Market Update

September 30, 2013

The third quarter of 2013 displayed a broad range of investment returns across capital markets worldwide. Economic disruptions and political upheavals played their usual role in unsettling the markets. Greater price volatility was evident globally as well, in some instances amplified by professional investors utilizing high frequency trading algorithms. In general, investment returns favored areas where economic improvement is occurring or where company and industry dynamics are above average.

Worldwide, third quarter results ranged from +11.3% for the EAFE index (Europe, Australia and the Far East) to +1.5% for the Dow Jones Industrials. Economic conditions are improving in EAFE countries while the rest of the world has a mixed economic outlook. The technology heavy NASDAQ index was up more than 10%, an indication that smaller companies generally, and technology companies in particular, did much better than the broad market, as represented by the S&P 500.

Fixed income markets gyrated throughout the quarter but ended in almost the same place they began, typified by the 10 year US Treasury yield at 2.6% at both the beginning and end of the quarter. That translates into an investment return of 0.65%, again lagging all equity indices for the time period.

For much of the summer, markets acted in ways contrary to accepted investment norms. Stock indices like the S&P 500 rose by 5% in July in spite of the general rise in interest rates. Ordinarily, rising interest rate levels are associated with stock market declines. The price of crude oil rose in July but later fell even as Mideast tensions increased, the result of riots in Egypt and chemical weapons unleashed in Syria. Energy demand increases during the summer months and the threat of supply disruptions from the Middle East would normally produce rising oil prices. Gold prices fell throughout this period of political and economic turmoil. Normally, gold prices rise as political tensions increase.

During the third quarter many professional investors gravitated towards the technology sector where there is almost always the risk of loss but also the possibility of outsized reward. Carl Icahn, well known corporate raider, and Michael Dell, CEO of Dell Computer, traded competing visions for the future of Dell as a public or private company. Michael Dell's group prevailed in their quest to take the company private. As a result, investors were not rewarded. However, investors in Hewlett Packard continue to be richly rewarded by a rising stock price even though CEO Meg Whitman's turnaround plans are lagging expectations. This crosscurrent of actions and outcomes illustrates the risks and rewards present in the technology sector.

The fact that well over one half of all professional investors are trailing the popular market averages this year (the S&P 500 is up 18%) is indicative of an environment where more risk is assumed to try to outperform the market and peers alike. I have learned from experience that such tactics rarely produce better investment performance.

With reported corporate earnings in 2013 likely to be only modestly better than last year, it is natural to wonder if the stock market, which recorded new all-time highs in September, can sustain and grow from these levels. I believe they can, but at a slower rate.

Warren Buffett, well known Berkshire Hathaway CEO, stated recently that stocks were fairly valued at the present time. Mr. Buffett, a champion of investing for the long term, has been successful for decades in his approach. It is always a good idea to listen to his comments about the attractiveness of stocks. The application of his approach during this just ended quarter would be to reduce trading frequency until a better sense of economic and stock market factors can be assessed.

As a professional investor, I wholeheartedly agree with Mr. Buffett's approach. I believe the outlook for equity investments is improving and we are investing consistent with that view.

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