Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger, CFA

The S&P 500 rose 6.4% during the quarter, bringing the year-to-date return to 16.5%. Aggressive actions by the Federal Reserve and the European Central Bank have assured markets for the time being and put a damper on market volatility. While red flags have occasionally flared up for the domestic economic recovery, the U.S. keeps chugging along at a slow but positive pace. In Europe the situation remains precarious and there has yet to be an inspiring solution. China has also given investors reason for concern as the country's leaders try to deal with a credit bubble and rising social unrest. Yet for the time being, markets have remained relatively calm. In the bond market, reasonably steady interest rates and low yields led to a return of 0.6% in the quarter, bringing the year-to-date gain to 1.65%.

There are bright spots in the U.S. economy, including a budding housing recovery, persistently low natural gas prices, and an accommodative Federal Reserve. Of course there are also risks, most notably the rapidly approaching "fiscal cliff." As always, we remind our clients that we have no crystal ball. We keep in mind John Kenneth Galbraith's warning – "We have two classes of forecasters: Those who don't know, and those who don't know they don't know." Instead, we do our best to build a robust, all-weather portfolio, understand what is happening real-time in markets and take action only when we are confident it will improve risk-adjusted returns (i.e. improve returns without increasing risk or reduce risk without decreasing returns). Such action is typically predicated on one of the following:

- Recognizing asset classes that are much more expensive or cheap than other asset classes on a risk-adjusted basis (this typically occurs during periods of extreme fear or greed, e.g. dot-com stocks in the late 1990s, real estate in 2005-06, risky assets in March of 2009).
- Finding stocks or other investments that are fundamentally mispriced for an identifiable reason unrelated to value.
- Working with external investment managers who have an edge in a relatively inefficient area of the market that is not easily replicated (e.g. arbitrage, distressed debt).

The current investment environment is tough. The Federal Reserve has anchored interest rate expectations at 0% through at least 2015, which has pulled down the prospective returns on other investment classes. Bernanke et al. are purposely trying to use interest rates to drive up stocks prices in order to create a "wealth effect" – i.e. people may react to higher 401(k) values by spending more money and thereby spurring the economy. But higher stock prices *now* shift future returns to the present, making *subsequent* returns more difficult to generate. Economist John Hussman explains:

> The higher the price you pay for a given set of expected future cash flows, the lower your prospective future rate of return. Higher prices essentially take from future prospective returns and add to past returns. Conversely, lower prices take from past returns and add to future prospective returns…An increase in price alters the profile of investment returns by turning prospective future returns into past returns (and vice versa when prices fall).[1]

[1] *Eating the Future*, John Hussman, September 24, 2012.

So while we no doubt enjoy the double-digit returns generated in the stock market year-to-date, it makes it more challenging to generate high returns going forward. Low interest rates on government bonds, a result of heavy Fed action, have driven down the potential returns in other asset classes – see the table presented at the bottom of the page for an illustration (note that given different measurement time periods, the size of current deviations relative to historical levels will differ by asset class).[2]

These figures are not predictions of future returns. While they should have a relation to potential returns, there are a number of other factors that will affect actual experience. However, the data does broadly suggest that it is a tough time for investors to generate yield, whether via high-quality bonds, low-quality bonds or even real estate.

The table lists two figures for the earnings yield on U.S. stocks.[3] The first metric, the adjusted earnings yield, normalizes profit margins for U.S. companies to average historical levels while the second metric, the current earnings yield, simply uses current profit margins. Because current profit margins are elevated relative to historical levels, the two measures have diverged. There is a debate in value investing circles about whether current margins are sustainable or not. If current margins are sustainable, then stocks still look relatively attractive; if they revert to historical means, stocks, like other asset classes, look expensive relative to historical levels. In any case, we don't think there is enough justification to make an aggressive change in portfolio allocations. However, investors should be aware of the difficulty of generating high rates of return even in riskier assets such as U.S. stocks.

One area that does screen attractively on measures of valuation is international stocks. Stock markets in Europe and China appear cheaply priced with high dividend yields. While we have maintained our core allocation to international markets amid financial worries, we have not increased our exposure at this point. For the time being, we don't have enough confidence that political leaders in the respective regions will be able or willing to do what it takes to contain potential crises.

Our commitments to U.S. homebuilding and banking have had a strong year. The two industry indexes that broadly track these sectors are up 45% and 25% YTD respectively.[4] We believe our investments in these industries still have room to run, but we aren't actively adding to positions given the rise in prices. We are working hard to find our next mispriced investment opportunity. We've built some exposure in commercial trucking supply and insurance, but nothing we consider material at this time. We will keep you updated.

Our cash balances have been slightly above-average given the expensiveness of many asset classes. To date, this has mostly come from our bond portfolios, but the recent rise in stock prices gives us a little caution there as well. Holding cash is difficult and potentially costly – it generates no returns and doesn't keep up with inflation. It does, however, give the investor potentially valuable "dry powder" – the ability to purchase attractively priced investments when markets fall. Since it is so hard to forecast markets, we are rather averse to holding too much cash. But if we begin to fail to find bottom-up investment opportunities that we feel comfortable with, our cash balances may increase until the situation reverses.

As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger, CFA

Asset	**Metric**	**Data Since**	**Median**	**Bottom Quartile**	**Current**
10-year U.S. Treasury Bonds	Yield to Maturity	1881	3.9%	3.4%	1.7%
Aaa Corporate Bonds	Yield to Maturity	1919	5.2%	3.8%	3.5%
Baa Corporate Bonds	Yield to Maturity	1919	6.6%	4.9%	4.9%
Real Estate Investment Trusts (REITs)	Dividend Yield	1971	7.4%	6.1%	3.4%
High Yield Bonds	Yield to Worst	1987	10.3%	8.6%	6.7%
U.S. Stocks	Adjusted Earnings Yield	1881	6.3%	5.0%	4.6%
U.S. Stocks	Current Earnings Yield	1881	6.7%	5.6%	6.2%

[2] Sources: Federal Reserve, NAREIT, Bloomberg, Robert Shiller.
[3] The earnings yield measures the amount of profit generated by companies divided by their market price.
[4] SPDR S&P Homebuilders (XHB) and iShares Dow Jones US Financial Services (IYG).