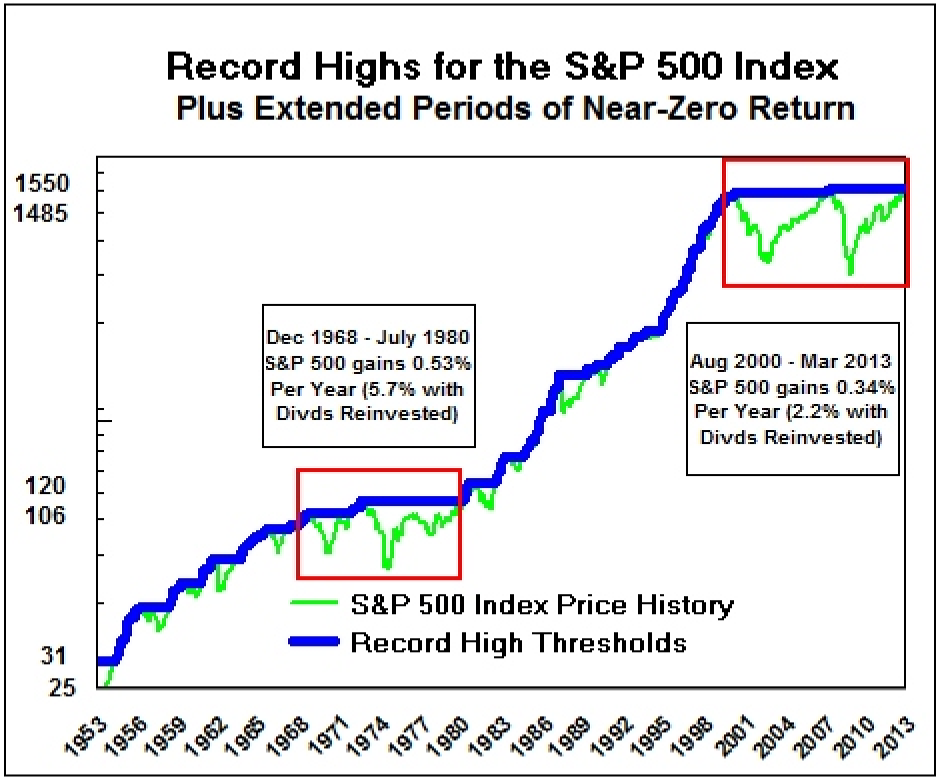
From: Warner A. Henderson, ChFC

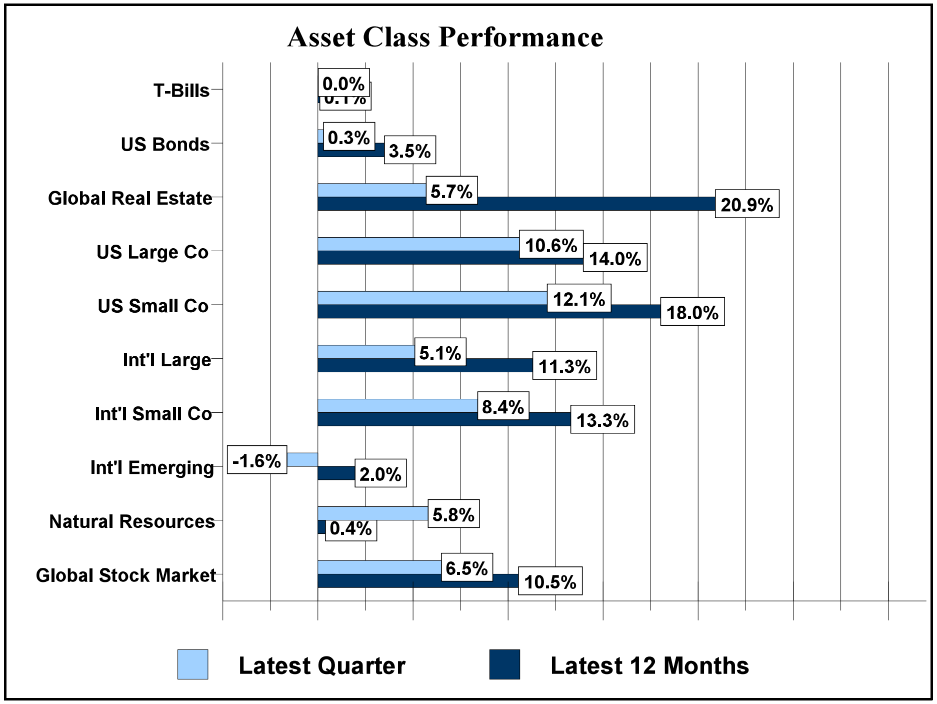
Subject: Stock Market Hits Record High........What's the Big Deal?

The US stock market's recent record high is newsworthy for the media, of course, but this "milestone" hardly deserves attention for long-term investors who might view this simply as a data point along the continuum of economic growth and progress. After all, stock prices are ultimately a reflection of corporate earnings which have been growing rapidly since the economic recovery began in 2009 (corporate earnings are now at record high levels). Over the past sixty years, the S&P 500 Index, one of the broadest measures of stock prices, has grown from a price level of 26 in 1953 to the current record level of 1,550+; an annualized gain of 7.1% for the Index *excluding dividends* and 10.7% with dividends reinvested. Since 1953 there have been 720 investing months and during that time span the S&P 500 Index reached a record high 187 times, or *an average of one record high every four months*. So, if the stock market followed a steady line of growth, the media would be announcing a record high every four months (hardly newsworthy). As we know all too well, the market doesn't move in a steady line and there are typically long periods of upward, downward and seesaw movements. In the chart at right, note the two extended periods of under-performance for the S&P 500 Index boxed in red. The first began at the height of the "Nifty-Fifty" stock bubble in 1968 and lasted until July of 1980 with only one record high achieved in between. During those 11.5+ years, the S&P 500 Index gained an average of just 0.53% per year (5.7% with dividends reinvested). The second even more dismal period began at the height of the Technology Stock Bubble in August of 2000 and lasted until March of this year; again with only one record high achieved in between. During this 12.5+ year time span the S&P 500 Index posted a *near-zero 0.34% annual return* (a mere 2.2% annual return with dividends reinvested). Globally diversified investors fared much better over this period thanks to robust returns from US Small Co's, Natural Resources and Emerging Markets which generated annualized returns of between 9% and 10%.

When I originally selected the past sixty years for my analysis, I didn't realize there were two eerie coincidences between March of 1953 and March of 2013. First, the US Public Debt in 1953 was 71% of Gross Domestic Product (GDP); today the debt level is just over 75%. One big difference, of course, is that the debt level was shrinking sixty years ago, thanks in part to a growing economy following World War II and a *top federal income tax bracket in 1953 of 91% and a capital gains tax rate of 25%* (tax rates deemed necessary to pay-off the debt accumulated during the Great Depression and World War II). A second coincidence is that in 1953 North Korea was at war with South Korea and the US; an outcome we hope will be avoided this time despite all of the saber rattling by North Korea's Premier Kim Jong-un.



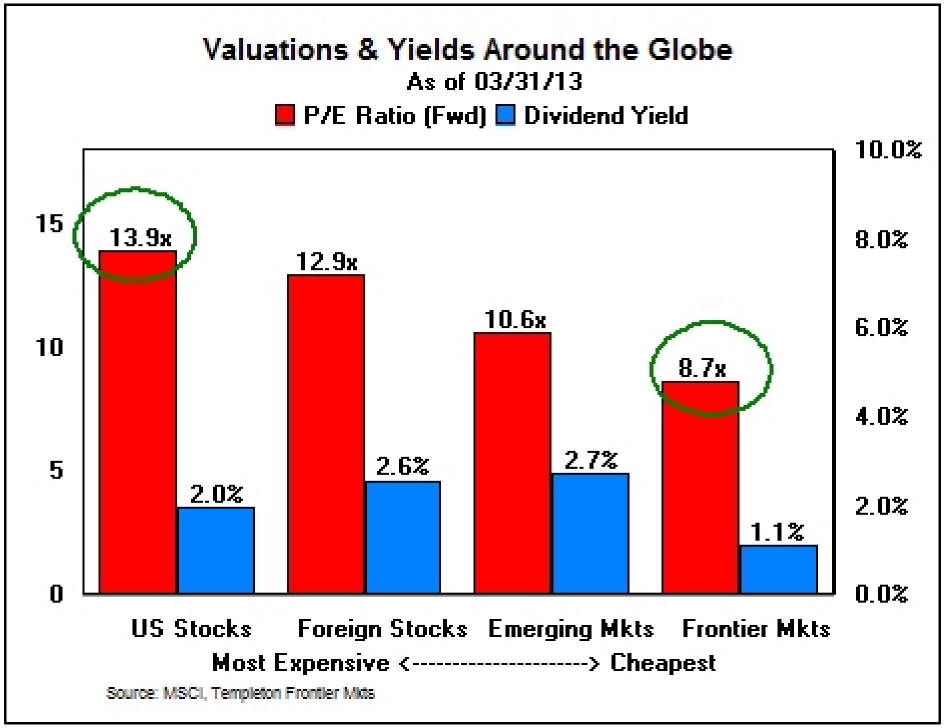
Later in this report, I'll examine some interesting facts about the recent record highs and stock valuations which may provide a clue as to possible future long-term performance. First, however, let's take a look at the latest asset class returns which were quite impressive.

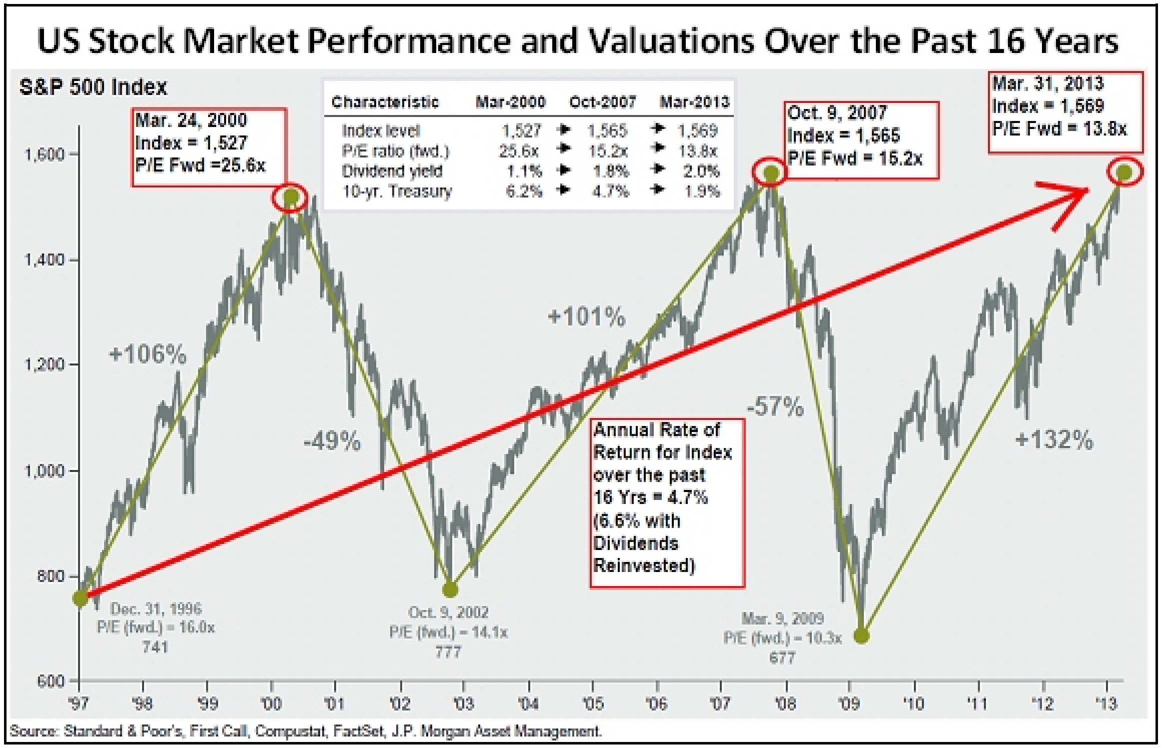


Asset Class Performance Observations

The returns for the first quarter were remarkably strong with the exception of Emerging Markets which posted a loss of -1.6% (a buying opportunity we believe). Leading the way were US Small Co's and US Large Co's which gained 12.1% and 10.6%, respectively, over just the last three months (performance numbers in line with historic average *annual* returns). Next in line were Int'l Small Co's (+8.4%), Natural Resources (+5.8%), Global Real Estate (+5.7%) and Int'l Large Co's (5.1%). Bonds came in with a return of just 0.3% and US T-Bills, once again, provided no return. The entire Global Stock Market gained an impressive 6.5% for the quarter (as measured by the MSCI All Country World Index). There were two surprises during the quarter; first, investor appetite for risk assets returned evidenced by the strong showing for stocks; second, stocks in the Emerging Markets were left out of the party (more on this topic below).

The order of asset class performance over the past twelve months was similar to that of the first quarter with the one big exception; Global Real Estate which led the pack with a return of 20.9%. Both US and Developed Markets stocks out-performed stocks in the Emerging and Frontier Markets which was somewhat surprising given the generally more optimistic outlook for the emerging economies (perhaps speculators were taking profits on Emerging Markets stocks given their strong showing in 2012). As a result of lagging performance, stock valuations in the Emerging and Frontier Markets appear particularly attractive. In the chart below, note that US stocks are priced at 13.9 times forward estimated earnings (i.e., a P/E Ratio of 13.9) compared to between 8.7 and 10.6 times earnings for stocks in the Emerging and Frontier Markets. At the two extremes, investors are paying $13.90 for each $1.00 of estimated earnings for US stocks compared to $8.70 for stocks in the Frontier Markets; a "discount" of about 60% which is unusually large. We believe that valuations in the Emerging and Frontier Markets offer *long-term* investors an excellent opportunity for capital appreciation (note the emphasis on *long-term* given the higher volatility and greater risks associated with those markets).





A Closer Look at the Recent History

One of the keys to successful long-term investing is to avoid or at least under-weight stock asset classes which appear over-valued and, conversely, over-weight asset classes which appear to offer superior relative valuations. In looking back at the S&P 500 Index over the past sixteen years, one can gain much insight into the merits of paying attention to valuations. Note in the chart above the path of the S&P 500 Index. The Index began with a value of 741 and a P/E Ratio of 16 times earnings. It so happens that a P/E Ratio of 16 is just about the average P/E for the S&P 500 over the past 80+ years, so let's assume that stocks were priced at an average valuation in 1997 (before the Tech Stock Bubble). Given a robust economy in the late 90's and investor interest in larger US companies poised to benefit from the technology revolution, the S&P 500 Index gained 106% by mid-2000 reaching a record high of 1,527 on the Index and also a record-high P/E Ratio of 25.6 (i.e., a time of *irrational exuberance)*. The stock bubble burst, as we well know, leading to a collapse in prices with the Index falling back to 777 with stocks valued at a P/E Ratio of 14.1 times earnings. With more attractive prices and with a growing economy following the 2001-02 recession, the Index doubled in price to squeak out a new record at 1,565 for the S&P 500 Index. The P/E Ratio was then 15.2 times earnings which seemed reasonable at the time; however, the collapse of the Housing Bubble in 2008 brought down the entire economy as well as corporate earnings. The S&P 500 Index plummeted to 677 and the P/E Ratio fell to 10.3 (a *great* time to rebalance from bonds into stocks). From those depressed price levels, the S&P 500 Index has now climbed back to a record high of 1,569, but only 42 points higher than the record set back in 2000! The P/E Ratio for the S&P 500 at the end of March was below average at 13.8 times earnings (lower than any of the extreme high or low points on the chart with the exception of March of 2009). While one might look at the chart and assume we're in for another plummet, it should be reassuring that the S&P 500 is not priced at an over-valued level and there don't appear to be any stock or housing bubbles. That being said, I think we should expect the path of the stock market to remain volatile given all of the global economic and geopolitical risks. Long-term, we believe the current valuation of the S&P 500 is attractively priced and there is good upside potential. Furthermore, we believe that a few other asset classes, including the aforementioned Emerging and Frontier Markets, offer even better valuations. By paying attention to valuations, maintaining the discipline of rebalancing and minimizing costs, we believe that a globally diversified investment strategy will continue to provide clients with superior long-term results.

Final Thoughts

"Every year I could sit down with a yellow pad and write down 20 problems the country faced. I could have done it when I was 20 years old, and I could do it now, but we've still got a machine that moves forward." (Warren Buffett, November 28, 2012.) Of course, the *machine* Warren Buffett is referring to is the global economy which has experienced all sorts of challenges and turmoil over the years, but has nonetheless moved forward and progressed through time. With an understanding that stocks represent an investment in the future of the global economy and by focusing on the long-term picture, the short-term problems we face can, perhaps, be more appropriately be viewed as opportunities.

Here's to the end of winter, longer days, and a time to renew hope for the future!