Review & Outlook

THIRD QUARTER 2014

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Review

2013 was a great year for the stock market. That year, the small and mid-cap indices returned 41% and 33%, respectively, with the S&P 500 index returning 32%. That means your portfolio did well, regardless of its allocation across the market cap sectors (small, mid, and large).

> "On the whole, the American economy appears to have a supertanker-like momentum, creeping slowly in a positive direction. Disturbances such as Ukraine and jihadi fanatics will be minor distractions, having little impact on forward progress."

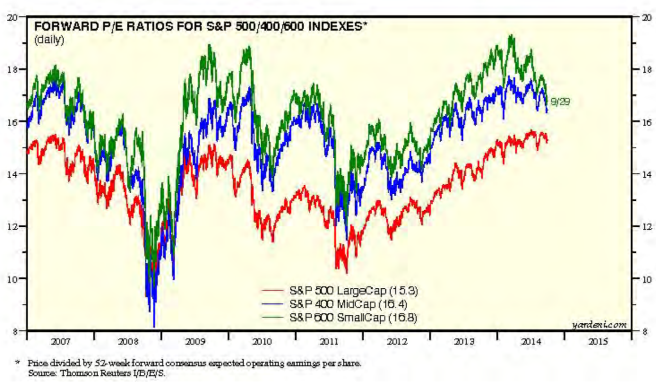
But 2014 has been a different story so far, especially during the second and third quarters. The S&P 500 returned 1.13% in the third quarter, and 19.73% for the past twelve months. While not as remarkable as 2013, this performance is still impressive, given the sluggish economic recovery from the "great recession," ongoing concerns about the relatively depressed job market, and increasing geopolitical tensions around the globe. However, unlike 2013, the small and mid-cap sectors have performed poorly, highlighting the importance of thoughtful allocation.

Part of the story is adjustments in price-to-earnings ratios (P/E's) within each of the market cap sectors. Small-cap stocks had the highest price-to-earnings ratios (P/E's) at the start of the year, followed by mid-cap stocks. Small and mid-cap companies tend to have higher P/E's because they are expected to have higher earnings growth rates over time. However, as P/E's start to exceed long-term historical averages within market cap classes, investors increasingly feel that market cap class may be overvalued.

For the large cap S&P 500, the "forward" (current price divided by forecast earnings) P/E is 15.6, which is slightly lower than the longer-term average of 15.7. As a consequence, we do not see significant "overvaluation"-related pressure on the S&P 500 index in the near term. However, our stock selection process tends to favor mid-cap, or mid-sized, companies. Fortunately, our stocks have done much better than the mid-cap index this year. They performed more like the large cap index this quarter and have outperformed the large cap index year-to-date, and over the past year. Our selection process puts considerable weight on stock price relative to actual earnings, which helps weed out stocks that have unsustainably high P/E ratios. Paying close attention to that ratio, and ensuring proper diversification, has served us well in recent quarters.

Stock prices, particularly prices of mid and small-cap stocks have been increasingly volatile during the first few days of October (as we prepare this Review and Outlook). The price drop has been significant in the last two weeks of the quarter, and the Russell 2000, an index of small cap equities, marked a three month "correction" of 10% on Oct. 1st. While this has resulted in short-term decreases in equity values, we believe the longer term story for steady economic growth in the US economy remains intact, and will continue to support equity values going forward.

Figure 1: Forward P/E Ratios for S&P Indices



Outlook

Our economic forecast remains largely unchanged. The Bureau of Economic Analysis revised its estimate of GDP growth in the second quarter up to 4.2% (following a decline of 2.1% in the first quarter). As the third quarter comes to a close, it looks like we are headed towards an annual growth rate of close to 2%. GDP growth has averaged 2.2% since June 2009, and that has essentially been our forecast for the past several

Outlooks. Some people see this rate as the 'new normal', and recall fondly the long-term trend, prior to the last recession, when GDP growth averaged 3%, or a bit higher.

Lending is up this year, especially for auto loans, which is a positive sign, but orders for durable goods declined in August, and building permit applications are still quite low in historical terms. While new jobs are being added at a steady pace, there is still some question about the "quality" of these jobs, as measured by wages paid. Additionally, the recent remarkable increase in domestic oil investment and production has unquestionably helped, both in creating jobs and in keeping downward pressure on the price of oil; hence gasoline, the latter an important detail for an economy that is driven largely by the domestic consumer. On the whole, the American economy appears to have a supertanker-like momentum, creeping slowly in a positive direction. Disturbances such as Ukraine and jihadi fanatics will be minor distractions, having little impact on forward progress.

Finally, we note that inflation appears to remain under control. Food production is mixed, with drought-related price pressure on fruits and vegetables being offset by record corn and grain crop production (and subsequent lower prices). As noted previously, gas prices remain low, and there is no compelling reason to see them increase significantly in the next few quarters. Additionally, we see no strong inflationary pressure on average wages, though we will be watching for stress from particular sectors of the labor force. The view of continued low inflation expectation is further backed by US Treasury rates, which are at 2.49% annual return for a 10-year bond, and 3.18% for a 30-year bond.

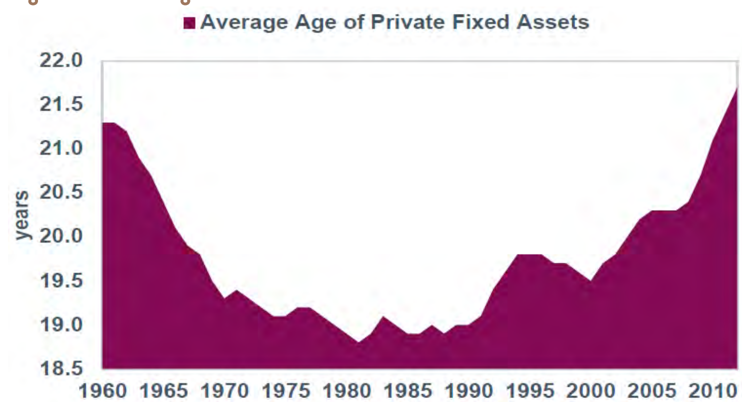
In Focus

You may have heard that some companies have been enjoying record profits, hoarding cash, and buying back their own stock. Well, all of that is true. At a recent luncheon in Seattle, Charles Schwab's Chief Investment Strategist showed that business deposits as a percent of GDP are higher now than they have been since at least 1950.

Figure 2: Corporate Deposits as % of GDP

The lack of investment in capital has resulted in an aging capital stock (Figure 3). Some imagine businesses continuing with their buyback plans, or paying more dividends. Others imagine a switch to business investment. The uncertainty around what companies will do with their revenues, and whether those revenues are sustainable, is always present.

Figure 3: Average Price of Fixed Assets



This sort of uncertainty, along with the inconsistency in the relative performance of different asset classes, highlights the importance of diversification. There will always be turnover in the best performing asset class. There will always be uncertainty about what corporations will do in the future. We cannot avoid those challenges. But we can ensure that our accounts are properly diversified, and conduct careful and thorough research about the markets as a whole, as well as individual investments.

1. Figure 1: http://www.yardeni.com/pub/peacockfeval.pdf
2. Figure 2: Sonders, Liz Ann. "Schwab Market Outlook." Fairmont Olympic Hotel, Seattle, WA. 23 September 2014. Presentation. Page 19.
3. Figure 3: Sonders, Liz Ann. "Schwab Market Outlook." Fairmont Olympic Hotel, Seattle, WA. 23 September 2014. Presentation. Page 21.