Making Sense of Finance

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Fourth Quarter Review

STOCK MARKET

The last quarter of 2013 proved to be as good as the first quarter as all the major U.S. stock market indices had impressive gains (S & P 500 + 9.9%). And this in the midst of a 16 day Federal government shutdown! It was a great finish to one of the best years for U.S. equities. The Dow Jones Industrial had its largest annual increase since 1995 with a gain of 26.5%. The S & P 500 Index and Nasdaq Composite performed even better increasing 29.6% and 38.3% respectively. Easy monetary policy has been credited with last year's exceptional stock market performance although it has been accommodating for the past few years. Reasonable valuations, a low interest rate environment (helped by the Federal Reserve's policies), increasing corporate profit margins, steady economic growth and a continuing flow of money from bond funds into equity funds are the more probable explanations. Even after the large run-up in stock prices last year, the S & P 500 dividend yield declined only slightly from 2.25% a year ago to 1.94% at the end of 2013 as dividend payouts in the aggregate grew approximately 13% year over year. Increasing dividends is usually viewed as a sign of confidence by corporations for the near future. And with a still historically low dividend payout ratio (dividends as a percentage of earnings), currently 36% versus an average of 52%, the increasing dividend trend may continue into 2014.

The best performing sector for the fourth quarter was technology which explains the jump in the tech-laden Nasdaq Composite last quarter. Healthcare had the second best returns last quarter and one of the best for the year. Biotechnology, in particular, has been the best performing sector for the last three years. The laggard groups for the quarter and for 2013 were telecom, utilities and REITs (Real Estate Investment Trusts) All three sectors are interest rate sensitive due to their capital intensive nature and the fact that they are considered by some investors as bond substitutes because of their relatively high dividend yields.

In general, foreign stock markets, as measured in U.S. dollar terms, did not perform as well as the U.S. equity market last quarter or for 2013 as a whole. The MSCI EAFE developed market index rose 5.4% in the 4th quarter and 19.4% for the year. On a local currency basis however Japan's Nikkei increased 56.7% last year. Translated back to U.S. dollars though negated a large portion of that gain as the Japanese Yen depreciated over 17% versus the dollar in 2013. This yen depreciation was somewhat orchestrated by the Japanese government in order to aid Japanese export companies which in turn drove their stocks higher. The German stock market also showed exceptional gains, on a local currency basis gaining 25.5%.

Making Sense of Finance

Everyone 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 geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Emerging markets did not keep pace with the developed markets for the fourth quarter or full year. The Indian market managed to show a 10% gain last quarter in U.S. dollar terms but still had a loss for the year. Other emerging market stocks fared much worse including most Latin American equities.

BOND MARKET

The majority of fixed income classes had negative total returns for 2013 and the fourth quarter with the exception of high yield (below investment grade) bonds which actually saw yields fall as the spread to Treasuries compressed. Interest rates rose throughout last quarter and the year. The 10-Year Treasury closed out 2012 at a yield of 1.78%, rose to 2.64% by the end of the third quarter and continued its rise into the fourth quarter ending the year at 3.04% when the Federal Reserve finally announced in December that they will begin their tapering of bond purchases by $10 billion to $75 billion per month beginning in January. These bonds are longer-term Treasuries and agency mortgage-backed securities. Interest rates had risen in anticipation of this %tapering+. Last year was the first negative total return for the Treasury index in 13 years and its worst performance in almost 20 years.

The Barclays U.S. Aggregate Bond Index which tracks various debt categories declined 2% in 2013, the second worst year in its history. Emerging market bonds (similar to EM stocks) declined the most, while corporate bonds held up relatively well within the fixed income category. The yield curve continues to steepen as the Fed continues to hold firm on maintaining the Fed Fund rate at near zero levels for the foreseeable future. This in turn will probably keep money market and short term CDs at historically low yields.

MARKET OUTLOOK

The big question for investors is %Is the party over?+ We think the easy money has been made, for sure, but to say that the %party is over+ is too myopic for a serious investor, in our opinion. Until the bulk of 2014 has passed, we wonq know if it will be a positive or negative year. Letq look at history. In 1975 the S&P 500 returned 37%, including dividends, and followed it up with a 24% return in 1976. 1995 was a similarly great year for equities, returning 37%, and followed that up with +23%, +33%, +28%, and +21% returns, respectively, in subsequent years. Had you sat out 1996-1999, you would have missed out on over 150% return ($100 would turn into over $250). The market would have had to decline more than 60% for an investor to lose money at that point. And, of course there were years when there WAS a decline after a big year. We simply donq have a crystal ball, and neither do the experts on television or in the newspapers/magazines. Serious investors should not look at monthly or even annual results, but rather look in terms of multiple years. Our outlook on stocks remains optimistic, but tempered based on 2013q excellent performance. Many companies achieved record results, and yet the economy isnq exactly booming. It is improving at a good clip, which we find encouraging.

The economy, in our view, is just warming up. Companies still have an enormous amount of cash on hand (over $1 trillion). Re-investment in new projects, acquisitions, stock buybacks, dividend increases, and capital flowing into equities from bond funds; these are all factors that will boost market returns. We have been bullish about the stock market for many years and the odds were stacked in our favor. In 2008 and 2009, the world was going to end (according to many experts), a good time to buy, in our view. When would be a good time to sell? When everything looks great! We are not there yet, from our perspective.

Fixed income securities continue to be unattractive and rates have begun to rise. Still, the negative returns have been relatively mild, and for individual bonds held to maturity, the investment will eventually be a positive return (assuming no defaults). Rates will likely keep rising for years but bonds still have utility as a hedge to control risk in diversified portfolios.

Our goal for this newsletter is not to give forecasts and then pat ourselves on the back when we are correct, but rather to give objective viewpoints based on the facts. Yearly forecasts on market returns are completely unrealistic. For example, CNNMoney surveyed investment strategists from 32 investment firms, asking where the S&P 500 would end up in 2013. The S&P 500 ended 2013 at 1,848 and ONE guy came close at 1,800. The bulk of the strategists forecast the index to be in the 1,200 to 1,500 range, well off the mark. We looked at a second survey taken by USA Today (published December 2012) from eight major Wall Street Firms. The average return predicted was +7% (S&P 500 returned over 30%). In this case NO ONE came close. The closest strategist estimated that the index would rise to 1,615 vs. 1,848, actual. Our investment strategies at Karagosian Financial focus on individual companies, rather than market movements. We have found this to lead to more consistent and greater returns over the long run.

"The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investors primary interest lies in acquiring and holding suitable securities at suitable prices. "

-Benjamin Graham (Father of Value Investing)

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