Beacon Trust Quarterly

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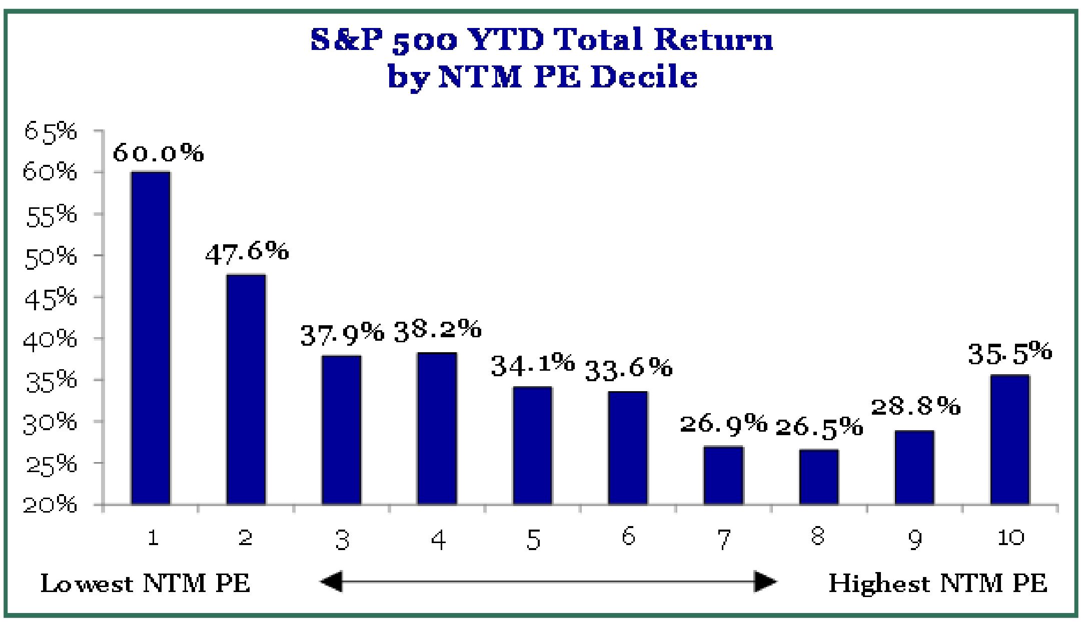
Buying Stocks at a Discount

About four years ago, while having lunch with the Vice President of Finance of a non-profit organization, the client continually queried if we bought stocks at a discount. I was tempted to reply that we did not trade with Wal-Mart but wisely avoided the sarcasm. Recently reflecting on that encounter, I see the client's query in a different light. Perhaps his word choice (discount) was somewhat inaccurate, but the gist of his question could easily be applied to the investment term "valuation." Do we buy stocks at discounted valuations? Or, do we buy value stocks? Isn't a discount something of value? Yes, this is my public mea culpa.

My reflection on "buying stocks at a discount" was prompted by recent analysis and utilization of a valuation factor. In our November Market Monitor, "All I Want for Christmas Is a Three Factor Equity Model" we defined a factor as "a force that explains or drives equity returns." The metric we utilize for the valuation factor is trailing twelve month price/earnings ratio (P/E), with lower P/E being better than higher P/E. In 2013, this valuation factor was a powerful contributor to the stock market's total return. For example, BMO Capital Markets reports that their seven valuation factors produced a combined total return of 61.4% last year, which is almost double the S&P 500's 32.4% total return. Similarly, Strategas Research Partners indicates that the top decile of lowest P/E (next twelve months) delivered a 60% total return in 2013. The accompanying chart shows the total return for each decile. Our analysis of the valuation factor concludes that valuation will produce above-average results in 2014 as well. This projection is predicated upon accelerated nominal GDP growth, lower precious metals prices, and a positive yield curve.



Source: Strategas Research Partners, LLC

It is interesting to note that valuation is an important component of our CORE Equity Model and our new Factor Information Return Model (FIRM). Regarding FIRM, earlier this month we increased the Model's allocation to the valuation factor based on our outlook. I guess one could say we are buying more stocks at a discount.

Will a Polar Vortex Blow Through the Financial Markets?

This winter season we have been introduced to the Polar Vortex. This weather phenomenon is characterized by frigid winds. A common investor worry in 2014 is whether markets will be cooled off by the transition in US monetary policy, or, expressed differently, will there be a "monetary vortex"? The concern is that the Federal Reserve is starting to take the punchbowl away (tapering) following an unprecedented and unconventional period of monetary stimulus. Even though the Fed is unlikely to raise interest rates in the foreseeable future, uncertainties associated with winding down the bond buying program could disrupt performance for certain asset classes. Overall, we do not believe the odds favor a vortex event. However, some conclusions and cautionary guidelines are worth noting:

- Increased market volatility is expected to accompany the shifting monetary landscape
- Unless a great rotation occurs between asset classes, trading volumes will remain low, contributing to heightened volatility
- A rise in global borrowing costs could impair select developing countries' ability to repay short-term foreign borrowings. Consequently, emerging market investments should be undertaken with great care
- Broad portfolio diversification is recommended to reduce risks associated with change and uncertainty
- Utilization of different investment strategies for a particular asset class is also recommended. For instance, stock portfolios could include fundamental stock selection and quantitative screening

Market Expectations 2014

Consensus thinking points to rising bond yields this year. Admittedly, the normalization of interest rates is in the cards as the Fed begins its unwinding of bond purchases. The scenario could get quite ugly if alarm bells in emerging markets go off and spread to developed markets. We view that scenario as less probable. Further, a few countervailing influences could limit or even prevent a rise in bond yields. First, although the Fed is reducing its purchases of Treasury and mortgage-backed securities, Treasury debt issuance is falling more rapidly.

The math is fairly simple. Between 2009 and 2012, the US budget deficit averaged $1.25 trillion per year, and Fed purchases represented 38% of net issuance. With the fiscal improvement reducing the deficit to $615 billion, even a lower level of purchases absorbs 68% of new issuance. With the Fed changing course ahead of other central banks and economic expansion likely, the dollar outlook is pretty positive. The corollary to a strong dollar is very decent demand for US fixed-income securities. Lastly, inflation, which is the bond bugaboo, could well continue to be in disinflation (declining rate of inflation) mode, accompanied by the danger of deflation (falling prices). These countervailing influences could limit the rise in 10-year Treasury yields to an average of 3.25% from the current 2.80%. Within the fixed-income market, we continue to prefer high yield bonds, which should benefit from economic growth, low default rates and declining yield spreads.

Following last year's 32% total return for the S&P 500, investors are skeptical of another double digit performance. We started last year anticipating a 16% total return from the S&P, and while that appears conservative in hindsight, at the time it was one of the highest forecasts among buy side and sell side strategists. In the movie business, 2014 will be marked by the release of about seven sequels. Similarly, in the capital markets, return expectations are a repeat of last year. Bond market returns, as exemplified by the Barclays Aggregate Bond Index, were a negative 2% in 2013, and we expect a similar result this year. We believe the S&P 500 can provide a total return of 13% this year. The stock market should continue to be supported by growth of the dividend return and low corporate bond spreads. Opportunities should be greatest in cyclical sectors and the value style.

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