

Don't Evaluate Return without Considering Risk

September 2014 Client Letter

Swiss investor Marc Faber PhD, also known as Dr. Doom, recently explained how news from McDonald's could spell trouble for the stock market. On Tuesday, September 9th, McDonald's reported a 3.7% decline in global same-store sales. That



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ranks as the company's worst global same-store sales results in more than a decade.

Said Faber, "We had, essentially, very poor sales from McDonald's. Now, McDonald's is a very good indicator of the global economy. If McDonald's doesn't increase its sales, it tells you that the monetary policies have largely failed in the sense that prices are going up more than disposable income, and so people have less purchasing power."

Faber has accused the policies of the Federal Reserve and other central banks of increasing asset prices and creating inflation. And while the Fed and others claim



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inflation is currently not a problem, he believes inflation is rising faster than income and reducing the amount individuals can spend.

While Faber does not believe the technical picture for the market is positive, he is hesitant about making a prediction to the timing of a bear market. “I have always argued that we don’t know how the world will look in five years’ time.... Maybe the S&P is at 3,000, but it could also be at 1,500—we just don’t know. There’s a lot of manipulation between fiscal and monetary policies. So I want to be diversified.”

Diversification is a central investment strategy of Faber’s. He wants to make



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money but is not interested in chasing returns of the hottest sectors.

In his September investment report Faber had interesting comments on the topic of diversification. “I am fully aware that diversification sometimes comes at the price of an underperformance of the best-performing asset classes. In this respect, I should like to mention that in the late 1990s, fund managers that did not overweight high-tech, media, and telecom stocks “did not understand” the importance of the New Economy, in the eyes of their clients, and consequently suffered from huge client defections. Just ask Jeremy Grantham,



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whose Boston-based fund manager, GMO, underperformed during the dotcom bubble, as it stuck to its “value” approach of investing in “inexpensive” equities. As a result, GMO lost a large number of its clients.”

“Most famous is the case of the late Tony Dye, who at the time was a star UK fund manager at PDFM. Known also as “Dr. Doom”, Dye refused to buy the dotcom fad, which led to an exodus of clients in the late 1990s. He was sacked in February 2000, just three weeks before his strategy began to pay off. In 2000, PDFM topped the performance tables. Unfortunately, it was too late for Tony Dye....”

An investment strategy



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overly focused on performance and past returns can wreak havoc on portfolios. As Faber alludes, many investors of the late 1990s placed too much emphasis in the speculative end of the market, believing long-time, experienced value managers had lost their way. Those over-exposed in the highest-performing NASDAQ sectors eventually learned the adverse consequences of the New Economy. For some, those lessons are still being learned today, as the NASDAQ 100, a sub-index of the 100 largest companies in the NASDAQ Index, is still down double digits since its March 2000 peak.

Chasing performance can



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be a tricky strategy. Investors late to the game invest in a high performer after most of the growth has occurred. During the tail end of the dotcom era, investors continued to load up on the most speculative shares, perhaps catching the remaining gains but absorbing most or all of the losses.

Mutual fund companies frequently promote their successful funds. Most fund groups manage lots of funds covering a wide range of investing styles and sectors. If enough ground is covered, you are bound to come up with a few winners each year.

Our Chief Investment Officer, Jeremy Jones, ran a Morningstar screen of the top-performing, U.S.-



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focused, large-cap blend (combination of growth and value) funds to determine which funds are beating the market year-to-date. This year, out of the 467 large-cap blend funds in the Morningstar database, about 94 have bested the S&P 500's 9.74% return.

The top-performing fund, according to Morningstar, is Upright Growth, up 20.1% year-to-date. How have Upright Growth and the other funds at the top of the heap beaten the market? Among the Top 10 performing funds on the Morningstar list, the five largest holdings (across the ten) are Apple, Microsoft, Gilead, Wells Fargo, and Amazon. Not the most conservative



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group of names.

In other words, the top-performing funds of 2014 have done well by taking on risk, and lots of it. The tiny Upright Growth Fund has a standard deviation (a measure of volatility) of almost 18% compared to the 11.6% standard deviation of the S&P 500. The average standard deviation of the top-five-performing large-cap blend funds is 15%. And four of the five fall into Morningstar's high-risk category.

As was the case last year, so far in 2014, the top-performing funds have been those taking the greatest amount of risk. High risk can look good on paper as markets rise, but in practice, high-risk



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strategies can lead to improperly balanced portfolios that are susceptible to significant losses when markets turn down.

In terms of future market returns, it may be prudent to temper expectations. Investors like Bill Gross and Jeremy Grantham believe that a combination of slower U.S. growth, poor policies, and prolonged Fed intervention will lead to a less promising environment.

Bill Gross, formally of PIMCO, has stated he can see a market where bonds return 3% to 4% a year on average and stocks return 4% to 5%. Part of his low-return predictions are based on lower expectations for U.S. GDP



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growth, which could stay around 2% annually.

Gross recently wrote, "This global monetary experiment may in the short/intermediate term calm markets, support asset prices and promote economic growth, although at lower than historical levels. Over the long term, however, economic growth depends on investment and a rejuvenation of capitalistic animal spirits – a condition which currently does not exist. Central bankers are hopeful that fiscal policy (which includes deficit spending and/or tax reform) may ultimately lead to higher investment, but to date there has been little progress. The U.S. and global economy ultimately



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cannot be safely delivered with artificially low interest rates, unless they lead to higher levels of productive investment.”

Last March, Jeremy Grantham told *Fortune* magazine that he believes the Fed has manufactured increases in the stock market. Grantham continues to have an uninspired outlook for the years ahead.

“There’s no proof on the other side, that the economy is any stronger from quantitative easing. There’s some indication that the crash would have been worse and the downturn would have been sharper had the Fed not stepped in, but by now the depths of that recession would have been forgotten,



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the system would have been healthier, and we would have regained our growth.”

“Yes, I agree that the Fed can manipulate stock prices. That’s perhaps the only thing they can do. But why would you want to get an advantage from the wealth effect when you know you are going to have to give it all back when the Fed reverses course? At the same time, the Fed encourages steady increasing leverage and more asset bubbles.”

“We invest our clients’ money based on our seven-year prediction. And over the next seven years, we think the market will have negative returns. The next bust will be unlike any other, because the Fed and



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other central banks around the world have taken on all this leverage that was out there and put it on their balance sheets. We have never had this before. Assets are overpriced generally. They will be cheap again. That's how we will pay for this. It's going to be very painful for investors."

The timing of the next market correction is, of course, difficult to predict. I like Marc Faber's view that no one knows how the world will look in the years ahead and lots can happen in a short period of time. The markets could continue to go up or we could have a significant correction. Significant market moves are often determined by future



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events that we did not expect to occur. The collapse of Lehman Brothers in 2008 and the Federal Reserve initiating quantitative easing are two examples of unforeseen impactful events.

And we also appreciate Faber's investment strategy of diversification. For most retired and soon-to-be-retired investors, we favor a balanced portfolio with a combination of short to intermediate term bonds, currencies, and a globally diversified mix of dividend-paying stocks. We invest with the goal of receiving a steady flow of interest and dividends each year.

Have a good month, and as always, please call us at (888) 456-5444 if your



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financial situation has changed or if you have questions about your investment portfolio.

Best regards,



Matthew A. Young

President and Chief
Executive Officer

P.S. In a September *WSJ* editorial, economist David Malpass writes how the Fed is planning to maintain its enormous balance sheet, approximately \$4.5 trillion in Treasuries and mortgage-backed securities.

“Far from being neutral or stimulative, these policies have caused



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huge distortions in financial markets, contributing to slow growth and falling median incomes. Given the tendency of government programs to expand and become permanent, the risk now is that the Fed's large pool of assets and liabilities evolves into a semi-permanent government-controlled investment fund, a U.S. version of the sovereign-wealth funds created by other governments.

The longer the Fed holds its portfolio, the greater the danger that political forces will nudge its investments away from Treasury securities. The Fed already owns bonds created by Fannie Mae



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and Freddie Mac, helping them take market share in the mortgage market from the private sector. There have been many proposals in recent years to set up infrastructure banks, for example. Perhaps the Environmental Protection Agency could set up an environment fund that issues bonds for the Fed to buy as a creative way to finance the fight against global warming. Japan, China, and others own large holdings of dollar-denominated bonds, and it's easy to see a future Fed edging its portfolio into euro- and yen-denominated bonds to manipulate the value of the dollar."



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P.P.S. According to a *WSJ* report dated September 15, 2014, “Falling crude prices could be good news for a U.S. economy still struggling through an uneven recovery. Gasoline prices fell to a national average of \$3.39 a gallon Monday, according to AAA, and are running nearly 4% below year-ago levels. Commerce Department data last week showed consumer spending rose as gasoline spending fell. The U.S. is producing 8.6 million barrels of oil a day, the highest level in nearly 30 years and nearly 13% higher than last year’s average, according to government data. Much of the oil produced from shale formations around the country trades at a steep discount to the U.S.



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benchmark, reflecting the glut in key markets such as the Gulf Coast.

P.P.P.S. Economist Richard Rahn, in a September 15th commentary in *The Washington Times*, suggests future U.S. presidential candidates run on a positive message that will resonate with voters. Included in his policy suggestions are: 1. Not being #32 in tax competitiveness among industrialized countries. 2. Ending the practice of asset forfeiture by our government, including a real punishment to the IRS for its continued misdeeds. 3. Properly recognize and address that excessive regulation is a clear drag on economic growth and



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regulation. 4. Putting an end to contradictory regulations which government agencies have used to extract huge, unjustified fines from companies, especially banks.



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