INVESTMENT STRATEGY
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Years from now investors will look back with great fondness at 2013, as virtually all the major U.S. stock averages reached new all-time highs, including a 29.6% gain for the S&P 500 Index. This was the largest annual gain since the exuberance of the late 1990's and the third best performance in the past quarter century. This past year was so rewarding for investors because it contained some major transformative events. Interest rates finally moved higher after persistently declining over the prior 30 years. Gold lost its luster after being considered a crucial safe haven. Most importantly, we saw average investors finally beginning to be comfortable with equity investments as the vivid memories of two horrific crashes in the past twelve years receded. All of these events are producing a major shift in market psychology. Ultimately, changing investor perceptions and expectations heavily influence where the different asset classes are headed next. Given this backdrop, we expect the equity markets to continue advancing in 2014.

This past year was the 22nd time since 1945 the S&P 500 had an annual gain of more than 20%. The last two instances were in 2003 and 2009, years when the market was recovering from deep bear markets. History tells us that 2014 should be a good year, but certainly not a repeat. On average, the S&P 500 gains 10% following a 20% up year. The only times the S&P 500 duplicated a 20% gain in the following year was during the exuberance of the late 1990's tech bubble and in 1954/1955. Interestingly, the 1950's surge contained a key psychological inflection point as the market finally recovered back to its 1929 high (after 25 years).

Improved investor confidence has also resulted in reduced volatility over the past two years. However, based on historical data we should expect a bumpier ride in 2014. The S&P 500 has now gone 26 months without slipping into at least a 10% correction. On average, the market suffers such a correction every 18 months. The market also has a habit of undergoing corrections during years that contain mid-term elections. Although these are mere statistics, we should be aware that we are likely due for heightened volatility. However, we believe any correction will probably be a buying opportunity rather than being the harbinger of a new crisis.

These are some of our baseline expectations for the year ahead. When considering the bigger picture, historians may look back at 2013 and remember it for a lot more than a great year in the middle of an ongoing bull market. In many ways, 2013 marked a psychological turning point for the average investor. This change in attitude is perhaps best illustrated by the price of gold. Over the past decade, gold had become the favorite investment for a number of hedge fund managers and became an accepted asset class by many large pension funds. Gold was touted as the ultimate inflation hedge as the price increased from $400 an ounce in 2004 to an all-time high of $1,889 in 2011. Proponents of gold believed aggressive moves by central banks to spur economic growth would result in elevated inflation. In reality, gold tracks investor fear much more closely than it does inflation. As investor anxiety declined, gold fell from roughly $1,700/oz to $1,200/oz. In contrast, stocks surged to new all-time highs.

The second great indication of this psychological turning point was discussed in our July strategy. Interest rates doubled on the 10-year U.S. Treasury bond, bouncing from all-time lows of 1.45% in the spring to 3.0% by the end of 2013. As we expected, this caused investment capital to leave emerging markets and return to the major developed countries, notably the U.S., Europe, and Japan. Due to this change in the flow of investment capital, worldwide growth expectations have shifted. Since mid-year when interest rates began to increase, projected growth rates across the emerging markets have consistently been revised downward. Meanwhile, projected growth rates in developed markets have been adjusted upwards.

We point out this dynamic once again because we do not believe the average investor fully appreciates the importance of this change. From an investment standpoint, it is essential to seek out situations where the reality is likely to exceed low expectations. On the other hand, investors want to avoid situations where there are unreasonably high expectations that cannot be met. Speaking in very broad terms, we believe investors have low expectations for developed markets that are likely to be exceeded. Meanwhile, after a decade of supercharged growth, investors have unreasonably high expectations for most emerging markets.

The unreasonable expectations that emerging markets will be forced to confront are coming not just from foreign investors, but from their own citizens. Due to breakneck growth over the past 10-15 years, people living in the emerging markets have much higher expectations for their countries and governments. They have been asked to make sacrifices for the sake of development with the promise of a middle class lifestyle in the future. Although there have been gains in moving people out of abject poverty, the majority of the benefits have gone to a small and very visible elite class. The dream of a flourishing middle class has largely been unmet in most of these countries. With their dreams unfulfilled, populations have grown restless and have begun to voice their displeasure. The ongoing “Arab Spring” is the most prominent example of this discontent, but during the past year we have also seen large demonstrations in Brazil, Turkey, China, and the Ukraine, among others. We believe growing unrest is likely to persist for many years. Unfortunately, instability causes additional investor capital to flee, further deepening economic problems.

As perceptions fade for emerging markets, the opposite has been happening in developed countries. In the U.S., housing prices are up, employment is increasing, and politicians have actually made meaningful compromises. Japan may have seen the biggest change in perceptions during 2013. After 20 years of deflation and economic stagnation, the new government has become extremely aggressive promoting growth and attempting to manufacture some inflation. Even Europe, which instituted austerity policies that exacerbated recessions, has seen glimmers of growth and fairly stable financial markets. Although Europe has a long slog ahead, leaders are now making some rational decisions, rather than just theatrics and emotional pronouncements.

Of the available options, we believe the future prospects for the U.S. are clearly the most attractive. As stated in our October strategy, the U.S. has a number of key advantages compared to other developed economies in the world. The U.S. is undisputedly the world leader in innovation, has more plentiful and cheaper energy, and has a far more flexible labor force. There are many other reasons the U.S. will be successful, but these key differences set the U.S. apart from other developed countries and they are differences that are likely to still be true twenty years from now. This long-term clarity allows CEO's to have confidence when deciding to start a new company or expand an existing one. We believe this will become more apparent in 2014 as corporate leaders step up investment, with the U.S. being the main beneficiary.

In addition to the psychological shift investors are undergoing, we see a similar change among corporate leaders. During the second half of 2013, corporations became far more aggressive making acquisitions, initiating large capital investments, and returning cash to shareholders. For instance, Verizon agreed to one of the largest acquisitions in history and food-giant Sysco offered to merge with their largest competitor, US Foods. We have also seen several companies announce plans to spin-off parts of their businesses to unlock value including Dover, General Electric, and Kimberly-Clark. Meanwhile, we saw surprisingly large dividend increases from Microsoft (+22%), 3M (+35%), and Boeing (+50%). This recent activity is indicative of a substantial shift in psychology. As companies boost investment, it should have a positive effect on economic growth, employment, and corporate profits in 2014.

We believe we are seeing the initial signs of a virtuous circle where improved confidence among investors, CEO's, and consumers feed off each other. There are strong indications this dynamic was developing during the tail end of 2013. This positive feedback loop can be a surprisingly strong force that results in greater consumer spending, increased corporate profits, and higher stock prices. Of course, there is always the possibility that one of the cogs in this mechanism gets disrupted. This past recession was so severe because the confidence of all three participants was damaged at the same time. In retrospect, we should not have expected a stronger recovery to come any more quickly. Five years later, perceptions are finally starting to brighten. As a result, we believe 2014 will be rewarding to shareholders as this renewed confidence becomes more broadly evident to average citizens, CEO's, and to the large number of remaining skeptical investors.

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