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Market Commentary

NEITHER DEPRESSED NOR EXUBERANT



Hersh Cohen Portfolio Manager, Co-CIO

- Last year equities finally attracted more investors and stocks rallied five times as much as corporate earnings, returning price-earnings ratios to more normal levels.
- Though fear is gone, we are not seeing the euphoria that usually accompanies market tops. While more people expect stocks to do better, we characterize prices as roughly fairly valued, rather than particularly cheap or expensive. As such, we continue to project a flattish to slightly higher market for the year, with dividends and buybacks providing the majority of gains.
- The market also seems to be ignoring major geopolitical risks, as chaos in the Middle East has not translated into sky-high oil prices nor scared investors into selling stocks.
 We are monitoring the situation accordingly, as well as the recent trend of taking riskier bets in the quest for yield.

In 1974, when the economy, financial markets and overall spirit of the United States were in shambles, we got the best investment advice of our career. A friend and very successful investor, who had lived through the Great Depression and World War II, would tell us daily about stocks that he was buying. What they had in common were big declines in 1973 and 1974, with long flat bases into year-end. We asked him how he could be so bullish with the world such a mess. His answer resonates with us to this day. There is always something to worry about. What matters is whether the issues are already factored into stock prices. That advice helped us to be bullish in 2003 and 2009 when the news flow was grim, and served as the counterpoint to the euphoria that accompanied major tops in the market in 1987, 1999 and 2006.

We have written repeatedly since 2009 how difficult it has been for people to reconcile a weak economy with a strong stock market. By early 2009, and into 2012, stocks were reflecting a great deal of fear and caution, as evidenced by low price-earnings ratios. On an absolute basis, stocks were inexpensive. On a relative basis, they were materially cheaper than bonds, as upfront dividend yields were often higher than yields on 10-Year Treasury notes for the first time in 50 years. Free cash flow yields² were also very high on both an absolute and relative basis. Caution was everywhere.

The collapse of 2007–2008 was different from other post-war recessions, in that asset prices, banks, credit and home prices all collapsed simultaneously. The headwinds to a stronger recovery remain to this day. Consumers no longer have the wherewithal or will to provide fuel for economic growth. Home equity can no longer be used as a source of funds, wages are stagnant, and unemployment remains sticky. Gross domestic product³ even contracted sharply in the first quarter of this year — unusual during a so-called recovery. Whether the contraction was because of weather, a slowdown in China or deflation in Europe, one should not expect strong growth for quite some time.

The Federal Reserve⁴ in 2009, seeing the tremendous damage to assets of all types, took interest rates to extremely low levels, and has kept them low. In addition to trying to revive housing by allowing refinancings and low mortgage rates, their stated intent had been to try and raise prices of riskier assets, especially stocks.

For three years after initiation of this policy, stocks rose smartly, though many people chose to stay on the sidelines. Last year, equities finally attracted more investors, and stocks rallied five times as much as corporate earnings. Price-to-earnings ratios finally returned to more normal levels.

There is always something to worry about. The question is whether it is already factored into stock prices.

Hersh Cohen

¹ The **price-to-earnings (P/E)** ratio is a stock's price divided by its earnings per share.

² Free cash flow yield is a company's free cash flow per share divided by the share price.

³ Gross Domestic Product ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

The Federal Reserve Board ("Fed") is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Accompanying this terrific rise in stock prices has been a big change in psychology, however. Stocks are no longer factoring in worst-case scenarios. The big bases of washedout stocks have given way to more extended advances, though the present situation has become more nuanced. Though fear is gone, we are not seeing the euphoria that usually accompanies market tops. While more people expect stocks to do better, we characterize prices as roughly fairly valued, rather than particularly cheap or expensive. As such, we continue to project a flattish to slightly higher market for the year, with dividends and buybacks providing the majority of gains.

The market also seems to be ignoring major geopolitical risks, as chaos in the Middle East has not translated into sky-high oil prices nor scared investors into selling stocks. We are monitoring the situation accordingly, as well as the recent trend of taking riskier fixed-income bets in the quest for yield. We have not yet reached the extremes of 2007, when 30 times leverage⁵ was being employed, but we have seen a departure from the de-risking of 2009 that created so many opportunities.

With these concerns in mind, we are sticking with higher quality securities, holding some cash reserves in case latent risks are translated into opportunities and we are avoiding the broad complacency associated with the gains of recent years.

Investment risks

All investments involve risk, including possible loss of principal. Past performance is no guarantee of future results.

The opinions and views expressed herein are those of the portfolio managers and may differ from those of other managers and are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

Common stocks generally provide an opportunity for more capital appreciation than fixed-income investments but are subject to greater market fluctuations.

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Foreign securities are subject to the additional risks of fluctuations in foreign exchange rates, changes in political and economic conditions, foreign taxation, and differences in auditing and financial standards. These risks are magnified in the case of investment in emerging markets.

Dividends represent past performance and there is no guarantee they will continue to be paid.

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Dividends and yields represent past performance and there is no guarantee they will continue to be paid.

Unless otherwise noted the "\$" (dollar sign) represents U.S. dollars.

⁵ **Leverage** refers to the degree to which an investor or business is utilizing borrowed money. Leverage increases the volatility of investment returns and subjects a Fund to magnified losses if a Fund's investments decline in value.



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