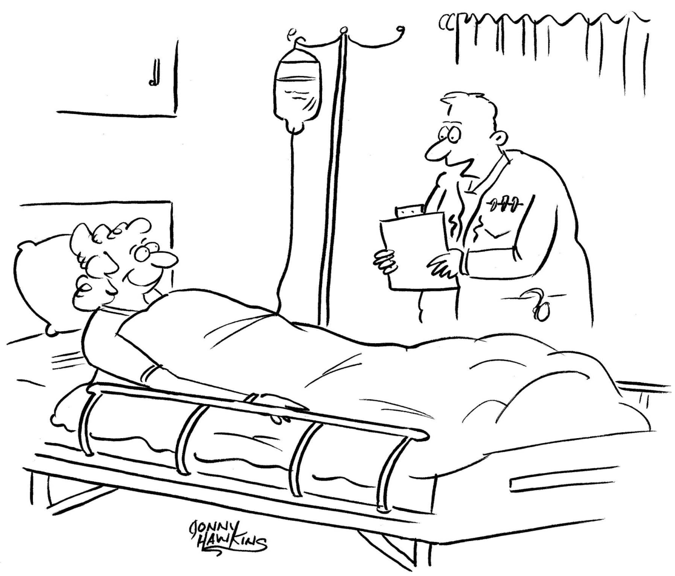
Optimists Have Reality On Their Side

"Keep your face always toward the sunshine – and shadows will fall behind you."
- Walt Whitman



"Good news. Your attitude check came back positive."

Autumn has arrived early this year in the San Francisco Bay Area. While October is known throughout most of the country for it's changing foliage and crisp air, here in the Bay Area, the months of September and October are synonymous with warm pleasant days that encompass the coastal region through the inland valleys. So far however, daily high temperatures have been coming in lower than average and "zut alors!" we've even received a couple days of light rain. Like it or not, I believe the weather has a meaningful psychological effect on many of us, which can contribute to our attitude, frame of mind, and how we approach situations. Beautiful sunny days lead many of us to focus on the possibilities, while cold dreary days may lead us toward excessive critical introspection.

October is also a popular month in which market bears as a group, become a bit bolder with warnings of imminent doom. In their corner, the pessimists have the memorable crashes of 1929 and 1987, while the optimists have - reality. According to a recent Wall Street Journal Money Beat column, "The downbeat outlook for the last three months of the year contrasts with what's typically a strong quarter for the market. Since 1945, the S&P 500 has risen, on average almost 4%, and it's up more than 70% of the time - S&P Global Market Intelligence."

Understandably there is a lot to be concerned about, whether one focuses on the uncertainty surrounding the U.S. Presidential elections, solvency issues related to Deutsche Bank, or the geopolitical mess in Syria. Investor risk appetite is low. This bias is illustrated through the AAII sentiment survey, which shows bullish market sentiment at 24% is well below the 38.5% historical average. Furthermore, the Wall Street Journal's Money Beat column goes on to say, "Citigroup Inc.'s institutional clients are holding a median of 7.5% of their assets in cash, according to the bank's quarterly survey of pension, mutual and hedge fund investors, matching the highest level in its seven year history."

Market bubbles seldom pop as large numbers of participants wait anxiously on the sidelines in anticipation. I would be more convinced of the bearish case if I sensed wide spread euphoria. But frankly, most of what I read and hear regarding market valuations is first, that aggregate stock prices are expensive based on high Price/Earnings multiples and second, that U.S. Treasury bond yields cannot possibly go any lower.

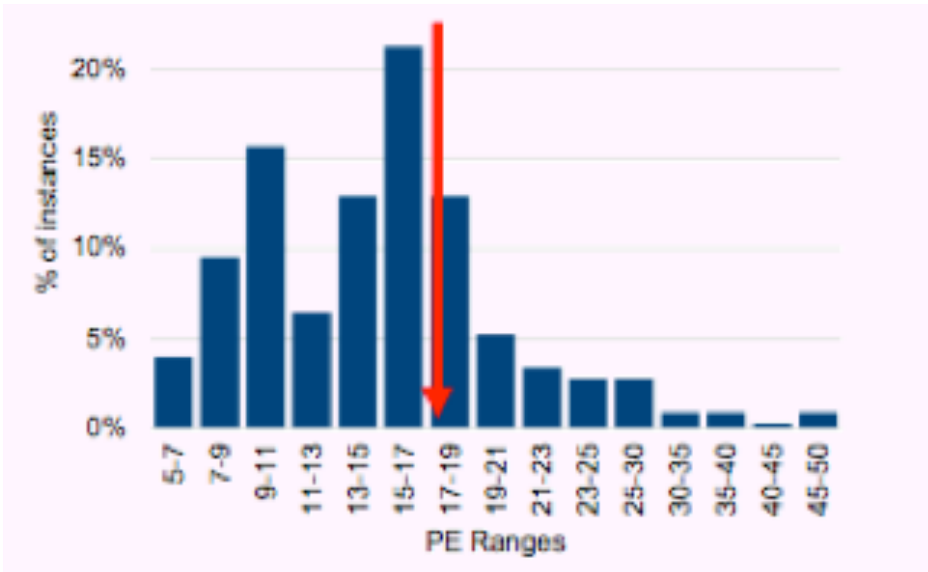
I will not pretend to know what market prices will do tomorrow, a month from now or over the coming years. However, I do believe that bond yields can stay low and probably go even lower, while earnings multiples could continue to expand. Inside a recent global macro strategy report – "Big Macro 04: Secular stagnation and equities: the new normal" the investment research team at UBS lays out the following points, which I have summarized below. For the most part their conclusions are consistent with how I am viewing the investment landscape.

- Corporate earnings growth has likely declined structurally due to slower trend nominal GDP growth.
- Equity valuations remain on the high side but are unlikely to decline. This is mostly due to a big decline in risk free yields (U.S. Treasuries).
- Low risk free yields and their impact on stocks (higher valuations) will likely persist.
- Overall, there is still value in stocks (particularly dividend stocks) relative to bonds, but the risk-reward has deteriorated.

Data sourced from The Wall Street Journal show the twelve-month forecasted Price/Earnings ratio on the S&P 500 index to be 18.5, while the historical average of the index dating back to the mid-1930's is 15.3, according to the Connected Wealth team at Richardson GMP. This may not be cheap but it is also not extremely expensive (see chart below). Furthermore, if we take into account repressively low global interest rates, I think it makes sense for markets to price in higher equity valuation multiples and in turn higher stock prices.

Lastly, I'd like to change gears and get away from what we cannot forecast – market prices, the future, etc., and instead focus on client risk and portfolio design. Out here in the San Francisco Bay Area, there are a large number of well-paid employees who are compensated through various deferred compensation schemes, usually in the form of corporate stock options or restricted stock. The risk inherent in a single stock position is very large and in many cases can be a signifint portion of one's assets. It is important to remember that deferred compensation in the form of company stock is just that, compensation and is not an investment.

Tax strategy aside, often the prudent thing to do is to diversify out of a portion of the concentrated risk and then reinvest the proceeds into a portfolio that takes into account the underlying risk factors of that single stock position. There's a saying on Wall Street that diversification is the only free lunch which exists. My message - take advantage of that free lunch and sleep better at night.



Source – Connected Wealth Richardson GMP/Bloomberg

Sincerely,

Justin Kobe, CFA
Founder & Portfolio Manager
