Monthly Commentary

January 16, 2014

"Good investors gather information, put that information into current and historical context, then make sound decisions."

2013 is in the record books. Bottom line, it was a surprisingly good year for equities, and a surprisingly difficult year for bonds. We are going to look at each of these financial markets later in this Commentary but first we need to stop and reflect once more on the past year, (and just once), before we focus our attention on the here and now. 2013 will be remembered primarily as a year that the federal government had to 'shut down' for 16 days due to Congress' inability to manage its huge fiscal responsibilities. 2013 also saw the first stage implementation of ObamaCare, which proved to be a logistical nightmare. Unemployment improved marginally. The housing market improved dramatically. Interest rates sat at rock bottom levels although the mere mention of the Federal Reserve easing sparked a Bear Market in bonds. Most of the year consisted of 'it wasn't as bad as we thought it would be, but it could have been worse, and it may not be over,' a less than desirable environment for financial assets. And, surprise, things turned out pretty well!

Equity markets enjoyed a banner year, with great breadth and good returns for the patient investor. So far in January we have continued to see new highs for major market indexes, albeit accompanied by markedly higher volatility. There is a great deal of temptation this time of year to get active with equity portfolios. There are considerable gains on the table and the prospect of giving them back is less than desirable. We, too, want to protect the unrealized gains in our managed equity portfolios, however we also don't want to fall off a horse that is just spinning around and not (yet) bucking. That requires maintaining our balance and fixing our vision somewhere other than the horse's feet. We have no desire to cling to a bucking horse, by the way, and stand ready to clear ourselves should the negative volatility persist. But it is still very early in the year, and the most prudent action is to respect the positive trends of 2013.

Bond markets had their own trouble in 2013. After hitting new highs in May, bond market indexes tumbled for several months before bouncing, retracing, and rebuilding new bases. Most indexes finished the year much improved from their September lows, but still underwater for the year as a whole. January has been quite kind to bonds thus far, as they have continued to build on their advances of the last four months of the year. The biggest trouble for the bond markets stemmed from their unfavorable comparisons to equity markets. It can be problematic to be so upstaged. The temptation to reevaluate one's investment philosophy and investment allocation after witnessing such dramatic diversion between two primary components of a diversified portfolio can be strong. Considering the intense mid-year volatility in bond markets, we regard their overall performance to be quite acceptable, and their long-term usefulness to be undeniable.

The fact is that for the first two weeks of 2014, bonds have been outperforming equities, and with considerably less volatility. Granted, two weeks does not a year make. We are very, very early into this new year and it is important to keep one's eyes on the horizon, or at least several hundred yards downrange. We would not be surprised to see bond returns rivaling equity returns for much of year, remaining mindful that equities always have the ability to sprint ahead.

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A more engaging situation for portfolio managers at this juncture is what portfolio sectors hold the most risk. This is far more complex than looking at what has done the best versus what has done the poorest over the past twelve months. There are certain market sectors that advanced by more than +40% in 2013, with little or no price correction the entire year. When you measure that absolute return versus another sector which advanced only half as much or even less, it can be deceivingly easy to want to avoid exposure to such a 'high flyer.' Conversely, if you have new monies to commit to the financial markets, would you not rather put it on a proven, recent winner versus some other option which consistently lagged behind? This is the situation that faces professionals and civilian investors alike. There is no simple response. There is, however, immeasurable value in having a discipline, a process to help regulate the pace and the direction of one's activity towards a definable goal. This is what separates the professional and the civilian.

We continue to maintain a positive posture, supported by the technical data that is key to our process. We also remain protective of our progress and look forward to the challenges this new year may hold. January has been an entertaining month but has offered few clues as to what lies over the next hill. What an adventure!

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Sources: Bloomberg, Marketwatch.com, StockCharts.com.