

Uncertainty Abounds but the World Goes Round

“Price is what you pay, value is what you get.” Warren Buffet

In a world of narrowing perspectives and shorter-term mindsets, we hesitate to write newsletters on market conditions. Market prices simply do not follow fundamentals as closely in the short-term as they once did, with momentum being a key driver of short-term performance. As a result, fundamental signs may point to a short-term conclusion, but the probability of that conclusion becoming reality is less than it once was – and it has always been far from an exact science.

A perfect example of the unpredictable nature of the investment markets was 1st quarter performance. Advanced knowledge of Middle Eastern unrest, a Japanese disaster, and \$3.50 to \$4.00 gasoline would have resulted in a dire prediction for stock market returns, but the outcome was a favorable gain of 6.38%. There is obviously an undercurrent supporting stocks as investors have been pleased with recent performance and their options appear less attractive on a relative basis – resulting in an increase in the demand for stocks (and thus higher prices) even though uncertainties exist.

Given the significance of the stock market rally since March 2009 (+112% for the Russell 3000 Index) and the level of uncertainty facing the investment markets, such as inflation, we felt compelled to address current market conditions in this newsletter. We are big picture, long-term thinkers, so our comments will likely disappoint those seeking short-term market timing advice. However, for those seeking information to help guide fundamental, longer-term allocation decisions, we hope you find the information useful.

Inflation / Economic Conditions

Inflation has captivated the minds of investors in recent quarters due to the fear that if inflation were to rise at an unexpected pace, the Federal Reserve would be forced to reverse its stimulative stance. This would likely damage the economic recovery. The Fed's goal has been to keep interest rates low until the economy can stand solidly on its own feet, allowing consumers and banks to repair their balance sheets (*i.e.* pay off their debt with lower interest payments).

Many investors believe it is a foregone conclusion that the amount of stimulus being pumped into the economy will cause inflation. Compounding that concern is an improving economy, rising global commodity prices, and an elevated level of inflation in many emerging market economies. While these are noteworthy, it is important to recognize that investor sentiment is gravitating toward the extremes more regularly these days, and the answer is often somewhere toward the middle. The degree of stimulus being pumped into developed economies is abnormal, but so are the structural headwinds for consumption and inflation (*e.g.* high unemployment, cautious business managers, cautious consumers, continued deleveraging, a weak housing market, etc.).

Inflation is caused by an increase in aggregate demand for goods and services, an increase in the price of inputs used to produce goods and services, or a combination of the two. During periods where the economy is stronger, consumers are not deterred by higher prices, which results in even higher prices. For this reason, the Fed often steps in to break the cycle by raising rates (which increases consumer borrowing costs and slows the economy and inflation).

While commodity and energy prices have risen, the barriers to price mentioned above cannot be overlooked. At this point, it appears the economy would break its own cycle if prices moved too far

too fast, but that may change if economic conditions continue to improve. Economic measures such as corporate earnings, unemployment, manufacturing, and of course GDP, all point to an improved economic picture and it is expected that this trend will continue in 2011. Therefore, it is imperative that Federal Reserve policy makers keep their fingers on the pulse and carefully reverse their stimulative stance at the appropriate time. This will be a challenge, but we have confidence this is their top priority.

To gain a perspective on current inflation levels, refer to Chart 1 on page 3, which illustrates historical values for the Consumer Price Index (“CPI”) and the Core Consumer Price Index (“Core CPI”). The difference between the two is that Core CPI excludes food and energy prices. Food and energy prices are more volatile components, so economists tend to focus on the less volatile Core CPI; however, since the impact of energy and food cost cannot be ignored, we include both measures.

We have also charted information regarding housing prices (Chart 2). The Case-Schiller 20 Index is an index of the top twenty housing markets in the United States. As illustrated, the country’s housing market has yet to gain positive momentum, which is a factor influencing the Fed’s decision to keep its foot on the gas pedal. (Continued housing weakness is not surprising though, since asset bubbles like the one experienced in the housing market do not correct themselves overnight, and it may be years before the prices seen in 2006 are reached again.)

Investor Sentiment (Demand)

Investor sentiment is obviously impacted by market and economic performance. However, the influence of large scale demand shifts on the markets by the average investor has increased in recent years – becoming more pronounced than at any time we can recall or have studied. These shifts are becoming commonplace due to the average investor’s increased market share and the fact that many of these investors have a limited understanding of the fundamentals of investing. Further compounding this problem is the number of institutional managers attempting to time or profit from these shifts.

Demand sets price, so our fate is directly influenced by demand in the short-term. It may be helpful to distinguish between price and value as we consider this idea. The value of a company is determined by factors such as its assets, growth, profitability, competitiveness, etc. A company’s stock price should reflect its value, but if investors move in lockstep away from the stock market, the company’s stock price will be negatively impacted by a lack of demand. Conversely, when investors flock to the stock market, price is positively impacted by demand. This causes short-term prices to deviate from true value, although ultimately there is enough savvy in the market to find value over the long-term. In other words, price volatility will likely be higher than history would suggest due to the increased market share held by less knowledgeable investors, but the trend of prices should continue to follow the trend set by the company’s value over the long-term.

Investor demand can be observed by monitoring mutual fund flows. For example, the primary cause of the stock market’s surprising result in the 1st quarter can be seen in Chart 3. After a period where investors avoided stocks, the flow of money into U.S. stock mutual funds has gained momentum since the end of 2010, and this has supported market prices – offsetting the negative affects of the Middle East, Japan and gasoline.

Currently, it seems investors are concerned that rising rates are inevitable, and their demand for bonds has slowed. This, combined with an improving economy, strong corporate earnings and balance sheets, relatively attractive stock valuations, historically low money market rates, and shaky real estate prices, leaves many investors with the belief the stock market recovery has room to

run – but before you adjust your allocation, keep in mind the difficulty of predicting the economy and investment markets. *A careful review of Chart 3 illustrates the poorly timed decisions of the average investor, with stock mutual fund flows peaking near market highs and stock flows at their lowest near market bottoms.*



Conclusion

What lies ahead in the coming quarters is tough to predict due to the number of uncertainties and potential outcomes. Bond investors may experience a period of lower returns if interest rates climb, but the fundamental attractiveness of bonds is moderate protection and moderate growth and investors should not lose sight of the importance of protection as they near the withdrawal date of funds from their retirement portfolios.

Due to the futile nature of market timing, investors would be well served if they broadened their perspectives and lengthened their mindsets. Over the long-term, the bond and stock markets find the trend set by value – and there are underlying forces that cause the long-term trend line to be upward sloping (*e.g.* population growth and global expansion). Fortunately, we don't see a change in these forces anytime soon. Even though the markets are currently more volatile than in the past, and price is deviating from value more frequently, we don't foresee a change in the fact that price ultimately follows the trend set by value - an idea supported by the data in Chart 4. This chart illustrates the rolling 30-year average returns for the S&P 500 Index with the first period beginning in 1926 and ending in 1955. As is illustrated, the lowest 30-year return average for any combination of 30-year periods is a gain of 8.47% and the highest is a gain of 13.74%.

With time, price volatility evens out and increased values drive returns. During periods of uncertainty, it appears that action is warranted, but the question to ask yourself is, "Will these uncertainties affect value within my time horizon?" While it is a more boring way to invest, broad diversification with allocation decisions based on fundamentals is the prudent approach for most investor.

Market Comments

Advanced knowledge of Middle Eastern unrest, a Japanese disaster, and \$3.50 to \$4.00 gasoline would have resulted in a dire prediction for the stock market in the 1st quarter, but the result was a favorable gain of 6.38% for the Russell 3000 Index. There is obviously an undercurrent supporting stocks as investors have been pleased with recent performance and their options are less limited. In other words, investors have been buying stocks due to the strong gains earned since the market bottomed in March 2009 and their relative attraction compared to other asset classes.

The Russell 3000 Index has gained 112% since the bottom and many investors are asking if the market still has room to run. Stock prices are certainly not as discounted as they were at the bottom, but the management teams we respect and utilize feel opportunities still exist on a stock by stock basis. Supporting a further advance is an improving economy, strong corporate earnings, and historically strong corporate balance sheets.

Inflation has captivated the minds of investors in recent quarters. Commodity prices have risen and emerging economies are already dealing with elevated inflation levels. The fear is that these factors combined with the unprecedented level of stimulus being pumped into the economy will result in higher prices for goods and services in developed economies like the U.S. If inflation were to rise at an unexpected pace, the Federal Reserve would be forced to reverse its stimulative stance, which would likely damage the economic recovery. Higher rates would also serve as a headwind for bond returns, a primary concern on the mind of bond investors. While this outcome seems certain to many, keep in mind that investor sentiment is becoming more polarized and the likely outcome is somewhere in the middle. During these uncertain times, it is as important as ever to make your asset allocation decision based on fundamentals, not emotion or short-term prediction.



Chart 1
Inflation Level

Inflation (CPI and Core CPI)

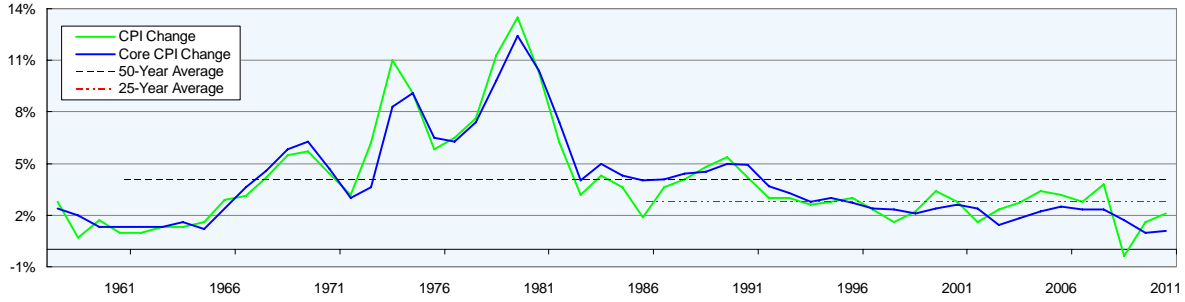


Chart 2
Change in Home Prices

U.S. Home Prices (Case-Schiller 20 Index)

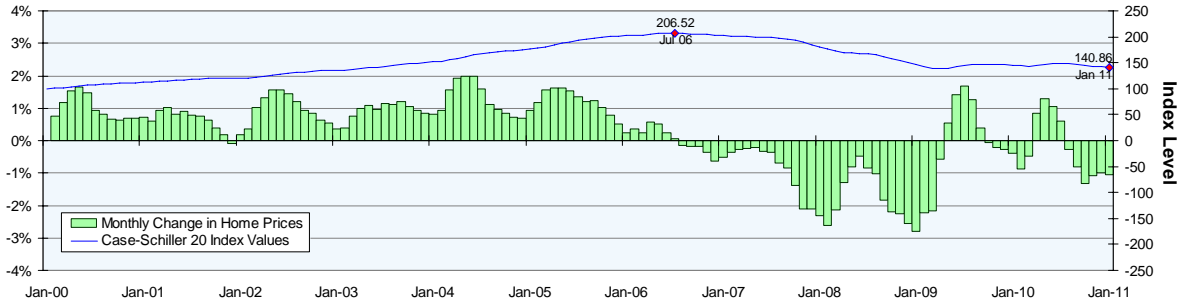


Chart 3
Billions of Dollars

Mutual Fund Flows

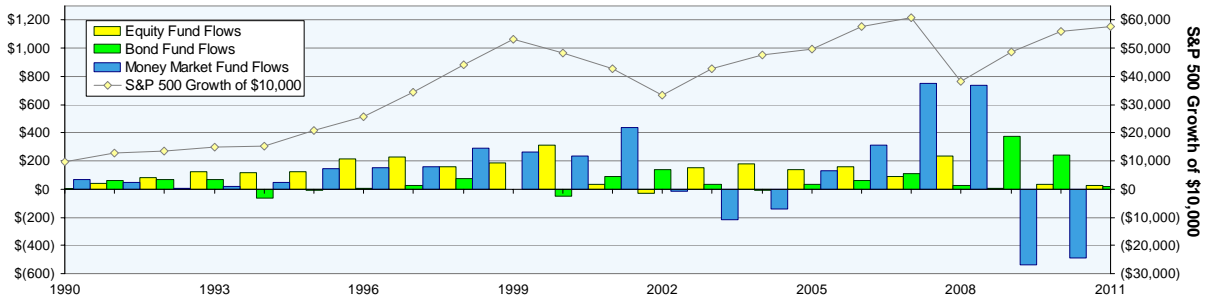
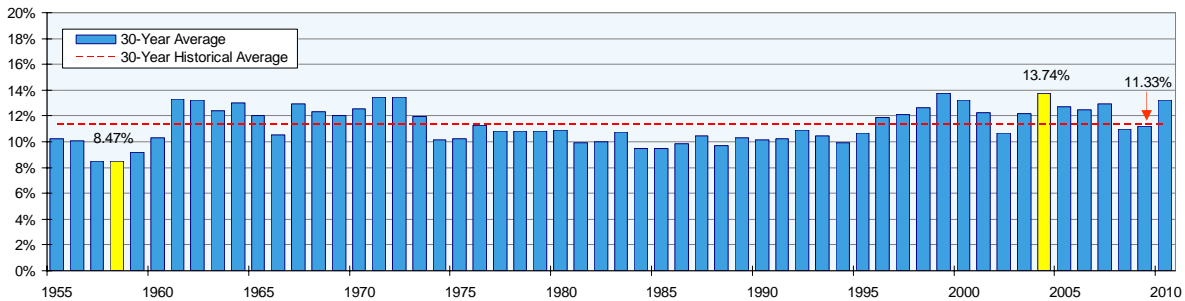


Chart 4
S&P 500 Average Returns

30-Year Rolling S&P 500 Returns



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