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FOCUSED ON WHAT MATTERS MOST.

Is 2014 the Year to Take More Risk?

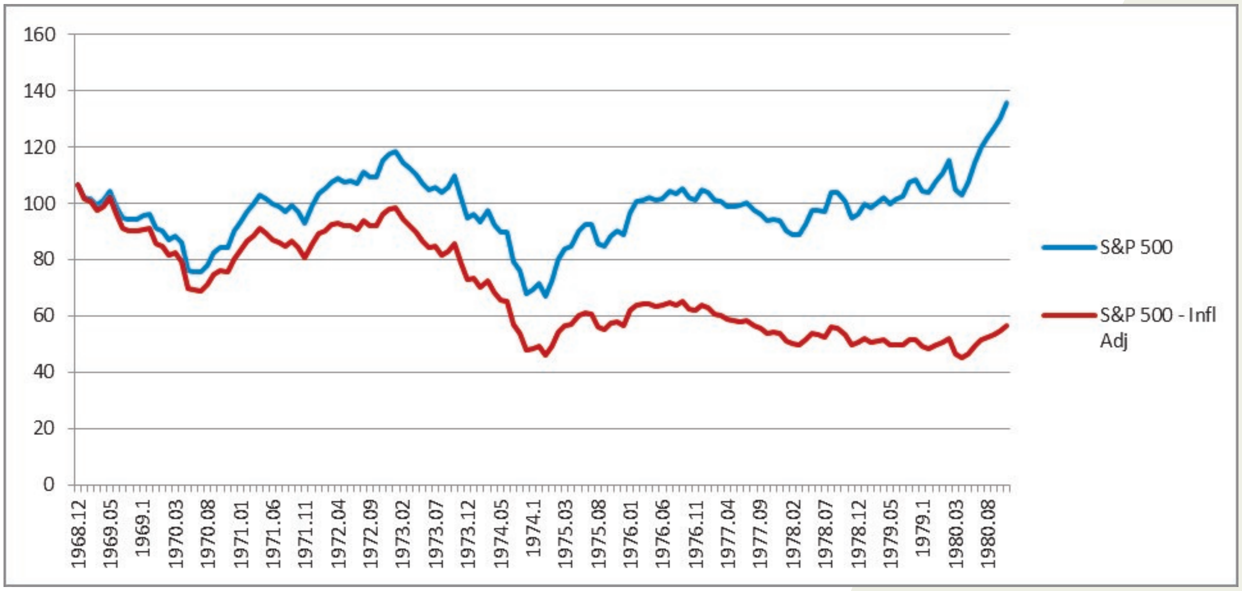
2013 will go down as one of the best and strangest years that US stocks have ever had. The S&P 500 was up nearly 30% last year, and over 46% the past three years even though US GDP growth was well below its long-term averages. For everyone who wanted to control their investment risk, conservative investments and safe strategies did not return even close to what US stocks did. In order to make money in 2013, you had to take risks, and not all equity risks paid off, as evidenced by emerging markets' negative return. On the bond side, only high-yielding, lower credit quality bonds were positive in 2013; the rest were negative for the year, and some by double digits. Risk minimization strategies, like absolute return or trend following strategies, in mutual fund or separate account form were also mostly negative on the year. It was one of those years where to avoid risk was also to avoid gains.

After a multi-year run-up on the S&P 500, especially with 2013 being such a banner year, the temptation could certainly be to increase exposure to risky investments. Using our emotions to gauge when to get more aggressive or more conservative has been scientifically proven to be the wrong approach, and just eyeballing the most common stock market graphs and charts provides little help. So at this point in time, how can we determine if we should get more aggressive, less aggressive, or continue our current approach? How likely is a continued lucrative stock market run-up verses a wealth destroying crash?

One technique we use to help us answer these questions is to express past stock market values in terms of today's dollars. This technique translates values during past inflationary and deflationary times into values consistent with our current environment and recent experience. Adjusting past prices into today's dollars helps overcome the fact that we cannot see the long-term effect of inflation in our day to day lives, and therefore have a difficult time knowing if something is actually cheap or expensive relative to historic values. In the case of the stock market, this helps us evaluate the likelihood of a continued increase verses the likelihood of a nasty downturn. This process offers clarity when evaluating a wide variety of prices, not just stock prices.

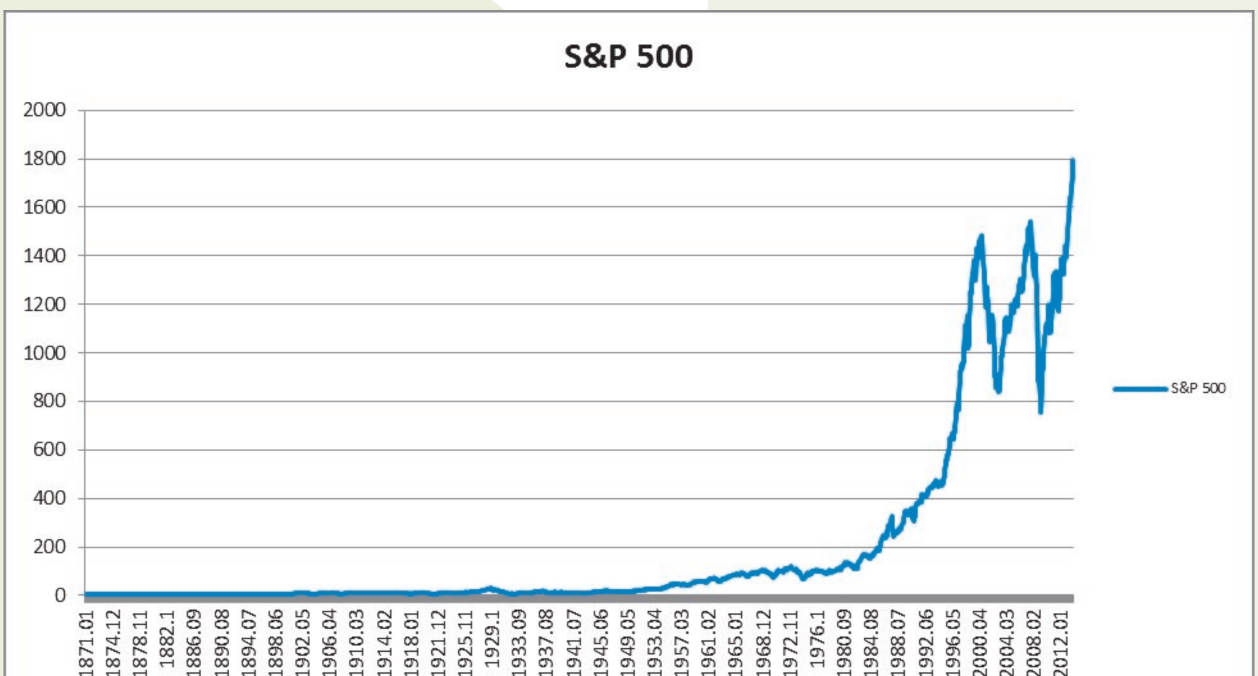
For example, when gasoline prices reached a nationwide average of $3.84 per gallon in May of 2011, it was seen as "the highest of all time", however in inflation-adjusted dollars prices were relatively higher in 1918. In 2011 when an ounce of gold peaked at $1,895 it certainly looked like the highest ever, and by a lot. In 1980 the nominal price peaked at $850 per ounce, making 2011's price look 123% higher than 1980's. However, in today's dollars, 1980's peak was actually $2,415, or 27% higher than 2011's peak.

It is difficult to know what investments are worth relative to historical prices, and therefore how over or under valued they might be, without adjusting for inflation. Before we adjust 140 years' worth of stock market prices, we're going to highlight twelve years to show you the usefulness of this process. Consider the S&P's value at the end of December 1968 of 106.5, and also its value at the end of November 1980 of 135.7. Not adjusted for inflation as financial news sources would report it, this is a 27% increase. However, corrected for inflation, the relative value of the S&P fell nearly 50% over that same time period:

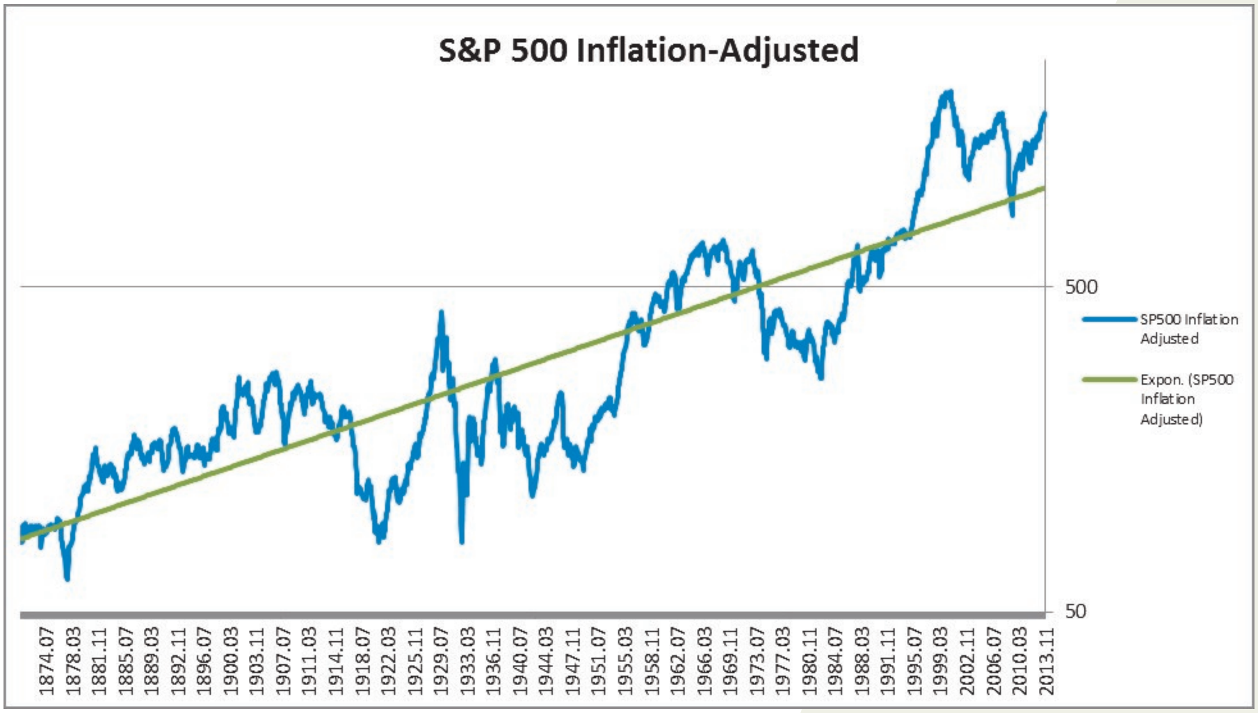


The S&P 500's increase was not great enough to overcome a high rate of inflation, and therefore even though its nominal value appeared to increase, its relative value actually decreased. Were you evaluating the likelihood of the S&P 500 being near a cyclical low or a cyclical high at the end of that period, you may have been much less likely to fear a market crash after correcting for inflation. But a 12 year period is not long enough to know whether or not a cyclical high or cyclical low is most likely.

Now for the full 140 years. First, consider how this information is presented to us every day. The following is the non-inflation adjusted, non-logarithmic chart of the growth of the S&P 500 index since 1871. Notice its current "all-time high", and its seeming severe increases and decreases since 1994. What does this chart tell you?



Not easy to interpret, right? Are those three peaks on the right normal; is the stock market currently over or under-valued and by how much; has the market gotten more volatile lately than it was historically; and, where does it go from here? All of these are valid questions which are impossible to answer without making some adjustments. Now, consider the S&P 500 taking inflation into account and using a logarithmic scale for the chart so the recent bigger values do not distort how the S&P has fluctuated in the past:



What correcting for inflation does is reveal historically relative values for the S&P 500, and we've added a trend line to show the periods where the value was above and below the long-term average. Armed with this new outlook, you are able to answer some of those previous questions:

1 In inflation-adjusted terms, the S&P 500 has not reached an all-time high. That honor still belongs to the dotcom bubble in the summer of 2000.

2 The peaks and valleys since the 1990's are not unique. The most recent run-up from below the trend line to above it started in 1982 and peaked in 2000, and that run-up is not as drastically different from the 1949 to 1968 run-up, or even the 1877 to 1906 run-up as the previous non-adjusted graph seemed to show. In inflation-adjusted terms, history does seem to resemble itself. What does seem to have less precedent is how much of the recent volatility has occurred above the trend line as opposed to on both sides of it. Historically, most large downward moves brought us below the long-term trend, but the previous two market crashes did not bring it below the long-term average in a meaningful way, so we're still due for that more meaningful correction.

3 It is incorrect to view being above the trend line as "good" and being below the trend line as "bad"; the major wealth-creating and wealth-destroying moves were the time periods that brought the values from below the trend line to above it, and from above it to below it. Over these 140 years, we have only crossed above the trend line during a major sustained move four times, and we have only crossed below it during a major sustained move three times, for an average of one major move every twenty years. Based on this, you can see the most recent major inflation-adjusted gain from investing in the S&P 500 index occurred between 1982 and 2000; since then, the two up and down moves have masked a decade-plus sideways move, if not slightly downward. You may also draw the conclusion, as we have done, that at some point we will be pulled below that trend line in a major downward move like the three previous. To fall below that line, the S&P 500 has to fall, inflation has to spike, or both.

4 <u>What might a downward stock market move look like?</u> Over the next five years if we were to ignore the effects of potential inflation, the S&P 500 would have to fall 38% to touch that trend line, and it would have to fall about 61% to reach roughly where it was when it bottomed out in 2009. If we assume inflation stays similar to what it has been over the past few years, around 2%, then the S&P 500 would have to fall about 32% to touch the trend line, and 57% to reach its 2009 low. However, if inflation were to shoot to 4.5% for five years, then the S&P 500 would only have to fall 23% instead of its current 38% to touch that trend line, and 52% instead of 61% to reach 2009's low.

All of these numbers matter for two reasons. The first is to illustrate that inflation plays a part, and as a result, getting to or below the trend line may be a function of both a decreasing stock market and rising inflation. The second is to illustrate that even though the last stock market crash brought us only to the trend line and not below it, due to inflation we may not need a more severe correction than 2008-2009 to get us back below the trend line because increased inflation would also pull us down, not that higher inflation is a good thing.

5 <u>There will be another major downward move in the future; it's inevitable.</u> Since we can't know exactly when this downward move back toward and possibly through the long term trend will begin, and nobody can consistently time market tops and bottoms as they're happening, we're left with one decision: Given what we know about stock market history and where we are in the current market cycle, do we choose to manage risk at this point or don't we? If the answer is to manage risk, then we have to live with the outcome of doing so in years where being protective doesn't work as well as taking higher risks, and trust that over the longer term as things play out, we'll be better off for it. The value of minimizing your losses when stocks are moving from being above to below their long-term average cannot be over-stated. Those are history making moves, they happen infrequently, and they're painful.

In inflation-adjusted terms, we're about as far above the long-term average as stocks have ever been, meaning we're nearly on par with the dotcom bubble and the peak before the 1929 crash. As the clarified chart shows, we can spend decades above that trend line, so it does not mean the correction to below it is imminent, but we believe that it is inevitable. The good news is there is always money to be made, whether we're above or below the long-term trend, and even when the market is correcting.

Key Takeaways:

- We've been above the long term average growth rate since the mid 90's and we'll eventually move back below it. Downward moves tend to be more abrupt and violent than upward moves.

- The last two market corrections did not take us back below that long term growth rate, implying there will likely be a bigger more protracted downward move in the future that takes us there, especially if inflation remains low. Getting back to the average would mean the market falls 38% from current levels. **<u>Moving below the long term average could look significantly worse.</u>**

- We are likely approaching a wealth destroying event in the stock market that could last for quite some time. There have been periods in the past where, adjusted for inflation, it would have taken over 20 years to get back to where we were prior to this type of event – far too long for the average person to wait.

- Given that nobody knows the exact timing of this downward move, the only way to protect against it when it happens is to choose to manage risk **<u>before it happens</u>**. As we've seen in 2013, the performance of risk management investment options could vary significantly up until this downward move begins, but will very likely provide a far better outcome than being overly exposed to the stock market once it does. Patience and a big picture view are crucial.

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