

From: Aequitas Investment Advisors

### Subject: Stock Corrections and Value Investing

Pundits have been calling for a stock market correction (i.e., a pullback of at least 10%) for close to six months; yet despite the geopolitical turmoil in Eastern Europe and the Middle East, as well as the surprising news of negative economic growth during the first quarter of 2014, investors have remained remarkably calm, volatility measures are low and the US stock market stands at a record high level. A 10% correction would see the Dow Jones Industrial Average fall to about 15,400 from its record high of 17,095 (as of this writing). Perhaps investors have simply become numb to bad news having survived the psychological roller coaster over the past seven years, or perhaps investors are choosing to see the glass as half full rather than half empty given mounting evidence the economy is gaining strength. Nonetheless, one thing we know for sure is that investor psychology is predictable and some future news event will rattle investors and trigger a pullback in stock prices. In looking at the graph at right, we have charted the course of global stock prices over the past three years which have been unusually volatile from an historic perspective. Note the red arrows which indicate selloffs following periods of bad news ranging from a mild 6% to the severe 23% plunge in the summer of 2011 following the US Debt Ceiling Debacle. While the Debt Crisis in the US and Europe has eased, the more recent developments in the Middle East and Eastern Europe have emerged as likely triggers for future stock market turmoil. Additionally, mixed economic reports and speculation about future actions of the Federal Reserve are adding to the caldron of uncertainty. Yet as we've learned over the long-run and the recent past, speculating about future events is seldom a useful or profitable exercise when it comes to investing. Rather, the most practical solution for dealing with stock market volatility and life's uncertainties is to maintain an appropriate *balance* between safe assets and riskier growth assets while also maintaining investment *discipline* through both periods of calm and turbulence.

### Stock Market Volatility and Valuations

In his renowned book, *The Intelligent Investor* published in 1949, the late Benjamin Graham, formerly a Professor of Finance at the Columbia Business School, offered the following observation about stock market volatility, "In the short run, the [stock] market is a voting machine, but in the long run it is a weighing machine." By this Graham meant that speculators and short-term traders would wreak havoc on stock prices as they *react* to news events, i.e., selling stocks during periods of fear and bidding up prices during periods of exuberance or greed. To Graham, these short-term gyrations were akin to a "voting machine" of investor sentiment. For patient investors, however, Graham believed that a diversified portfolio of stocks would likely provide a substantial profit over the long-run which could be "weighed" or measured as a rate of return. Furthermore, Graham's research indicated that by investing in stocks with lower prices relative to their intrinsic value (i.e., "value" stocks),

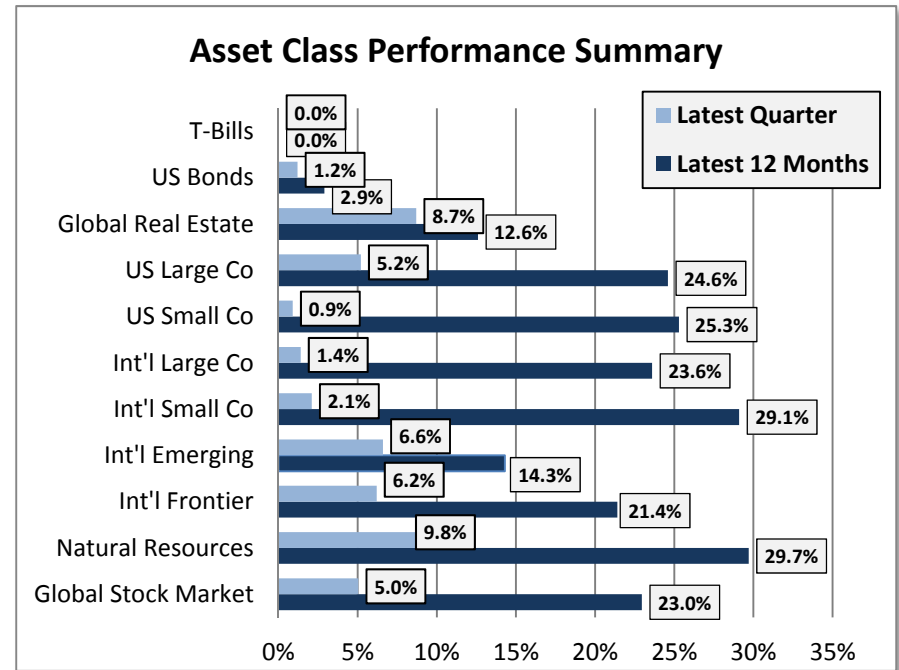


investors could avoid overpaying for stocks and, thus, improve the odds of a successful outcome (intrinsic value includes factors such as corporate earnings, assets and liabilities). Warren Buffett, a student of Graham's at the Columbia Business School and the only student of his to earn an A+, took Graham's value philosophy to new heights and became one of the world's most successful investors (Buffett credits Graham as being the most influential person in his life after his own father). And while approaching the subject of value stocks from a purely academic perspective, Eugene Fama of the University of Chicago's Booth School, analyzed more than fifty years of stock price data and arrived at essentially the same conclusion; i.e., stocks which have traded at low prices relative to their intrinsic value have historically outperformed stocks which traded at high relative prices (Fama's research inspired the founding of Dimensional Fund Advisors in 1981 and recently earned him a Nobel Prize in Economic Sciences).

Given the compelling academic evidence (Graham and Fama) as well as actual performance results (Buffet and DFA), it should come as no surprise to learn that all of our model portfolios are weighted heavily toward value stocks. On an individual fund level, practically all of the recommended DFA mutual funds have a "value tilt" and most of the active managers we recommend pay close attention to stock valuations. Furthermore, by looking at valuations across the entire global stock market, one can identify countries and regions where stock prices appear to be relatively more attractive. We'll take a closer look at global stock valuations later in this report, but first, let's review the latest investment results.

### Asset Class Performance Review

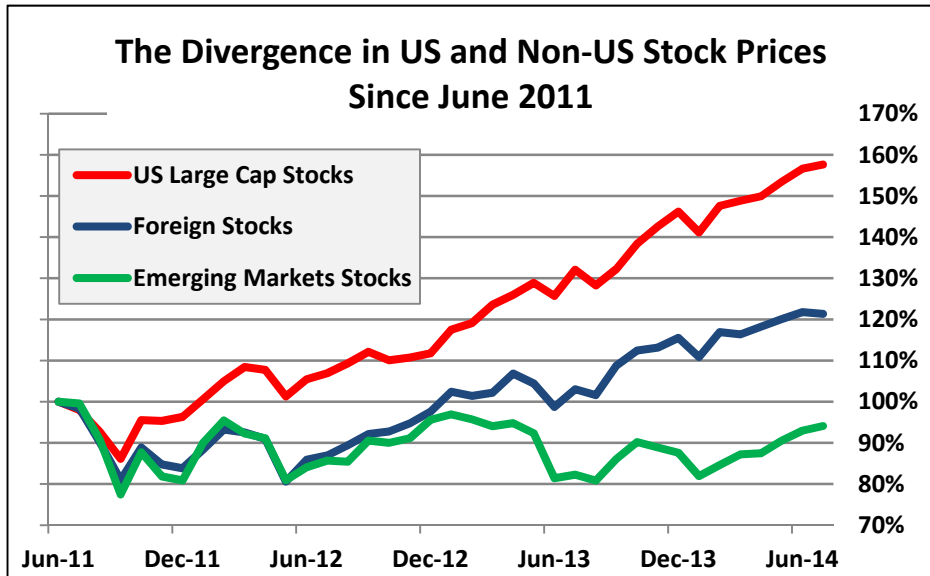
For the latest quarter, all of the major asset class returns were in positive territory with the entire Global Stock Market gaining 5%. The biggest gainers this quarter were the biggest laggards in the first quarter; notably, Natural Resources, Global Real Estate and Emerging Markets (EM) with remarkable gains of 9.8%, 8.7% and 6.6% respectively. During the first quarter, investor concern about slowing economic growth and political turbulence in the Emerging Markets triggered an EM stock sell-off; subsequently, those fears subsided and capital began flowing back into EM stocks as investors determined their prices had fallen sufficiently to compensate for the risks. Following the three leaders were the Frontier Markets (+6.2%), US Large Co's (+5.2%), Int'l Small (+2.1%), Int'l Large (+1.4%), US Bonds (+1.2%), US Small Co's (+0.9%) and T-Bills, once again, at zero percent.



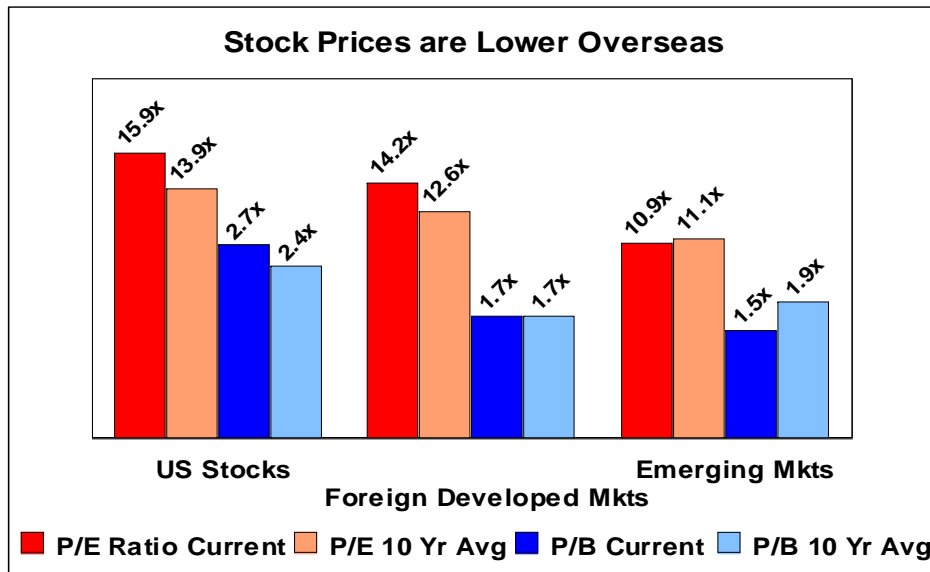
For the trailing twelve months, returns across all of the stock asset classes were extraordinary with the broad Global Stock Market gaining 23%. Leading the way were Natural Resource stocks (+29.7%), Int'l Small Co's (+29.1%), US Small (+25.3%), US Large (+24.6%), Int'l Large (+23.6%) and the Frontier Markets (+21.4%). Down a notch, but nonetheless higher than their historic average, were Emerging Markets stocks (+14.3%) and Global Real Estate (+12.6%). Lastly, US Bonds gained 2.9% and US T-Bills, once again, at zero percent.

### Global Stock Valuations

Over the past three years, US stock prices have surged by close to 60% while Foreign Stocks have gained just 15% and Emerging Markets Stocks have lost about 8%. In the next chart below, one can clearly see the "divergence" in stock prices which, at least, provides a rebalancing opportunity to trim US stocks and add to non-US stocks (i.e., sell high and buy low). Moreover, in looking at current global stock valuations, i.e., prices relative to intrinsic value à la the Graham methodology, the divergence is reinforced. In the second graph below,



*Stock Prices are Lower Overseas*, we've compared the current Price to Earnings (P/E) Ratios and Price-to-Book (P/B) Ratios to their averages over the past ten years. The P/E Ratio compares prices to estimated future corporate earnings while the P/B Ratio compares prices to Book Value (i.e., the total amount a



company would be worth if it liquidated its assets and paid back all its liabilities). Both ratios indicate that US stocks are more expensive than they've been on average over the past ten years and they're more expensive than non-US stocks. Foreign Developed Markets stocks are slightly less expensive and Emerging Markets (EM) stocks look significantly cheaper. Of course, EM stocks are more volatile than US stocks, but the price "discount" for EM stocks appears to be sufficient to compensate for the higher risk. Given our assessment of P/E and P/B Ratios, as well as additional valuation metrics, at our most recent investment committee meeting we decided to reduce the recommended weight for US stocks in our strategic model by 5%, from 55% to 50%, and concurrently raised the weight to Foreign Developed Markets stocks from 28% to 33%. We had previously raised the recommended weight to Emerging and Frontier Markets, so their allocation remains at 17%. (Note that these percentage weights apply only to Equities, not Fixed Assets, and are independent of the recommended allocations to Real Estate and Natural Resources).

#### Closing Comments

We live in very complicated and uncertain times with no quick fixes to the array of geopolitical and economic uncertainties. Yet, history has a way of repeating itself and the lessons learned in the past can provide us with a lens to better understand the world's current events as well as a framework upon which to chart our courses into the uncertain future. The alternative of reacting with our emotions and allowing speculation to guide our decisions is akin to heading out to sea on a boat without a rudder. With regard to investing, the lessons learned from Benjamin Graham and Eugene Fama can help us evaluate stocks *rationally* and improve the odds of achieving successful long-term results. Furthermore, to help offset the inherent volatility of the stock market (i.e., the *voting machine*), we've learned that creating *balanced* portfolios with high quality bonds can help reduce risk and provide a safe haven from the inevitable storms.

While Graham is best known for his contributions to the world of investing, his philosophy for daily living also provides food for thought. At the age of eighty, Graham told a close friend that he hoped every day to do "something foolish, something creative and something generous." Amen.