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SIGNATUREFD

MARKET SENSE:
A Mixed Start to 2013

MARKET REVIEW

The first quarter of 2013 got off to a mixed start, with U.S. markets ending at record highs and all major domestic indexes eclipsing their 2007 peaks. The positive U.S. story is a bit of an anomaly, however, with only Greece, Japan, the Philippines and Indonesia exceeding U.S. returns. In fact, equity markets in the eurozone and emerging markets actually registered losses for the quarter. When digging into the U.S. markets and analyzing holdings by sector, the story is also mixed. While defensive consumer names and health care registered double-digit gains, more cyclical sectors like basic materials and energy were essentially flat for the quarter. These general trends, though they did reverse for a few months late last year, have been ongoing since 2011.

Across bond indexes, the news was also mixed. The key Barclays U.S. Aggregate Bond Index was down slightly during the first quarter. This is the first loss in the opening quarter of a year since 2006. Across real asset sectors, real estate and infrastructure assets did have modest gains while commodity indexes posted losses for the quarter.

We are seeing opportunities open up across many of the forgotten parts of the market, especially outside the U.S. It is true that momentum is helping push the markets along and investors seem to be pushing money toward ABB (anything but bonds). Specifically, the equity sectors of the market that look the most like bonds—especially low-volatility, dividend-paying, defensive companies—seem to be attracting investor interest as the risks in bond market continue to grow. Strategas, one of our top research providers, uses the term TINA (there is no alternative) to describe the U.S. equity market. While we continue to hold healthy stakes in large, high-quality U.S. equity positions, any time a market moves for reasons other than underlying fundamentals we become concerned and begin looking for other opportunities.

LOOKING AHEAD

A major theme of market commentators this quarter was the “great rotation” from bonds to equities. It is important to dig into these news stories to see if they are truthful or just driven by sound bites. In the case of a major shift from bonds to equities, we can only say that the stories are, at best, partially true. The market is certainly moved by supply and demand for equities, but the reality of that story is more complex than it appears on TV. For example, the market has risen by more than 130% since March 2009, even while individual investors have reduced their equity holdings by almost $200 billion. How can the market rise by this much if individual investors have on net been removing money? The buyers with the greatest impact in the market have actually been companies

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themselves, which have bought back more than $1 trillion of their own equities over the same time period. In reality, fundamental investors haven't pushed the market higher, but rather company CFOs have been able to issue debt cheaply for four years and are doing so to buy back their own stock. Though this may make sense from a financial engineering perspective, it doesn't necessarily indicate future market gains.

To assess current opportunities, we would rather look to more durable metrics like valuation. U.S. stocks don't appear expensive based on their current record-high profit and cash flow margins, but we know these indicators can be cyclical and tend to be mean-reverting. Current profit margins are near record highs and are at levels about 50% above long-term norms. We much prefer looking at normalized earnings that take into account likely profits over a full cycle.

The Leuthold Group, one of our research providers, wrote extensively about this in a recent piece and concluded that "The longest-dated and most reliable of our U.S. stock market valuation measures generally find stocks trading at historical percentile readings of 75–80%." This means that stocks are trading at valuations higher than three-quarters of their history. In a recent blog post[1], we analyzed U.S. equity valuations in some detail and concluded that returns over the next five to seven years could be in the 4% range. Compared to extremely low interest rates, returns of this nature are not historically abnormal, but they will be disappointing to most investors buying in at today's levels.

Even with U.S. stocks trading at normalized price-to-earnings ratios greater than 20, we find that opportunities can still be found in the U.S. But even better opportunities seem to be hiding elsewhere. The normalized price-to-earnings ratio outside the U.S. is now approximately 13.5, and many of these markets are trading at extreme discounts to the U.S.

If you have followed our thinking over the last few years you will know that we believe that the three major economic regions of the world—the U.S., Europe and China—are all going through major transitions. In each of these economies, there will be periods of improvement followed by setbacks. Currently, the U.S. economy seems to be drawing the most attention, but this could be temporary. We are finding some of the most unique opportunities in Europe and certain emerging markets. While Europe is not out of the woods (we are paying especially close attention to economic trends in France), the combination of depressed values and structural reform leads us to conclude that patient investors could see stocks there outperform comparable U.S. options.

WE ARE CONTINUING TO SHIFT OUT OF U.S. EQUITIES AND TOWARD INTERNATIONAL MARKETS.

PORTFOLIO SHIFTS

In response to our views for global investment opportunities, we are making the following portfolio changes in April:

- At the macro level, we continue to move assets away from traditional fixed-income strategies and toward growth-focused managers. Portfolios are now 5–10% overweight equities. Across most of our strategies, however, the expected total risk of the equity positions is moderately less than the broad equity index.
- Within the traditional equity markets, we are continuing to shift out of U.S. equities and toward international markets. Earlier, we discussed the valuation advantages in the non-U.S. markets. Though we can't guarantee that in the near-term the U.S. market won't continue to outperform, we are confident this will be a rewarding shift over time. The additional international investments are focused on Europe, certain emerging markets (generally commodity users vs. producers) and frontier markets. Frontier markets are generally the next set of developing economies, especially countries in Africa and smaller economies in Southeast Asia.
- In the other portions of our growth allocations we have removed a majority of our positions from direct energy investments and allocated these to more value-oriented real asset investments. We are also initiating positions in two new strategies: an aggressive credit strategy and managed futures. Both of these are designed to reduce directional equity exposure and increase diversification.
- Finally, within the capital preservation allocation, we are making modest changes, with the majority of reduction coming from traditional/core fixed-income strategies.

These portfolio shifts will happen this month. We welcome questions you have about them. Additional moves in a similar direction could occur during the second half of this year. Most notably, we have had significant overweight to U.S. stocks compared to global indexes in recent years, but a migration back toward a more neutral weight seems likely.

We appreciate the confidence you place in our firm and look forward to our future communications with you. In our weekly "News or Noise" blog posts, we share our thoughts on the investment landscape on a more real-time basis. If you don't already receive "News or Noise" in your email inbox, you can subscribe by visiting www.signaturefd.com/blog and clicking the "Subscribe by Email" button (select the "Asset Management" category). If you would like to receive a hard copy of our weekly blog posts, please let us know.

RESOURCES

1 News or Noise, "Investor Confidence Drives the Market." http://www.signaturefd.com/2013/03/18/news-or-noise-investor-confidence-drives-the-market. March 18, 2013.