Verity Asset Management

Commentary

Core Model

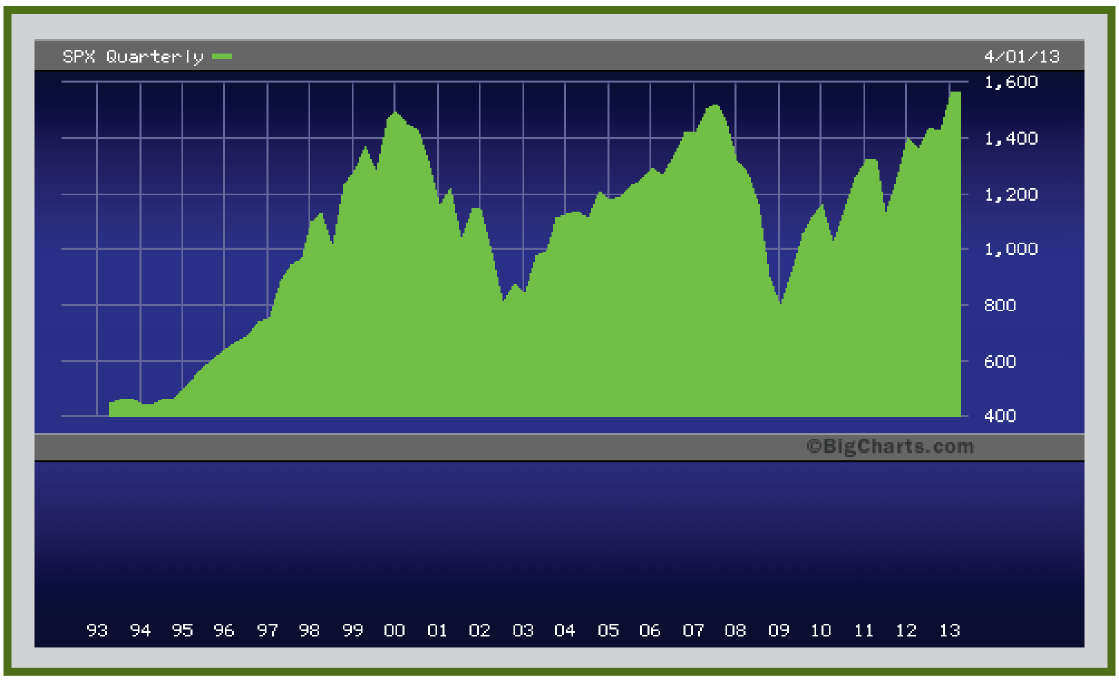
March 31, 2013

Playing For Keeps

As 1st Quarter 2013 came to a close, two items dominated financial news: the Dow Jones Industrial Average reaching new all-time highs and the tumultuous emergency bailout of major Cypriot banks. It would be difficult to construct a more appropriate framing of the current predicament of the investment universe.

Are the market woes of the past decade behind us – are we on to better times? Or, are serious unresolved problems just a whisper away from taking us down again?

An appropriate visual is provided by the 20 year price history of the S&P 500, which on the last day of the quarter also surpassed its previous closing high, reached in October of 2007:



Where will we go from here? We've reached this general price level twice before, in 2000 and 2007, each followed by devastating bear markets.

Further complicating the picture, the U.S. equity market's recent well publicized run distracts from the reality of the results in the broader investment universe over the quarter. U.S. equities have been almost like a one-legged stool …

Investment grade bonds were flat to down
Foreign and emerging markets bonds were down
Emerging markets stocks were down
Commodities were flat to down
Gold was down

… And developed foreign markets (primarily consisting of Europe and Japan), one of the few other positive spots for the quarter, continue to be fraught with such significant risks that it's hard to prudently commit significant assets there.

Our Predicament

Stepping back to get a fuller perspective, a powerful case can be made that this market is floating on a massive and rapidly expanding sea of Dollars, Euros, and Yen. Some would say that's a good thing – that this process is effectively buying time, and giving economies a chance to heal.

The scary thing for investors is that this is all a *grand experiment*, the printing of money, globally, on a scale we could have never imagined. We're in uncharted territory – impossibly complicated by political wrangling and currency wars. If it is actually possible on some level to "borrow your way out of debt", central bankers from the U.S. to Europe to Japan seem determined to find out - with the help of their printing presses – *all at the same time*. In what many would consider an understatement, in an interview on CNBC addressing the Federal Reserve's most recent quantitative easing program, Federal Reserve Bank of St. Louis president James Bullard said, in part, "… We are taking risk. We are getting deeper and deeper into the woods..."

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For investors, what happens if/when the Fed cuts off the spigot? Or what happens when markets simply say, "No more … we no longer believe in your theories or trust in your creditworthiness, and we simply are no longer willing to absorb the risk that perhaps you have tragically miscalculated the outcome of this experiment."

Even if the central banks could conceivably make all this work, left to their own devices, will the politics allow it? The political will to continue piling on debt at an astronomical pace is decaying in the U.S. and Europe; so, will the messiness of politics destroy whatever predictability might otherwise exist? And would that be a good thing or a bad thing?

The point is, the outlook is extraordinarily complex at a time when the stakes are huge.

Traditional Solutions

If the domestic equity market's buoyant performance during 1st Quarter could be a reliable guide, we could all just invest in U.S. stocks – the Core model's 30.5% target allocation to U.S. equity generated a return of 13.5% in the first three months of the year, outpacing the S&P 500, just as the Core's U.S. equity allocation did during the S&P's 16% run in 2012 - but that approach would be simplistic, not to mention dangerously unbalanced.

Traditionally, it has been common for broad investment portfolios to have three primary legs:

- Investment grade bonds, with a heavy reliance on U.S. Treasury securities - After a 30 year secular cycle during which interest rates on U.S. Treasury securities have fallen to previously inconceivable lows, the interest rate risk embedded in Treasuries, as well as bonds in general, is very significant. Given the Federal Reserve's intervention, the timing is unpredictable, but at some point, investors who have piled into bonds – and particularly, bond funds – for "safety" face a risk of being severely harmed, not only by a direct loss of principal but also by the potential purchasing power effects of any rise in inflation. Bonds, of course, offer two ways to make money:

    a) Interest – but rates are now excruciatingly low, and
    b) Price appreciation - which occurs when interest rates drop, but with rates so near zero, there is little meaningful room left.

  As a consequence, it is mathematically impossible to sustain the returns of the past 30 years, and very high risk of loss when interest rates begin to rise again. When the remaining money to be made is very limited and the potential for loss is significant, bonds must for the present be questioned as a legitimately defensive investment.

- Equities of developed foreign countries (which consist primarily of Europe and Japan) - Keeping it simple, this can be viewed from two perspectives: (a) European (and Japanese) stocks are so depressed in response to their serious economic concerns that they represent good value, or (b) Europe could be deemed a house of cards – it has simply postponed an inevitable and very severe outcome, one which could still very easily turn catastrophic. And, while they have flown under the radar for the past few years, Japan's ultimate outlook also appears dire, though their newly launched round of money printing, on a scale that staggers even Fed watchers, may alter the time frames. In our view, this is not an environment in which one should lean too heavily on option "a", as if this was simply a game of musical chairs. The consequence of being wrong could be more like a trap door than the mere absence of a place to sit.

- U.S. equities – Despite its challenges, the U.S. market has a number of legitimately positive elements, but it is significantly attractive only in a relative sense. And with the other two legs in danger of "breaking", this portfolio is at risk of becoming a one-legged stool, imprudent even under the best of circumstances. A well designed portfolio cannot be expected to stand on only one leg.

Stopping to Think

Stepping back to 2010/2011 for perspective, the systemic risks confronting the market remained daunting. Despite this, and due, at least in part, to massive easing by central banks worldwide on a scale that could not have been relied upon or even imagined in advance, the course that stocks and bonds have charted in recent years has been favorable. Things could easily have gone in very different directions, and at various times have looked like they would. As a consequence, the traditional portfolio structure has had some scary moments, but has ultimately fared well.

However, investors must discern between good fortune and good strategy, for the systemic risks are far from resolved. In an environment where so much seems artificial – the unbridled expansion of fiat money, artificially low interest rates, manipulated currency exchange rates, sequential asset price bubbles - the course could quickly change.

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It is fair to say that the actions of central banks have, at least temporarily, created some sense of stability. However, they have not solved most of the problems, they have merely repositioned them, and there is a legitimate concern that they may be creating even bigger ones. Only time will tell how the grand experiment plays out.

What we do know very clearly is that there are multiple possible outcomes from where things currently sit. Part of our job is to protect investors from things they may – hopefully - never see. It can understandably be difficult to appreciate the attention to those protections when things appear to be going well. But we have all learned that worst case scenarios do happen. Investors must dispassionately ask, do I want a legitimate opportunity to succeed financially regardless of market outcomes, or do I want to bet my future on the hope that I have bet on the right one? Presuming the answer, the portfolio design should make an effort to consider all potential outcomes.

The Test of Time

Over time, *portfolio design* is crucial. As noted, a portfolio standing on one leg is precarious and likely at some point to topple. But additional legs which are weak and unreliable may create false confidence, ultimately doing more harm than good. Particularly in an uncertain environment, where nervousness is just below the surface and volatility can spike at the least provocation, one should seek a measure of genuine balance, with multiple sound legs on which to stand.

Since the Core model is designed to evolve based on a thoughtful and continuous assessment of changing conditions, its makeup can vary considerably over time. At quarter end, it looked like this:

- U.S. equities (30.5%) - Given the potential for continued expansion in the price of financial assets, equities, despite their risks, are an important portfolio component. U.S. equities, as previously addressed, continue to be more attractive than those in most of the developed world, so we have split our equity allocation primarily between U.S. and selected emerging markets, with the larger allocation to U.S. equities. The individual components are carefully selected, with primary themes at present in biotechnology, water, and agriculture.

- Emerging Markets equities (21.5%) – Unlike Europe and Japan, many emerging markets countries have younger populations which are moving into peak productivity years, and they have rapidly growing middle classes. They also provide more significant portfolio diversification than developed foreign stocks. Their markets will be more volatile, but have superior growth potential. We try to limit risk by investing primarily in countries with relatively low sovereign debt and sound fiscal positions. Though emerging markets performed well in 2012, we have used periods of price weakness since mid-2011 to gradually expand our overall allocation from 15.0 % to 21.5% of the portfolio.

- Commodities (10%) – Outright depletion of some natural resources and growing demands on renewable natural resources in very large emerging markets worldwide have created upward pressure on commodities prices during the past decade. Although new discoveries and more advanced technologies are able to slow the pace, the combination of world population growth and expanding middle classes in countries from China to India are having a significant effect on the longer term price outlook for many commodities. However, the outlook for individual commodities can vary widely, so we have taken a selective approach, with a current focus on grains.

- Gold (12.5%) – Though technically classified as a commodity, gold as an investment is greatly impacted by its perceived role as an alternative currency, and thus we treat it as a category of its own. From Japan to Europe, much of the developed world has amassed a volume of government debt which, complicated by unfunded social obligations and aging populations, appears almost impossible to contain, much less materially reduce over the foreseeable future. While not yet past the point of no return, the U.S. is also dangerously indebited. Under these circumstances, the potential for governments to resort to devaluation of their currencies is very real, if not predictably well underway. In such a global environment, gold is regarded by many as the most effective hedge against this risk, as well a an opportunity for gain. This outlook is supported by a number of factors and is evidenced by the ongoing purchases of gold by central banks of numerous emerging market countries as they seek to build their gold reserves.

- Other (25.5%) – Further diversity and important elements of risk management are supplied by a combination of smaller holdings which include an equity hedge (5.5%) and a merger arbitrage strategy (5%), along with a small residual foreign bond holding and cash.

The primary elements each provide significant independent opportunity for growth; collectively, they provide considerable balance and realistic potential to effectively handle uncertain and changing conditions.

Playing for Keeps

Things are not "back to normal". Four years after the crash, the U.S. economy is still struggling to gain the ability to grow without Fed support, Europe is showing renewed cracks in the dike, and Japan is looking squarely in the face of a demographic nightmare. And the central banks continue to push out printed currency at a pace that borders on desperation. Is that a veiled prediction about the U.S. equity market's direction from here? No, it is simply the reality we must respect as we allocate investment dollars. The market may very well continue to climb, but it is clearly not rising on the firm, reliable foundation of a healed and rejuvenated economy, much less a strong global outlook, so it could turn sharply at any time.

We don't focus on short term predictions – even for the best forecasters, they are too often unreliable. As a consequence, we have always placed our focus – not on attempting to predict – but on observing and carefully preparing, taking a clear-eyed look at the realities of current circumstances and responding with an approach that seeks growth and adaptability across the full range of realistic possibilities.

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