StaufferWilliams
ASSET MANAGEMENT · LLC

FEBRUARY 2014 INVESTMENT COMMENTARY

EMERGING MARKET TURMOIL HEATS UP WHILE THE U.S. ECONOMY GETS HIT BY THE POLAR VORTEX

Last month's U.S. equity sell-off was the worst January stock performance since 2009, price action that too easily reminds investors of the pain associated with the 2008-09 financial crisis. Plus, with market volatility and geopolitical risk back after taking a yearlong vacation, the media has not been shy about sensationalizing stock market losses and, ultimately, increasing investors' concerns. Unfortunately, when the markets are doing well, as they did last year, and investors become complacent, TV ratings fall for the financial news shows due to a lack of interest. Therefore, it is not surprising that the financial press has done its best to turn the most recent 4% market dip into something potentially more ominous.

As usual, our attention was focused on earnings reports, company specific events, and portfolio construction. While holdings such as Facebook performed very well after releasing another good quarterly earnings report, we eliminated several other positions where we felt that the upside opportunity no longer outweighed the potential downside exposure. These sales made room in portfolios for investments that have been researched over the last several months. However, we did sell a mutual fund purchased in the first half of 2013 that provided exposure to the developing nations of Asia. This action was taken in order to protect our portfolios from potential contagion related to macros risks unfolding in several of the emerging market countries.

Over the last several months emerging markets have been riddled with political instability. This instability has become particularly worrisome in Turkey, Argentina and Thailand. Plus, many other emerging markets are beginning to feel the contraction of investment flows into their economies due to the prospect of higher U.S. interest rates, which stems from the Federal Reserve's systematical reduction of previous stimulus efforts. Relative interest rates and corresponding currency values are a delicate balancing act for lesser-developed nations who find it very difficult to temper the enthusiasm of investors in their economies during times when monetary stimulus in the developed world is in full gear. This foreign investment, which can be a major source of growth capital for these lesser-developed economies, is very sensitive to both real and anticipated changes in borrowing costs, investment yields, and currency risk. Therefore, just as the developing nations seem to have entered a period of sustained positive economic growth, many developing nations are experiencing contractionary forces.

Illustrating the stability and strength of the largest developed economy, the U.S. reported that the first reading of 4th quarter GDP in January came in at 3.2%. This solid quarterly growth followed the 3rd quarter's 4.1% reading. From these reports, it appears that the second half of 2013 is shaping up to be the strongest consecutive two quarters of economic growth in the U.S. since the financial crisis. The unemployment rate is now 6.7%, although labor participation rates continue to drop to multi-decade lows. However, labor participation rates in the U.S. have been trending downward for over a decade due primarily to a growing percentage of the population moving into the pre-retirement/ retirement age. Thus, it is not surprising that this trend has been exacerbated over the last 4 to 6 years due to the financial crisis and structural changes. And yet, in regard to the overall economic growth seen in this past quarter, corporate revenue and profit reports have been generally as expected.

I believe that the poor equity performance in January has been less of a function of real risks to the U.S. economy from the emerging markets or underlying domestic weakness, and more so caused by too many investors looking for a reason to lock in some large gains that were created by the strong equity markets in 2013. The emerging market instability, plus a weaker than expected December jobs report, which was impacted by poor weather, have provided a plethora of worrisome data points that may be used to justify a sell decision. Additionally, market dips are not likely to be bought as enthusiastically by money managers as in the recent past due an environment of stretched valuations. As a result, asset managers will likely hesitate to add to equity allocations, while weak handed retail investors, who are typically scared by volatility, will tend to sell into weakness. Lastly, market swings are exaggerated as short-term oriented traders eagerly trade the resulting volatility.

In our search for long-term opportunities and continual assessment of potential deterioration of fundamentals, we do not see any real threats to the fundamental drivers of the U.S. economy and equity markets. January's volatility has allowed us to add to existing positions at lower prices and put new client money to work more quickly. Distinguishing volatility from risk and staying focused on fundamental value drivers has always been the hallmark of my portfolio management process.

I will keep comments relatively short this month, as I am including a short paper written by The Applied Finance Group (AFG) in this month's commentary. This paper is a timely compliment to the basic comparison that I included in the January commentary highlighting the U.S. equity market's return to valuation levels last seen in 2007.

AFG, which has been an equity research partner of mine for the last five years, is one of the primary resources that I utilize for generating new ideas and valuation analysis. AFG's tools enable very rapid access to data, which is critical to being able to identify equity investment ideas that would be usable in client portfolios. The methodology, which determines whether a company is a "value creator" or "value destroyer", utilizes a variation of return on invested cash flow and has proven itself to be remarkably effective for over 15 years.

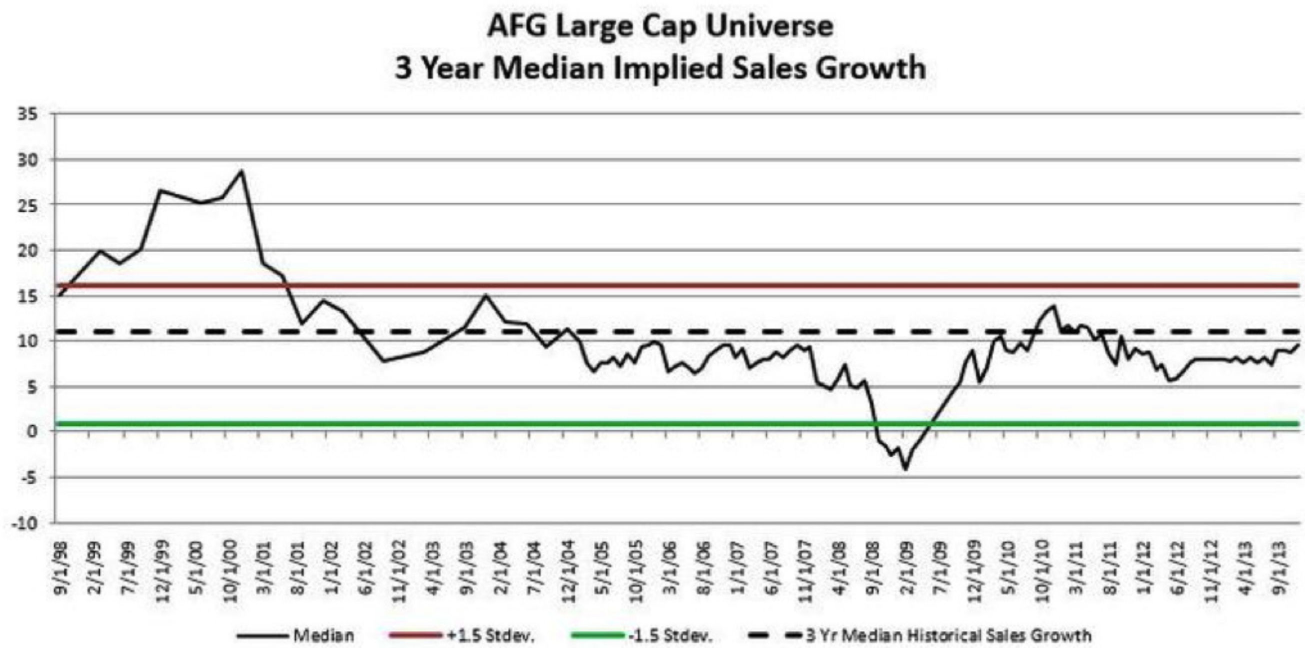
The AFG analysis included in this month's commentary below reinforces my assertion that although the broad U.S. equity market is not currently under-valued, when carefully looking at markets from the bottom-up, there still remain a meaningful number of companies that have attractive risk/return characteristics relative to valuation and growth prospects.

SET IT AND FORGET IT - DON'T FEAR THE MARKET RUN-UP - S&P 500 / JANUARY 24, 2014

The New Year brings a natural reflective response to most people, and with regards to investments and stocks in particular a common question lately is whether to stay in the market given its run over the past 4 years. I believe assets invested in the market should stay in the market" almost" all of the time. The result of this philosophy is simple; I tune out the majority of talking heads constantly talking about the coming crash. While the Bearish type commentators sound convincing at a point in time, when one examines their records across time most of them are massive losers. Investors that tend to try to move in and out of the market tend to directly or indirectly lose significant wealth.

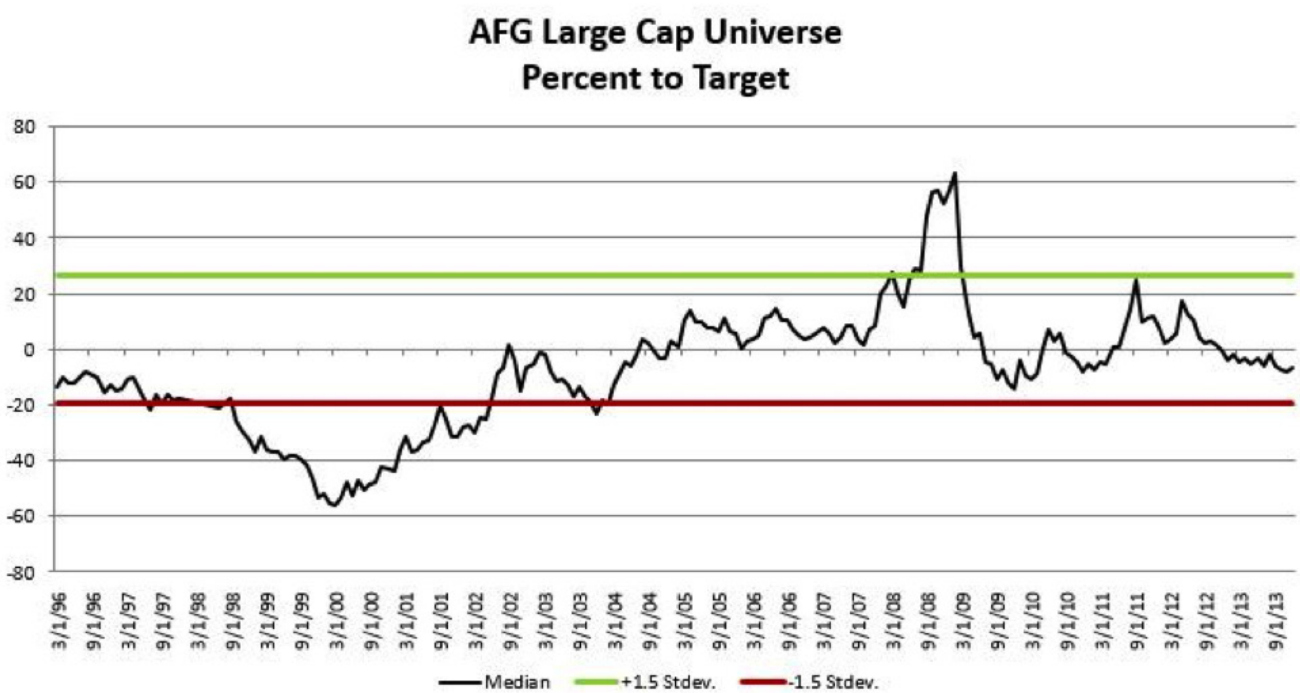
I understand that pull to time the market is just too great for many people, so I will share two charts I use to make sense of market valuations and provide discipline to any thoughts about reducing market exposure when things get scary. Taken together, my conclusion is – The market does not look particularly attractive, but it is not over-valued to the point that warrants adjusting target exposure levels.

The first chart displays the implied sales growth embedded in the market price for stocks with market capitalizations over $6 Billion, or what is commonly considered to be "Large Cap" stocks, and compares those expectations to the sales growth these stocks have delivered over the past three years.



The main takeaway from this chart is simple – the market has priced the typical Large Cap company to grow its sales at just under 10%, while over the past three years such companies have grown at just over 10%. From this perspective, I conclude the market is fairly valued.

Another perspective that I like to incorporate into creating my market view is to evaluate the intrinsic value of each company relative to its traded price and determine if the market is over or under valued from a bottom up perspective. This is displayed in the following chart.



Going back to 1996, using this approach we see two distinct "bubble" periods – the tech boom of '99 and the mortgage crash of '08. In each instance, market valuations deviated from the intrinsic value of companies by 60% in each instance. In mid-'09, we issued a study titled "Then and Now" which contrasted the extreme opportunities available to investors in 2009, relative to the train wreck awaiting investors in late 1999 and concluded that the stock market presented a generational opportunity to amass wealth by being long++ the market. Today, market valuations slightly exceed intrinsic values, but not by enough to warrant any significant actions.

Earlier I mentioned that market calls should "almost" never be made. I call that the Max the Miracle Worker rule. Max from Princess Bride could bring those that were "almost" dead back to life. Similarly, I begin to get excited about overall market adjustments to portfolios when we see extreme readings on our various macro metrics, for the intrinsic value chart above, I would need to see market prices exceed the intrinsic value of individual stocks by over 15%. For now at least we are not close that figure, until then I would continue to just "Set It and Forget It".

I stated in last month's commentary that I was more cautious going into 2014 than in any year since 2007. I have been asked by several people recently what could spark a market correction. The obvious answer is the effects of Fed QE tapering and a slow-down in China. However, experience tells me that many times stock market corrections occur simple because many investors are looking for a reason to sell. Therefore, the reason for a correction in markets does not have to follow an intuitive script, but simply occur because the correction or conversely a rally is long overdue and some combination of data points spur investors to buy or sell. Experience also teaches that such periods should be viewed opportunistically.

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