# Making Sense of Finance

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## Third Quarter Review

### STOCK MARKET

The third quarter of 2013 had all major U.S. indexes continuing their upward trajectory from earlier in the year. Even given a setback in the market in August, the Dow Jones Industrial Average and S & P 500 Index increased last quarter with gains of 1.5% and 4.7%, respectively, while the technology-laden Nasdaq Composite again exceeded the other market indexes with a return of 10.8%. Though the stock market has shown a respectable rise already this year, by some valuations, the market may still be attractively priced. In the aggregate, the forward price/ earnings ratio of the S & P 500 Index is 14.3. This compares with a fifteen year average of 16.3. Also the current dividend yield of the index is 2.2% which also compares favorably with the 20 year average of 1.7%. (This generous dividend yield has more significance when you compare the relationship to the current yield on a ten year Treasury of approximately 2.6% and the 20 year average yield of 4.6%). Rising interest rates are not necessarily bad for the stock market when rates are at such extremely low levels as they are now. Numerous incidences over the past 50 years point to stocks showing positive returns in the face of rising rates as long as the interest rates are not excessively high (ten year Treasury yield greater than 6%).

One of the best performing sectors last quarter was biotechnology which has been a favorite industry group for investors all year. Another industry which continued to do well is automobiles as some manufacturers posted record sales on pent-up demand. Real estate investment trusts (REITs) compromised part of the small group of stocks that lost value in the third quarter. The fear of rising interest rates weighed on this sector along with utility stocks. Both groups have outsized exposure to higher interest rates due to the nature of their businesses having hefty debt levels. Smaller capitalization stocks continued to outpace their large cap peers both in the third quarter and year to date. Some reasons for this are higher earnings growth rates, relatively more exposure to the U.S. economy than larger companies, and acquisitions of these smaller sized companies by larger businesses with huge amounts of cash to spend.

Foreign stock markets in general outperformed our domestic market. According to the MSCI indexes (priced in US dollars), the EAFE developed market index posted over an 11% gain in the third quarter. Among the developed markets, France, Germany and the United Kingdom all outperformed the U.S. stock market although some are still lagging the U.S. year to date. Emerging markets had mixed results. China and Russia had double-digit percentage gains last quarter while Brazil and India lagged. These laggards underperformed partially due to their weakened currencies.

### BOND MARKET

The majority of fixed income sectors had positive returns last quarter except for the longer dated Treasuries. Excluding the ten year and longer maturity Treasuries where yields rose (therefore their prices declined), bonds held their

## Making Sense of Finance

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is more about making sensible and prudent choices based on logic and experience, and not on emotion.


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own in the third quarter. However there was volatility in this period. Investors reacted negatively to Federal Reserve minutes release in August only to be surprised in September by the Fed's inaction as far as tapering their huge $85 billion a month buybacks. Many bond investors were troubled by these comments made public in August: "if economic conditions improved broadly as expected, the Committee would moderate the pace of its securities purchases later this year. And if economic conditions continued to develop broadly as anticipated, the Committee would reduce the pace of purchases in measured steps and conclude the purchase program around the middle of 2014." But then the bond market was surprised by this statement made in last month's FOMC press release: "The Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases. Accordingly, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month." Suddenly with these words, the yield on the ten year Treasury, which had increased from 2.52% at the end of the second quarter all the way to 2.98% on September 5th , now went back down to 2.64% by the third quarter end. Most likely, interest rates are headed higher long term but in the short term it is very hard to predict as we can see that those officials that have a huge bearing on interest rates in the U.S. are not sure what direction they want to proceed.

The high yield (non-investment grade) fixed income sector performed the best last quarter as investors felt better about corporations' balance sheets and their ability to pay their debts. Municipal bonds were the laggards as they have been all year. With the very public financial troubles of Detroit, investors appeared to be worried about all municipalities as municipal bond funds continue to see net outflows. These concerns may not be well founded as recent statistics show that only 5% of current expenditures of state and local governments is used to service debt.

**MARKET OUTLOOK**

The hot topic the past few weeks is undoubtedly the "government shutdown". Should we be worried? For the sake of the entire country; the answer is "Yes", but how much does it really affect the economy. So far, not much, but obviously the longer this impasse continues, the worse for America. STILL, if we look at what has happened in the past, namely the 1995/1996 government shutdown, lasting about one month, the S&P 500 stock index actually rose 4% during that time period. Again, we take the optimistic view that the government will start running again soon enough. Since the start of the shutdown (10 days so far) the S&P 500 is basically flat; hardly a stock market crash.

The landscape for Equities (stocks) and Real Estate remain the most attractive, in our view. Low interest rates allow companies to borrow cheaply and expand or renovate existing facilities. However, with the strong run-up in both asset classes the past year, we would characterize the stock market and real estate market as fairly priced. Still, we think through careful selection we can still find some good value, but it is certainly more difficult. Bonds remain unattractive to us because of the potential upward long-term trend of rising interest rates. If rates increase, bond prices would decrease in value, but that would also mean that the economy is likely stronger. Because of this, bond holders are in a difficult position. Lower rates that would boost bond prices are unlikely and would probably mean a weakening economy; another scenario no one wants to see. In addition, a weaker economy would INCREASE default risk because a company or government entity's ability to pay the interest would most likely decline. Our best solution would be to keep the duration of bond investments short (less than 10 years) and allow existing bonds to mature, which would ensure a return of principal. Even holding to maturity, a 10 year treasury bond only yields 2.65% (as of 10/9) which is below the historical average inflation rate of 3%-4%; meaning a loss of real value every year. Within the bond sector, however, municipal bonds seem the most palatable, yielding nearly the same as corporate bonds and potentially allowing triple tax-free status (city, state, and federal taxes) which would be most advantageous to high tax-bracket investors. Comments of massive defaults by pundits have proven incorrect and except for isolated incidents, i.e. Detroit, municipalities are mostly in solid shape. Finally, gold is our least favorite asset class, but it still has some utility. The average historical return of gold is close to that of stocks and real estate over long stretches of time, but with much greater volatility. People forget that from 1980 to 2000, a $100 investment in gold would be worth only $46 at the end of that period. But from 2000 to 2010, a $100 investment in gold would be worth $521 in 2010. A person could look like a genius for 10 years just by buying and holding gold during this period but that would not be a smart investment strategy for an entire portfolio. Still, it makes a good inflation hedge (currently only about 1.5%) and tends to move in the opposite direction to equities, thus cancelling out some volatility, making it more attractive to very long-term holders.

In conclusion, we encourage all our clients to be cognizant of the world news, but more importantly, to take perspective. Every year there is a war fought somewhere, a natural disaster that decimates a city or region, political unrest in a number of countries, government shutdowns, mass shootings at schools, Flu/West Nile Virus/Avian Flu scares, terrorist attacks, etc. Just remember that unless the world ends, people will always strive for a better life, more money, innovate and discover new technology, start new fashion and social trends; all of which contribute to a growing economy. And although we are still in a sluggish recovery, there will be good times again.