REGISTERED INVESTMENT ADVISER

Third Quarter 2013 *Key Takeaways*

The quarter ended with a surprising turn as the Federal Reserve's much-anticipated shift toward tapering its monthly bond buying failed to materialize at its September meeting. Shortly thereafter, monetary policy was upstaged by fiscal policy as Congress clashed over the budget and veered toward a government shutdown (which began just after the quarter ended).

Despite these twists and turns, stocks posted another strong quarter. Large-caps rose 5% and are now up 20% for the year. These gains have occurred even as the U.S. economic recovery remains only moderate and corporate earnings growth has slowed.

International markets improved in the third quarter following a rocky start to the year, particularly for emerging markets. Among emerging markets, China showed signs of stronger growth (albeit at a lower rate than in prior years) so this was an overall positive given the country's significance among emerging (and developed) market economies. Emerging markets as a group rose in aggregate for the quarter (despite losses for some countries) and developed international markets outperformed U.S. stocks by a wide margin.

Core bonds in aggregate were modestly positive for the quarter thanks in large part to a rebound in September as both the Fed's decision to stand pat and investor risk-aversion in the face of an impending budget stalemate (and looming debt-ceiling standoff) were favorable for bonds. Absolute-return-oriented and flexible bond funds collectively outpaced core bond funds during this changing fixed-income environment.

We continue to believe we are investing in a time of uncertainty, where an unusually broad range of outcomes remain possible. Building a sensible portfolio strategy in this environment is not just about having different pieces in place to ensure the portfolio can withstand different scenarios, it is also about understanding the risk and reward of each asset, the role of each asset in the portfolio, and how assets interact with each other.

An important part of our investment discipline is to protect client portfolios against risk scenarios we believe are plausible and not already adequately factored into asset prices. Taking this precaution means we will likely lag the broader stock market if these risk scenarios do not play out. However, the fear of leaving some money on the table over short periods is not sufficient cause to deviate from the investment discipline that has served our clients well over the long term.

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Third Quarter 2013 Investment Commentary

The word "fiduciary" is defined as "relating to, or involving one that holds something in trust for another." Another word that goes hand in hand with being a fiduciary for our clients is "prudence," which is defined as "careful management." In our industry, these words—fiduciary and prudence—are used liberally. We want to share what these words mean to us and how they influence our day-to-day management of client portfolios.

Our typical client in a balanced portfolio expects us to maximize long-term return without taking on substantial market risk. There's an inherent trade-off in this dual objective. Managing to a downside risk threshold sometimes means we have to be willing to leave some return on the table. We have always said we do not manage portfolios to one economic or asset-class scenario because we don't think we can know with confidence which scenario will play out. We hope optimistic scenarios play out, but do not build portfolios based on them unless we believe they are likely. Investing based on hope would not be in line with acting as a responsible fiduciary for our clients who have specifically entrusted us with the mandate to care about downside risk.

Managing portfolios to withstand various scenarios is as much art as science. In shielding our clients from one scenario, we expose them to others. The key is to strike a reasonable portfolio balance that allows us to meet our clients' risk and return objectives over the long term. Both inflation and deflation risks exist, and both are bad for risk assets. Our economy is still fighting significant deflationary headwinds due to ongoing private- and public-sector deleveraging. At the same time, the experimental monetary policy of keeping short-term interest rates near zero over extended periods could easily stoke inflation, and we don't know if and when that would occur. In this inflationary scenario our clients would expect us to protect their purchasing power. It would be nice if we had a crystal ball to know which outcome will occur and when, so we can position our clients' portfolios accordingly. But part of being intellectually honest is acknowledging that we do not have a crystal ball and there are many unknowns, especially now, when we are going through a major deleveraging episode and the range of possible outcomes is unusually wide. Our job becomes harder in a period when most assets appear to be richly valued. So, how do we balance out two extreme risks—inflation and deflation—given each scenario warrants a vastly different portfolio positioning?

To protect client portfolios from a recession or deflation outcome, we continue to recommend and hold positions in investment-grade or core bonds. In such an environment, interest rates would likely fall, and core bonds would increase in value as most risky assets are declining. Given their very low interest yield levels, core bonds would not give as much protection as they did in the past, but would still do a much better job of protecting capital than most other asset classes in this scenario.

That said, we acknowledge that relative to history, core bonds carry a significant opportunity cost. Despite a recent spike, interest rates remain very low by historical standards, which mean that expected returns from core bonds are extremely low. As a result, a significant amount of our bond recommendations have gone to absolute-return-oriented and flexible bond funds. Over 12 months, in a recession/deflation scenario, these bond funds are likely to lag core bond funds that have a longer duration and heavier emphasis on Treasury bonds. But over a five-year investment horizon, absolute-return-oriented and non-core bond funds are likely to generate significantly better returns. The value of these bond funds comes from their underlying managers' ability to add value by investing opportunistically across fixed-income sectors (without being constrained by the core benchmark) as well as from individual issue selection.

Over a 12-month period, we expect our absolute-return-oriented and non-core bond fund investments to have much less downside risk than stocks. Through a strong period for stocks, they have provided a reasonable return with much less risk. In addition, by having a lower allocation to stocks, we worry a bit less about capital preservation in a deflation/recession scenario and can afford to have less protection in the form of core bonds, which, in addition to having poor return prospects over our five-year investment horizon, expose us to the risk of rising interest rates.

Rational Reasons for a Bearish View on U.S. Stocks

Over the past two years or so, GAAP trailing 12-month earnings have gone nowhere but the market has continued its ascent, especially over the past year. The S&P 500 now trades at a price to earnings ratio (P/E) of 19 times trailing 12-month earnings. The price to earnings ratio of the market is a useful measure to observe because it illustrates what investors are willing to pay for one dollar of earnings and therefore indicates how overvalued or undervalued the market may be. Under normal market conditions, we consider a price to earnings ratio of 15-17 times earnings to be indicative of a fairly valued market. This is an average historical multiple excluding the market's frothiest periods and a prudent multiple in our view given the deleveraging headwinds that are still in place. If the S&P 500 were to trade at 15 times current trailing 12-month earnings, it would imply a price of around 1,350 on the S&P 500 index, i.e., a decline of roughly 20% from present levels.

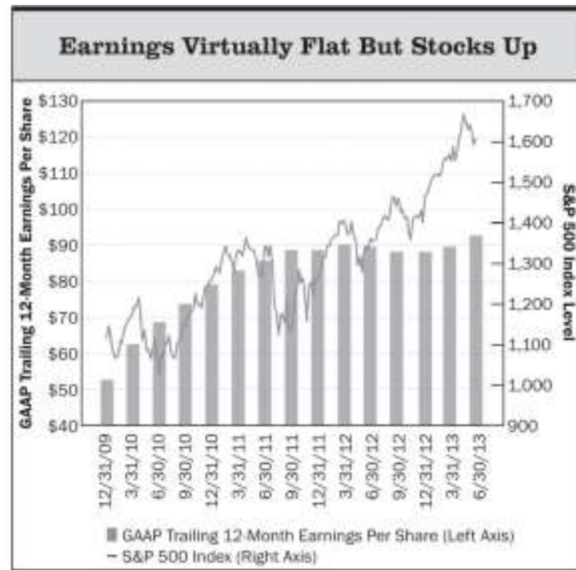

CHART 1 *Data as of 6/30/13 (estimated). Source: Standard & Poor's.*

On the other hand, given that most investors expect the Fed to keep short-term rates near zero until 2015 at least, P/E multiples of 18–20 times earnings are quite conceivable in this environment, and quite normal to most investors who in their professional lives have only experienced the post-1980s investing world. Applying those P/E multiples to our normalized earnings five years out, then adding a dividend yield of slightly over 2%, we get returns in the 6%–8% range—not bad at all considering that the expected returns of other asset classes we can invest in are generally lower.

Why Bother Investing Outside the United States?

This is a question we have been getting more frequently in recent times. We were getting similar questions back in the late 1990s after U.S. stocks experienced a great run of outperformance over international stocks. Developed international stocks subsequently went on to outperform U.S. stocks for six years, and emerging-markets stocks did even better. The most important reason for having a globally diversified strategic mix is that it should provide a much smoother ride than just being invested in U.S. stocks. The second reason to invest outside the United States is to tap into a broader investment opportunity set—much of which is not well-covered by Wall Street—allowing active managers to add significant value.

The case for having a dedicated long-term allocation to emerging markets is particularly compelling. On a purchasing-power-parity basis, emerging-markets' share of world GDP has grown from 37% in the late 1990s to nearly 50% as of 2012. Yet emerging markets still represent a much smaller share of global market value (on a market cap basis). The rapid pace of knowledge transfer from developing nations ultimately contributes to higher productivity, per-capita incomes, GDP, and profit growth in emerging economies. As this plays out emerging-market countries will see the gap narrow between their share of world GDP and market cap. We want our clients to participate in this long-term opportunity.

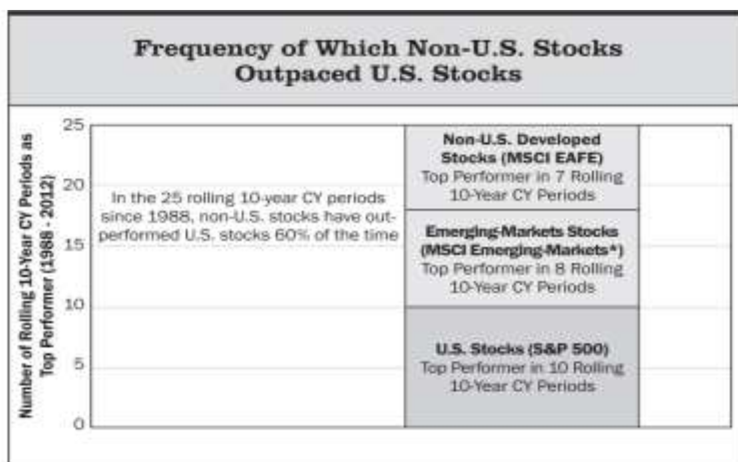

CHART 2 **MSCI Emerging-Markets Index's inception date is 12/31/87, first rolling 10-year period used in analysis is year-end 1997. Data: Rolling 10-Year CY Periods from 1988 to 2012. Source: Litman Gregory Analytics.*

Taking Stock of Emerging Markets

Emerging-markets stocks were hit especially hard this year after the Fed indicated its intent to taper QE, and over the last couple of years have underperformed U.S. stocks. For some of our clients, who are comfortable with the risks of investing in emerging-markets, we have taken advantage of the recent volatility to make an opportunistic investment. However, as we've reiterated along the way, the primary reason we have not made a recommendation for all of our clients to make a sizeable investment in emerging-markets is related to our ongoing concern about China's credit and infrastructure bubble. Also, as we have mentioned in the past, emerging-market stocks have many other risk factors, such as political risk and currency risk, which are not as prevalent in the developed world. Because of these risks we believe it is reasonable to expect that emerging markets stocks will continue to be more volatile than U.S. and European stocks.

Coming to emerging-markets local-currency bonds, they too suffered this spring and summer as emerging-markets currencies declined versus the U.S. dollar. Therefore, we believe it is important to review how we think about this allocation. Our time horizon for this type of investment has always been longer than the five years for typical stock and bond mutual funds. We see it as a good way to hedge a potential decline in the U.S. dollar/U.S. inflation. Insuring against this risk remains prudent in our view, given the Fed's unprecedented monetary policies in recent years that have bloated its balance sheet. In aggregate, long-term fundamentals—primarily balance sheets and growth prospects—for emerging markets are stronger than the United States. As such, in a normal scenario we believe we can get at least mid- to upper-single-digit returns over our investment horizon. These returns are better than what we expect from U.S. stocks in our likely subpar recovery scenario. Finally, to adequately factor in emerging-markets currencies' equity-like risk, which we clearly experienced this summer, we fund them mostly from U.S. stocks. Overall, looking out five years and longer, given the role they are playing in the portfolio and taking into account the risk from our allocation to emerging-markets stocks, we remain comfortable recommending that our clients hold their positions in emerging-markets bonds.

We believe the problems we've seen this year in emerging markets are only a blip on what we expect to be a very long-term, upward path. At the same time, we are cognizant of and continue to analyze risks to our emerging-markets investment thesis, but that does not negate the strategic case for owning emerging-markets stocks (and bonds) in client portfolios.

Parting Thoughts

An important part of our investment discipline is to protect client portfolios against downside risk scenarios we believe are plausible and not already adequately factored into asset prices. Taking this precaution means that at times investment performance is likely lag the broader stock market if a more optimistic scenario plays out. However, the fear of leaving some money on the table over short periods is not sufficient cause to deviate from the investment discipline that has served our clients well over the long term.

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