April 2013

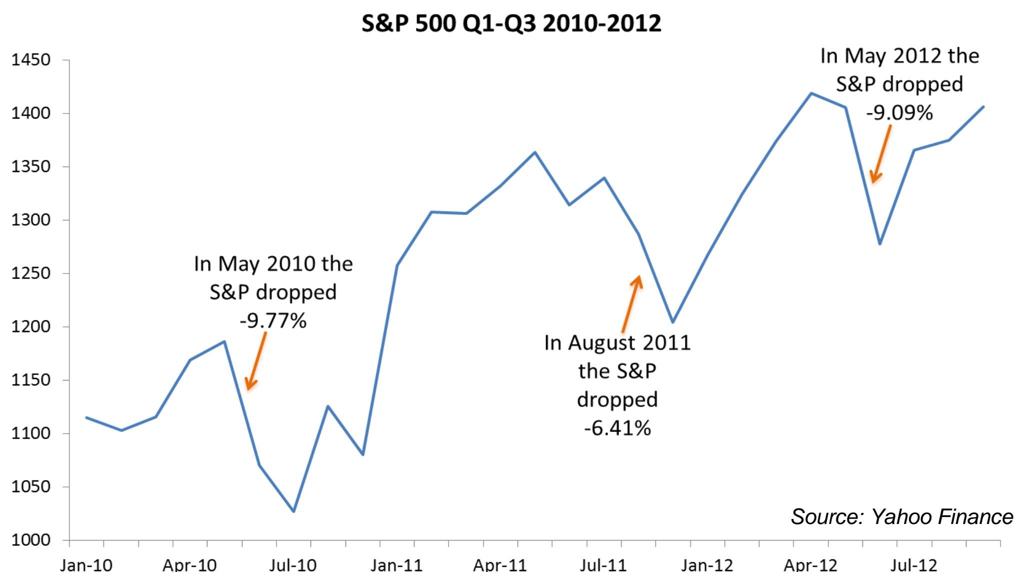
NAVIGATING THE SHORT-TERM TO PROFIT IN THE LONG-TERM

Short-term events can create long-term opportunities – as an investor you have to be able to recognize how to take advantage of this. In April, over a seven-day period, we experienced a terrorist bombing, an industrial explosion, and a downward trending market that sent large US stocks down over 3% and small US stocks and mid-cap US stocks down more than 4%. For some investors, the recent market shocks were seen as the beginning of the overdue pullback in equities and the perfect opportunity to take profits. Others saw it as a minor pause in an otherwise strong bull market.

We think it is neither. The markets are getting more volatile because there is increased short-term risk from sluggish economic indicators and a growing perception that asset bubbles are starting to form on the horizon. However, many asset classes remain fairly valued and therefore pullbacks create opportunities for nimble investors to enhance their portfolios for the long-term.

UNDERSTANDING THE MACRO

After a raucous 1st Quarter led by US equities, the 2nd Quarter is off to a bumpy start with lackluster economic data coming out of the US, China and Europe. In the US, the employment recovery lost steam in March with a tepid 88,000 new jobs added versus an estimated 190,000 jobs[1]. In addition, March retail sales data showed the biggest drop in nine months as consumers digested reinstated payroll taxes and anticipated additional impacts from the sequester. After a very difficult quarter for emerging markets, China reported a less than expected GDP number of 7.6%[2]. A slowing China coupled with the recent Cyprus banking crisis has reignited fear of another post March pullback in the markets.



As you can see from the chart at right, the US equity market performance of the last three years presents an eerily familiar story of boom and bust.

Although the catalyst for the pullbacks in each year was somewhat different, they all occurred on the back of specific macro challenges. In 2010, the flash crash on May 6th started a fear spiral that drove the markets down almost 10% from its high. In 2011, it was the US debt downgrade and heightened recessionary fears that sent the US market down 18% from its April 2011 market high. In 2012, the May swoon was driven primarily by escalating concerns about the Eurozone debt crisis, with Spain and Greece keeping contagion worries front and center. ***Given the strong housing rebound and continued intervention by the Fed, we do not see a magnitude correction of over 10% as in past cycles. Instead, we see the potential for specific dislocations (ie: gold, emerging markets, and select opportunistic yield strategies) to create great opportunities to tactically shift our allocations for the long-term.***

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[1] Bloomberg, *Job Gains Slow Amid U.S Unemployment at Four-Year Low.* April 5, 2013.
[2] Reuters, *China Growth Risk in Focus as First Quarter Data Falls Short.* April 15, 2013.

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BEING NIMBLE

In the post-2008 investment environment, volatility is a constant and so it is not surprising to see extreme moves in many asset classes than can quickly eclipse their expected returns over several years. These dislocations require action. It isn't "timing the market," but simply a necessary component of a sound investment strategy. Below is a snapshot of the most recent tactical trades we have made for clients in the wake of the recent run-up in US equities:

- **Bought the Volatility Index (VXX) on 4/12 and sold it on 4/18 for a gain of approximately +17.5%**
  Rationale: Downside protection tool in wake of S&P500 run-up

- **Maintained overweight to Utilities allocation (XLU) which was up over 16% including dividends YTD through April 23rd**
  Rationale: Fiscal Cliff tax concerns and Hurricane Sandy dragged down performance late in 2012 creating an attractive entry point

- **Sold Basic Materials (XLB) and Sold Technology (XLK) in front of weaker earnings reports**
  Rationale: Decreased overall higher beta US exposure due to expected earnings challenges

- **Bought iShares 20 Year Treasury (TLT)**
  Rationale: Hedge against market correction

- **Bought the US Energy Sector ETF (XLE)**
  Rationale: Bought after the Sector corrected over 6% in the first two weeks of April

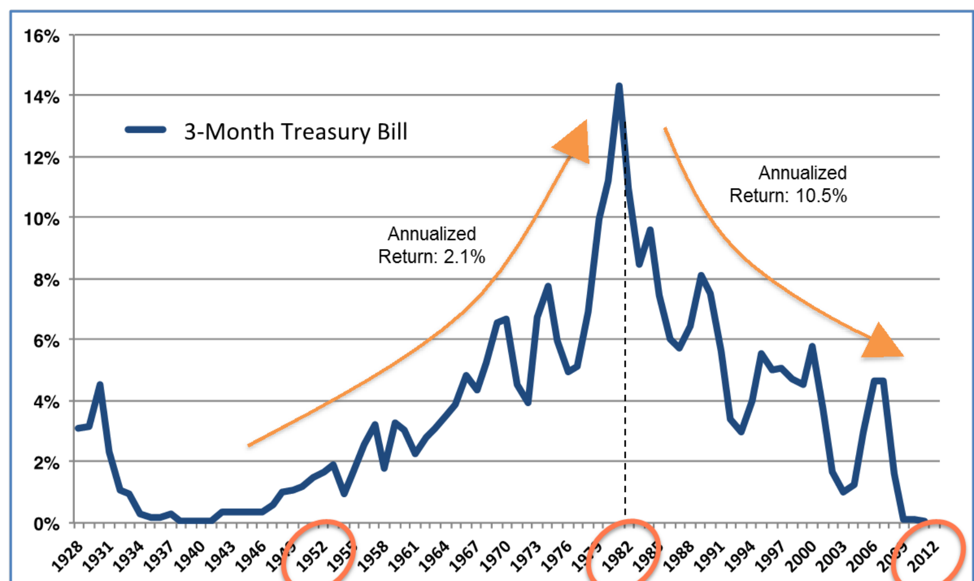
REBALANCING FOR THE LONG TERM

Short-term moves in prices give us ideal opportunities to rebalance and achieve our long-term portfolio objectives.

Over the last several months, we have spoken with clients about the eventual impact of rising interest rates on the total return of traditional bond portfolios. The reason for today's unsustainably low long-term rates is not complicated. We are at the end of a 30 year bull market cycle for bond yields which has been driven by a falling rate environment. ***T-Bills have averaged over 10% annual returns for the past 30 year cycle vs. just over 2% in a rising rate environment (yes, that is what is coming next).***

As the global economy slowly recovers, the Fed will eventually have to wind down its "long-term asset purchases," also known as "quantitative easing" which have kept rates artificially low. The Fed is buying Treasury bonds and long-term mortgage-backed securities at a rate of $85 billion a month, equivalent to an annual rate of $1,020 billion – not sustainable.

Although it has not indicated just when rates will rise or how high they will go, the Congressional Budget Office (CBO) projects that the rate on ten-year Treasuries will rise



Source: Ibbotson Indexes, US LT Govt Bond TR is annualized from 1952 to 1982 and 1982 to 2009

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above 5% by 2019 and remain above that level for the next five years[3]. ***If any of the CBOE projections ring partially true, the loss in the price of the bonds will wipe out most of the gains earned in interest for clients.***

Given these potential challenges facing traditional bondholders, we do not believe that clients can depend solely on traditional fixed income portfolios to produce the 4-7% total return numbers that they have produced over the past decades. As a result, we have used the recent pullback as an opportunity to continue our broader shift away from more traditional fixed income and defensive holdings to higher yielding income allocations in other asset classes (see table). The net result will be to replace core fixed income yields with other assets without materially changing the overall risk profile of the portfolio.

ETF	Current Yield
XLE	1.76
EMLP	2.61
TLT	2.72
BKLN	3.83
PCY	4.30
PFF	5.62

*Source: PowerShares, SPDR Fund, iShares, First Trust North American Energy Infrastructure **

Another long-term theme we build on is our belief in emerging market growth. In the short-term, emerging markets have significantly underperformed the US creating increasingly attractive valuations on a relative basis. When these markets diverge by over 15% as they have this year, it creates a clear opportunity.

WHAT'S AHEAD

In Warren Buffett's recent annual letter to investors of Berkshire Hathaway, he once again addressed the uncertainty that preoccupies many members of the media and has dampened the willingness of American business to invest. He points out that uncertainty has been a constant in the United States since 1776; the only variable is whether people ignore the uncertainty or fixate on it[4]. In practice, it is probably best to do neither. We pay attention to uncertainty, especially in the short-term, as it does create opportunities to tactically make money for clients. And in the coming weeks we expect more volatility and potential sell offs but no big structural failure like in 2008 or 2011. It is hard to believe that the mere 3-4% pullback last week represents the big pullback that every technical strategist has been predicting. After a surprising first quarter equity run led by defensive sectors, we will be anxiously analyzing macro and micro factors this earnings season for further proof of sustainable growth in the equity markets.

[3] Congress of the United States Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013-2023.* February 5, 2013.
[4] Warren Buffett's Annual Letter to Berkshire Shareholders. March 1, 2013.
*30-Day SEC Yields as of 3/28/12 except: XLE as of 4/22/2013 and TLT as of 4/19/2013.

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