October 3, 2014 – The Bard and The Oracle

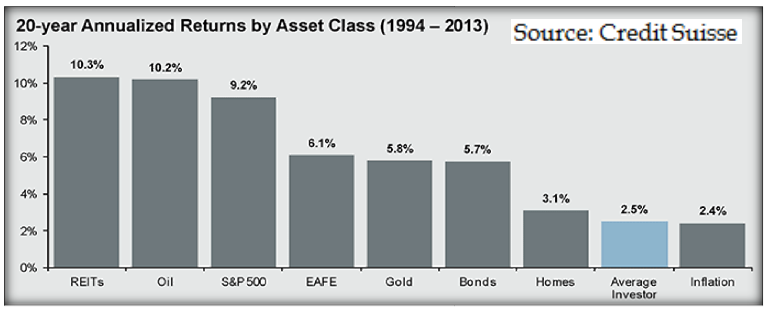
As always, we hope that this letter finds you and those you care about healthy and happy. We are now three quarters of the way through 2014 and the stock, bond and commodity markets continue to send signals that this 5-year-old, Fed stimulus-induced bull market in risk assets may be drawing to a close. As the Federal Reserve has been gradually winding down, or tapering, its latest round of bond purchases known as QE3 over the last nine months, the market has shown continual signs that the smart money investors are beginning to reduce risk in advance of the artificial support of quantitative easing being withdrawn.

We have covered in great detail in past letters the many indicators that we feel have been pointing, as they have prior to previous major bull market peaks, to an imminent reversal of recent stock market gains. Some of those indicators include broad equity market valuation as determined by numerous metrics, retail investor enthusiasm and allocation to risk, degree and duration of the S&P 500's* separation from longer-term moving averages, recent S&P 500 sector performance (i.e. defensives vs. cyclical), corporate earnings growth vs. revenue growth, peak in margin/GDP, spike and peak in corporate buybacks and duration of this bull market and length of time since 10% correction. We have shown that many of these indicators are at extremes seen only three other times in US stock market history: 2007, 2000 and 1929. All of our past letters detailing these indicators are available for your review on our website, www.UlmanFinancial.com.

It is certainly plain to see in reviewing our past letters that we were early in our move to raise the caution flag and recommend a reduced exposure to what we have seen as an artificially inflated equity market. It was our detailed study of prior bull markets (a gain of >20%), and the signals that have typically forewarned of the following bear markets (a loss of >20%), that lead us to err on the side of caution. Historically, the typical bear market has erased more than half of the preceding bull market's gain. The most recent bear market from late 2007 through early 2009 erased more than 11 years of gains. It's amazing to us how quickly investors have forgotten that experience and have lined up for another likely dose of the same.

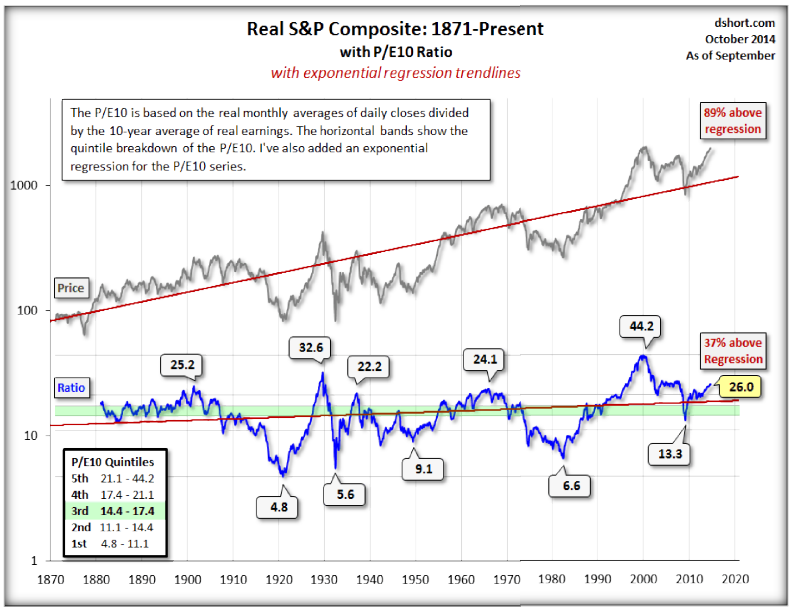
Since 1926, the average length of time it has taken stocks to recover from a bear market has been 3.3 years. As you can see in this graphic from the Wall Street Journal, following the S&P 500 bull market peaks of 1929, 1937, 1968 and 2000, it took investors who stayed the course more than seven years to get back to break-even. The most recent recovery from the 2007 bull market peak, which took more than five years, occurred in large part thanks to an unprecedented and ongoing 'emergency' monetary policy response from the Federal Reserve. Of course, in order to fully recoup

losses from each of these bear markets investors would have needed to stay invested, which is something history has shown to be easier said than done. According to Credit Suisse, in the 20-year period from 1994 to 2013 the S&P 500 returned an average annual return of 9.2% while the average stock market investor averaged only 2.5%. This underperformance was due to the natural human tendency to respond emotionally to steep losses by selling low, which of course precluded their ability to benefit from the ensuing rebound.

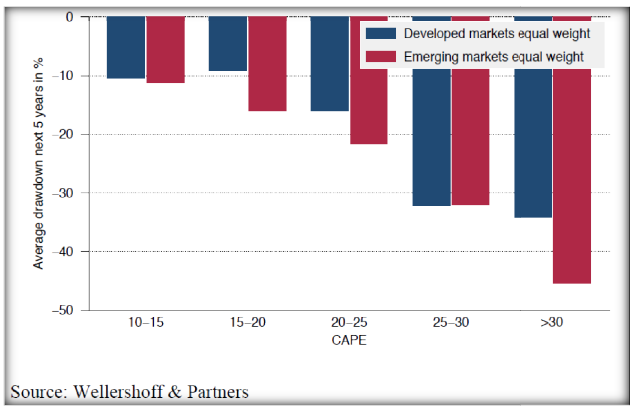


While we certainly left a good deal of potential gains on the table in 2013 it is our firm expectation that, as happened following the last two easy money-induced bull markets, we will have ample opportunity to make up for that opportunity cost by putting our increased level of cash reserves back to work at much more attractive price levels. Our intention is that not only will our current strategy provide the cash reserves that will have been preserved during the market sell-off, but equally importantly we and our clients will have preserved the psychological fortitude necessary to buy when the rest of the retail investing universe (i.e. the average investor) is tripping over each other to sell at any price. We will have the willingness to invest when the proverbial blood is in the street, which is when the most successful investors have historically made their most lucrative long term investments.

Nobel Laureate and Yale economics professor Robert Shiller's cyclically adjusted price to earnings ratio, also known as the CAPE or P/E10, is a valuation metric that we have discussed in the past. This metric provides a ratio of the current price of the S&P 500 to the past ten years' inflation-adjusted earnings for the companies comprising that index. Dr. Shiller uses the past ten years' earnings as opposed to the last year (trailing twelve month, or TTM P/E) or analysts' expectations for the coming year's earnings (Forward P/E) in order to remove the variability of the business cycle, thereby allowing a valid comparison across all time frames. The third quarter ended with an S&P 500 CAPE of 26.0, which is higher than all previous secular bull market peaks with the exception of 1929 and 2000.



We have shown in the past that from this level history suggests negative annual returns for the next 3, 5 and 10-year time periods. This historical performance suggests that, adjusted for inflation, the S&P 500 would be lower 10 years from now than it is today. You can see in the graph on the left how periods of extreme overvaluation have always been followed by steep corrections and decade plus periods of recovery. In fact, over the past 140 years no secular (or long cycle) bear market has ever bottomed before the CAPE hit single digits, which has led many analysts to suggest that the secular bear market that began in 2000 may not yet have seen its CAPE low.

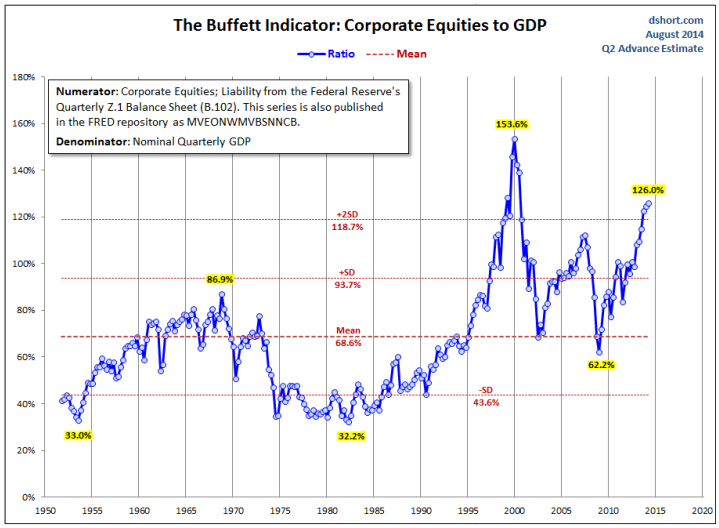


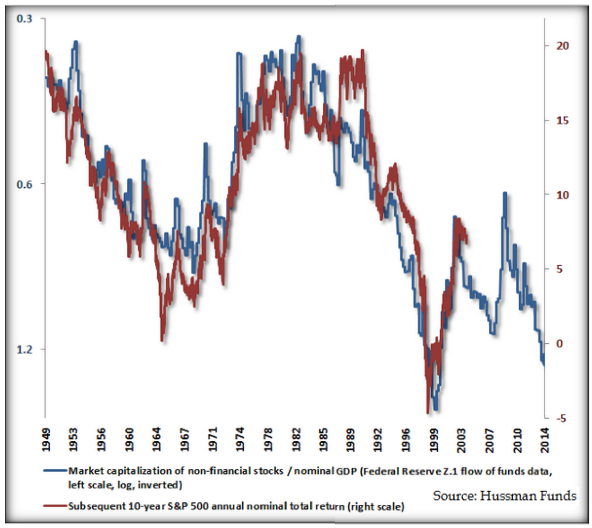
Source: Wellershoff & Partners

A recent study by market research firm Wellershoff & Partners found that from a CAPE of 25-30 the average peak to trough drawdown in both emerging and developed economies' stock markets over the following five years is greater than -30%. This drawdown would obviously be something to avoid if possible, but it would also present an incredible long term opportunity for those with the ability and willingness reinvest at or near the end of that drawdown.

Knowing that a historically overvalued market has the ability to become even more overvalued in the short term, as it did in 1999 and again in 2013, we continue to believe that the higher this market moves without sustainable economic improvement the greater the eventual correction will be. Our goal has been to preserve our clients' hard-earned savings in the meantime and to preserve their ability and willingness to buy when the time is right. To quote William Shakespeare, who is the Bard referred to in this letter's title, from his comedy *The Merry Wives of Windsor* – "Better three hours too soon than a minute too late."

This quote from Shakespeare regarding the all-importance of timing is one that is often referenced as financial market pundits and participants debate the timing of the next significant change in market direction. We of course have no way of knowing exactly when the markets will change direction, which is why we rely on time-tested metrics like the CAPE to point to likely future returns as an indicator of inherent risk.



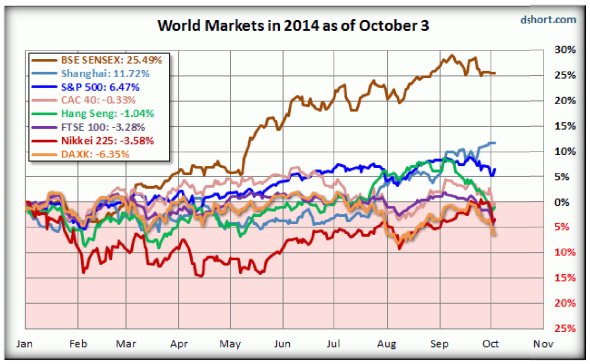


Another metric that has in the past proven to be quite predictive of future returns is known as the Buffett Indicator. This metric measures the ratio of the market cap of corporate equities to the GDP of the United States and is called the Buffett Indicator because it is the favorite broad market valuation metric of Warren Buffett, who is widely referred to as the "Oracle of Omaha" due to his seemingly prescient investing ability. This valuation metric is currently at a point that has only been surpassed once in the post-WWII era and, like the CAPE, is currently predicting a negative average annual return for the next decade, as evidenced in the top right chart which overlays the Buffett Indicator (inverted) and subsequent 10-yr returns of the S&P 500.

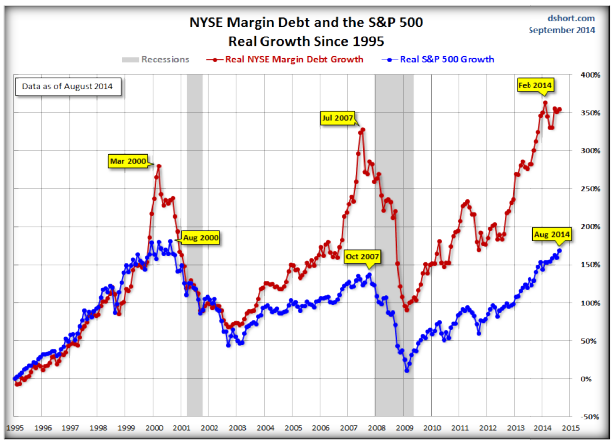
Mr. Buffett is also credited with a quote that we have found very instructive, especially in light of what his eponymous indicator is predicting for current equity investors:

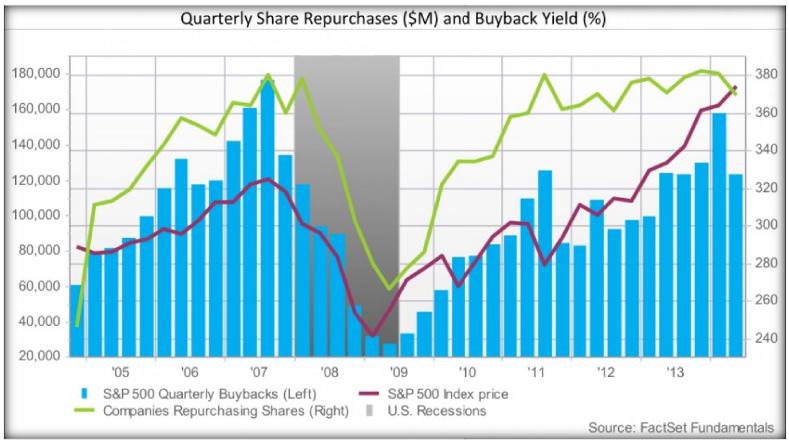
"The stock market is a highly efficient mechanism for the transfer of wealth from the impatient to the patient." -Warren Buffett

The month of September finished as a down month for all US stock indices, while the third quarter was roughly flat. The S&P 500 Index finished the quarter up 0.82%, while the Russell 2000 index of small cap stocks, which typically leads in during the early and middle stages of a bull market, finished the quarter down -6.87%. The two widely-followed indices that provide a composite view of the entire US equity market, the Russell 3000 Index and Wilshire 5000 Index, finished the quarter down -0.21% and -0.16%, respectively.



We continue to feel that the market is likely in the late stages of a long-term topping process that began at the turn of the year as discussed in our April letter entitled "HFT, Topping and Tapering *is* Tightening". Of the eight largest stock markets around the world, only those of India, China and the US are in positive territory year-to-date. Europe is flirting with a return to recession and outright deflation and there are mounting concerns that China may not be able to meet its reduced GDP growth target of 7.5%. The numerous geopolitical crises around the world have as yet been unable to significantly rattle investor confidence, but with valuation at historic levels, margin debt having peaked out in February, share buybacks having peaked in the first quarter and the Fed ending QE3 by the end of this month, we are skeptical that this resilience can continue for much longer.





As always, we appreciate your trust and confidence and welcome your feedback to this letter. Please do not hesitate to call or email with any questions or to schedule a face-to-face portfolio review.

Sincerely,

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**Indexes, such as the Dow Jones Industrial Index, the S&P 500 Index and others listed above are unmanaged and investors are not able to invest directly into any index. Past performance is no guarantee of future results.*

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index and represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The Russell 3000 Growth Index is an unmanaged index comprised of those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 3000 Value Index measures the performance of those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

The Wilshire 5000 Total Market Index, which consists of more than 5,000 companies, represents virtually all of the capitalization of the entire US stock market.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.