FA Financial Alternatives Inc

integrated wealth management

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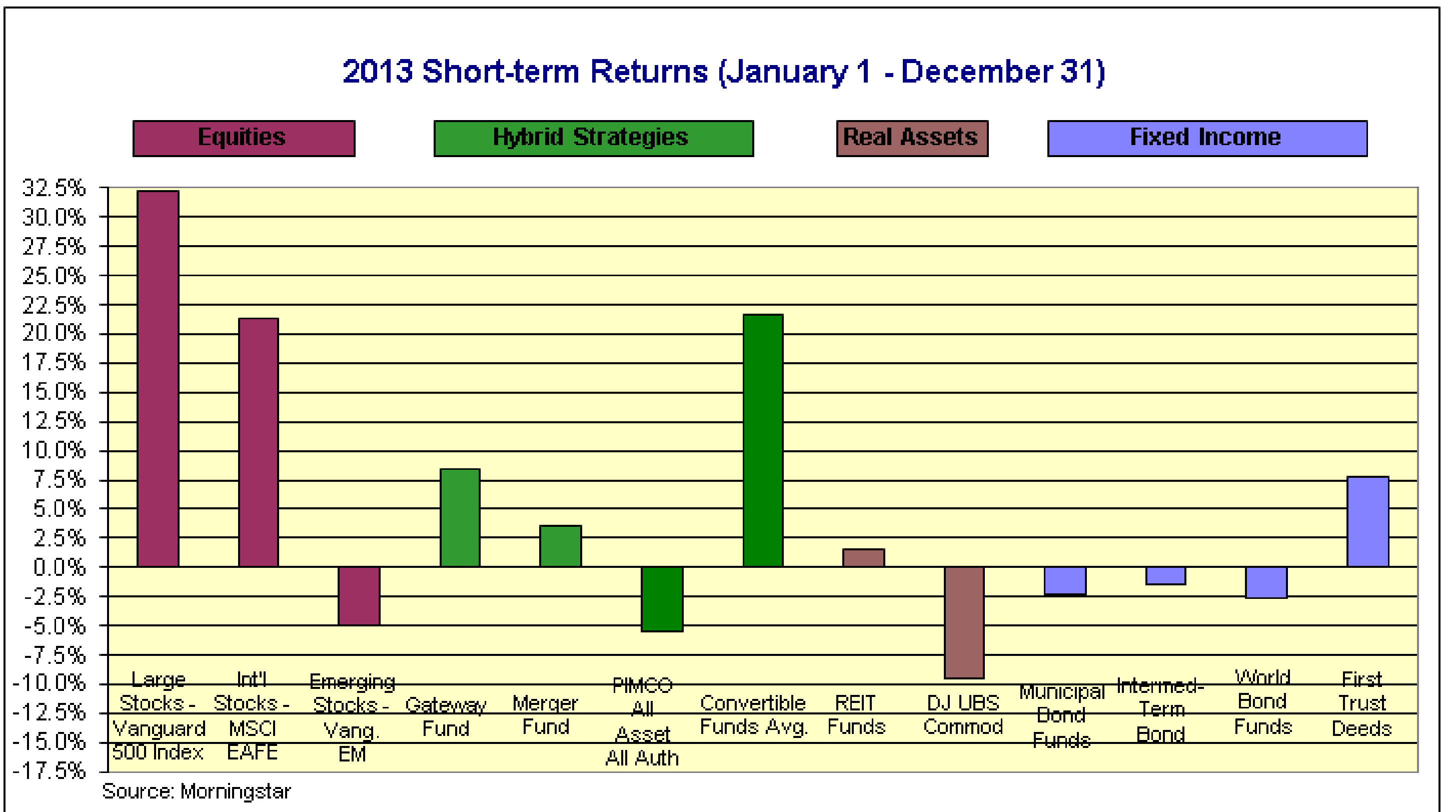
Review of 2013: The Worst of Times – The Best of Times

Conservative investors were punished in 2013 with negative returns. Last year was the worst year for US bond investments (as measured by the Barclays Aggregate Bond index) since 1994! In 1994 US bonds returned -2.9% versus a return of -2.02% in 2013. On the other hand, 2013 was the best year for US stocks (as measured by the S&P 500 index) since 1997. In 1997 stocks returned 33.4% versus a return of 32.39% in 2013. The short-term returns graph below shows the wide dispersion of returns between various asset classes.

As you can see, 2013 was truly a mixed bag. It is interesting to look back to 2012 and remember the fear that was caused by the presidential election, the sequester debates and the impending fiscal cliff. At that time, some clients called us and questioned whether or not to reduce their stock allocations. We worked hard to convince them to maintain their long-term target allocations. Of course today, they are no doubt glad they made no stock reductions and some may be feeling regret that they didn't have

Executive Summary

- US high quality bonds had their worst investment performance since 1994.
- US stocks had their best investment performance since 1997.
- If you feel the urge to increase your stock allocation, consider waiting to do so.
- If you were tempted to reduce your stock exposure in 2012 but stayed the course and benefited from the high returns of 2013, consider trimming your equity exposure now.
- Short term stock market predictions should be uniformly ignored and a longer term perspective adopted.
- Long-term valuation measures indicate that longer term returns could be below historical averages.
- Lower risk hybrid investments continue to offer more downside protection than stocks.
- First trust deeds should continue to outperform high quality bonds.



an even larger allocation to stocks. Emotions change quickly in the investment world.

This movement from fear to regret during bull and bear markets is what leads investors to buy high and sell low. Everyone is subject to these emotions; yet, successful investors are simply better than others at recognizing and controlling them. The slide above illustrates this phenomenon.

Learning from 2013

We believe that reflecting on last year can help you gain insight into whether or not you have the proper portfolio balance to fit your temperament. If you are feeling a significant amount of regret for not having had a larger allocation to stocks, it is important to acknowledge this and discuss it with us. The key is to not rush out and substantially increase your stock allocation now but rather to be patient and intentional – perhaps even waiting to do it when fear has returned to the market and you are once again feeling fearful yourself. Of course this is easier said than done.

If you felt like you had too large an allocation to stocks in 2012—while we were bombarded with concerns about the election and fiscal cliff—and were tempted to reduce your stock allocation at that time, consider talking with us about reducing it now after we have had strong equity returns. Also, resolve not to reduce it the next time the fear of a correction or an actual correction takes place.

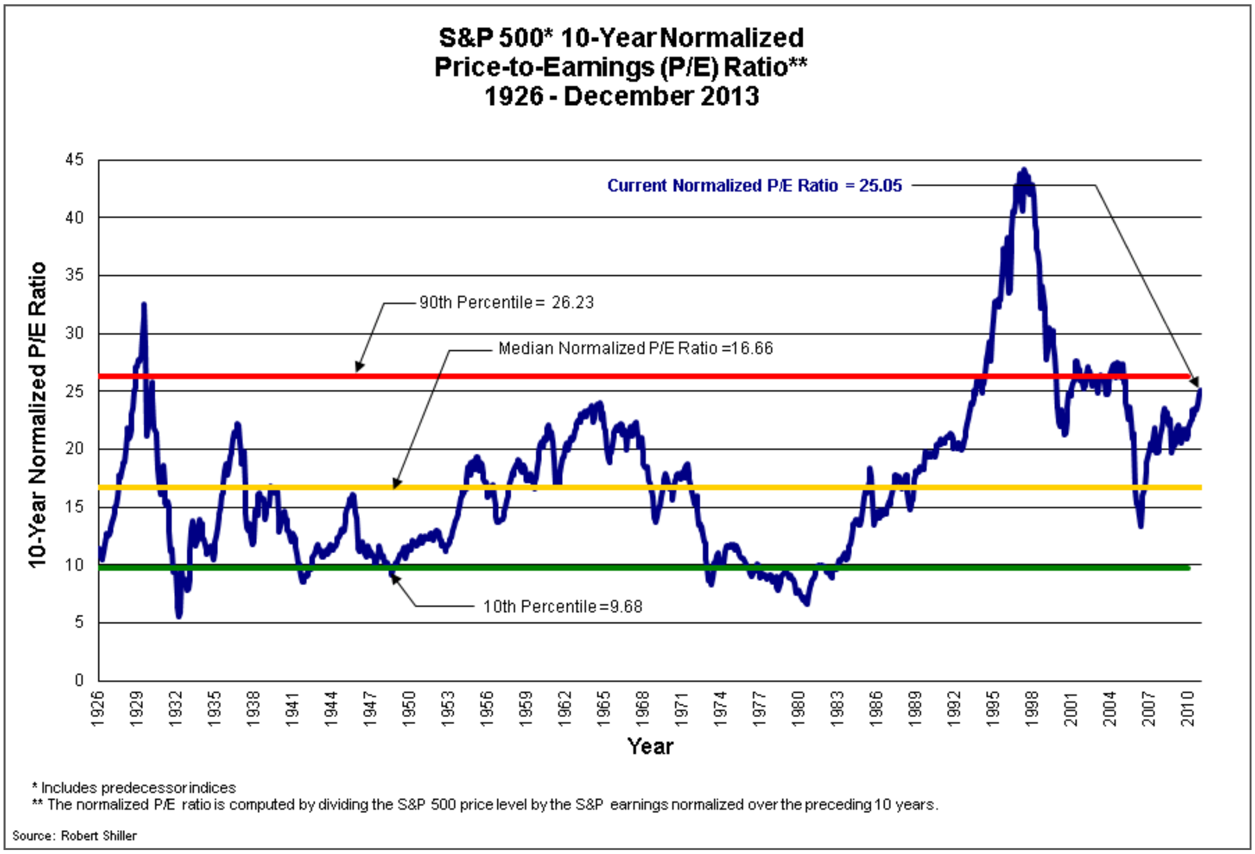
It is important to learn that in most cases when adjusting the balance of your portfolio, you should act in the opposite manner of your feelings of fear and regret. When you are feeling fearful, you should not sell stock investments but consider buying them. If you are feeling regret on the other hand, you should avoid buying more stocks and consider selling stock investments.

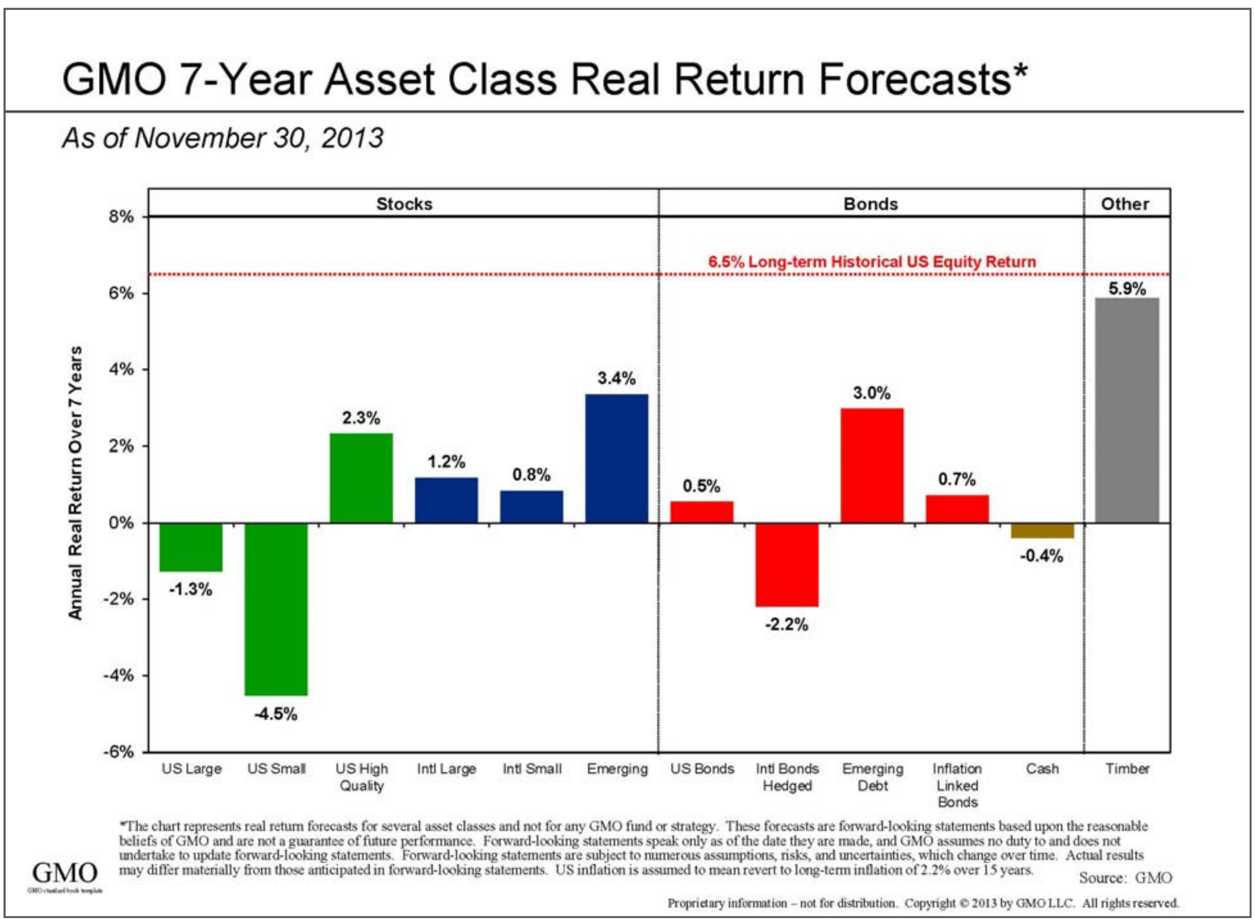
By rebalancing periodically to maintain your target allocations - you act in a slightly contrarian manner by buying when you and others are fearful and selling when you and others are feeling regretful and greedy.

Short Term Market Predictions

All of us are bombarded on a daily basis with short term market predictions that can lead us astray if allowed to take hold. Here is a sample of headlines from last year:

- 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
- May 18: "Stock Market Optimism on This Scale Hard to Explain," Financial Times
- July 7: "As Investors Rush in, Stocks Are Sending Warning Signals," Wall Street Journal
- August 24: "Lofty Profit Margins Hint at Pain to Come for U.S. Shares," Wall Street Journal
- September 18: "Profits Boost Needed for Wall Street's Equities Run," Michael Mackenzie, Financial Times
- October 7: "Get Ready For a Drop in Stock Prices," Shefali Anand, Wall Street Journal


S&P 500* 10-Year Normalized Price-to-Earnings (P/E) Ratio** 1926 - December 2013
Current Normalized P/E Ratio = 25.05
90th Percentile = 26.23
Median Normalized P/E Ratio =16.66
10th Percentile =9.68
10-Year Normalized P/E Ratio
Year
45
40
35
30
25
20
15
10
5
0
1926 1929 1932 1935 1938 1941 1944 1947 1950 1953 1956 1959 1962 1965 1968 1971 1974 1977 1980 1983 1986 1989 1992 1995 1998 2001 2004 2007 2010
* Includes predecessor indices
** The normalized P/E ratio is computed by dividing the S&P 500 price level by the S&P earnings normalized over the preceding 10 years.
Source: Robert Shiller


GMO 7-Year Asset Class Real Return Forecasts*
As of November 30, 2013
Stocks
Bonds
Other
6.5% Long-term Historical US Equity Return
Annual Real Return Over 7 Years
8%
6%
4%
2%
0%
-2%
-4%
-6%
-1.3%
-4.5%
2.3%
1.2%
0.8%
3.4%
0.5%
-2.2%
3.0%
0.7%
-0.4%
5.9%
US Large
US Small
US High Quality
Intl Large
Intl Small
Emerging
US Bonds
Intl Bonds Hedged
Emerging Debt
Inflation Linked Bonds
Cash
Timber
*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.
Source: GMO
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- November 16: "Is This a Bubble?" Joe Light, Wall Street Journal

Having a long-term perspective and confidence in your portfolio will help you ignore the market warnings and prognostications of the day. No one really knows what is going to happen in the short-term.

Valuation Update

Even though nobody can predict what is going to happen to markets in the short-term, we do feel it is constructive to look at valuation measures in an effort to gauge future long-term expected returns. Two of the valuation measures we have introduced and covered in the past are the GMO 7-Year Asset Class Returns Forecast and the Shiller S&P 500 Normalized P/E 10 ratio.

As you can see from the graphs on page 3, both of these measures of valuation are indicating that future stock market returns both foreign and domestic may be below historical averages. Given the current economic environment and the recent increase in stock prices, we believe this is a reasonable expectation. Because of this possibility, investors should maintain broad asset class diversification in their portfolios.

Hybrid Investments

Due to the lower expected returns for equities (stocks) we still feel it is prudent to maintain an allocation to Hybrid investments because of the greater downside protection they provide relative to stocks. We have sold or reduced the investments in this Hybrid category that were most like stocks - namely the convertible security funds and the utility stock investments. The proceeds from these sales were invested into more diversified stock investments including a portion into Emerging Markets. A portion of these proceeds was also invested into more conservative investments so as to maintain the overall equity exposure in a portfolio.

Fixed Income

High quality bonds serve to reduce the risk of stocks in client portfolios but they had their worst year since 1994 and dropped -2.02% last year. Although bonds will continue to reduce overall risk in portfolios, we do not expect them to provide much return for the foreseeable future (as you can see from the GMO forecasts).

Because of this, for many clients we use a high quality first trust deed pool in place of high quality bonds. This investment provided returns of 7.8% last year or almost 10% more than high quality bonds. We continue to believe that this investment will outperform high quality bonds over the long-term and help to insulate our clients from the risk of rising interest rates. Because the investment is highly diversified, has no leverage and a very low loan to value, we are confident it will continue to perform as expected.

We will also maintain a small allocation to emerging market bonds and lower rated multi-sector bonds for diversification purposes.

Summary

There was a wide dispersion in returns between different asset class investments in 2013. In times like these it is tempting to chase the highest returning asset classes, but this is rarely a sound investment strategy. If you are experiencing regret for not having had a larger allocation to stocks this year, try to avoid rushing out and haphazardly increasing your stock allocation. Instead, consider revisiting a long-term strategy you can stick with.

If you were particularly fearful in 2012 but stayed the course and benefited from the high returns of 2013, you might want to consider trimming your stock allocation now after such a good year; and then vow not to reduce it during the next market correction. Staying disciplined and acting against the emotions of fear and regret is often the best course of action.

Thank You for Your Referrals

As always, we want to thank you for your referrals. Our business was built through word of mouth and we sincerely appreciate these referrals.

Don't hesitate to call if you have any questions or anything on your mind that you would like to discuss. We hope you had a great 2013 and are looking forward to a productive and enjoyable 2014. From all of us here at Financial Alternatives, Inc. we want to wish you a Happy New Year!

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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