The Long & Short of It
Quarterly Newsletter
Third Quarter 2013

Finding Certainty in Uncertainty
Today's combination of aging demographics and excessive debt levels force the government to take a heavy hand to the economy. For investors there is no rising tide of wealth creation. Reasonable yields from traditionally safe investments are scarce. This is an environment that benefits those nimble investors who can profit from the noise—the back and forth—in the market.

While individual stocks and bonds comprise the majority of our holdings, we recognize that Exchange Traded Funds (ETFs) offer the ability to adjust exposures to equities, bonds, gold miners, and cash efficiently and at low cost. In this post-crash, government-managed economy, active tactical asset allocation is more important than ever. So, whether the opportunities are addressed at the asset class level through ETFs, or at the industry and security level through individual stocks and bonds, the environment dictates that our strategies take advantage of the short-to-intermediate term shifts in uncertainty and/or liquidity. Non-random, cadenced events like seasonal weather changes, reporting periods, and certain political and business-related events often drive recurring activities of consumers, business managers, government, and even investors. Frequently, these create temporary pricing inefficiencies, i.e. opportunities for our clients' portfolios.

Government Kicks the Tired, Confused Horse… Again, and On Schedule
ZIRP (zero interest rate policy) and QE3 (quantitative easing, round 3) are the descriptions of the ongoing efforts by the Federal Reserve Bank to stimulate economic activity and investor risk taking. With $85 billion of purchases in fixed income instruments each month, the Fed uses ZIRP-Plus to offer hope to those investors who understand that the economy would be operating at significantly lower levels if not for government intervention. Slow growth due to a toxic blend of aging demographics, excessive debt, loss of trust in government and business, regulatory excess, and policy uncertainty keeps our economy stuck in quicksand. In 2009, PIMCO dubbed this blend "The New Normal" to describe a vision of persistently slow economic growth, elevated unemployment, high levels of geopolitical tension with social inequality and strife. The Fed's historic mandate is to balance inflation with unemployment. Currently both rates fall short of their targets. The economy is nowhere near what could be called "escape velocity" and unlikely to see it soon.

Without a rising tide of real wealth creation, investors begin to chase yields. With investment yields so low only a pauper could live on them, investors are compelled to take more risk. Again, through ZIRP-Plus, the Fed encourages risk-taking behavior. Investors who prefer short maturity bonds are tempted to lengthen maturities; those who prefer treasury bonds pursue corporate bonds; those in investment grade corporates dip their toes into junk bonds. Similarly, investors in large company stocks drift toward small caps and international stocks; and even shareholders of high quality companies find themselves under pressure to buy stock in companies with highly leveraged balance sheets. Still other investors pursue private equity opportunities which are frequently untested and painfully illiquid. At this point in the business cycle, there is not much blood left to be squeezed out of the investment opportunity turnip. Lemmings flood Wall Street.

As we all know, one day the music will stop. Credit will contract or an exogenous event will scare. Stocks will fall significantly (sneeze). International, small cap and highly leveraged holdings will drop much more significantly (catch a cold). Decisions will be made by investors and trustees to "get out of those crazy things" –small caps, internationals, private equity-- at the worst possible moment locking in irreversible losses.

No Rising Tide to Lift All Boats
So, economic growth will remain anemic, primarily supported by governmental provision of liquidity and debt issuance. If the government were to behave as everyone liked, providing policy perfection and policy certainty (an obvious impossibility), the economy would still not produce significant, sustainable growth simply because of our country's debt and aging demographics. The large growth rates of the 70's – 90's are a relic of the Baby Boom. Boomers created the tailwind then. It appears that the current headwind could last another ten to fifteen years.

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While the economy's performance was better-than-sustainable in the last one-third of the 1900's as Boomers entered the work force and Keynesian debt was issued at every economic slowing to "stabilize the cycle"; governments did not follow John Maynard Keynes' admonition to run a surplus during good times. Today, after fifty years of excessive debt issuance, the federal government's ability to issue debt is slowly being constrained. In the last year, federal government debt as a percent of GDP rose from 98.4% to 101.6%. Credit ratings agencies will continue to gravitate toward reviewing US Treasury debt for a downgrade, citing the two major risks as slower than expected GDP growth and higher interest rates. It is our position that both of these are likely and at least one is certain.

What to Do?

Stocks will win out over time. After fifteen years of a near-zero return from stocks, the future for stocks should be more rewarding. In equity allocations, well financed big cap companies have offered the best risk/reward ratio historically. They have been increasingly out of favor since their peak in March 2000. We will continue to embrace them, especially individual securities that are out-of-favor. In fixed income allocations, we will continue to seize solid yields in high quality instruments where reasonable in light of the risk. With rising confidence narrowing quality spreads, we will move toward higher quality issues. US Treasury bonds may not remain on the high quality list forever, so the highest quality corporates will be a more solid choice for safety.

A key factor across all of our strategies--equity, fixed income, and tactical--is to be nimble. Rather than adding risk at the Fed's behest, we will take a more defensive posture with a portion of the portfolio at times when that portion (an asset class, sector, or holding) is particularly vulnerable to a shock; when events surrounding an investment indicate greater potential for downside than upside or vice-versa. When the cadence of those events corresponds with regularity to the price history, it indicates that the investment responds to the event, and that opportunity exists. This type of movement in price is primarily emotion-based. It only has to do with valuation insomuch as perceptions of risk rise and fall due to media coverage and human nature which causes excessive investor focus on the events of the day. Implementation requires an understanding of the rhythms and functioning of our economy, its bureaucracies and their calendars. The government's September 30th fiscal year end repeatedly puts the federal budget in play. As a result, late September to early October is rarely kind to equity holders. Whether it is a holiday, Congress reconvening, or tax payment due dates, liquidity and uncertainty have a cadence. As for the holidays, enjoy. For what politician wants to be called Scrooge? Beyond "asset class" opportunities, there are scores of opportunities at the sector, industry and company specific levels. We will discuss these in future issues of *The Long & Short of It*.

Repeating events impact perceptions of economic activity, creating investment opportunities. While ***actual risk*** levels may be stable or change slowly over time, the media and the short term focus of human nature serve to magnify the ***perception of risk*** as events approach in time and then pass. Beyond our traditional "value-oriented, somewhat contrarian" approach, we are finding success in helping our clients take advantage of this noise in the market with a portion of their portfolio. We have found the cadence factor to be helpful in reducing risk, as well as enhancing returns. The lack of a rising tide and the absence of healthy yields from safe sources make this factor increasingly useful when integrated into an otherwise traditional investment approach.

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