

Market Review

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. 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. See the chart below for a summary of the various indices and their returns over multiple periods.

Index Returns

Through 9/30/2013

Index	QTD	YTD	Annualized Returns		
			1-Year	3-Year	5-Year
S&P 500	5.25%	19.79%	19.34%	16.27%	10.02%
Russell 2000	10.21%	27.69%	30.06%	18.29%	11.15%
MSCI EAFE	11.56%	16.14%	23.77%	8.47%	6.35%
MSCI All Country World Index	7.90%	14.43%	17.73%	10.21%	7.71%
MSCI Emerging Markets Index	5.77%	-4.53%	0.98%	-0.33%	7.22%
Barclay Capital US Aggregate Bond	0.57%	-1.89%	-1.68%	2.86%	5.41%
Barclay Capital Municipals	-0.19%	-2.87%	-2.22%	3.24%	5.98%
Dow Jones UBS Commodity	2.13%	-8.56%	-14.35%	-3.16%	-5.29%
HFRI Fund of Funds Composite Index	1.74%	5.19%	6.58%	2.50%	1.95%

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.

We view U.S. stocks as slightly overvalued and are maintaining our small tactical underweight across our portfolios. The case for investing outside the United States, particularly in emerging markets, continues to look compelling, though near-term economic risks in China have waned on performance and kept us from increasing our exposure to emerging-markets stocks and bonds.

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.

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 expects us to maximize long-term return while protecting the downside in any normal 12-month period. 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 our 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 our portfolios from a recession or deflation outcome, we continue to have a decent allocation 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. We cannot ignore this outcome as it is a possibility creating real risk. Given their very low 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

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mean that expected returns from core bonds are extremely low for the foreseeable future. As a result, some of our bond allocation has been complemented by absolute-return-oriented and flexible bond funds.

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 longer 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.

Rational Reasons for Not Over-Weighting U.S. Stocks

We are maintaining our slight underweight to U.S. stocks across our portfolios. 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 19x trailing 12-month earnings. Most prudent investment managers assume a 15x multiple on normalized earnings five years out. This is an average historical multiple excluding the market's frothiest periods and a prudent multiple in our view given the deleveraging headwinds are still in place. If the S&P 500 were to trade at 15x 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. This would bring U.S. stocks within fair-value range and roughly the level where we'd consider raising our exposure to U.S. stocks to our strategic level.

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 18x–20x are quite conceivable in this environment, and quite normal to most investors who in their professional lives have only experienced the post-1980's 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. This is one reason we are not more underweighted to U.S. stocks. On the other hand, if stocks continue to rise to the point where U.S. stocks start looking unattractive, even given these optimistic valuation multiples, we would likely lighten-up further.

Why Bother Investing Outside the United States?

This is a more recent question and one that was posed in the late 1990's 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. It is important to revisit why we have investments outside the United States as part of our "strategic" allocations. The strategic allocations are the starting point for our investment process.

They are intended to be an appropriate, fixed-asset allocation for a long-term investor, as they reflect a weighted mix of asset classes we believe offer the best long-term-return potential for a given risk threshold, which we define as a maximum acceptable loss over a 12-month normal worst-case period. Our investment horizon in regard to strategic allocations is 5 years or longer. 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.

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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 1990's 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.

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. During this time we have taken advantage of price weakness in emerging-markets stocks by moving toward our strategic weighting at a gradual, measured pace. The primary reason we have not increased our weighting further is our concern related to China's credit and infrastructure bubble.

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, which we have through PIMCO's Emerging Local Bond fund. 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 have thus far been comfortable holding a low single digit percentage-point allocation in emerging-markets local-currency sovereign bonds across our portfolios.

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 we will 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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