

Walker & Associates

Walker & Associates Investment Advisors, Inc.

First Quarter 2013

First Quarter 2013 Key Takeaways

U.S. stocks posted a robust 10.6% gain in the first quarter, beating both developed international stocks—which overcame ongoing issues in Europe to return 3.8%—and emerging-markets stocks, which lost 3.5%. Meanwhile, the broad bond-market benchmark Barclays Aggregate Bond Index was nearly flat.

Our portfolios faced three market headwinds as a result of our positioning: Our balanced (stock/bond) portfolios are tactically underweight stocks and overweight lower-risk asset classes and investment strategies. Within our stock exposure, we are tilted away from U.S. stocks toward emerging-markets and developed foreign stocks. Within our U.S. stock exposure, we are tilted away from small-cap stocks toward large-caps.

On the positive side, our actively managed bond funds continued to add value relative to the core bond index (Barclays Aggregate Bond Index).

Supported by an accommodative Federal Reserve, U.S. economic fundamentals have continued to grudgingly improve. Unemployment is slowly falling, home prices have been rising, and corporate earnings and profitability are near record highs. Fed actions have also continued to support—and drive—strong U.S. stock market gains.

Looking ahead, significant uncertainty surrounds fiscal and monetary policy in terms of what policies will be adopted and their ultimate economic and financial market impacts. More broadly, still-high global debt levels pose an economic headwind.

Against this backdrop, our outlook for stocks has not improved. If anything, given the sharp run-up in stock prices, we are getting closer to reducing our U.S. equity exposure further than we are to increasing it.

We continue to find emerging-markets stocks attractive, both relative to U.S. stocks and in absolute terms over our five-year time horizon.

Most parts of the bond market offer paltry longer-term return potential particularly given our expectation for rising rates over our five-year investment horizon and we continue to favor actively managed bond funds.

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First Quarter 2013 Investment Commentary

What Now for U.S. Stocks?

With U.S. stocks hitting new highs, we are naturally getting two questions from clients:

- 1) With stocks up so much, shouldn't we reduce our exposure (to lock in gains, given all of the big picture risks)?
- 2) With stocks up so much, shouldn't we increase our exposure (since the economy must be much better than people expected)?

Our short answer to both questions right now is, no. Overall our outlook for stocks has not improved, and, if anything, given the sharp run-up in stock prices, which implies lower *future* returns over our five-year tactical horizon, we are getting closer to reducing our U.S. equity exposure than we are to increasing it. Our assessment of the potential risks and returns to stocks is based on looking across a range of scenarios that we think are at least reasonably likely to play out, as well as considering more extreme negative scenarios that we believe are lower probability, but hold serious negative implications (at least over the shorter term) for risky assets like stocks. This downside stress-testing is critical because while we assess potential returns across asset classes over our five-year investment framework, most of our portfolios are managed against a 12-month downside loss threshold.

We view the upside return potential of the U.S. equity market as insufficient to compensate us for the downside risks of owning U.S. stocks. However, we also believe there is an unusually wide range of possible outcomes for economic fundamentals and hence the market. This includes some positive scenarios for U.S. stocks (with annualized returns in the low double digits), as well as some severely negative outcomes as the U.S. and the entire global economy works through the aftermath of the financial/debt crisis of 2008. While we believe the weight of the evidence tilts more toward the left side (the worse side) of the distribution of possible outcomes, the reality is that we do not have a high level of conviction in any one particular scenario playing out.

To some extent, we are hedging our bets—also known as *diversifying*—and that is the prudent thing to do in an environment this uncertain. We are constructing portfolios that we believe should perform reasonably well across a *range* of potential outcomes, any one of which we believe has reasonable odds of actually playing out. But if one of the more extremely negative or positive scenarios unfolds, our portfolios are not going to do as well (at least over the shorter term) as a portfolio that has made a big bet on that particular outcome. Of course, if a particular extreme scenario doesn't happen, then those extremely positioned portfolios would experience commensurately poor performance. We don't think making a big bet on an outcome that can't be determined with confidence is in the best interests of our clients.

The Environment: Policy Uncertainty and Modestly Improving Economic Fundamentals

A major contributor to the uncertainty we face in today's environment surrounds government policy, both fiscal and monetary, specifically what policies will be adopted as well as their ultimate economic and financial market impacts. With respect to fiscal policy, in the first quarter the markets digested the sequester's spending cuts without much drama. But the sequester's impact (estimated at around a 0.6% hit to GDP growth in 2013) is small potatoes compared to the debt and fiscal policy challenges that still confront the nation. Although we would agree that there is not an *immediate* federal budget deficit crisis, and that there is a real risk of snuffing out what remains a weak economic recovery with too much near-term fiscal austerity, there is clearly a debt/deficit crisis, at least in the medium to longer term, given the mismatch between federal revenue and spending. This calls for a strong and credible longer-term fiscal policy response, and the sooner the better. We won't hold our breath, but

maybe our political leaders in Washington are starting to get the message. If so, that could be a major positive catalyst for both the financial markets and the real economy. On the other hand, it may yet take a crisis to create the political will necessary to implement meaningful structural fiscal changes.

On the monetary policy side, there is more clarity at least in terms of the policies already in place. The leadership of the Federal Reserve (Chairman Ben Bernanke and Vice Chair Janet Yellen, among others) continue to be very vocal in stating that the Fed is not close to starting to unwind their stimulative policies, which involve purchasing \$85 billion per month of Treasury bonds and mortgage-backed securities (quantitative easing) and holding the federal funds policy rate near zero percent. But there is significant uncertainty as to the medium- to longer-term ramifications and unintended consequences of these policies and whether or not the Fed's ultimate exit plan will be executed successfully and without collateral damage. Based on the Fed's historical record of policy overshooting—and just the inherent complexity of the task at hand for *anyone* to get it right without a lot of luck—most, including us, are skeptical.

In the meantime, Fed statements and actions continue to be an important support and driver of short-term stock market performance. While central bank actions have always influenced the stock market, the markets appear particularly attuned to and reliant on ongoing highly accommodative Fed policy. Again, over the near term, we don't see any catalyst for Fed policy to become restrictive. So that leg of support to the markets is likely to remain in place. But the uncertainty increases as the time horizon extends, and our confidence in our ability to be "ahead of the market" in assessing a change in Fed policy and repositioning our portfolios accordingly is very low.



The NAHB-Wells Fargo Housing Market Index is a monthly survey based on the responses of NAHB members. Respondents rate: present market conditions for new home sales, expected market conditions for new home sales in six months, and traffic of prospective new home buyers. Data as of 28 February 2013. Source: National Association of Home Builders.

deleveraging on economic growth and corporate profits remain.

Supported by accommodative monetary policy, U.S. economic fundamentals have continued to grudgingly improve. The unemployment rate continues to slowly fall, although that's partly driven by a particularly sharp drop in the labor force participation rate, meaning there are fewer people working or seeking work, which is not a good thing. The housing market is strengthening, although mortgage lending to households remains tight, and household wealth is growing, driven by stock market and housing price gains—a key goal of the Fed's QE program. Finally, corporate earnings and profitability are around their all-time highs. (That said, S&P 500 earnings growth in 2012 was actually slightly negative for the year; the market's 16% return in 2012 came from stock valuations getting richer, not profit growth.) But our concerns about the impact of global debt-

Outlook for Stocks

Based on our analysis of potential returns across our entire range of scenarios, we have concluded that an underweight to the U.S. equity market is warranted. However, and importantly, our portfolios still maintain significant exposure to U.S. stocks because our analysis suggests that stocks should perform at least reasonably well across a meaningful portion of our potential return range, both in absolute terms and relative to other competing asset classes/strategies in which we could invest.

Emerging-markets stocks underperformed U.S. stocks significantly in the first quarter. This led to an increase of more than two percentage points (annualized) in our relative return expectations for emerging-markets stocks versus U.S. stocks, compared to our year-end return estimates.

Comparison of U.S. and Emerging-Markets Five-Year Expected Returns Across Our Scenarios

Stocks	Base	Bear	Optimistic
U.S.	3%	-5.6%	12%
Emerging-Markets	10.9%	1.6%	20.9%

In addition to their attractiveness relative to the U.S. market, we also believe the prospective *absolute* returns for emerging-markets stocks are now sufficiently high to compensate us for their risk over our five-year time horizon.

Update on Bond Markets and Fixed-Income Positioning

The big-picture bottom-line is that the fixed-income marketplace, particularly the highest quality parts, continues to offer paltry longer-term returns given our expectation for rising interest rates over our five-year investment horizon. Most areas of fixed-income are trading at historically elevated prices, and yield levels are at or near historic lows.

What this means in terms of our fixed-income positioning is that our balanced portfolios remain heavily underweight to core investment-grade bond funds, at slightly under half of our strategic target weighting. In their place we have large allocations to flexible and absolute-return-oriented bond funds that we expect to outperform the core bond index (and core bond funds) across our five-year scenarios.

Concluding Comments

Investing is a marathon, not a sprint. The key is to maintain discipline. We can analyze the longer term with far greater confidence, and invest accordingly, but realizing the benefits demands the discipline to ignore inevitable shorter term gyrations that are impossible to predict with consistency. Succumbing to the temptation to jump into “what’s working” based on a recent run of outperformance is a path to disappointment and subpar long-term investment results.

As always, we will continue to work our hardest to make the best investment decisions we can on your behalf, taking into account your long-term financial goals and the level of risk you can accept.

– Walker & Associates Investment Advisors, Inc. 4/10/2013