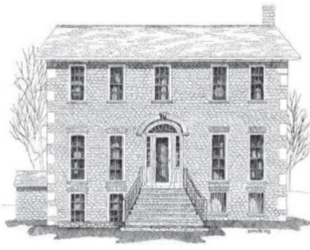

# ON THE HORIZON...
# NEWS, NOTES, AND COMMENTARY
# FOR CLIENTS AND FRIENDS OF THE HORIZON GROUP

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## LESSONS FROM A SURPRISINGLY STRONG MARKET

APRIL 15, 2013

Let's step back in time to the beginning of this year. We'd just come off a divisive election and were facing the possible consequences of the "fiscal cliff". A constant flow of negative stories on the economy, inept politicians, our deficit, and the European debt crisis had most investors extremely nervous and on edge. Many clients called to ask me to make them safer because they were certain the market was headed for a meltdown. Others were gravely concerned about the direction and future of our country. All that negativity was the impetus for my keynote speech at this year's financial fair, "The Future is Brighter Than You Think". It was the highest rated talk of my career, proving my belief that the average person is craving to hear reasons why the glass is half full.

The best part is that I didn't have to dig, stretch, or make up reasons to be optimistic about the future. Demographic trends, the housing recovery, money supply, and corporate profits are just a few of those reasons providing a foundation for record high stock prices. But as this recovery marks its fourth year, most people still doubt its staying power, and some even refuse to acknowledge it's happened. I was reminded of this heightened anxiety level when four different clients called this past week wanting out of the market, compliments of Kim Jong-un and North Korea. We closed April 15th – a very tragic tax filing day – with a year-to-date gain in the Dow of 11.4% and many people feeling uncomfortable. It seems a perfect time to reiterate and review many of the points made at the fair that are now being validated by the market:

***Making investment decisions based on how you "feel" is a recipe for disaster***. A recent survey showed average investors are feeling the same level of fear they did during the height of the financial crisis. This is confirmed by the trends we've seen in mutual fund flows. Equity mutual funds have seen net redemptions throughout the recovery. In addition, investors have been favoring bonds over equities by more than a two to one margin. Record levels of cash are on the sideline, suggesting the rally from the lows of 2009 has bypassed a general public that is wary of the market. It would be expected - and even healthy - to suffer a significant correction after the 138% gain since the March 2009 market lows. What wouldn't be healthy is letting the memory of the financial crisis allow you to alter your long-term income and investment strategy.

***Diversification is the only strategy that makes sense***. Again, the primary reason our clients have participated in this rally is that part of their portfolios are committed to equities based on the "bucket strategy". This system mandates diversification. Investing in stocks as part of a

long-term income strategy is much easier than making random investments based on market outlook or sentiment. This was backed up in a recent study by HSBC, which concluded there were distinct psychological benefits to investors utilizing a "bucket strategy" for investments [1]. The peace of mind provided by a predictable income stream allows investors to reap the benefits of their equity diversification by staying invested in turbulent times.

***Japan provides a sneak peak at the benefits of devaluing currency***. The falling dollar is yet another reason to be bullish on America in the long run. A weaker dollar can stimulate economic growth by driving exports and manufacturing activity. In addition, the inflationary aspect of currency devaluation could make our national debt far more manageable. But one of my biggest arguments was that shares of stock in multinational companies could become the currency of choice in such an environment. We haven't had to wait long to test these theories as Japan has undertaken a major push to devalue the yen. It has come crashing down against both the euro and the dollar. At the same time, the Japanese stock market (Nikkei) has jumped by 29.7% this year. Money has flooded the market with big gains in shares of manufacturers and exporters. But the average Japanese citizen has seen market gains offset by a decline in their purchasing power worldwide – a visit to New York City costs almost 20% more than it did just months ago.

The situation in Japan also gives us a glimpse of the geopolitical problems that can arise when a country devalues a currency too rapidly. Their aggressive monetary manipulation has irked China and other manufacturing nations. This past Friday the Obama administration harshly criticized Japan and demanded their leaders slow the depreciation of the yen. Washington is certainly keeping a close eye on this situation, since America will have to follow almost the same path to manage our debt levels. I'm watching intently to see which strategies and investments do well under these circumstances. When it happens here, I'll be poised for action.

***Fear-based investing rarely makes sense***. Since the crisis, there's no shortage of advisors or firms trumpeting the benefits of owning gold. Almost every client has asked me about gold at some point - mostly as an investment or hedge against a collapse. I think it's a bad idea on both counts. I'm all for investing in precious metals or commodities as a hedge against inflation, though I prefer it's done by a professional manager in a well-diversified mutual fund. No matter how you own it, gold is in a bear market. It plunged to $1,360 per ounce today on receding inflation fears. That's a drop of 28% from its high of $1888.70 per ounce in August of 2011. Gold mining stocks - like the ones recommended by one of our guest speakers at Mario's several years ago - have been punished as well. I'm not picking on gold. But I am taking a swipe at those touting gold as a "can't miss" investment or guaranteed hedge against economic collapse.

I'm not saying to invest with blind optimism, or not to include defensive positions in your portfolio. But rather than betting heavily on a single "end of the world" type investment, it's a much better strategy to weave together a number of diverse positions having a low correlation to stock market returns. That's why our portfolios contain a number of diversified bond funds, foreign bond funds, commodities, real estate, and alternative investments. It's a far better hedge against a market collapse, without being severely punished if things continue to go well. The last part is of utmost importance, given my optimistic expectations for the future of the market.
Today's horrible events in Boston and severe market drop don't alter my positive view.

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[1] *AAII Journal, April 2012*