



Paul R. Ried Financial Group, LLC

Security for your future

A MESSAGE FROM YOUR FINANCIAL TEAM

Review – 4th Quarter 2013

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Dear Clients,

2013 turned out to be a banner year for US stocks. It was also quite impressive for stocks in developed international countries as well (places like Japan, Germany, France and Italy). However, stocks ended in the red in places like Brazil, China, Russia and many other countries termed 'Emerging Markets'. Also, as longer-term interest rates rose by over a percent during the year, interest rate sensitive bonds also fell in price. You can see below the mixed results in 2013 for different assets.

2013 Returns

US Stocks¹ = 32.4%

Developed International Stocks² = 22.8%

Emerging Market Stocks³ = -2.6%

US Bonds⁴ = -2.0%

International Bonds⁵ = -4.6%

Commodities⁶ = -9.5%

A Dash of Earnings and a Dollop of Optimism

Ofentimes when people eat a mouthwatering meal they like to know how it was made. Usually with the hopes of recreating it, or maybe just to find out how long they might have to run on the treadmill the next day. Similarly, when investors see mouthwatering returns, it can be very useful to look at what went into producing those returns.

When we look into the components of the 32% return from US stocks last year we see that approximately 11-12% of that return will have come from earnings growth (4th quarter earnings are still being reported). That's a pretty solid year for earnings. Returns made up of earnings growth is ultimately what we want to see.

But how did we get to 32% from 11-12%? Essentially, investors just became willing to pay more for every dollar of earnings that was already there. You see, there is this other ingredient to stock market returns, it's this really unpredictable thing called...human emotion. And it can have a significant impact.

Investor enthusiasm for stocks can be measured by the price they are willing to pay or what they require someone else to pay them (as measured by a Price-to-Earnings ratio⁷). Throughout time this has varied greatly. For example, in 1982, investors were willing to pay only six times earnings for the S&P 500, while in 1999 they were willing to pay 44 times earnings. At a restaurant you could be quite confident a \$44 steak is going to taste better than a \$6 steak. However, paying more does not result in more savory returns when it comes to investments, quite the opposite. Higher ratios correlate strongly with lower long-term returns and visa-versa. Although it says very little about short-term returns.

Where are we now?

There are a number of different ways people try to gauge valuations. Each method has its own strengths and weaknesses. However, regardless of their differences they are all generally saying the same thing (although to varying degrees). Things are looking expensive.

So what are investors willing to pay for stocks now compared to history? Let's take a look at the Cyclically Adjusted Price-to-Earnings ratio I mentioned above, it was popularized by Robert Shiller who recently won a Nobel Prize for his research on asset pricing. At the same time we will look at a broad measure popularized by Warren Buffett who in 2001 called it "probably the best single measure of where valuations stand at any given moment". That measure takes the value of all publicly traded companies and divides it by the Gross National Product (MarketCap / GNP). For both measures a lower number indicates stocks being cheaper.

	As of 1-1-2014	60 Year Median (since 1953)	2000 Peak	2007 Peak
Shiller PE	25.4	18.5	43.5	27.3
MarketCap / GNP	113%	66%	153%	111%

So we are quite a ways above the historical median on both measures. Although we are nowhere close to the 2000 peak, we are essentially in the ballpark of 2007. While the Federal Reserve's policies have had questionable effect on the economy, it appears they have had considerable effect on financial markets in the form of asset price inflation. However, as history has shown, expensive assets can still get more expensive or stay expensive for an extended time.

It should also be noted that not all places are trading at historically expensive valuations. Due to unique circumstances in each country some companies are trading at extreme discounts to what investors would normally pay, not because of their earnings prospects but because "headlines" have influenced fickle investor psychology.

Going Forward

We can be sure that investors are going to be hanging onto every word coming from the Federal Reserve going forward. As this month comes to a close, Ben Bernanke leaves his post as Federal Reserve Chairman and Janet Yellen takes over. While it is widely believed that Janet Yellen will follow the path set by Ben Bernanke, it is quite convenient timing for Bernanke. He got to oversee the relatively easy part of the policy which essentially came down to pumping money into the economy. Now he is leaving right when the difficult part of the policy starts, which is withdrawing the stimulus and supposedly taking some of that stimulus back out. This will likely be a long and orchestrated process but one that may bring about some extra volatility.

The reason this is such a delicate phase of the process is that it is playing on the opposite side of investor emotions. It no longer matters whether the stimulative policies of the Federal Reserve were responsible for the "Risk-On" attitude of the markets and ultimately helped support asset prices, because whether that was the case or not, investors believe it was. Therefore, the Federal Reserve's mission now is to convince investors that the reversing of those policies won't have the opposite effect. The Federal Reserve will look for continued positive signs regarding employment, housing and retail sales to make its case to investors.

Until Next Time

After a year when US stocks gained 32%, investors can be tempted to chase returns by increasing their allocation to stocks. What they often don't realize is that if they didn't do anything, they already increased their allocation to stocks. For a hypothetical investor that started 2013 allocated 50% to US Bonds and 50% to US Stocks, they would have ended 2013 with an allocation of approximately 43% US Bonds and 57% US Stocks. Unfortunately this means that were the market to fall, they would be more exposed to the market on the way down than they were to the market's rise in 2013. This is why rebalancing portfolios periodically is important to maintain your appropriate risk profile and is something we often address at your meetings as needed.

We continue to monitor the economy and the individual fund management teams within your portfolio, and make changes as needed. We thank you for your continued confidence and trust.

As always, we encourage you to call or e-mail with any questions.

Paul R. Ried, MBA, CFP®
Personal Financial Advisor
Regional Director*

Timothy R. Kimmel, CFP®
Personal Financial Advisor*
Registered Representative*

Adam Jordan, CIMA®, AAMS®
Director, Investment Research and Management
Registered Principal*

Lucy Beppu, CFP®
Personal Financial Advisor*
Registered Representative*

Prepared By:
Adam Jordan, CIMA®, AAMS®
Director, Investment Research and Management
Registered Principal*

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¹ - S&P 500 index ² - MSCI EAFE index ³ - MSCI EM index ⁴ - Barclays US Agg Bond index ⁵ - Citi WGBI Non-USD Index ⁶ - DJ UBS Commodity index ⁷ - Referring to the cyclically adjusted price-to-earnings ratio commonly known as CAPE or Shiller P/E.

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