Individual Asset Management

750 Menlo Avenue, Suite 200
Menlo Park, CA, USA 94025
Tel: (415) 358-0138
Fax: (415) 948-2136
Email: iam@iamadvisors.com
Web: www.iamadvisors.com

16 January 2014

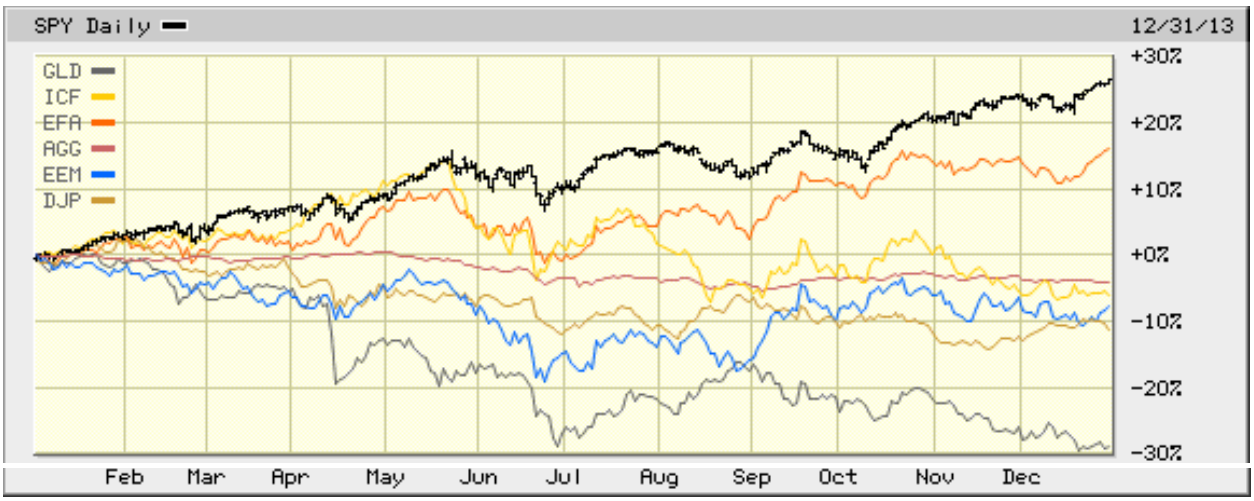
Year-End 2013 Update

The Year in Review

This time last year I wrote that I expected 2013 to be a good year for the US stock market and especially for growth rather than value investments. I also thought the European markets would bottom out and I expected Asian, particularly Chinese, markets to do well since they had underperformed up to that point. At the beginning of 2013 I advocated holding some gold and commodities as a form of diversification but wasn't expecting these investments to do particularly well and I also suggested minimizing exposure to bonds and replacing bonds with other income-producing investments.

It turns out I was correct about the US and European stock markets and about the expected poor performance of bond markets but emerging markets didn't have a good year and diversification in general was a drag on performance.

In fact it was a very strange year from an investment management perspective; investing in stocks, particularly US stocks, yielded excellent returns – but practically nothing else worked. So an investor with a diversified portfolio, especially a conservatively-allocated one, didn't do very well compared to someone who was not diversified at all and in an aggressive equity-only portfolio. The charts below show why.

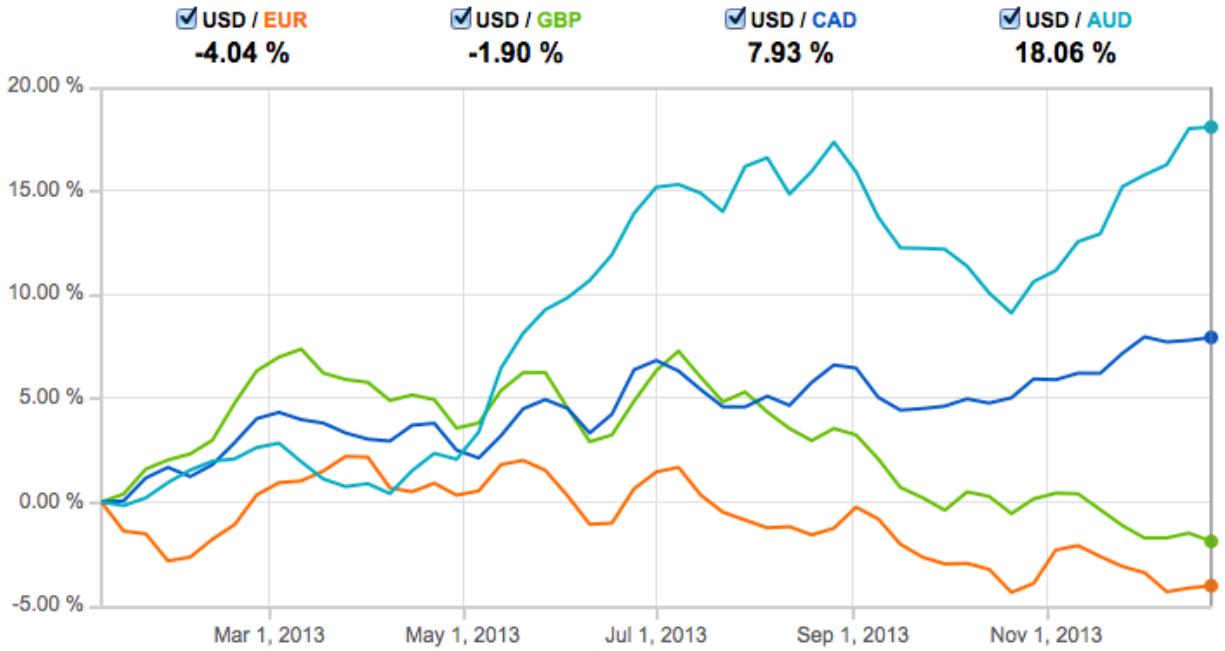


<SPY: US Stocks, GLD: Gold, ICF: US Real Estate Investment Trusts, EFA: Non-US Developed Market Stocks, AGG: US Bonds, EEM: Emerging Market Stocks, DJP: Commodities>

In the chart above the thick black line at the top represents the US stock market (the S&P500 index) and the orange line below it represents the performance of other developed-country stock markets. Below that, showing negative returns of -5% to -10% are US bonds, US real estate investment trusts, emerging market stocks, and commodities. Finally, way at the bottom, showing a return of -30%, is gold.

Clearly, in a portfolio diversified amongst asset classes or conservatively allocated to bonds, it would not have been a good year compared to one invested only in the stock market.

There were also some interesting movements in currencies, as can be seen in the chart below.



<EUR: Euro, GBP: British Pound, CAD: Canadian Dollar, AUD: Australian Dollar>

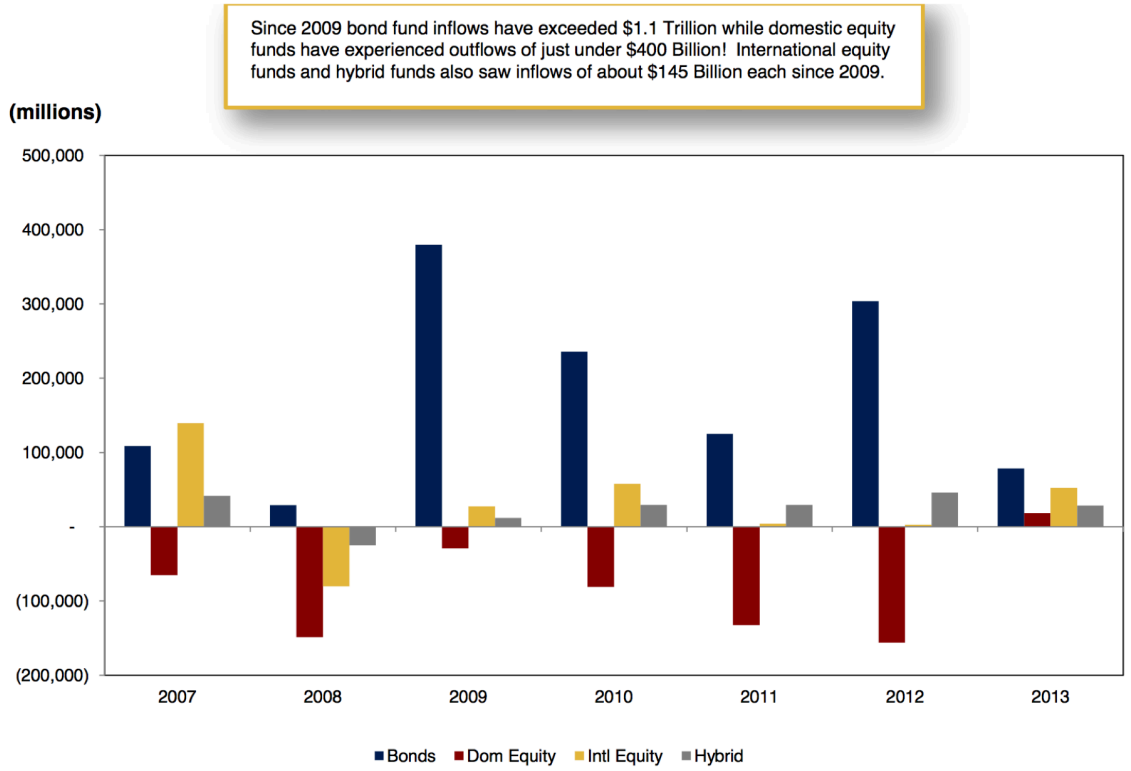
In an up-and-down year the US Dollar ended up slightly weaker against the British Pound and the Euro but substantially stronger against the Australian and Canadian Dollars. The US Dollar also broadly strengthened against most emerging market currencies – notably up 26% against the Indonesian Rupiah, 13% vs. the Indian Rupee, and 16% vs. the Brazilian Real despite the fact that interest rates increased in some of these countries.

So clearly investment returns measured in US Dollars would also have been negatively affected by international diversification in 2013 in many instances.

One event that happened last year is particularly interesting to consider because it highlights an important shift in investment markets. I call it a "shift" because, while investment markets and currencies go up and down in value from year to year, I believe we also experienced a more permanent adjustment in markets last year.

Ever since the financial crisis of 2008 we have seen vast amounts of investor money flow into bonds, especially conservative US bonds. We see this because we monitor the flow of money into various types of mutual funds and bond funds have by far experienced the

greatest inflows while stock funds have, in most years since 2008, experienced negative or, at best, neutral money flows. The chart below shows the situation up until the middle of 2013.



The blue bars represent flow of funds into US bond mutual funds and the red bars represent flow of funds into US stock market mutual funds. There is clearly a dramatic difference between the large inflows into bond funds in 2009-2012 and the large outflows from stock funds in the same period. In 2012 $150 billion left US stock funds and $300 billion was invested in US bond funds.

There are a few reasons for these fund flows: First of all, investors still remember the financial crisis of 2008 and how that decimated many stock portfolios, and so they are still cautious. Secondly, while the global economy seems to be recovering from the financial crisis, clearly there is still weakness in many parts of the world and unemployment has still not fully recovered – which also makes investors cautious. Thirdly, demographics: Investors are broadly aging and therefore there is naturally more money flowing into more conservative investments. Finally, the interest rate and inflationary environment have been supportive of fixed income investments since interest rates and inflation are low in most developed markets.

For a couple of years now I, and many other advisors, have been cautioning our clients and anyone who would listen about the fragility of this situation and the potential for a reversal in this flow of funds. Clearly interest rates cannot stay at zero forever and, as economies recover, we would expect to see some inflation as well as more confidence in stock markets. The difficulty lies in predicting the timing of this shift. Clearly when interest rates begin to rise this would be an incentive to switch from bonds to stocks but investment markets often anticipate such moves so waiting until rates rise may be too late. I believe that we saw the

bubble burst towards the middle of 2013 when the US Federal Reserve hinted that it might reign in its easy money policy, called "quantitative easing". This precipitated a dramatic move in bond markets, as can be seen in the chart below.

<TLT: US Long-maturity Treasury Bonds, TIP: US inflation-indexed bonds,
AGG: Broad US bond market, PFF: US Preferred shares>

The black line in the chart shows the performance of long-maturity (20-year plus) US Treasury bonds. From beginning of May to mid-August, a period of only 3 ½ months, this index dropped 18%. Less dramatic moves were seen in other fixed income investments as well as in other income-producing investments such as preferred shares, real estate investment trusts, and even dividend-producing stocks.

I'll go out on a limb and say that I think we experienced a watershed moment in mid-2013 that will represent a multi-year shift in asset class investment performance. I expect that fixed income markets will underperform for many years to come as economies pick up, the US Federal Reserve stops its quantitative easing program, and eventually interest rates increase. This will also have negative implications for other income-producing investments so care needs to be taken to control interest rate risk on what is usually the less risky part of the investment portfolio. Indeed, if I am correct, then interest rate risk will be a more important consideration in conservative portfolios than minimizing volatility, which is the traditional rationale for holding fixed income investments.

Going Forward

It seems that many developed economies are picking up steam but many emerging economies are slowing. The International Monetary Fund (IMF), in its October 2013 World Economic Outlook and a subsequent update commented that it expects the US economy to continue to strengthen, relatively weak growth in Europe with improving conditions in the UK, and possibly a slowdown in Japan. However, they also expect that capital may flee many emerging markets if there is fallout from the withdrawal of economic stimulus in the USA – which would lead to lower growth and currency weakening in these countries.

The Organization for Economic Co-operation and Development (OECD), in its November 2013 update, said it was expecting global growth to pick up in both OECD and non-OECD countries in 2014 and 2015. The OECD is a club of 34 countries comprised of most

developed economies and several emerging markets. Importantly this group expects global trade to increase almost 5% in 2014 and almost 6% in 2015 after 3% increases the last two years.

The World Bank in its January 2014 *Global Economic Prospects* report expects global growth to increase in 2014, led by recovery in high-income countries but also with the expectation that after two years of weakness many developing countries will show stabilized or stronger growth.

All three agencies warn about the negative effects that the end of the Federal Reserve's stimulus program may have – the view seems to be that this tapering will only occur when the US economy is strengthening and so they expect it to affect emerging markets more than the US market.

In Europe, we have recently seen surprisingly strong growth in the UK and also economic conditions seem to have generally picked up in some of the recently troubled countries like Greece, Spain, and Portugal. Each of these last three countries has recovered from a current account balance of -10% to -15% in 2009 to a 0% or even mildly positive current account presently.

Putting all this together it seems like the way to go in 2014 is to continue to focus on stock market investments rather than fixed income investments. I would expect the US market to continue to do well but not anywhere near as well as in 2013. The US market is now probably slightly overpriced compared to corporate earnings growth and there should also be some drag as a result of the continuing tapering of economic stimulus measures. In such an environment I expect that investment selection will be more important going forward.

In fact, I wouldn't be surprised to see a few European stock markets outperform the US market in 2014 and I think there is good value in certain Spanish, British, and other selected European equity investments. Also, I would expect a more balanced year in 2014 than in 2013 when, as seen above, stocks were the only asset class that did well.

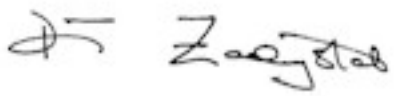
The consensus outlook among economists for many emerging markets seems negative except that the OECD expects Chinese GDP to pick up in 2014. I have somewhat of a contrarian view here since many of these markets are now cheap in terms of price/earnings ratios and other such metrics. I think we should continue to have an allocation to these markets, with a focus on China (and its neighbors), sub-Saharan Africa (outside of South Africa), and Mexico. I would expect Mexico to benefit from the expanding US economy, more competitive labor costs compared to places like China where these costs have now increased substantially, and the many economic reforms that the Mexican government says it will be making in the near future.

I think we should continue to avoid fixed income investments and focus on other income-producing investments on the conservative side of investment portfolios. I am talking about dividend-producing investments such as real estate investment trusts, business development corporations, preferred shares with call features, etc. While all income-producing investments will likely be affected negatively by rising interest rates, at least the higher yields available in such investments will protect us to some extent. Alternatively, in conservative portfolios we could put in place bond ladders and hold these bonds to maturity, thus taking out the risk of falling bond prices with rising interest rates.

From a diversification perspective I would advocate holding US real estate investments, infrastructure funds, and certain commodities. Commodity investments are problematic because I think there may be considerable downside risk to gold and oil. Gold because there has been so much money chasing this investment over the last decade and because it is traditionally a hedge against market uncertainty and inflation – neither of which is particularly prevalent at the moment. Oil because the current shale oil boom in the USA and other countries will significantly expand supply in the years to come and also because it seems the political crisis in Iran is diminishing, which would lead to stronger exports from that country. The problem is that oil makes up a substantial part of most commodity indices and so buying a broad-based commodity fund means a significant allocation to oil. It might be better to invest in certain commodity-producing companies, and also in companies that will benefit from the oil boom such as those that transport oil and gas.

One thing to be aware of is the current very bearish environment for mining companies and the commodities they represent. The slowdown in China from 10% GDP growth to about 7.5% and also a slowdown in many other emerging market countries, coupled with the massive expansion that has taken place in the mining industry over the last few years as China's appetite for raw materials seemed insatiable a few years ago, means that there is now a glut in certain hard commodities and miners are curtailing production and putting on hold new projects. This is a classic example of a business cycle: Demand increases – prices rise – the industry expands to meet demand – prices level off – inevitably supply surpasses demand – prices and profits fall – supply needs to shrink or demand needs to expand. The stock prices of many mining companies have suffered recently and the environment is still bearish – but there is opportunity around the corner as the industry consolidates. Especially attractive is that many of these companies pay good dividends. So this is one area where we may cautiously tread, perhaps later in the year after considerable research.

Best Wishes in the New Year,



Tom Zachystal