The Financial Navigator – March Newsletter

The Dow Jones Industrial Average hit an historic peak during the first week in March as it beat its previous high set in October 2007. The financial press reacted with its usual excited chatter and hoopla. Below we attempt to put the recent developments in perspective and suggest a course of action one might take depending on how you interpret the stock market peak. In addition, our guess columnist, Weston Wellington of Dimensional Fund Advisors reviews the record of one of the more renowned stock market timers, Martin Zwieg, who gained notoriety by calling the crash of 1987. Subsequent to this timely call Mr. Zwieg went on to a long career managing money, so one might wonder how many more great predictions did he make, and how did his investors fair? Read on for more insight.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Market Commentary

When the Dow Jones Industrial Average hit a new record during the first week of March as it rose over 14,200, beating the previous high set in October 2007, the excitement was evident in the breathless pronouncements by the hyperventilating CNBC commentators. As the average crept closer and closer to the October high they provided the minute by minute play by play. But would the party end there? Not according to the CNBC talking heads, Dow 15,000 was next, 17,000 not out of the realm of possibility, let the party start. But leave it to economist, or practitioners of the 'dismal science', to be the killjoys as they quickly proclaimed that in real terms, which adjust for inflation, a Dow Jones closing price of more than 15,652 would have been required for the average to exceed its 2007 peak.

The question that many have now is has the stock market run too far too fast, and is it now overvalued and primed for a fall? Or are we entering an extended bull market still in the early stages? As usual you can find as many arguments supporting the view that the stock market is overvalued and due for a fall, as there are that it is undervalued and will continue to rise. So what is one to do; buy, sell, or hold? Staying firm and sticking to one's plan is probably the best advice for most, but below we present a brief summary of the Bull and Bear arguments with some suggested actions you might take based on current market conditions.

Bull Argument

- Stocks aren't expensive based on many earnings, dividend-yield and cash-flow metrics. The price/earnings ratio (P/E is a common measurement of the stock market valuation) of the S&P 500 based on earnings expectations over the next 12 months is about 13.5 vs. a long-term average of 15.
- The US market appears relatively cheap in comparison to developed markets elsewhere; this group includes Germany, United Kingdom, and Japan has a P/E ratio of about 12.7.
- University of Pennsylvania professor Jeremy Siegel has studied stock market returns dating back to 1871. In his view P/E ratios are likely to expand since bonds are unattractive alternatives, and dividend payouts are increasing. He believes that "15,000 Dow Jones average by year-end looks pretty easy now…with 16,000-17,000 within range by the end of the year." He has also found that over the past 142 years, stock market returns following a period of worse-than-average returns, as we experienced during the 2000s, tend to be better than average.
- There is more than $3.5 trillion in cash on American corporate balance sheets, but dividend yields are at 2.1%, which is historically about average. Many argue that with all this cash earning less than 1%-2% corporations will need to be either return some cash to shareholders via dividends, or put it to work in the market via acquisitions, either which could drive stock prices higher.
- The Federal Reserve and central banks worldwide continue to prime the pump by essentially printing money to keep interest rates low, which will continue to fuel higher stock prices as investors search for alternatives to low yielding bonds and cash.

Bear Argument

- Margin debt, or the amount of money that investors have borrowed to invest in stocks, is climbing. When this borrowing rises, it can suggest that individual investors are becoming too comfortable with risk, a sign the market is overheated.
- Skeptics argue that stocks only look attractive relative to both risky and safer bonds and because investors are frustrated with the puny rates on their savings.
- To project long-term returns, many investment strategists divide the market price by average earnings for the last 10 years, adjusted for inflation. The measure is known as the cyclically adjusted P/E or the "Shiller P/E" after Robert Shiller, the Yale University professor who helped popularize the measure. On that basis, U.S. stocks look relatively expensive. At the end of January, the S&P 500 cyclically adjusted P/E stood at about 22, versus the historical average of about 16. That doesn't mean U.S. stocks will necessarily suffer; in the past, when U.S. stocks have had a P/E between 20 and 25, they have gone on to return about 4.9% annually after inflation over the next five years.
- QE3 is not a ship name; rather it is the nickname for the third iteration of the US Federal Reserve's bond buying program. The goal of the program is to keep interest rates low thus helping the economy to recover, but many argue QE3 is artificially inflating the stock market, and when it ends as it must at some point, it will be akin to removing the punch bowl from the party, and the stock market will suffer.

- And finally, during an interview Mila Kunis, the young actress who starred in last year's comedy hit *Ted*, revealed in an interview that "I've just started investing in stocks, which is new for me." For many institutional investors, when celebrities start making market calls and touting stocks, the game is over and the market has reached its peak.

As mentioned above, buy, sell, hold is the question on the minds of many investors, but with the so called experts, not including Mila, in disagreement there is really no consensus on the appropriate course of action. However, many small investors seem to be following Mila's lead and are jumping into the stock market based on the high level of cash now flowing into stock mutual funds. Whether this will end well for US investors remains to be seen as most investors historically seem to be very adept at 'buying high-selling low' when it comes to the stock market; over the long-term US investors tend to underperform the S&P 500 by 4%-5%.

Therefore, proceeding with caution would probably be prudent; a few suggestions are listed below.

- With US large, small, and mid cap stocks all up between 10%-12.8% on an annualized basis over the past three years, taking profits now would be wise. Rebalancing your portfolio and returning the percentage of your portfolio in US stocks to its original allocation would keep one in the market if the bulls are right, and take some profits off the table if the bears are right. Reallocating those profits to international stocks and bonds would help to bring those asset classes into balance.
- If you have a lump sum of cash that needs to be invested, perhaps dollar-cost-averaging the cash into the stock market over a 6-12 months would serve to dampen the volatility in your portfolio that we might experience over the next few months, allow you to participate in the market if it goes up, and to buy at cheaper prices if it decreases as long as you stick to the plan.
- Continuing to invest into the market via your retirement account would ensure you stay in the market and take advantage of any future increases. And since the typical retirement plan invests your contributions by dollar-cost-averaging them into the market you would benefit from some of the points made in the above bullet.

He Called It

Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.

The investment community lost one of its more colorful characters last week with the passing of Martin F. Zweig, a prominent market pundit, author, and chairman of Zweig-DiMenna Associates LLC, a New York investment firm. His death also marks the close of another chapter in the long-running debate on the virtues of market timing.

Zweig took a keen interest in stocks as a teenager, and after earning a PhD in finance from Michigan State University, he began writing investment newsletters while teaching in New York. He launched The Zweig Forecast in 1971 with a handful of subscribers and continued to publish it, with considerable success, for the next 26 years. Zweig loved numbers (including baseball

trivia) and was closely associated with statistical measures of monetary policy and market momentum that he combined into what he called a “super model” to assess market conditions. He is credited with introducing the put/call ratio, a measure of investor sentiment, to the toolkit of market forecasters. He transitioned to money management, and in October 1986, he launched the Zweig Fund, a closed-end mutual fund that relied on his analysis of market trends to adjust its exposure to stocks and bonds.

Zweig was a frequent contributor to both print and broadcast media and wrote numerous articles for Barron’s, a weekly publication with a devoted following among those seeking comprehensive market statistics. Perhaps his finest hour was an appearance on the television show Wall Street Week with Louis Rukeyser on Friday evening, October 16, 1987. When his host asked him to comment on assertions from other market commentators that the “bull market is dead,” Zweig replied he was expecting a crash but was reluctant to say so publicly. It was too similar, he said, to shouting “fire” in a crowded theater. Zweig’s prediction proved eerily accurate: The Dow Jones Industrial Average fell by a staggering 29.2% in chaotic trading the following Monday, an even bigger setback than the combined losses from Black Monday and Black Tuesday in October 1929. The Zweig Fund emerged relatively unscathed: According to a profile several years later in SmartMoney, the fund had 58% of its assets in cash leading up to the crash, and experienced a loss of only 6.2% on October 19. Traumatized by the unprecedented market break, many investors sought out advisors or analysts who appeared to have avoided the debacle. Zweig’s reputation as a financial expert soared. For years, he was introduced as “the man who called the crash.” The headline of Zweig’s obituary in the Wall Street Journal described him as a “master market timer.”

Zweig was not the only analyst to predict the 1987 crash, but his appearance on Wall Street Week was so visible and so perfectly timed that his status as an astute financial guru was greatly enhanced. By the time SmartMoney published its profile in 1995, his firm was managing nearly $4 billion in assets. In 1999, Zweig purchased a multistory penthouse above the Pierre Hotel, the most expensive residential transaction in New York City up to that time.

Should investors seek to enhance their returns by applying Zweig’s statistical timing tools? The evidence is mixed at best. Zweig’s October 1987 market call was on the money, and the *Hulbert Financial Digest* once reported that *The Zweig Forecast* ranked first among market newsletters for risk-adjusted performance. Many investors have discovered, however, that making one or two great predictions is often insufficient to generate above-average long run results—you have to be right over and over again to outperform Mr. Market.

Moreover, it appears that achieving excess returns with real dollars is more challenging than making prescient forecasts in a newspaper column. Annualized return for the Zweig Fund from inception in October 1986 through January 31, 2013, was 6.79% calculated from net asset value and 5.84% based on NYSE closing share prices. (The latter figure reflects the difference between the fund’s reported net asset value and the market price of the shares in NYSE trading.) Over this same time period, the annualized return was 9.84% for the S&P 500 Index and 7.90% for a static mix allocated 30% to the S&P 500 Index and 70% to the Barclays Aggregate Bond Index. A tilt toward small cap or value stocks within these indices over this period would have produced even higher returns.

Market timers often acknowledge that their signals do not provide sufficient guidance to outperform a buy-and-hold, 100% equity strategy. Their goal, they say, is to avoid major bear market losses by holding a large fixed-income allocation during market downturns and capturing a meaningful portion of equity market rewards by increasing stock holdings during the upswing. Reducing bear market losses may be a laudable goal, but as this example shows, it can also be pursued with greater simplicity by adopting a lower equity exposure at all times and ignoring the costs and frustrations associated with constant fiddling.

It's safe to say that no one worked more diligently or enthusiastically than Martin Zweig to tease out tomorrow's stock prices from today's data. But the evidence suggests that even the most dedicated student of market statistics is unlikely to meet with long-run success.

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Dow Jones data provided by Dow Jones Indexes.

S&P data provided by Standard and Poor's Index Services Group.