# Quarterly Newsletter

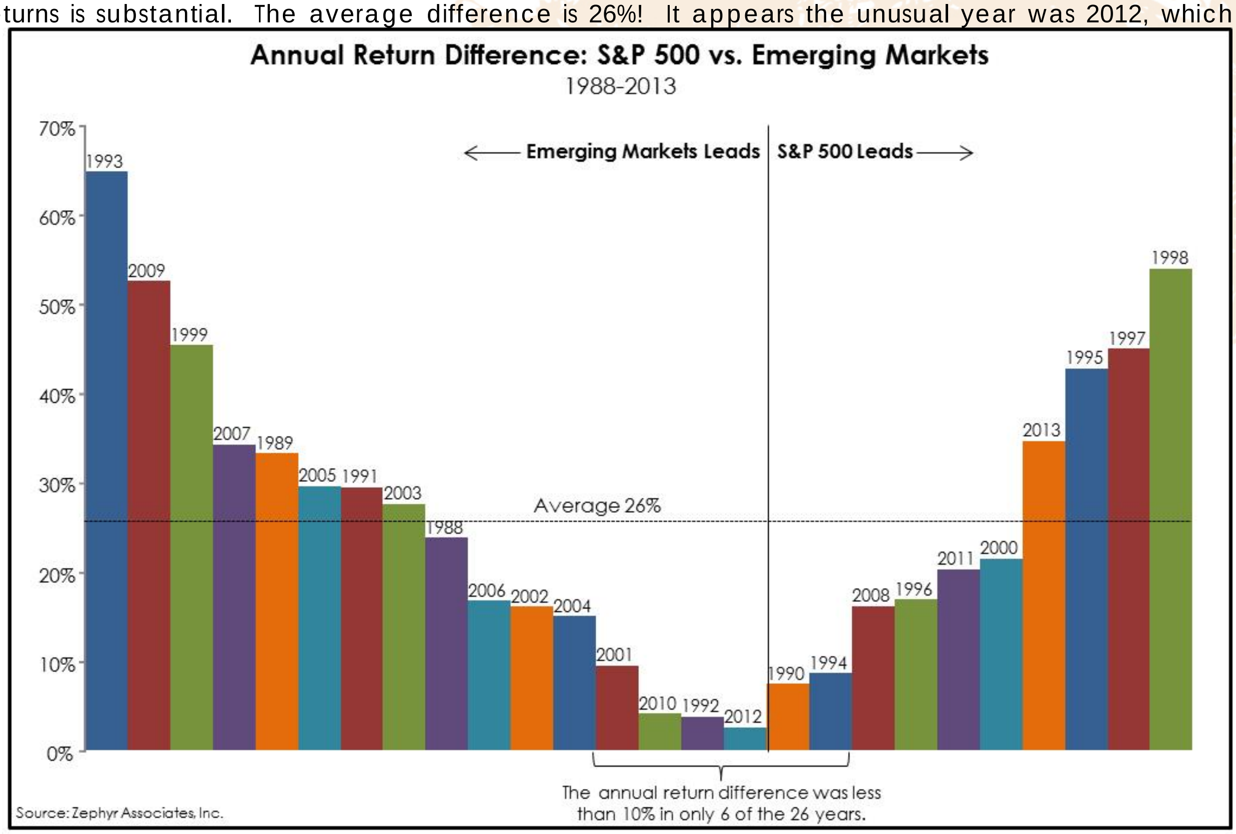
APRIL 2014

**CAPITAL MARKETS UPDATE |** Global equity markets started the year with an abrupt sell off and recovered in February and March. U.S. Large Cap (+1.8%) led the way, outperforming U.S. Small Cap (+1.1%), International (+0.7%) and Emerging Markets (-0.4%). Commodities rebounded sharply (+7.0%) after trailing all asset classes in 2013. Declining bond yields drove a rally in the U.S. bond market (+1.8%) in spite of reduced bond purchases by the Fed.

**EMERGING MARKETS |** Investment articles touting Emerging Market Equities are in short supply these days. All the praise goes to U.S. Equities, as it should, as recent performance has been spectacular. In 2013, the S&P 500 beat the MSCI Emerging Markets Index by a whopping 35% (S&P 500 +32.4% vs. Emerging Markets -2.3%). Most attribute the lagging performance to concerns regarding changes in the U.S. Fed's monetary policy, slowing growth in China and pockets of social unrest/geopolitical tension (the Ukraine being the most recent example). Some caution that Emerging Market countries may face challenges similar to the crisis in 1997-1998, which included some currency devaluations, debt defaults and reduced access to capital.

To their credit, most Emerging Market governments have learned from that experience and are soundly positioned today with stronger balance sheets, lower debt levels, flexible exchange rates, large foreign exchange reserves, little currency mismatch in their debt obligations and longer term funding commitments. Compared to the developed world (U.S., Canada, U.K., Europe, Japan, Australia), the Emerging Markets (China, India, Brazil, Russia, Eastern Europe, Latin America, parts of Asia) in aggregate boast more than double the economic growth rate, less than half the level of government debt/GDP and much more attractive demographics: three big advantages in a slower growth world.

**DIVERGING MARKETS |** Looking back at the 26 year history of the MSCI Emerging Markets Index, large performance gaps with the S&P 500 Index have been the norm. The chart below inventories the performance difference each year between the S&P 500 and Emerging Markets sorted (left to right) from the largest Emerging Markets outperformance (Emerging Markets Leads) to the largest S&P 500 outperformance (S&P 500 Leads). The divergence in returns is substantial. The average difference is 26%! It appears the unusual year was 2012, which registered the smallest gap on record of 2.6% when Emerging Markets earned 18.6% vs. the S&P 500's 16.0%. Interestingly, the performance difference has exceeded 10% more than ¾ of the time. Last year, it seems, was a more typical year in terms of one equity index beating the other by a wide margin.





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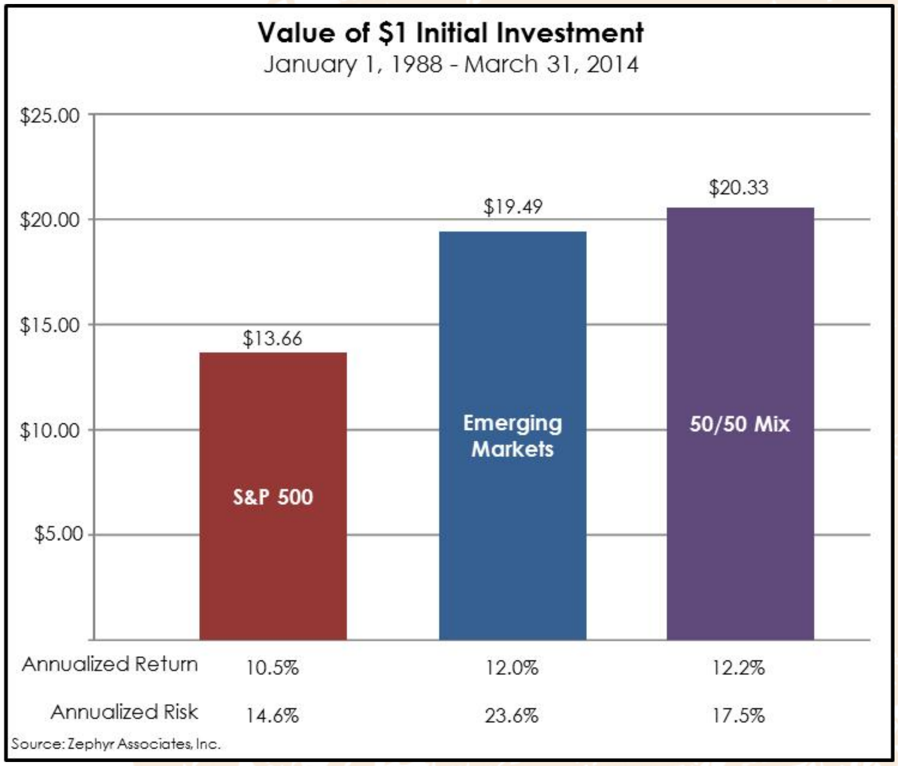
**BENEFITS OF DISCIPLINED REBALANCING** | It is natural for past returns to shape investor sentiment. How we feel about an asset often depends on how it has recently performed. Strong S&P 500 returns embolden our confidence in U.S. Equities while weak or lagging returns in Emerging Markets challenge our convictions. Reinforcing headlines may even sway investors and perpetuate current trends. However, history tells us that investor sentiment is volatile, subject to abrupt reversals and prone to overextension. The volatility in the prior chart is testament to the intensely changing sentiment among these two asset classes. When investing, following our emotions can lead us down a path that feels better initially but delivers lower returns over the long haul. Disciplined investing can harvest the greatest rewards with volatile assets.

Consider a robotic portfolio strategy that invested in a 50/50 mix of the S&P 500 and MSCI Emerging Markets indices at the beginning of 1988 (the first year of data for both) and annually rebalanced to the 50/50 target no matter what happened along the way. The chart at right depicts the March 31, 2014 value of a one dollar initial investment. In retrospect, it would have been tempting to solely invest in Emerging Markets since it beat the S&P 500 by such a large amount. Note, however, that the diversified portfolio outperformed both of its component assets—rebalancing is the reason. Maintaining discipline and rebalancing to targets require us to do the uncomfortable: trim what has performed the best and add to what has lagged the most. Said another way, we adjust the portfolio contra to our prevailing emotions. Note also that the risk (standard deviation of returns) of the 50/50 mix is much lower than that of the Emerging Markets portfolio it beat.




**ENCOURAGING METRICS** | Retail shoppers tend to be rational, value aware bargain hunters in passionate pursuit of the best deal—*how can I get the most for my hard earned money?* Investing is less concrete, as prices weigh the likelihood of uncertain future outcomes. That said, it is instructive to compare several metrics for these two asset classes to better gauge their relative value.

**Valuation Metrics**

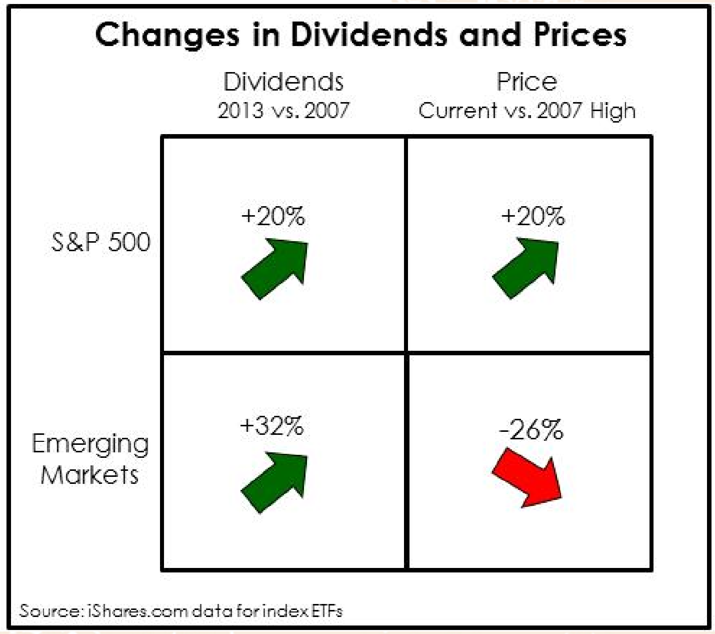
| | Price/ Book | Price/ Sales | Price/ Earnings Historical | Price/ Earnings Forward | Price/ Cash Flow |
|---|---|---|---|---|---|
| S&P 500 | 2.1 | 1.7 | 17.7 | 15.2 | 10.1 |
| Emerging Markets | 1.5 | 1.0 | 11.5 | 10.4 | 6.5 |
| Price Discount | (29%) | (42%) | (35%) | (32%) | (35%) |

Source: J.P. Morgan Asset Management, Research Affiliates, LLC

At minimum, the above table strongly confirms that Emerging Market Equities are out of favor. On a relative basis, they appear to be "on sale." If the past is any guide, these metrics may portend significant outperformance by Emerging Market Equities over the next 5 to 10 years. Cheaper valuations are generally a precursor for better returns.

Dividends are another key metric with an important and appealing difference. Unlike the ratios above, dividends are not a financial accounting measure—they are simply a historical record of cash paid directly to investors. The dividend yield is the sum of dividends paid over the last 12 months divided by the current price (2.0% for the S&P 500 and 2.7% for Emerging Markets). By this metric, Emerging Market Equities are paying investors 35% more income at the current rate.

The most striking comparison is the change in dividends and stock prices from before the 2008 financial crisis through today (see chart at right). For the S&P 500, dividend growth and stock prices have tracked one another. S&P 500 dividends paid in 2013 are 20% higher than those paid in 2007 while the Index (stock price) as of March 31, 2014 also is up 20% from its pre-crisis high in October 2007. Though Emerging Market dividends grew faster at 32%, the Index is down 26% over the same period.




INVESTMENT IMPLICATIONS | The Emerging Markets are clearly out of favor lately. Any asset class that is less liquid or less widely held by investors is prone to larger price swings in both directions. When investor sentiment shifts, the resultant price reversals can be dramatic. Bob Farrell, a renowned market strategist for decades with Merrill Lynch (now retired) has observed that the consensus is often wrong. In fact, it is Rule #9 of his 10 Rules of Investing: *When all the experts and forecasts agree—something else is going to happen.* We can observe Rule #9 at work at the end of 2013. The year concluded with the yield on the 10-Year Treasury reaching a 2 ½ year high and most pundits calling for bond yields to continue marching higher as the Fed began tapering its bond purchases in January. What ensued? Yields declined and the bond market recovered almost all of its 2013 loss in the first quarter. We advocate sticking to the time proven discipline of diversifying broadly and rebalancing to target allocations, not trying to time the markets.