The Financial Navigator – Winter Newsletter

Happy 2014, with the start of the New Year I thought there were two events in 2013 worth discussing; the surprisingly strong US stock market, and the precipitous drop in emerging market stocks. The two articles below discuss these topics and put the events in some perspective relative to many of the blaring press headlines, and perhaps your portfolio.

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,

Bill Simpson, CFP®, MBA
Azimuth Financial Planning, LLC
(603) 373-8793
bsimpson@azimuthplanning.com
www.azimuthplanning.com

Surprise! No Selloff in 2013

Weston Wellington, Vice President-Dimensional Fund Advisors.

The unusually strong performance of US stocks in 2013 was a welcome surprise for investors who are following a simple buy-and-hold strategy and a source of exasperation for many professionals caught flatfooted by the steady rise in share prices.

It was the best year for the S&P 500 Index since 1997, with a total return in excess of 32%. To some experts, it wasn't supposed to look like this. A Barron's cover story appearing in November 2012 warned investors to "get ready for the recession of 2013." The title of a Time article on the outlook for financial markets that same month shouted, "Why Stocks Are Dead," in oversize type. A prominent economic forecaster who predicted the downturn in 2008 suggested that four elements—stagnating US economic growth, the European debt crisis, a slump in emerging markets, and military conflict in the Middle East—could combine and lead to a "superstorm." Another prognosticator—and longtime Forbes columnist —ticked off a long list of worries, including a new wave of housing foreclosures, persistent government deficits, weak consumer spending, high unemployment, and unsustainable corporate profit margins. His prediction for 2013: "the S&P 500 Index drops to 800, a 42% decline." Others fretted about a deepening slump in China that could drag the rest of the world down with it.

Detroit's bankruptcy filing in July—the largest American city to do so—and the acrimonious debate over public finances in many cities and states suggested to some that a tectonic shift in municipal finance was underway with worrisome consequences. One prominent Wall Street researcher observed that "the aftershocks of the largest municipal bankruptcy in US history will be staggering, and Detroit will set important precedents."

Individual and professional investors alike braced themselves throughout the year for a sharp selloff that never materialized. At times, the perverse reaction to rising prices was not delight but apprehension of an even steeper decline to come. On March 5, 2013, for example, the Dow Jones Industrial Average finally eclipsed its previous record of 14164.53, set in October 2007. But the Financial Times reported that the prevailing mood among veteran New York Stock Exchange floor traders was “more anxious than joyful.”

Month after month, a Greek chorus of financial journalists recycled the same arguments we have heard regularly for the past several years: economic growth is well below average, stocks are expensive relative to earnings, corporate profit margins are historically high and can only come down, earnings growth is too weak, asset prices have been artificially inflated by an expansive monetary policy, and so on. A sample of headlines that might have unsettled investors appears below.

January 12 – “Rebirth of equities Ain’t Necessarily So,” – *Financial Times.*

February 8 – “Scant Pickup in Economic Growth Seen for 2013,” – *Wall Street Journal.*

March 7 – “Stock Markets Defy Economic Woes,” – *Financial Times.*

April 2 – “Lesser Expectations: Earnings Hopes Dim for First Quarter,” – *USA Today*.

October 7 - “Get Ready For a Drop in Stock Prices,” – *Shefali Anand, Wall Street Journal.*

November 16 - “Is This a Bubble,” – *Joe Light, Wall Street Journal.*

With so many economic hobgoblins to frighten them, many investors found it easy to dismiss more positive developments as unsustainable or irrelevant. Auto sales, for example, have been surprisingly strong in recent years, but investors could find plausible reasons for caution in 2013. A New York Times financial reporter observed, “After steady increases for decades, Americans are driving less. ... Walkable cities are growing faster than suburbs. And wherever people happen to move, they are buying smaller, more fuel-efficient cars. ... All this means that autos—one of the biggest industries in the United States—will not soon regain the explosive growth of the early 2000s.”

Some Americans are indeed buying more fuel-efficient cars; electric-only Tesla luxury sedans are popping up in driveways in tony neighborhoods across the country. But many other Americans are eagerly signing contracts for powerful full-size pickup trucks; light-duty truck sales were up roughly 20% through November, and the Ford F-150 continues to be the best-selling vehicle in America by a substantial margin. Last year turned out to be a rewarding one for shareholders of most auto manufacturers and suppliers as well.

What can investors learn from this year’s market behavior? Most of us accept the idea that predicting the future is difficult, and predicting how other investors will respond to unpredictable events is harder still. But, for some of us, the temptation to engage in such efforts is irresistible. If only we could do so, we could be so much wealthier, have the satisfaction of outwitting other clever market participants, and make ourselves more attractive to members of the opposite sex. But results from this past year tell us we should be skeptical of our ability—or anyone else’s—to do this well enough to outperform a simple buy-and-hold strategy. When investors are studying the long-run record of US stock market returns several years from now, we suspect many of them will find it difficult to recall exactly what it was that they were so worried about and discouraged them from pursuing the capital market rewards that were there for the taking.

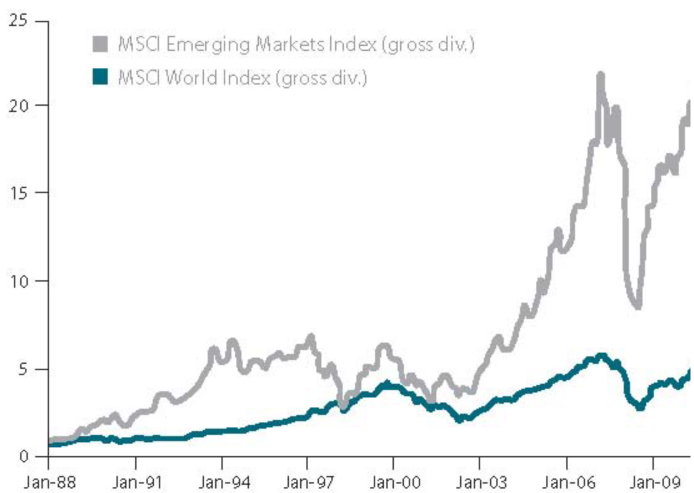
Riding the Emerging Markets Tiger

Jim Parker, Vice President-Dimensional Fund Advisors.

Many investors fell for emerging markets in recent years when they delivered sizeable returns. More recently, the associated risk has reasserted itself and the infatuation has faded. What's the right approach?

A major theme in media commentary since the turn of the century has been the prospect of a gradual passing of the baton in global economic leadership from the world's most industrialized nations to the emerging economies. Anticipating this change, investors have sought greater exposure to these changing economic forces by including in their portfolios an allocation to some of the emerging powerhouses such as China, India, and Brazil. An emerging market is broadly defined as the market of an economy that is in the process of rapid growth and industrialization. The chart below shows that these markets historically have provided higher average returns than developed markets.

Table 1. GROWTH OF WEALTH (MONTHLY JAN 1988–AUG 2013, USD)



But the flipside of these returns is that emerging markets also tend to be riskier and more volatile. That's because their systems of law, ownership, and regulation are still developing, and they are often less politically stable; this is reflected in their higher levels of risk. The risk associated with emerging markets has reasserted itself in recent months. Expectations of the US Federal Reserve "tapering" back its monetary stimulus have led to a retreat by many investors from these developing markets. In its latest economic assessment released in September, the

Organization of Economic Cooperation and Development (OECD) noted that while advanced economies were growing again, some emerging economies were slowing.

“One factor has been a rise in global bond yields—triggered in part by an expected scaling back of the US Federal Reserve’s quantitative easing—which has fueled market instability and capital outflows in a number of major emerging economies, such as India and Indonesia,” the OECD said.

Naturally, many investors will be feeling anxious about these developments and wondering whether emerging markets still have a place in their portfolios. There are number of points to make in response to these concerns.

First, this information is in the price. Markets reflect concerns about the impact on capital flows of the Fed tapering. Changing an agreed portfolio allocation based on past events is tantamount to closing the stable door after the horse has bolted.

Second, just as rich economies and markets like the US, Japan, Britain, and Australia tend to perform differently from one another, emerging economies and markets tend to perform differently from rich ones. This just means that irrespective of short-term performance, emerging markets offer the benefit of added diversification. And we know that historically, diversification across securities, sectors, industries and countries has been a good source of risk management for a portfolio.

Third, emerging markets perform differently from one another, and it is extremely difficult to predict with any consistency which countries will perform best and worst from year to year. That’s why concentrated bets are not advised. Rather than taking a bet on individual countries or even groups of countries (like the “BRICs” – Brazil-Russia-India-China), the key to investing in emerging markets is to take a cautious approach—investing in a number of countries, keeping an eye on costs, and regularly reviewing risk controls.

Fourth, in judging your exposure to emerging markets, it is important to distinguish between a country’s economic footprint and the size of its stock market. According to the IMF, the world’s 20 biggest economies last year, ranked by GDP in current prices and in US dollars, were the US, China, Japan, Germany, France, the UK, Brazil, Russia, Italy, India, Canada, Australia, Spain, Mexico, South Korea, Indonesia, Turkey, the Netherlands, Saudi Arabia, and Switzerland. Of that top 20, eight nations are classed by index providers as emerging markets: China, Brazil, Russia, India, Mexico, South Korea, Indonesia, and Turkey. Yet despite the size of those individual economies, the size of their markets in a global sense is relatively small. China makes up only about 2% of the global stock market—and that is the biggest single emerging market. Combined, emerging markets make up 11% of the total world equities market.

This is not to downplay the importance of emerging markets. The global economy is changing, and the internationalization of emerging markets in recent decades has allowed investors to invest their capital more broadly. Emerging markets are part of that.

The increasing opportunities for investment also increase diversification, so while one group of markets, countries, or sectors experiences tough times, another group may be posting strong returns. The increasing opportunities for investment also increase diversification, so while one group of markets, countries, or sectors experiences tough times, another group may be posting strong returns. We know that risk and return are related, so getting out of emerging markets or reducing one's exposure to them after stock prices have dropped means forgoing the increased expected return potential. Volatility is part and parcel of the emerging markets experience. A bumpy ride on this tiger is not unexpected. But for those adequately diversified with an asset allocation set for their needs and risk appetites, it is worth holding on.

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