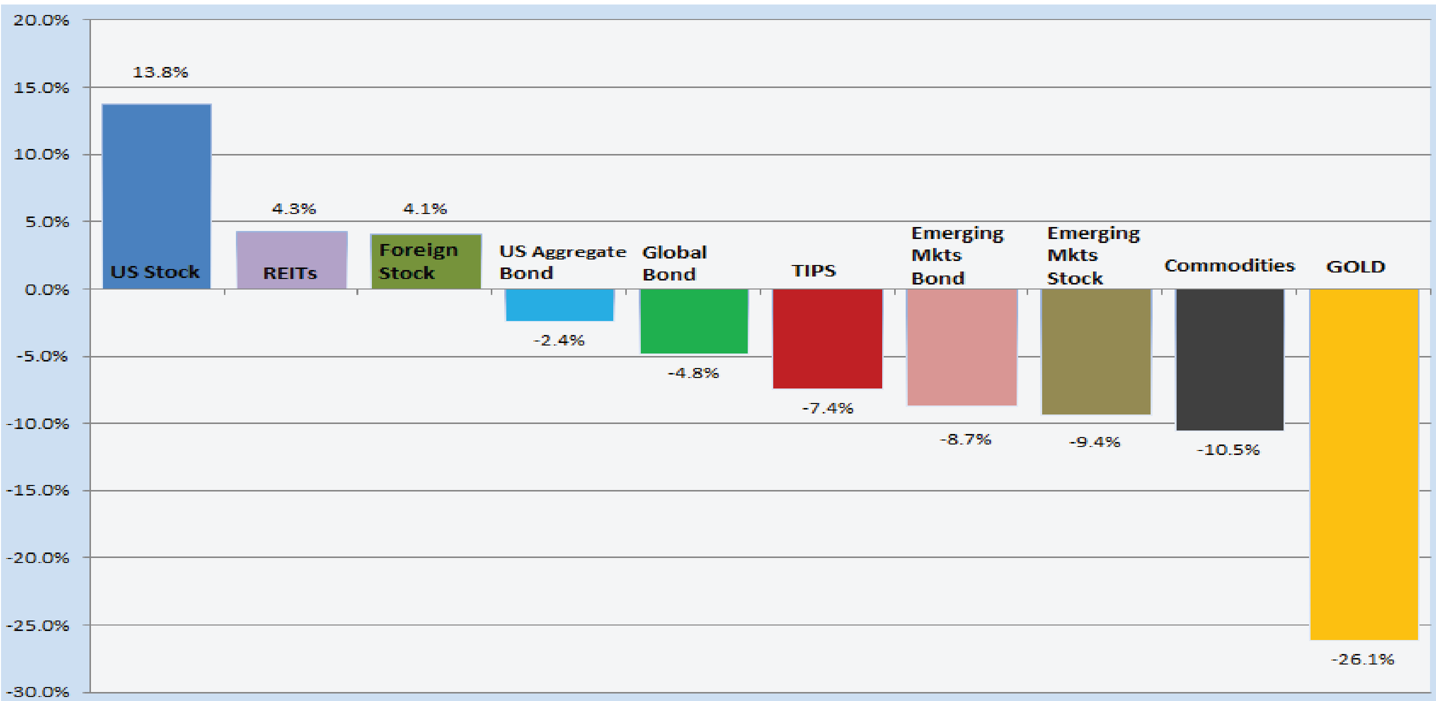
Keeping It Real

For the first half of 2013, the U.S. equity market was practically the only game in town, as the chart below so starkly illustrates.



Across the broad investment spectrum, the second quarter was even worse, with every single one of these market categories in negative territory for the quarter except for U.S. stocks. In such an unusual period, it can be easy to lose sight of the larger reality.

It is pretty simple to make the case that the sudden dichotomy between U.S. stocks and nearly everything else is:

1) Temporary – If history is a guide, such extreme aberrations are not sustainable – they correct themselves over time.

2) Somewhat Artificial – As was discussed in our 2nd Quarter Commentary, the incredible scope of the bond buying programs of the developed world's central banks, known as "quantitative easing", has distorted international capital flows, upsetting the balance among financial assets throughout the world. During 2013 to date, the U. S. stock market has found itself the prime beneficiary of this imbalance.

However, particularly given the tone of the financial news during 2013, it might be a surprise to most to learn that S&P 500 corporate earnings have in real terms actually weakened over the two year period concluding with the 1st quarter earnings season, declining roughly 2% after inflation. And despite hopeful data points scattered along the way, the U.S. economy remains persistently weak.

Many are predicting that the economy will improve in the second half of the year. Predictions are fine for the possibilities they may suggest, but in an era of global economic weakness, crushing sovereign debt loads, and financial relationships distorted by unprecedented worldwide central bank intervention, the real investment process plays out in an environment of considerable uncertainty.

Circumstances are so complex that things could develop in a number of different ways and over completely unpredictable time frames. There are in the mix genuine reasons for optimism; there are also reasons for fear. As an investor, it is perhaps more important than ever to keep both feet firmly grounded and avoid serious errors in judgment. We find that, amidst the noise, it helps to keep several things in focus:

1) Time frames
   - Most of the positions in our portfolios are built upon themes we envision playing out over a period of years. They will inevitably go through periods of disfavor; but unless the underlying fundamentals have changed, we know that it is meaningless to compare them to unrelated markets over shorter time frames.
   - By design, in effectively diversified portfolios, not everything will work the same way at the same time. The value of this approach was outlined in our 1st Quarter Commentary. The objective is greater balance, greater stability, and superior risk adjusted results over time.

2) Investment discipline
   - Periods like the present can pose a tremendous psychological challenge for professionals and individual investors alike. It's tempting to chase the winners, though we all know that one of the greatest strategic errors in the pursuit of long term performance is to abandon a well constructed process in the emotion of the moment. Circumstances can change quickly, particularly in market conditions such as these.
   - As conditions change and new information emerges, adjustments are vital, but they should be made on a disciplined basis within the framework of the investment process.

3) Tangible investment themes

   It became increasingly apparent over the past few years that investors were facing an era unlike any we have ever seen. The scope of the 2008 financial crisis was in some respects too great to fully comprehend. But that was only the beginning; the overwhelming response by central banks was not a solution to the crisis, but rather a repositioning of the debt in an attempt to restore confidence and buy time. They have succeeded in some measure at both, but it was and is impossible to rationally conclude there will be no further consequences to their actions. We live, at present, in a very unstable equilibrium, hoping against hope that any positive signs are rooted in stable soil and not subject to being swept away in the countercurrents of changing capital flows.

   Given this reality, we have worked to concentrate our investments firmly in the path of tangible opportunities for growth – investing in themes we feel can provide enduring value, capable of weathering any serious market declines and recovering profitably. Some primary global trends and the investment themes we are pursuing in concert with those trends fall into the following categories:

   - **Global population growth** - As global population continues to expand, companies which support the increasing demands being placed on critical resources have significant potential for growth in revenues over time.
     - Water – With population growth comes greater demands for water for urban, industrial, and agricultural needs. Water shortages are already constraining economic growth in the western United States, not to mention many developing countries. This is on top of the need for revitalization of aging infrastructure; in the U.S. Northeast, aging infrastructure causes as much as 50% of clean water to leak into the ground before reaching the tap. In this critical and rapidly evolving sector, both conventional solutions and innovative technologies provide investment opportunities in areas of treatment, distribution, infrastructure, and conservation of existing groundwater and other sources of supply.

- Agriculture – On top of general population growth, it has been estimated that one billion people will enter the middle classes worldwide by the end of the decade. One characteristic of this demographic group is a change in diet, particularly the increased consumption of protein from animals fed with grain. Yet the supply of arable land is limited. The resulting supply/demand profile creates diverse opportunities for investment, both in grains themselves and in companies involved in related enterprises ranging from fertilizers to processing.

- **Aging populations** – Worldwide, the populations of developed nations are aging significantly. In the U.S., while this overall demographic trend is not as extreme as Europe and Japan, the huge baby boom generation is moving into its later years, creating growing demand for medical solutions.
  - Biotechnology – Innovative, cutting edge research and development is providing life-transforming treatments in many areas of medicine. Baby boomers are more affluent than any other generation in history and have a logical willingness both to pay for the products of biotechnology research and to invest in biotech and medical device companies that could make life-saving discoveries and push back the aging process. New discoveries are turning into major income producers, providing a sound foundation for climbing share prices.

- **Favorable demographic trends** – In many emerging markets, younger populations are moving into peak production years, and emerging markets are the source of rapid growth in the middle classes mentioned above.
  - Emerging markets – Concurrent with the positive demographic trends, economic growth rates in some emerging markets countries are significantly higher than the developed world, and – particularly after the recent period of underperformance - stock valuations can be much less expensive than U.S. stocks. In the second quarter, recognizing that short term international capital flows were clearly negative for emerging markets, we made adjustments to our portfolio, eliminating weaker emerging markets positions and reducing overall allocations. But the longer term value appears intact, providing attractive opportunities for investment moving forward.

- **Central bank balance sheet expansion** - As we have repeatedly noted, we live in an era of unprecedented balance sheet expansion by the Fed and other major central banks throughout the developed world.
  - Gold - As an investment, gold inspires considerable debate. However, unlike a company which can completely fail and go out of business, gold is tangible, enduring, and desired, and will thus always have value. Despite significant intermediate term price pressure, gold provides to portfolios an element that is hard if not impossible to duplicate. Quoting from our 1st Quarter Commentary: "Though technically classified as a commodity, gold as an investment is greatly impacted by its perceived role as an alternative currency … From Japan to Europe, much of the developed world has amassed a volume of government debt which, complicated by their 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 indebted. 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 as 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."

In sum, we see strong opportunity in a number of selected areas. By diversifying our portfolios, we are not betting against the U.S. market – we have for some time favored the U.S. market, and some of our major themes are centered in U.S. stocks. But the near-unilateral primacy of U.S. stocks during 2013 to date does not suggest some enduring new reality and thus should not undermine the integrity of the broad investment process.

U.S. Stock - S&P 500 Index – Composed of 500 large company U.S. stocks, often used as a proxy for the domestic stock market.
REITs – Cohen & Steers Realty Majors Index – Designed to represent the market of selected U.S. Equity Real Estate Investment Trusts.
Foreign Stock - MSCI EAFE Index – Designed to represent the stocks of developed foreign countries in Europe, Australia, and the Far East.
U.S. Aggregate Bond - Barclays U.S. Aggregate Bond Index – Used to represent intermediate term U.S. investment-grade bonds.
Global Bonds - Barclays Global Aggregate Bond Index – Designed to provide a broad-based measure of the worldwide investment grade bond markets.
TIPS - Barclay's U.S. Treasury Inflation Protected Bond Index - Includes all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value.
Emerging Markets Bonds - J.P. Morgan EMBI Global Core Index – Used as a broad, diverse U.S. dollar denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.
Emerging Markets Stock - MSCI Emerging Markets Index – Designed to represent the stocks of developing countries worldwide.
Commodities - Dow Jones-UBS Commodity Index – Aims to provide broadly diversified representation of commodity markets.
Gold – Based on the actual spot price of gold, a commonly used standard for the value of an ounce of gold.

Illustrated returns are for the period from 1/1/2013 - 6/30/2013. One cannot invest directly in an index. Index returns do not reflect any management fees, transaction costs, or expenses.

280 South Mangum Street
550 Diamond View II
Durham, NC 27701

(800) 247.6717
www.verityinvest.com

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