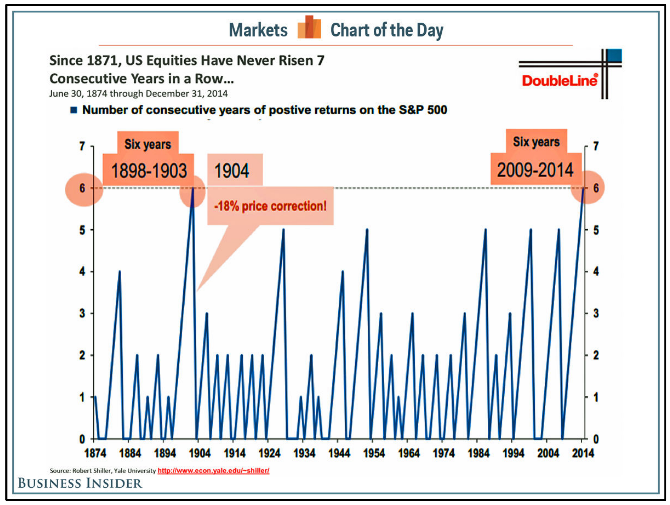
The Long & Short of It

Quarterly Newsletter
First Quarter 2015

The bull market in stocks celebrated its sixth birthday this quarter. The proverbial bloom is off the rose and even though spring has just begun, the best days of this bull market are certainly in the past. We find ourselves asking how best to be prepared for the next stock market correction—or even the next bear market.

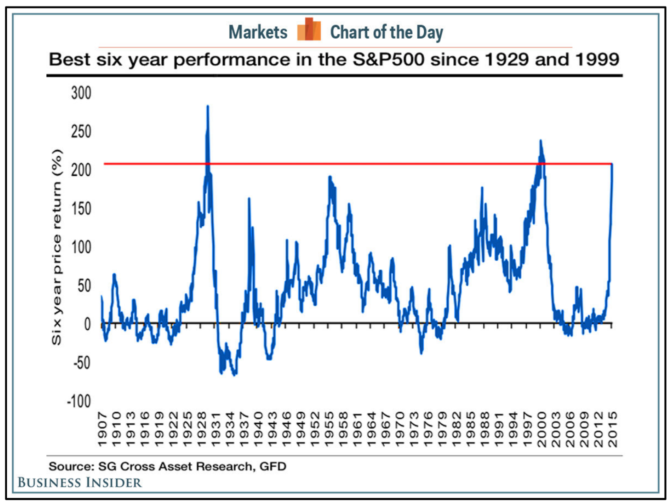
Why We Are Cautious

A variety of evidence supports our stance. First of all, since 1871, there have never been seven consecutive rising years (as the chart on the right illustrates). Second, yet another characteristic of an aging bull market is narrowing leadership. Over the past year, biotech and technology stocks have led the market higher despite relatively lackluster gains from most other areas of the stock market. But perhaps, as the media likes to say, "This time is different". Has the slow nature of this economic recovery left some upside potential for the stock market? Perhaps, but the chart to the right suggests not. The S&P 500 has enjoyed a remarkably swift ascent by historic standards. And the evidence does not support the continued rise of the market.

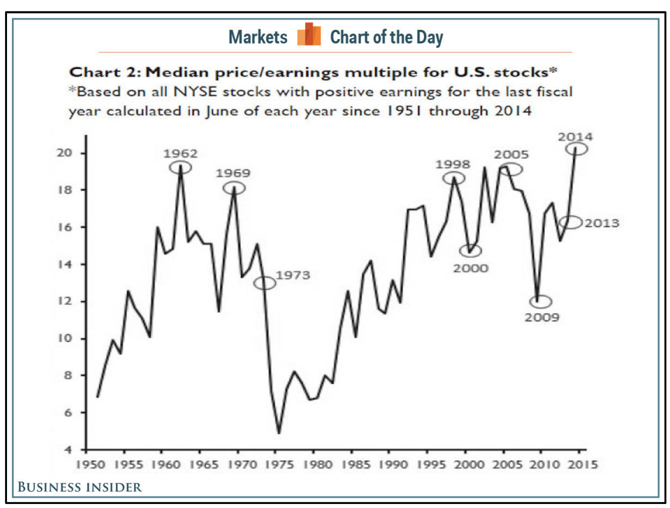


Fundamentals and Sentiment

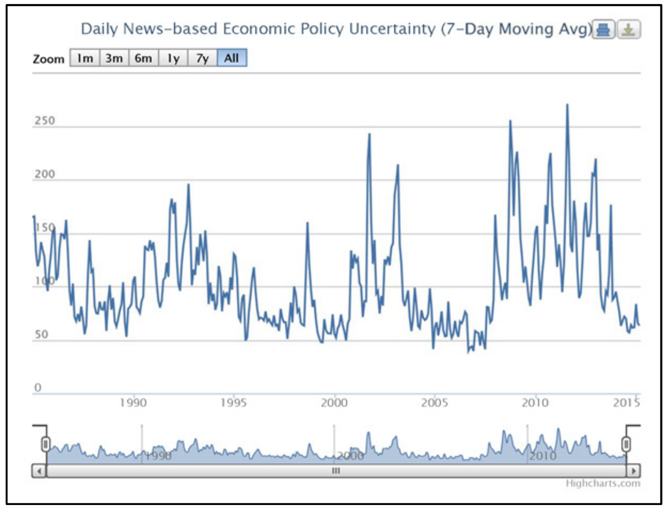
Do the underlying fundamental measures of value tell a different story? In looking at valuation, we find that the stock market is expensive by traditional standards and trading at or near all-time highs. "Expected returns" from the S&P 500 suggest a very modest 2%-4% annual return from the market over the next ten years. This is an average, and it could be better or worse, but typically when the market reaches extreme valuations it is far more susceptible to meaningful corrections, if not bear markets. The third chart on the right supports this observation as it shows how the median price/earnings multiples for US stocks are at all-time highs. Although much of the increase in P/E is attributable to the current low interest rate environment, the prospect of rising interest rates creates a new set of challenges for equities.



When looking at stock markets, much analysis centers on feelings, otherwise known as investor sentiment. How do investors feel about the market, the economy, their disposable income, etc.? However, sentiment is very tricky to define and even harder to measure. The Economic Policy Uncertainty Index was created by a group of academics from the University of Chicago, Northwestern, and Stanford. They have set out to track uncertainty as it pertains to Washington policy-making. The table on the next page illustrates how low uncertainty coincides with strong stock markets and high or rising uncertainty



coincides with falling stock markets. It is no coincidence that the steepest increases in uncertainty take place around the time of new presidential administrations. At the current low levels, we know the measure leans strongly toward the benign. Any guess as to when it might change and begin to rise—perhaps in 2016?



March Madness

During the first quarter of 2015, domestic equity markets and bonds were close to flat. The S&P 500 returned 0.95% and the Barclays Capital 1-5 year Government/Credit Bond Index returned 0.96%—a rather unremarkable quarter except for the strength of the US dollar. As measured by the DXY, an index of the value of the US dollar relative to the currencies of a majority of its most significant trading partners, the US dollar rose from $90 to $98 during the quarter. This is a continuation of the rise it began in July 2014 when it was at $80. Essentially, the purchasing power of the US dollar rose by 9% during the quarter and by a remarkable 22% over the last nine months when compared to a basket of other currencies. The strengthening dollar typically leads to a stock market decline as exports become more expensive, which damages earnings derived from foreign sales that comprise approximately 40% of the revenues of large, publicly traded US corporations. But earnings do not always equate to a change in the price of stocks. The two do not necessarily move together in the short run. This was certainly the case in the first quarter, as the aimless markets grappled with a complex mixture of data: slowing economies around the world, a strong dollar, volatile and weak oil prices, continued violence in the Middle East, and improving employment and generally low interest rates.

An Aggressive Defense

Much like basketball, the best defense is often the best offense when it comes to investing. At Robinson Value Management, we have successfully weathered several bear markets: 2001-2003 and 2007-2008. Our expertise in selecting industry leaders with strong balance sheets is rewarded in down markets. The one sure thing about stock market investing is that for every down market there is a subsequent up market. While the average manager will take greater risk than his benchmark in order to achieve better performance, Robinson Value Management works to keep the volatility of equity holdings down so our clients are able to make greater allocations to equity. The low volatility approach helps clients remain invested in stocks during volatile times so they can stay the course and be emotionally prepared to add to equity after large drops—in other words, being able to go shopping when stocks are on sale and enjoying the benefits of the next bull market. The few managers we see with a truly risk-averse or defensive approach typically encourage their clients to hide out in the bunker during the battle. At Robinson Value Management, we choose to put our helmets on and hunt for bargains while the battle rages; that is to say, we are aggressively defensive.

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