INVESTMENT OUTLOOK FOR 2013

Increased Visibility & Income Scarcity

JANUARY | 2013

Despite numerous troubling headlines in 2012 most major investment classes posted solid gains. Chalk that up to the power of central bankers. Even though GDP grew at a slower rate than most predictions and inflation was higher than expected, unprecedented and aggressive monetary policy overrode underlying economic conditions.

In the year ahead, the outcome of global events and substantial monetary policy will continue to have a large impact on asset prices. For investors, the clouds are parting. The election is behind us, the so-called “Fiscal Cliff” has been addressed, the Federal Reserve has made their intentions abundantly clear and Congress has shown little political will to reduce spending.

There are few fundamental catalysts for price appreciation in equities, but monetary policy, a reduced consumer debt load, the so-called “wealth effect” from improving real estate values and investor re-allocation decisions should support further equity gains.

In 2013 we see US real estate strengthening and commodity prices moving higher, interest rates remaining low and inflation heating up. We see further gains in China and several other emerging economies. We see investors searching for income like a desert wanderer looking for water. We see improved mobility for job seekers and deterioration in the purchasing power of retirees on a fixed pension income.

Our long term allocation models suggest that value opportunities exist in emerging markets, real estate, commodities and certain international developed economies like Singapore and Australia. In the US, larger companies are preferred to smaller companies. In fixed income, mortgage-backed and global government securities are preferred to US government bonds.

Our work also suggests variability of outcomes will be very high. Asking “what could go wrong” will be of extreme importance in determining a proper asset allocation in 2013. An economic recovery based in part on unproven monetary policy, central bank intervention and supported by unsustainable government spending is less than perfect. But all-time low interest rates encourage borrowers and investors to buy assets and improve corporate balance sheets.

Interest rates act like gravitational pull. The higher they are the more downward pressure on equity prices. All-time low rates have asset values floating higher as if on the moon rather than on earth. Workforce reductions helped corporations post productivity improvements and new bond issuance has improved corporate margins. Lower fixed costs and lower interest costs have fueled a corporate earnings boom that has far outpaced corporate revenue growth. Without substantial improvement in the fundamentals of the recovery, asset prices could experience large price adjustments. On the positive side, a real estate recovery will make people feel a lot better about life and many of the largest corporations are flush with cash.

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Maximize What You Can Control

The clouds may be parting for investment allocations, but the future outcome variability will rise to extreme levels. Many investors will be tempted to take on additional risk to find yield. At some point in the future, governments will be forced to address unsustainable policies. Key input variables will require close examination as will the budgets and spending plans of households and businesses.

A Monte Carlo planning analysis seeks to use inputs including 1) investment growth (price appreciation), 2) inflation, 3) tax rates, and 4) income (yield and earned income) to project a range of outcomes into the future. A range of outcomes are typically measured by running thousands of scenarios and provide a “probability of success.” An investor who has completed a financial planning model has likely used a Monte Carlo assessment engine.

The Federal Open Market Committee (FOMC) has stated that a “highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery gains steam.” Financial planning assumptions should include scenarios of substantial inflation.

Further, the FOMC has stated their intention to keep interest rates low until at least 2015 (and perhaps longer). Due to the nature of investment returns, modeling assumptions should also include scenarios of prolonged low total returns from investments. Historically, a balanced portfolio could rely on income to account for 4-5% of the total return of the portfolio. Today, that same balanced investment-grade portfolio yields just over 2%.

With a $16 trillion national debt and a Congress with contempt for a balanced budget, increased borrowing (Treasury debt issuance) and revenues generation (tax increases) will be necessary. Planning assumptions should include a trend of rising tax rates in the intermediate term.

To combat uncontrollable variability in tax rates, inflation and investment returns, an investor can take actions to exercise more control over their own lives. Here are a number of suggestions:

Earned Income

Any income, whether from a job or defined benefit pension or from savings, is worth its weight in gold. Before making any decision to discontinue an income stream (whether it is from retirement or from selling an income producing asset) be aware of the implicit value of recurring income. A good rule of thumb is to equate the income stream to a yield on an investment-grade bond portfolio earning 4%. A $1,000/month income stream would be the equivalent of a $300,000 bond portfolio.

Budget

A detailed spending plan is the most controllable part of any business or household plan. By rule, lower fixed costs and low recurring expenses increase the ability to react to adverse times and improve savings.

Risk Assessment

The need for investment income and for respectable gains will drive many households and businesses to make “out of the box” decisions. Be sure to quantify the risk of loss in each case and compare risk types to minimize the downside impact from a single event.

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Scenario Analysis (Flexibility)

Have a main course of action, a current life plan, but spend some time thinking through "what-if" scenarios. A loss of income, a disability, a change in health, a commitment to family or loved ones are a few examples of major events that can alter life. What changes would need to be made? Thinking through these scenarios before they occur can result in better preparation than trying to be reactive once a major event happens.

Liquidity

If two opportunities are similar in return or outcome potential, choose the more liquid option. Maintain a proper level of liquidity to maximize control over life scenarios. Have the liquidity to bridge a gap in income and the ability to become liquid quickly in reaction to a life changing event. One important note, liquidity does not mean cash. Liquidity means the ability to sell or otherwise use savings or assets quickly. Typically, publically traded stocks, bonds and mutual funds are liquid. Additionally, a line of credit can provide emergency liquidity.

Addressing 2013 Challenges & Opportunities

Rising living costs (like food, health, education and energy) and historically low interest income combine to create a key long-term challenge for investors. As noted earlier, a balanced portfolio that typically yields 4-5% is now yielding 2-3%.

Think outside the box when it comes to income. There are numerous opportunities that can increase yield without substantially increasing risk.

A strengthening of real estate values will offer income opportunities. Real estate related income opportunities include 1) rental properties, 2) mortgage-backed securities, and 3) real estate investment trusts.

Rising commodity prices and the continuous need for food and energy can offer opportunities from 1) pipeline revenues, 2) transportation and storage of energy, and 3) other inflation-protection investments.

Sovereign nations with balanced budgets and economic growth still offer attractive government debt with yields in the 4-6% range.

Companies with sustainable dividend policies can offer yields of 3-5% and unlike bond investments, can also increase their dividend payouts each year. In the case of dividend-paying stocks, price risk may be higher than some bonds, but the chance to receive higher and higher dividend payouts (that can outpace inflation) is a compelling reason to tolerate the volatility. There are over 50 high quality companies in the US alone that have raised their dividend every year for 25+ years.

We expect asset prices to be supported primarily by policy actions and consumer confidence (driven by the wealth effect of rising real estate values) and by a lack of investment choices in traditional income securities. Housing should add to GDP and offset some negative impacts of corporate margin compression. While this is the view for 2013, we will need fundamental growth and a broader recovery to sustain our outlook for asset growth. The market is currently "moderately over-valued" as measured by history (GDP/total market capitalization).

We suggest that investors avoid speculative income vehicles and avoid companies with high debt leverage. Income allocations should be reasonably low in volatility, have an understandable business model and demonstrate the ability to continue to make payments in the future.

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What Could Go Wrong?

While there are numerous possibilities, and black swans are by definition unknowable, we can point to several risks on the horizon:

Congress: partisanship will increase volatility

Iran: possible military action

Europe (Spain and France): any adverse news from Spain or France could cause alarm

Credit Downgrades: rising debts and a continuation of government spending could cause another rating agency downgrade.

Asset Allocation

It's time to be a discriminate owner (of assets), minimize cash and Treasury obligations which will be eaten up by inflation, and think outside the box as a lender (owner of bonds).

Our proprietary long-term allocation modeling suggests that total return from a traditional allocation of investment grade bonds and S&P 500 stocks will be somewhat below historic levels. This is primarily due to lower levels of income from both stocks and bonds.

The models suggest tactical allocations to emerging markets, international developed markets, global bonds, mortgage-backed securities, TIPs, real estate and commodities. Our models suggest that small-cap stocks and high yield (junk) bonds are too richly valued and carry large downside risks and do not warrant additional investment allocations in 2013, but nearly every other major asset class we track has merit in 2013.

The resultant tactical allocations improve the expected portfolio returns significantly.

Summary

- We feel there are very large forces that support asset prices in 2013
- Owning assets can help offset the inflationary pressures caused by monetary policy
- Investors should be diligent in maximizing their control and flexibility
- For equities: think big in the US and emerging internationally
- For bonds: think outside the box, but don't chase yield into the danger zone
- Include real estate and commodities in portfolios

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