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The stock market continued to show momentum in the 3rd quarter, with the S&P 500 up 5.3%, bringing the year-to-date tally to 19.8%.[1] Domestic stocks finished the period just below their all-time highs and up over 170% from their 2009 lows. Stocks in international developed economies had an even better quarter, up 11.7%, though their year-to-date returns of 16.8% are a bit below U.S. stock returns.[2] International emerging markets have had a tougher go, however, with returns of 5.9% in the quarter but -4.2% year-to-date.[3] Emerging market currencies have weakened relative to the dollar and select markets, including India, Brazil and China, have been wrestling with economic pressures. Bonds posted a return of 0.4% in the quarter and -0.8% year-to-date, reflecting low current interest rates and upward pressure on those rates over the past few months (as interest rates rise, bond prices fall, and vice versa).[4]

As this newsletter was going to press, the U.S. government was in the throes of a government shutdown, the first since 1996. Perhaps in anticipation of probable chaos on Capitol Hill, and definitely because of the stubbornly slow pace of the economic recovery, the Federal Reserve announced in September that they would continue their õeasy money policies,ö which came as unexpected news to some market participants. Stocks rallied on the belief that the Fed will continue pumping money into the economic machine. What is clear is that the certainty business leaders desire ó on public policy, monetary policy, economic growth, etc. ó will continue to be elusive and that the economic recovery, while still moving forward, will probably remain lackluster.

We donøt know what the endgame will be for the government shutdown, the even more dangerous debt ceiling debate or the eventual unwinding of the Federal Reserveøs balance sheet. It would not be a surprise to see volatility in financial markets as investors try to grapple with the economic implications of these events. But investors should also remember that (a) no one possesses a sustainable edge trying to predict such events and in-turn profit from them and (b) financial markets are forward-looking, meaning that if the majority of investors expect an event to happen, it will *already* be priced into markets. This doesnøt mean that everything is priced into markets, only that investors should be cognizant of the difficulty in trying to outsmart the crowd. Only when investors have superior insights driven by in-depth research and the conviction to act independently from the crowd can superior returns be generated at modest levels of risk. It is incredibly difficult to base stock investments on something as complex as political wrangling. It would seem reasonable to predict that a government shutdown would wreak havoc on the market, yet stocks were generally strong in September and were actually up the morning after the shutdown became official.

[1] As measured by the S&P 500.
[2] As measured by the MSCI EAFE index.
[3] As measured by the MSCI Emerging Markets index.
[4] As measured by the Citigroup 1-10 year Treasury index.

As we often repeat, our focus is on finding individual investments that we believe have a high probability of generating strong *long-term* returns and a low probability of poor returns, no matter the ultimate economic environment. But as interest rates have remained low and stock prices have risen to new highs, itøs been õslim-pickinsö of late.

Consider a portfolio invested 50% in bonds and 50% in stocks. That portfolio has two sources of õearningsö ó the bonds pay coupons to the investor and the stocks generate profits. The current interest rate, or yield, on the bonds equals the value of the annual coupon payments divided by the price of the bond (assuming the bond is priced at par).

Likewise, we can calculate an earnings yield on the stocks by comparing the amount of profit generated by the company to its current stock price.[5] In the case of a bond, the entire coupon is sent to the investor as an interest payment. In the case of a stock, some of the profits are paid out to the investor as a dividend while the rest is retained and reinvested by the company. Nonetheless, all of these profits ultimately belong to the stockholder. For example, if a corporation earns $8 per share and you can buy the companyøs stock for $100, the earnings yield will be $8 / $100 = 8%.

Accordingly, we can examine the total earnings yield of the portfolio, which equals 50% times the current interest rate on bonds plus 50% times the earnings yield on stocks. We carry out this exercise for the last seven and a half decades below, taking the average portfolio earnings yield over the relevant period (see the figure below).

Column D, the Average Portfolio Yield, represents the yield on the typical investment portfolio during that decade. Based on this measure, the current portfolio yield of 4.1% is quite a bit below the average since 1940 of 6.8%.

However, what investors should really care about are yields *after* accounting for inflation. The real yield consists of the portfolio yield less the current rate of inflation. It is much better to earn 5% in interest when inflation is at 2% (5% - 2% = 3% real rate of return) then it is to earn 10% in interest when inflation is at 12% (10% - 12% = -2% real rate of return). On this measure (column F), the current real portfolio yield of 2.5% is still below the average since 1940 of 3.1%, but the gap is not as wide.

(Please note that the current Real Portfolio Yield of 2.5% is not a forecast of real returns going forward. It is simply a measure of the current yield that an

[A] Time Period	[B] Average Rate on 10-Year U.S. Treasury	[C] Average Earnings Yield on S&P 500	[D] = Avg[B,C] Average Portfolio Yield	[E] Average Rate of Inflation	[F] = [D] - [E] Average *Real* Portfolio Yield
1940-1950	2.3%	13.6%	7.9%	5.7%	2.3%
1950-1960	3.0%	9.8%	6.4%	2.1%	4.3%
1960-1970	4.7%	5.9%	5.3%	2.5%	2.8%
1970-1980	7.5%	9.3%	8.4%	6.5%	1.9%
1980-1990	10.6%	10.5%	10.5%	6.1%	4.5%
1990-2000	6.7%	5.5%	6.1%	3.2%	2.9%
2000-2010	4.5%	5.7%	5.1%	2.2%	2.9%
2010-2013	2.5%	6.6%	4.6%	1.6%	3.0%
Average	*5.2%*	*8.4%*	*6.8%*	*3.7%*	*3.1%*
Current	*2.7%*	*5.6%*	*4.1%*	*1.6%*	*2.5%*

[5] All on a õper-shareö basis.

investor can generate. Future returns will be driven by additional variables, such as the rate of inflation, earnings growth, changes in interest rates, etc.)

In our estimations, stock and bond markets are somewhat expensive, but given slow economic growth and low inflation, they donøt yet appear to be *too* expensive. This would change if inflation rates were to increase substantially. If inflation increases to 4-5%, both stock and bond prices would need to fall in order to offer higher *real* yields to investors (i.e. yields after taking the rate of inflation into account).

That being said, we continue to believe that higher inflation is a low probability *near-term*. Yes, the Federal Reserve has õprintedö a lot of money. But that money has not found its way into the economic system. Individuals, corporations and banks are carrying much more cash now than they did several years ago and the rate of monetary velocity ó i.e. how fast cash cycles through the economy ó has -slowed considerably since the great recession of 2007-09. Consider that in 2007, banks held just $1.8 billion above the minimum reserve levels required by the Federal Reserve, versus $2.2 trillion today![6]

Accordingly, we are holding the line and remain committed to our core stock and bond investments. Though stocks and bonds arenøt cheap, we are happy to hold onto our current investments. Meanwhile, we are actively hitting the pavement for attractive stocks to buy and remain conservative in our bond purchases. Our recent *Notes from the Road* chronicled some of our recent stock research. Unfortunately, there arenøt too many õfat pitchesö in the market, but weøll keep our collective nose to the grindstone.

Please contact us if you have any questions. As always, we thank you for your continued confidence.

Sincerely,

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[6] *Grant's Interest Rate Observer*, 9-20-13.