



February, 2013

Dear Clients,

It has been some time now since I last wrote to you about the investment markets, the issues facing us as investors and the contributing factors to our financial well-being. This failing on my part will be rectified going forward. I hope that these and future writings will provide either a fresh perspective on events affecting your financial well being or offer ideas or strategies to specifically address financial goals you may have.

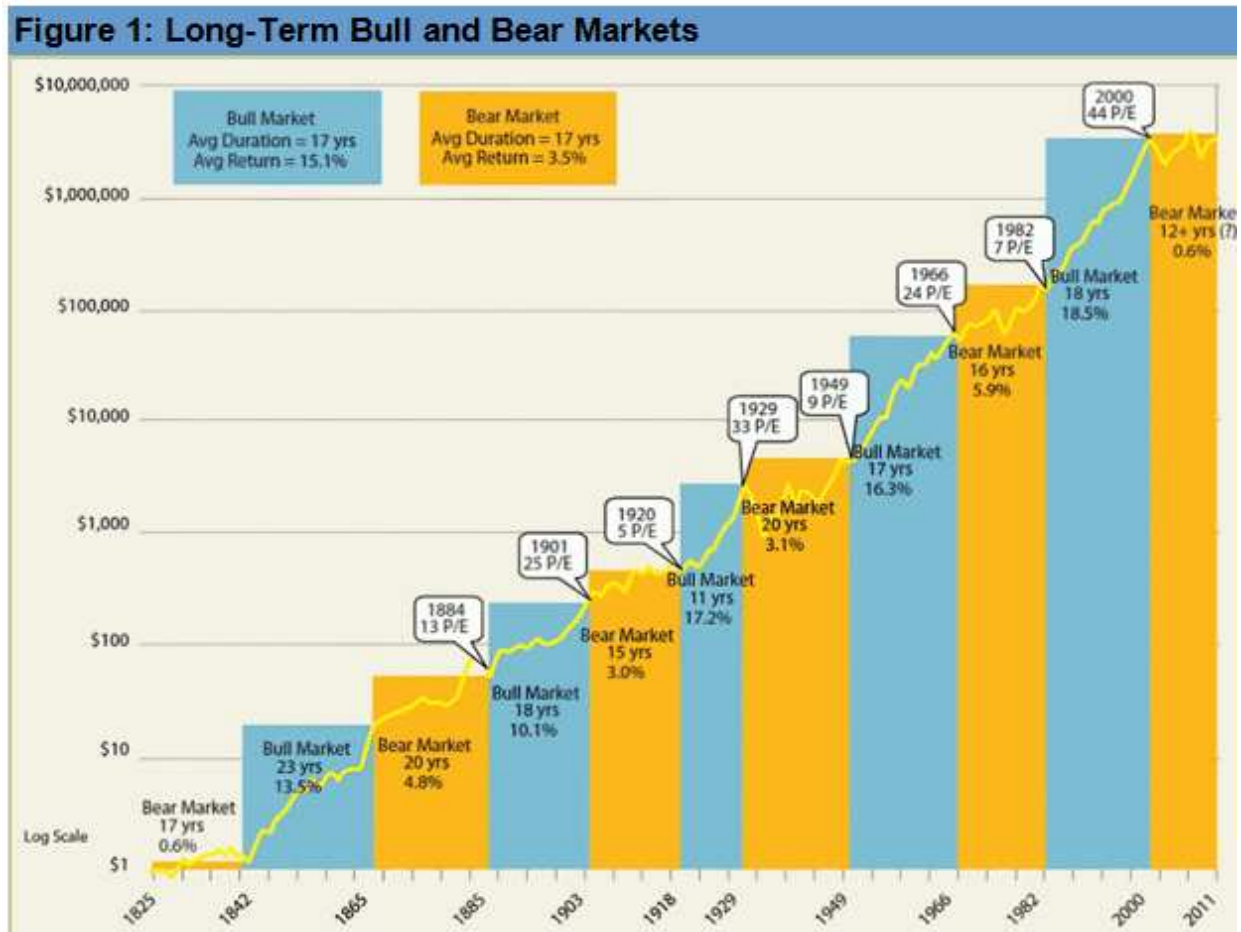
The last dozen years has been a particularly frustrating period for all of us. We have been rocked by several investment bubbles, terrorist attacks, unprecedented corporate fraud, the buildup of massive amounts of government debt and the near collapse of the global banking system. To think we began the new millennium with such high promise for the future: Technology was rapidly transforming the mundane tasks of life; housing values were growing by double digit each year; unemployment was lowering to levels not seen in decades. This last decade, more people around the world were lifted out of poverty than at any time in history in both absolute and percentage terms. We marveled at China. Who could not be impressed by the building of the equivalent of New York City every year. So what happened?

The Technology and Housing Bubbles, the Corporate Reporting Scandals of 2002, the Sub-Prime Mortgage Fiasco, the buildup of Government Debt and the near collapse of the Global Banking System are all systematic of a much simpler and perhaps more mundane reality. All were expressions of a consistent theme in investing. The price of investments exceeded the reasonable value that these investments were worth. In each of these examples, they were the result of unsupportable efforts to justify really expensive investments. The collapse of one drew us to another. All fueled by really cheap money. And we in the investment business, trained in the unstoppable progress of modern society, are agents for this. Not, (and I can't say this loud enough or with more emphasis) with any malice or malfeasance in mind. We are optimists. We have an unbending belief in all of our efforts to improve our lives. The fact is, sometimes the investment market just doesn't really grow very much. Investments just get too expensive. In addition, it usually occurs when things seem to be going really well. Almost too well. Still we ask; How could my investments do so poorly, when so many things seemed so right with the economy.

A few years ago, one of my clients brought to my attention a study he had come across which endeavored to explain market performance over a long period of time. In this instance, the researcher had studied the performance of the S&P 500 over a period of time from 1890 to 2009. (As many of you already know S&P 500 is the 500 largest corporations in the United States by market valuation.) The names of the companies will change over time as the economy evolves, but the largest 500 is still the largest 500. This study was both highly technical and not really understood. In any format that would be easily presented. This said I considered the insights to be profound in its simplicity.

What this study determined is if the P/E ratio for the S&P 500 is greater than 23x earnings, then the succeeding performance of your investments will be very poor. Frequently with negative returns over the next 10 years. If the P/E ratio is 13x earnings or less, then the succeeding period's returns are very good, frequently greater than 10%. The attaining of a 23x earnings valuation does not mean that things will suddenly turn for the worse. Nor does a valuation of 13x earnings or less mean that it can't go lower. There are many factors that can contribute to market performance that defies history. Alan Greenspan uttered his famous "Irrational Exuberance" comment in 1996 and the market continued to grow for almost another 5 years.

Recently, I saw a version of this same study going back to 1826. What has compelled me to distribute this to you is the simplicity and clarity of the presentation. The graph is easy to understand and decipher. What are more challenging are the factors that contribute to both the growth of any one market and the fall of any other market. I've attached a PDF of the entire article for those who would like to read it.



Beginning in 2000, the S&P500 traded at a PE Ratio of 44x earnings. The most expensive market in the history of investing. The reasons may be unique as to why, but the result was the same: The market ultimately had only one realistic place to go: Down. These things are never so clean and clear. There are competing forces, which will try to fight this. Government policy, creative finance or compelling sales pitches telling us "this time it's different", all play a part in mudding the water. The simple fact is that at some point in time the investing public will look at a stock or group of stocks and conclude that they are too expensive. At other times, the opposite will take place and the conclusion will be that collectively things are very cheap. There is usually some catalyst. This could be a political event, business surprise (which is frequently a significant miss in earnings or sales), military crisis, or a change in monetary policy. However it may initiate, the changes can be profound and last years. The difficulty is in determining when a notable event is taking place from a minor event that has less of a profound impact.

By way of example let me reference 9/11 and the reporting scandal of 2002 (ENRON). First 9/11 was an incredible tragedy. However, at the time I considered it a minor economic event. From an investment perspective, its impact on portfolios was temporary. By January of 2002, the effects were out of the market and all portfolios had fully recovered. There are very many who would take exception to this and argue about disruptive actions around security, political and military action, the Middle East and forced regime change in Iraq & Afghanistan. And they would be right. However, for me from an investment perspective, the reporting scandal of 2002 was far more disruptive. For me it said that corruption, corporate valuations and shoddy governance were wide spread. Simply you and I could not trust the numbers. It took out one of the largest accounting firms in the world, Arthur Anderson, not to mention ENRON, WorldCom and others. My advice at the time was to underweight the US. Over the ensuing next few years, my catch comment was "I can't make sense of the numbers". However, the study will point to the bursting of the Tech Bubble as the beginning of a too long decade of investment volatility and loss. The fact is the market was way too expensive. It was the most expensive market in the history of the S&P 500.

In technical terms, what we are experiencing is a reversion to the mean or Mean Reversion. Simply put this is a theory suggesting that prices and returns eventually move back towards the mean or average. This mean or average can be the historical average of the price or return of the stock market, the economy or growth of the economy. It holds that any and all of these things have a natural pace of change along an average and any deviation from this pace of change will result in a correction to the mean. These corrections can be both positive and negative. Positive changes typically are more gradual. Conversely, negative change is usually more disruptive.

All changes or reversions to the mean have some catalyst. While there are many theories for what was the tech bubble trigger, it may be nothing more than the unhappy marriage of the greater fool theory and insatiable greed. I think it was symptomatic of a larger mispricing of our lifestyle, but that is both far more complex and contentious than the scope of this letter. Suffice to say this multi-year readjustment of pricing is coming to an end.

As always thank you for your business and the trust you place in the quality of my advice.

Sincerely, Kevin