

# Investment Outlook

FALL 2014

## Fourth Quarter 2014 Investment Outlook | Third Quarter 2014 Review

### It's Getting Uncomfortable ... Looking for Opportunities

We have been reiterating for some time now that market volatility has been abnormally low and is likely to change at some point. We have positioned our clients' portfolios prudently and carefully. That caution has felt frustrating at times, as markets have surged higher and market volatility has continued to be suppressed. Managing risk (a critical aspect of our investment process) feels unnecessary when virtually every asset class is moving higher.

Such market sentiment changed abruptly in the past quarter. Market volatility has picked up sharply. While it remains to be seen whether this is a full blown market correction or a shallower pull-back, it is clear that we are no longer in a "Goldilocks" market pattern.

The most obvious reflection of this change was a much wider dispersion of returns by market sector. A number of markets posted sharply negative returns. Some markets such as the U.S. Small-Cap Sector (Russell 2000) entered full-blown "correction mode," down more than 10% from recent highs.

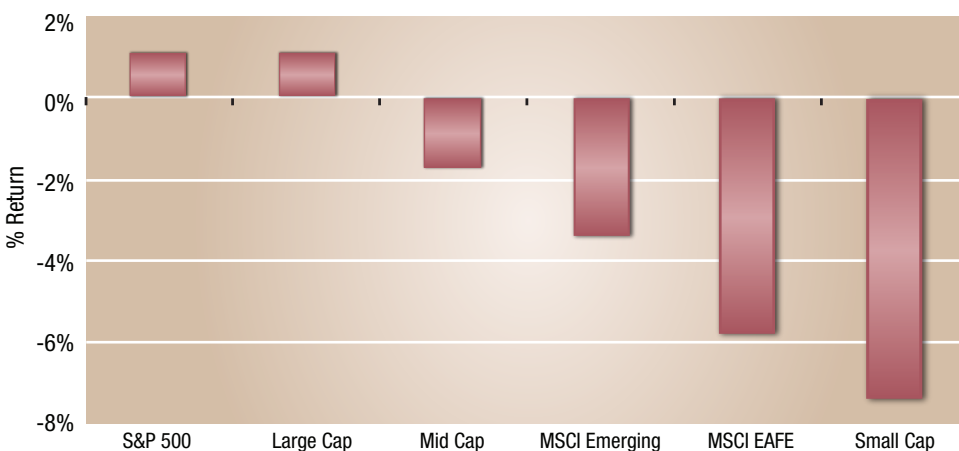
 "It is clear that we are no longer in a "Goldilocks" market pattern."

Within U.S. equity markets, only the largest cap equities were able to post marginally positive returns over the quarter. Mid-Cap sectors were negative, although much less negative than the Small Caps. Additionally, many of the most volatile stocks (higher "beta") and stock sectors experienced the most downside in what can generally be described as a "risk off" environment.

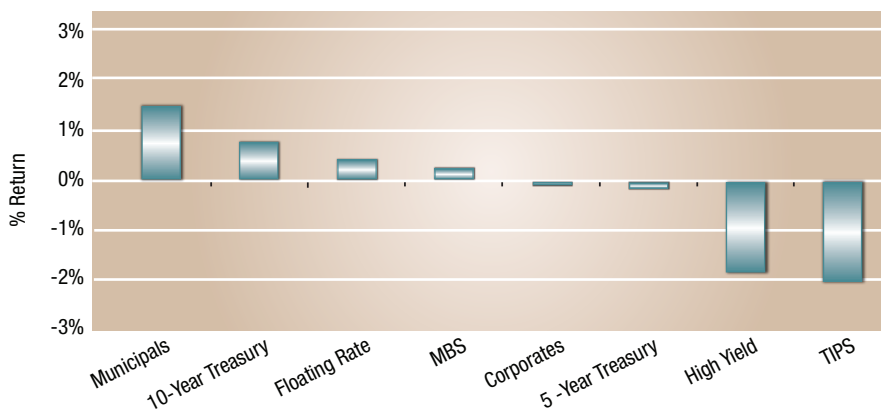
Non-U.S. equities were negative across the board. Much of this damage was due to a surge in the value of the dollar. In fact, many of these non-U.S. sectors were generally in line with U.S. markets in their local currencies.

Within Fixed Income markets, large dispersions in returns were also evident. Here, the "risk off" environment was even more clearly visible with the sectors having the most credit risk clustered at the bottom: High Yield, Senior Loans and

#### Equity Returns Quarter to Date



## Fixed Income Returns Quarter to Date



Data: J.P. Morgan Asset Management Chart: Argent Wealth Management, LLC © 2014

Emerging Market Debt. What has been a surprise to many investors is that the higher grade Fixed Income markets have continued to do quite well. A good portion of this surprise is that the surging dollar and weakness in European economies have created a huge income advantage for foreign investors (who are buying U.S. Fixed Income). Surprisingly, U.S. Fixed Income may be the highest return asset class year-to-date for many European and Asian investors.

### Healthy Market Correction: Not the Start of Major Bear Market

In the short run there are a number of factors that may create additional market anxiety. Among these factors are an escalation of the fight against ISIS (and other tensions in the Middle East, Iraq and Syria), the impact of the Ebola virus, a slowdown in Europe and an increased risk of deflation there, U.S. earnings season, and a U.S. Fed that is positioning for raising interest rates for the first time in eight years (more about that later).

Despite this formidable list of short-term concerns, a major bear market in U.S. equities is unlikely. Such major bear markets are created from one of two primary conditions: 1) a market bubble or 2) a recession or major economic shock to the system, such as the collapse of Lehman Brothers. In our opinion, neither condition exists or is likely to exist within the next 24 to 36 months.

U.S. equity markets are priced at a historical average 15 times forward earnings. Our economy is expanding at a nice clip and our expansion is broadening despite a lot of

skepticism. Corporate earnings continue to grow, although we expect that rate of growth to be moderate given currently high profit margins that are not likely to expand. It is important to note that interest rates remain exceptionally low and there are limited investment alternatives to high quality equities that offer investors appreciation potential at acceptable levels of risk. While we may indeed experience a shorter-term correction that may be uncomfortable, the so-called “secular” bull market is not over and equity prices are positioned to be higher two or three years in the future.

Additionally, we believe that it is important to appreciate that a major benefit of the “great recession” of 2008 was an unwinding of leverage of biblical proportions. Highly leveraged firms went bust or were recapitalized (AIG, Lehman Brothers, Bear Stearns, GM etc.). The firms that survived became stronger. We can find virtually no firms or sectors that are at a high risk of collapse, although an unanticipated shock to the system is always possible.

That is not to say that more highly valued and more speculative sectors such as the Russell 2000 Small-Cap index may not go down significantly more. We remain significantly underweight these speculative sectors with little temptation to add back to these areas.

A correction that falls in the historically normal range of 10 to 15% from market highs would be a great opportunity to add to quality areas of the market. While that may feel uncomfortable, it would set the stage for better returns going forward and would create a market that is much more healthy and balanced. We have our shopping list ready.

### Expectations for the Fed: Disconnect from Reality

A major source of market volatility (hence, opportunity) may well come from the transition of the Fed to “normalizing” short-term interest rates. It has been a full eight years since the Fed last raised interest rates. With the Fed Funds rate having been anchored near zero ever since late 2008, it is understandable that market participants may struggle with interpreting the Fed’s guidance and pricing in reasonable expectations.

Market participants currently expect the tightening cycle to be smooth, predictable and shallow by historical standards. That expectation can be determined by a variety of techniques such as looking at the “forward” Treasury yield curve.

Where the disconnect comes in is that the average tightening cycle over the past 50 years has been about 300 basis points (three full percentage points) and lasts about 18 months. Many of these past cycles have been far from smooth, predictable and gradual. However, many of these cycles began with similar naiveté about future expectations.

U.S. economic data has continued to significantly exceed the Fed’s internal forecast; most notably, the decline in the unemployment rate. Making matters confusing and complex, the Fed continues to shift the goal posts and to alter their own guidance. For example, the Fed’s “marker” for the unemployment rate under the Bernanke regime was set at a 6.5% unemployment rate. That marker was promptly abandoned and is now based on a host of factors that attempt to measure the degree of slack in labor markets. With the employment rate having fallen in this month’s report to 5.9%, much more rapidly than of any of the prior forecasts, we believe that it is virtually impossible to argue that the Fed will not begin the process of raising short term interest rates in 2015.

## Unemployment Since 2009



Data: Ned Davis Research Group Chart: Argent Wealth Management, LLC © 2014

What will matter most for financial markets is how these future expectations shift. The stock market, and other financial markets, are forward looking. They are the best predictors, bar none, of where economic activity is going -- not where it is currently. In other words, the markets will be much faster to adjust than the Fed and may well price in such changing expectations earlier.

Our view is to expect additional market volatility as expectations become more realistic. That does not necessarily entail a major bear market, but it does mean some additional periods of discomfort potentially for both equity and fixed income markets. As those more realistic expectations are priced into the markets thinking, we would expect some excellent investment opportunities. We stand at the ready.

## Portfolio Positioning: What Does This All Mean

### 1. First and foremost, make sure that your portfolio matches your tolerance for risk!

This is the most fundamental rule of investing. It also can be overlooked particularly when markets are going up. That can lead to getting trapped in the current emotion of the market and in “unintentional” risk finding its way into a portfolio.

This is a perfect time to make sure that your portfolio truly matches your risk tolerance and expectations. For more conservative investors, that may suggest dialing back the percentages that are allocated to some of the more aggressive areas of equity and fixed income markets.

### 2. Broader is Better; Diversification Matters

Unquestionably, the best defense against market volatility is a broadly diversified portfolio. That means owning a wide variety of assets and asset categories; equities, fixed income, Non-U.S. assets, commodities, alternative assets, private equity and private real estate (where appropriate).

While we do and will make significant shifts as to how a portfolio is constructed and where we believe the best investment opportunities are, these are always done within the context of a well-diversified portfolio. Markets can take unanticipated shifts. For example, how many investors expected fixed income to have some of the best returns this year?

### 3. Evaluate Returns Over a Full Market Cycle (generally three to five years)

Obviously, longer-term returns are the accumulation of returns over shorter-term periods. Having said that, what is ultimately critical for all investors is whether those longer-term returns match or exceed their requirements. It is not so much how a portfolio does during an up period

or a down period, but is the compound annualized return over the full market cycle. That full market cycle will have periods whereby each asset class has experienced both up and down periods.

This is perhaps the most challenging issue for most investors. We all get trapped into shorter-term thinking. The media bombards us with current information and we naturally feel tempted to react immediately to whatever is the “news of the day.” Often these reactions are harmful to the longer-term financial health of our portfolios.

#### 4. Successful Investors Take Advantage of Periods of Market Anxiety

In our decades of market experience, the very best investment opportunities are never comfortable. How many investors were bullish at the equity market bottom of March 2009? Be honest.

To be fair, it is extremely difficult to think clearly and make rational investment decisions at market inflexion points. The overwhelming market sentiment is pointing in the opposite direction by definition. That is, in fact, a pre-condition that creates and is associated with any major market top and market bottom. Success requires a disciplined approach that is grounded in buying quality assets at favorable prices.

#### 5. Moderate, Disciplined Adjustments in a Portfolio Produce the Best Results

We are big believers that active, disciplined investing can significantly improve long-term results. These moderate, disciplined adjustments mean trimming asset classes that have recently done really well and may be getting more expensive and adding to asset classes that we believe are attractive. While each of these adjustments may seem modest, the accumulation of their impact over time is substantial.

A key to success is accepting that markets are highly unpredictable in the short run. Precise timing of entry and exit points is virtually impossible. That is why we make a number of moderate adjustments over a longer period of time. That kind of process assures that the average entry and exit prices are attractive and that there is no single huge change in the portfolio that is poorly timed.

### Successful Portfolio Construction Involves Not Just Diversification; Correlation Matters

Putting all of this together in the construction of a portfolio is complex. It is not just having a lot of stuff in a portfolio. What really matters is how each component of that portfolio relates and interacts with other pieces. Technically that subject is about correlation.



**“What really matters is how each component of that portfolio relates and interacts with other pieces.”**

We like to explain our investment philosophy in its most condensed form by saying that the best portfolio is the most diversified combination of cheap, non-correlated assets.

In the current environment that we have described that means higher weights in larger cap, higher quality U.S. equities and reduced weight in the smaller cap and more volatile sectors. It means adequate weights in both non-U.S. equities and Emerging Market Equities. We have positioned Fixed Income assets more defensively than normal, given low interest rates, although there remain pockets of opportunity. We continue to be committed to a basket of lower risk Alternative assets. These assets are critically important to reduce risk and portfolio correlation. Finally, we think that holding some moderate amounts of liquidity (cash) is appropriate and will give us the fire power to take advantage of market opportunities.



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