Making Sense of Finance

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First Quarter Review

STOCK MARKET

The last quarter of 2013 was a tough act to follow as was the full year. The year 2014 had a slow start in the U.S. stock market. With January down, February rebounding and March moving sideways, domestic stock indices managed to have a flattish first quarter. The S & P 500 was the best performing out of the three major U.S. indices with an increase of 1.3%. (It also hit a record closing high on the first day of the second quarter.) The Dow Jones Industrial Average had a loss of less than 1% and the Nasdaq Composite gained a fraction of a percent in the first quarter. Given the crisis in the Ukraine, a banal stock market performance was tolerable.

The trailing 12 month P/E ratio of the S & P 500 is approximately what it was a year ago (17.7x). Even though stock prices in the aggregate rose quite a bit, valuations at least for this index have not. Also the dividend yield is still a healthy 2.0%, just slightly below this time last year. And as we stated in the previous newsletter, the trend of dividend increases will carry into 2014 and it has. Just today P&G announced a dividend increase adding to another fifty or so large companies announcing dividend increases in the first quarter.

Healthcare stocks again were one of the better performing sectors last quarter as they were at the end of 2013. The best performing group, though, was utility stocks, increasing 9% in the first quarter. These stocks typically do better when interest rates are declining which is what happened at the start of 2014. Utilities are typically purchased for their attractive yields therefore when bond yields decline their dividend yields appear more desirable. REITs (Real estate investment trusts) also did very well last quarter for similar reasons. Consumer discretionary stocks had the worst performance by far in the first quarter with a loss as a group of over 3%. The especially bad winter weather was often blamed for the poor performance in this sector which includes companies such as retailers, and auto manufacturers.

Foreign developed markets, as represented by the MSCI EAFE (based in US dollars) index, were actually unchanged for the first quarter. Surprisingly with the conflict in Eastern Europe, the European markets did better than the Asian markets. Many emerging markets declined last quarter both in local currency terms and when measured in U.S. dollars on slowing growth concerns, particularly in China. Interestingly, the MSCI East Europe index excluding Russia was one of the few positive emerging market indices in the first quarter.

BOND MARKET

After a posting a rare negative total

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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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return last year, bonds rebounded in the first quarter of 2014. Although most investors expect that the long term trend in interest rates is that they will go higher, in the near term it is hard to predict (same as the stock market). The Barclays U.S. Aggregate Bond index had a total return of 1.8% last quarter. The best performing bond market segment was long term Treasuries with a gain of 7%. Although the Federal Reserve has continued its tapering of buying longer term Treasuries, demand for these securities was met by investors seeking "safety" in addition to probably some portfolio rebalancing as demonstrated by bond fund inflows in the first quarter. As of March 26th, bond mutual fund inflows year to date were $21.7 billion (which compares with domestic stock inflows of $16.4 billion).

Emerging market bonds, in contrast to EM stocks, fared relatively well last quarter with a gain of close to 4%, although it was a very volatile period. Municipal bonds also had a good showing as the Barclays Municipal Bond Index returned over 3%. A lack of new tax free bonds coming to the market led investors to bid up existing bonds. Investment grade bonds had a solid first quarter performance (2.9%). With a low risk of default, they continue to have a slightly positive yield compared to Treasuries.

Market Outlook

Most advisors spend their time telling people how much they know about the market. However, our value at Karagosian Financial comes from understanding what we CAN NOT KNOW and instead invest based on more reasonable assumptions.

Recently, a Chief U.S. Equity Strategist for a major bank declared that there was a 67% chance of a 10% pullback in stock prices from the peak. Whether his prediction occurs or not is absolutely useless. Does this mean he thinks it will happen or won't happen? Either way, he will be 67% right or 33% wrong, or vice versa. There is no investment decision that can be concluded. Could any strategist predict that Russia would invade The Ukraine? The word is that Sarah Palin predicted it, but I doubt she could have nailed it down to the first quarter of 2014, otherwise she would have said something more recently than 2008. As a side note, this strategist predicted a 5% increase in the stock market from mid- 2013 to the end of that year. The market did more than double that, at 11%. In other words, he was off by over 100%. I do not write this to disparage this particular strategist who is very well educated and most likely highly intelligent, but because of his position, he is forced to give forecasts requested by clients that he could not possibly make accurately on a consistent basis.

So, what do we look for if we do not forecast the market? How about relevant numbers, such as; how much money does a company make? What is its profit margin? Is management's strategy sound? Can they keep growing and how fast? What is competition like? What is a good price to pay for this stock? In most cases the numbers are given in SEC reports.

Even with large gains in 2013, valuations remain similar to the year-ago period. This tells us that profits, in the aggregate, have nearly kept up with stock price increases; thus the market did not become increasingly expensive. At current prices we are still finding plenty of good buys in the stock market. Bond yields are still depressingly low, but improved. In general, bond prices will likely continue suffering, but be partially offset by the coupon it pays. Factors that might temporarily boost stock market returns are the increased flow of funds into equities (something that started occurring again in late 2012), and continued mergers and acquisitions and dividend increases stemming from huge cash stores on the balance sheet. These are all things we have covered the past three years and little has changed. We do not expect much help from the government. Our reasoning is that if it could have been done to boost the economy, it would have been done already, and in the current political environment, further initiatives such as tax cuts are unlikely in the near future. Investors should consider this; since the great economic meltdown of 2008, it has been a very bumpy and painful road for Americans. Yet, since January 2009, the stock market has just about doubled (up 98%). This is a reflection of profits that have recovered and balance sheets that are likely the strongest in a half century. Companies have simply become more efficient. Unfortunately, this increased efficiency and the elimination of many industry bubbles; i.e. real estate, are keeping unemployment high. No, the economy has not roared back, but there remain many sound investments that should do even better when the economy accelerates.