March 2013

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"Never look back; something might be gaining on you."

SUMMARY:

2012 was a very good year… to be an investor in stocks. 2013 has also started off strong, with gains of 6% or more.

The big "macro" risks have receded slightly into the background. 2013 might be a year based on corporate fundamentals.

Interest rates are likely to stay low for another year. Inflation risks are out there, but probably will not flare up soon. We discuss alternative strategies for getting yield.

There was a tax deal made at year end, and the Obamacare tax begins this year. It will mostly affect earners above $250,000 and for some taxpayers marginal rates could exceed 50%.

In This Letter

Dear Clients and Friends,

2012 was a terrific year to be an investor in stocks. The fourth quarter turned out to be a non-event for U.S. stocks, but global equities did quite well. The election came and went, as did the fiscal cliff. There was one thing we were sure of, and that was that the sun would come up, and it did. However, as one Client told me, "It shone a little brighter for some people than for others". Investors have gotten "Washington fatigue". After so many deadlines and crises, we are moving away from giving the politicians our attention. They will periodically bring the spotlight on themselves as narcissists are wont to do, but increasingly the financial markets are going to pay less and less attention to them. And that would be a wonderful thing!

In our October letter, we wrote of the many risks facing the market in 2012 and how the market kept right on climbing. Nowhere was that more true than in Europe. Last year Europe (the Euro-zone) had negative economic growth and an average unemployment rate of 11.8%, but the Euro stock index was up 18%. In Greece, the unemployment rate exceeds 25% and the economy contracted by 6.9%, but the stock market rose by 46%. We are often asked how these disparate results can make any sense. The reason is that the market is forward looking. Investors have decided, rightly or wrongly, that the European situation is not going to end in the collapse of the Euro. Greece received a loan restructuring and lives to fight another day. We have reported in the past about our "Financial Stress Indicators". Currently, they are giving us a green light. For the last four years, flare ups of financial stress – meaning risks to the banking and financial system at large – have been the primary driver of financial market returns. When fears rose, stocks fell and bond prices rose; when fears subsided the opposite occurred. Europe is not out of the woods, but we believe that for the time being the risk from there has subsided enough that we should turn our attention elsewhere.

The most common question / debate we get about systemic risk is related to the U.S government in one way or another. Primarily, people are worried about the debt level or the current deficit. As always, I will try to comment on policies without being political (but inevitably someone will be offended).

Returns as of Feb. 22, 2013	YTD 2013	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative *(thru 1/31/13)*
Large Cap U.S. Stocks	6.7	45.4	114.4
Mid Cap U.S. Stocks	8.5	54.8	200.6
Small Cap U.S. Stocks	7.8	57.5	191.5
Nasdaq 100	3.1	54.3	177.9
Foreign Stocks - Developed	2.9	20.9	141.9
Foreign Stocks - Emerging	-2.4	15.7	384.7
U.S. Bonds – Taxable	-0.5	17.2	64.5
U.S. Bonds – Tax-Free Municipals	1.1	19.3	64.0
REITs	5.4	67.6	176.0
High Yield Bonds	0.8	35.9	169.1
Commodities	-1.9	9.9	42.0
Hedge Fund Index	0.9	18.7	96.6
Gold	-5.6	40.3	353.0
60/40 Balanced Index	3.9	35.7	107.0

The U.S. fiscal situation is improving. It doesn't mean everything is blue skies and green grass. It isn't. But, the annual deficit was 10% of GDP three years ago and it will be 6% or less this year. It will be around 4% next year. The U.S. debt level as a percentage of GDP is likely to peak this year and should be lower next year.

This is not due to good stewardship from our government, quite the contrary, but rather from the growth of the economy itself. This is something I wrote about last year. If the government just stops growing the debt and spending levels, then as the economy grows then debt as a percentage of the economy gets smaller.

We have commented before that tax revenue as a percent of GDP has fallen to a historically low level of 15%. This will rise as the economy improves, employment improves, and as the stock market improves it creates more capital gains and capital gains taxes. Finally, Congress adopted a new tax policy that is permanent (as much as tax policy is ever permanent). At least it doesn't expire in a year or a few months. The new tax code does increase tax revenues to the Treasury – not by a lot, but it is an increase.

Furthermore, the new healthcare surtax of 3.8% begins. From a debt/deficit point of view these taxes help reduce our dependence on borrowing to fund our government spending.

So, our view is that the fears regarding U.S. government spending, debts, and taxes will recede in 2013. They won't go away, and Congress is like a spoiled child that can't live without attention. They will lurch from one self-imposed crisis to the next, but it will become less and less important. Thank goodness. However, they still are not dealing with the real problem, which is Medicare and Social Security. These programs must be reformed. Any progress we make on the deficit in the next few years will be swamped by the growing liabilities of these programs if nothing is done.

There will be flare ups, but if we don't have to worry about Europe or Washington D.C., what will drive the markets in 2013? And, what are the other big risks we have to watch out for? We believe this year could be a year of back to the basics investing. Earnings growth and valuations.

Earnings growth was a little slower in 2012 than expected. S&P 500 operating earnings growth was only about 6% higher than in 2011. However, since the market in 2011 didn't really move, then the 16% gain we saw last year was just catch up. Stocks did not move to an overvalued level. The way we look at valuations, the market remains below long term averages but not at the significant discount we saw a couple of years ago.

What should we expect this year? Consensus estimates are for earnings growth of over 10% this year. It is a little hard to see how we get growth this strong. Our expectation is for nominal GDP growth to be 4% to 6% in the U.S., Europe and Japan somewhat slower, and the emerging world a little higher. If you add in some productivity growth and share repurchases, then it seems earnings growth could be 8% or a little better. What could be the surprise this year would be more multiple expansion. If the market were to value stocks at 16x earnings, for example, which is the historical average, and if earnings came in at about $108, then the market could trade to over 1,700 – a 15% gain from here and close to 20% for the year. If (and it's a big if I admit) we avoid the big macro political and economic risks this year, this scenario seems logical.

The Pillars

Let us quickly revisit the principles we use to help us allocate capital in our portfolios.

<u>The Economy:</u> Growing: 2% - 2.5% (after inflation) this year in the U.S.; Global growth is 3% - 3.5% - Europe and Japan slower, emerging economies stronger.

<u>Earnings growth:</u> Growing, but at a slower pace. Probable growth rate this year 8% or so. Profit margins are at historical highs, interest rates are very low. Earnings growth will have to come mostly from revenue growth, although there will be some share buybacks, and merger activity too.

Year	Operating	Change
2007	82.54	-6%
2008	49.51	-40%
2009	56.86	+15%
2010	83.77	+47%
2011	91.70	+9%
2012	94.44	+3%
2013	102.00	+8%

<u>Interest Rates:</u> No change. Rates will remain low through 2013.

<u>Valuation:</u> Attractive. Current P/E is 14x – 15x. Below historical average, but not as cheap as in our last several newsletters.

<u>Financial Stress:</u> Green light.

<u>Political Policies:</u> Better than before because the election is over, and the tax law has been settled. The sequester (automatic spending cuts) is the crisis du jour, but maybe we would be better off just letting it happen. It will reduce economic growth, and there will be real cuts to both defense and domestic programs. But, isn't that what we need to do?

Strategy & Analysis

By Kreighton Bieger, CFA

Stocks – Ruminations on Risk Assets: We continue to be bullish on stocks. While the whole of 2012 finished strongly for equities and equity-like assets around the world, the fourth quarter saw a pause. January was one of the strongest first months in history, and we have seen a slight pause in February.

As I wrote last time, ***half all stock market volatility in the last 61 years occurred in 2008***. That experience, wherever you were, was memorable. Most likely we all share memories of both 2008 and 2000, where stock declines literally destroyed lifetimes of savings. In 2000 we saw historical overvaluation of markets and myriad textbook 'bubble' situations; in 2008 we saw similar valuation dislocations and 'bubbles' in financing. In 2000 everyone had a story about stocks – the barber, the cabbie, the kindergarten teacher. In 2008 it was housing – everyone knew someone who was flipping houses or getting rich on cheap easy financing and ever rising home prices. What do investors share today? A collective narrative of losses, fear and mistrust of markets.

However, despite the popularity of referring to the current state as "the new normal", I see very little new at all. Booms, busts, debt bubbles, currency failures and internecine economic systems – history is rife with examples of these situations. I wrote a paper in 1997 about the Thai bhat crisis which set off the (fortunately brief) Asian currency crisis. What happened? Those nations took their medicine, cleaned up their balance sheets and are now the darlings of the debt world. The number of failed currencies in the world's history may in fact exceed the number of currencies in existence today.

It was Thoreau who wrote, "*People don't change, things change; sell your clothes and keep your thoughts*". All investors, including us, risk the very real problem of ***hindsight bias***. Risk assets, such as stocks, have uncertain futures and are subject to a nearly inestimable number of factors which can move their prices on any given day or week. The uncertainty is higher, and thus the long term rewards are much higher when we pay the right prices for our assets. Markets look ahead and correct. Markets are fearful and greedy, and little in between. But markets are made up of people. If we are willing to escape the dominant narrative of fear, we can see where we really are today: modest, steady economic growth, declining financial stress (which we measure), improving global macroeconomic fundamentals, robust improvement in the balance sheets of companies, low interest rates and even possibly the winds of change blowing through Washington, starting with the possibility of sequestration.

Stocks are still being buffeted by the uneasiness of global investors with the pace of the recovery, the shakiness of the European recovery and the bad assets in the European banking system. In the meantime, we expect 8-10% earnings growth in the US. The fourth quarter "beat/raise" ratio was right in line with historical averages. The S&P 500 is trading for 14.5x forward earnings, well inside the long term average of 16x; European stocks are even cheaper.

Fixed Income

In the last newsletter we noted the availability of low borrowing rates. Recently Ray Dalio, of the successful Bridgewater hedge fund was quoted as telling investors to "borrow money and go buy anything". That may be a bit extreme, but we continue to see evidence that the Federal Reserve will keep interest rates low into 2014 and probably to 2015. Rates on 10 year Treasury bonds have risen from around 1.65% to about 2% today; a 21% increase, and we have seen very weak returns from bonds. Our strategy continues to be owning high quality corporate bonds with shorter maturities – which protects us from rising rates and also allow us to reinvest in higher rates sooner. Muni bonds outperformed the broad bond market last year and through January. We reviewed our "Build America Bonds" recently and sold those that were at risk of a potential subsidy cut as part of the sequester deal.

High yield, both globally and domestically, is part of our alternative assets and strategies. Last year high yield rose as much as stocks, and there has been much talk that this market is in a 'bubble'. In January, high yield's performance was muted relative to equities and its comparable assets. However, one thing to note is that while in the proverbial reach for yield, investors have poured dollars into high yielding assets, (preferred stocks, REITs, MLPs), high yield corporate debt does not appear to be in a bubble. First, there is a long standing, and intuitive, relationship between the default rates on HY bonds and their corresponding yield. Our fundamental work tells us that high yield is still appropriately priced. That said, we expect a correction here and are strategizing ways to protect and profit from this event.

We have started to add floating rate bank loans, in the form of a mutual fund, to portfolios. Floating rate loans are made by banks and sold to investors. Their rates reset usually every 90 days, and are tied to a reference rate, such as Libor. Thus, as rates rise we should participate and be protected from declining prices.

Alternative Strategies

In 2012 alternatives did their job perfectly, so to speak. With equities up 15-18%, bonds at 4-7%, our alternatives rose 10-12%. The hedge fund index against which we benchmark alternative assets rose about 7.6%, so we did well comparatively. We did a review of the positions in AS in the fourth quarter and decided to add positions in TIPs (treasury inflation protected bonds), gold and commodities. We continue to include a basket of MLPs, multi-strategy managers, domestic high yield, and international corporate and sovereign bonds in the basket. In the coming year, we are watching high yield closely and also continue to look for uncorrelated sources of return that will bolster the AS group's performance in your portfolios.

Due to investor demand, we have recently developed a Diversified Income portfolio designed to offer much higher yields than the aggregate bond indices with an improved risk/return tradeoff, which is not completely tied to interest rates. Please call us if you would like more information on Diversified Income and how we can incorporate elements into your portfolio.

Portfolio Implications

Two of the risks we see in the markets right now are inflation and the prospect of rising interest rates. One of our managers, the Invesco Risk Balanced Fund, recently published research looking at returns during periods of rising rates and inflation. The conclusion is that commodities and stocks fare the best. As we have underweighted bond positions for alternatives and stocks, we believe we are well positioned against these two risks. The piece also included a chart showing the steady decline in volatility in government bonds since 1983. As rates have fallen so too has the volatility. We recognize that another risk we face is how to manage the volatility that we will see even in fixed income when rates rise. We are actively working to construct portfolio allocations that consider the risk and return tradeoffs we face in order to continue to protect your capital, preserve your wealth, and achieve your financial goals. Thank you for your continued confidence and trust in SBL.

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Financial Planning
By Gary Powell

As witnessed with the media lights blazing, cameras documenting every move and commentators filling the airwaves with repetitive dialogue, our elected federal officials passed tax legislation on New Years' day to veer from the "fiscal cliff" at the last minute. "When push comes to shove" as the ole saying goes.

The net result is a higher marginal rate than you may think. The rates on upper-incomers can be far greater than the ones listed in the new income tax brackets.

The new law created a new tax bracket of 39.6% for taxable income over $400,000 for singles and $450,000 for marrieds. "Not to worry" you say, because my income is well below those high-income folks. But we caution you that this tax law may be a harbinger of tax legislation to come in our collective futures. The legislative techniques used to reach a political compromise are actually stealth tax rate increases that may be deployed on less-affluent taxpayers to address our fiscal policy woes in 2013 and beyond.

With that cheerful thought in mind, let's look at the items increasing your marginal rate above 39.6%.

<u>The cutback in itemized deductions adds up to 1.19% to your marginal rate</u>. After 2012, these write-offs are reduced by 3% of the excess of adjusted gross income (AGI) over $250,000 for singles…$300,000 for couples. The total haircut can't exceed 80% of total deductions. Medical, investment interest and casualty loss deductions are exempt from this cutback. Taxpayers with extremely large itemized deductions on Schedule A can start to feel the effects of this phaseout in the 28% bracket.

<u>The loss of personal exemptions adds as much as 1.05% per exemption to your marginal rate.</u> Personal exemptions are trimmed by 2% for each $2,500 if AGI over the $250,000/$300,000 thresholds mentioned above. The exemptions deductions disappear once AGI exceeds $372,500 for singles and $422,500 for joint filers. So a family of four in the phaseout zone can have a 4.2% hike in their family's marginal tax rate.

<u>Two other brand-new taxes for 2013 can increase your marginal rate:</u>
<u>The 0.9% Medicare surtax on high earners</u> is owed by singles once earnings top $200,000…couples, over $250,000 on wages and self-employed income.
<u>And the 3.8% Medicare surtax on net investment income…gains, interest dividends, royalties and passive activity income</u> will increase your marginal rate with AGI over $200,000 for singles and $250,000 for married couples.

The 3.8% Medicare surtax raises the effective tax rate on tax favored capital gains and dividends to 18.8% for taxpayers below the 39.6% bracket and to 23.8% for upper income folks.

<u>Marginal rates on long-term capital gains and dividends can be higher than expected</u>. If you are in the 10% or 15% tax brackets this year, gains and dividends are tax free until they push you into the 25% bracket… starting at $72,500 for couples and $36,250 for singles. After that, they are taxed at 15% until your gains and dividends bump you into the 39.6% tax bracket, when the 20% top tax rate kicks in on the excess.

<u>The marginal rate can be even greater for high-incomers who owe the alternative minimum tax (AMT)</u>. Generally, the 15% and 20% rates on gains and dividends also apply for AMT. But for filers in certain phaseout zones for the AMT exemptions, the marginal rate is 6.5% or 7% more. This can increase the marginal rate from 20% to 22%. And the 3.8% Medicare surtax would generally apply on top of that, boosting the rate to 25.8%.

The bottom line - the marginal tax rate of 39.6% can move north of 48% and potentially move above 50% for certain taxpayers.

Company News

By Patty Meneley, COO

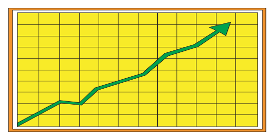
1099s have now been issued by Schwab, TD Ameritrade and Fidelity. We have seen a few corrected versions going out already, so please watch for notices of corrected ones being issued. Usually the differences are small but it is best to wait for the "last" version. Also remember that your tax package is not complete until you have received all documents, including K-1s if there were any investments in your portfolio that might have produced one of those. Your portfolio manager will know if you are in that category. We sent out our Realized Gain/Loss schedules in January, but your 1099 is the official document so be sure to use that in the preparation of your return. If you would like for us to communicate directly with your tax preparer, just let us know. We are happy to do so.

In company news, we've told you about babies being born in the last few years, but now we are thrilled to announce that wedding bells are in the future for Trace Welch, our equity analyst and trader. We're so happy for Trace and Lindsey who will be tying the knot in Alabama in April of this year.

2013 marks the 25th anniversary of the founding of Sargent & Company – now Sargent Bickham Lagudis. We hope to have a celebration of some kind this summer and see you all there. Jordan is working on updating our website. It should be live within a few weeks. Please check it out and let us know what you think.

As we say in every letter, all of our growth over the years has come from referrals from clients and other professionals. We thank those of you who have referred your friends and colleagues, and remind the rest of you that if you know of anyone who might be interested in our services have them give us a call or check us out at www.sargentbickham.com. We are also happy to send a newsletter to your friends, and it can be found on our website.

Many happy returns,



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Risk Adjusted Returns

How to Assess Returns and Risk

There are several measures used by financial professionals to analyze returns and adjust for risk. However, for the average investor, the jargon and calculations can be difficult to understand. Following is a simple calculation that you should be able to implement.

Comparing Yields on Bonds

First, as background, let's go through the calculation for comparing yields on two different bonds : taxable and tax-free. What is better… a corporate bond yielding 3% or a municipal bond yielding 2%? We can compare the two by "grossing up" the tax-free bond by the tax rate as follows:

Investor tax rate = 40%

1 – tax rate = 60%

Tax-free yield	2.0%
Divided by	0.6
Equals taxable equivalent yield	3.33%

We can prove this by doing the calculation in reverse.

Taxable yield	3.33%
Less Taxes of 40%	1.33%
Equals after tax yield of	2.00%

The taxable equivalent yield of the municipal bond, therefore, of 3.33% is greater than the corporate bond yield of 3.0% and would be our preferred choice.

Comparing a Balanced Portfolio to a Stock Only Portfolio (or the "Market")

Is there a way to use the concept used for comparing bonds to compare a balanced portfolio return to the return on the stock market? What is better…a balanced portfolio return of 10.5% or a stock market return of 14%?

Yes, we can calculate a risk-adjusted portfolio return (yield) using a similar method. Most investment managers can provide a measurement of risk called "beta". Beta is a measure of relative risk or volatility. When compared to a stock market index such as the S&P 500, beta tells us how volatile a portfolio is relative to the S&P 500. For example, a portfolio with a beta of 0.65 is 65% as volatile (risky) as the market, which has a beta of 1.00.

Assume a portfolio has the beta mentioned above, 0.65. We can now calculate a risk adjusted return (yield).

Balanced Portfolio Return	10.5%
Divided by beta	0.65
Equals risk adjusted return	16.2%

The risk adjusted return of 16.2% is greater than the stock market return of 14%, so we can say that on a risk adjusted basis the balanced portfolio return is higher.