphasize that these conditions are a little frothy even for our post 2008 risk on/risk off market environment and we expect things to settle down most likely after a minor correction. These times provide the ideal example as to why managing a static portfolio without regard to macro events and their impact on the global markets simply doesn't work and can create significant losses in times of uncertainty.

As always, please contact any member of our team with any additional questions or thoughts.
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