Market Update

December 31, 2013

Equity markets finished out the year with a flourish as market indices, such as the S&P 500, rose 9.9% during the fourth quarter and 29.6% for the full year. NASDAQ did even better, up 10.7% during the fourth quarter and 38.3% for the full year. Bonds traded down late in the quarter and for the full year the Barclays Bond Aggregate index was down 2.0%, its first negative year in the last 15 years.

Ordinarily, such a wide disparity in investment returns would signal an opportunity to rebalance investments away from stocks and into bonds. We agree that rebalancing in a portfolio is currently warranted, but we would advocate for reinvestment in Emerging Market equities (which were down roughly 10% in 2013) rather than in bonds. In our view, bonds remain vulnerable to further price declines and sub-par investment performance.

Looking ahead to 2014, most forecasters expect a pickup in economic activity to perhaps 3% real GDP growth for the full year. With that as a backdrop, most market strategists are forecasting a gain for stocks of 6-10%. We are more sanguine about the outlook based on a very small sample of actions taken by companies where we have invested on behalf of clients.

In November, Ingersoll Rand, a diversified industrial company, completed the spin-off of its security monitoring business, Allegion. Earlier in the year they sold Hussman companies, a manufacturer of refrigerated display cases used in supermarkets. Notwithstanding our long term bias in favor of companies that have been spun-off, we used the days following the spin-off to add to or initiate positions in Ingersoll Rand. Our reasoning was the company was obviously rebalancing its business portfolio away from slower growing, lower margin businesses. We agree with their judgment.

In December, Berkshire Hathaway, a diversified insurance company, announced a deal with Phillips 66 in which they delivered 17 million shares of Phillips 66 stock to the company in exchange for a chemical business that Phillips had decided was “non-core.” Berkshire Hathaway owns Lubrizol, a specialty chemical company, that might be able to utilize the chemical additive business from Phillips 66. This is a very low cost way for both Berkshire Hathaway and Phillips 66 to rebalance their business mix. In the same press release Berkshire Hathaway said they had liquidated their position in Conoco and had made a substantial investment in ExxonMobil. Eighteen months ago when Conoco spun out Phillips 66 to shareholders, we sold our Conoco shares and reinvested the proceeds into more Phillips 66 shares. In more than 40 years of investing this is the first time I recall making an investment change before Warren Buffett did.

These two actions by corporations which we own and follow closely, are emblematic of the kinds of actions we expect companies to pursue in 2014 and beyond. Companies will rebalance their portfolios to benefit their operating results and hopefully we as shareholders will benefit along with them. Good strategic rebalancing always makes sense, and we believe now is the right time to execute, both for them and for our client portfolios.

Raymond A. Beplat, CFA
Chief Investment Officer