



Quarterly Market Outlook & Strategy Letter

First Quarter of 2013

April 2013

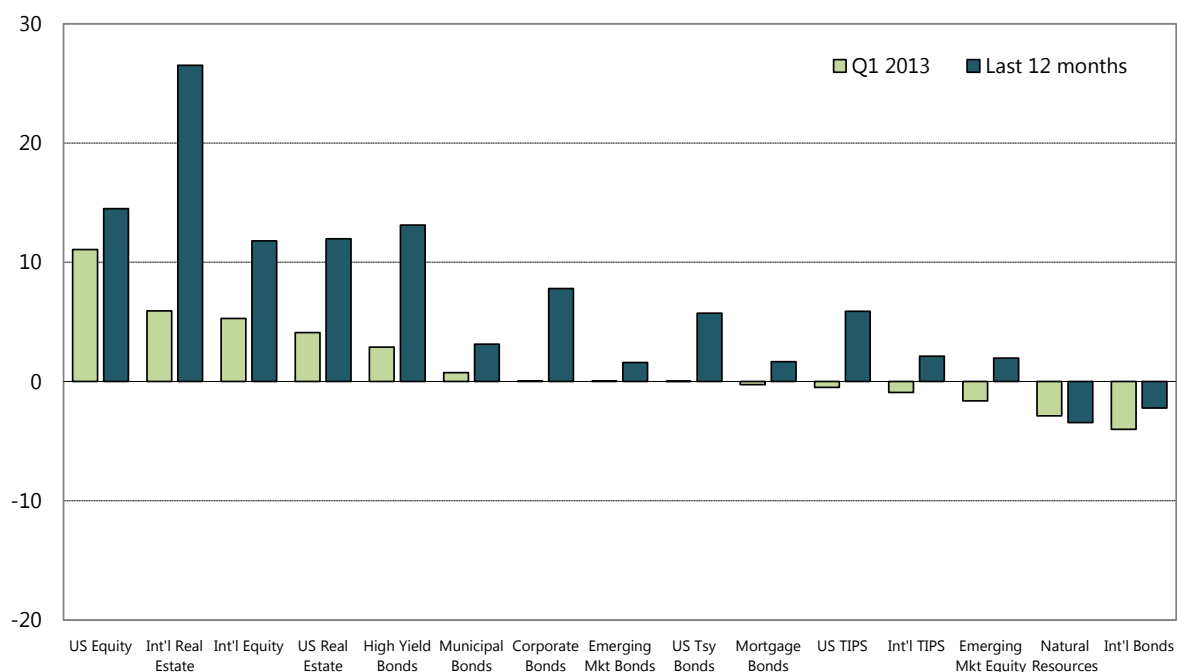
Executive Summary

- Financial markets again delivered strong returns in the first quarter of 2013, but with increasing performance disparity across asset classes. The contrasting performance of various “risk” assets (US and foreign equities, corporate credit, real estate and commodities) indicates divergent opinions regarding the global economic outlook. Markets are caught in the cross-currents of weak economic fundamentals and aggressive government intervention to support asset prices.
- Caution is warranted. Many of the economic risks we highlighted last quarter are now materializing. US and overseas economies are slowing (or, in the case of Europe, failing to recover) and it appears that the global economy is heading toward yet another soft patch. These developments are not indicative of a looming recession, but are an inevitable result of higher payroll taxes and sharp cuts in government spending adopted as part of the fiscal compromise at the end of last year.
- Against this sluggish but stable backdrop, US corporate earnings have stagnated since late 2011, even as the S&P 500 has gained 45%. Some multiple expansion can be justified by the stabilization of the global financial system, which has improved the outlook for future growth and earnings. However, it appears that US earnings expectations are now unrealistically high, posing risks to stocks over the coming months.
- We are not among those who believe that US earnings must necessarily or quickly revert to historical norms. The decades-long improvement in US corporate profitability owes, in large part, to structural changes (technology and the integration of global goods, labor and capital markets) whose effects are enduring. For this reason, and given relative valuations, we are constructive on equity investments over the longer term. Even so, we doubt US earnings can accelerate when global growth is slowing and inflation declining.
- How much of a pullback might occur, when the markets are awash in money, is difficult to say. The US economy is now a mule, but the Fed is feeding it high-octane fuel in the hopes of turning it back into a racehorse. The Bank of Japan has joined the party, with an infusion of liquidity that is on par with the US, despite having an economy one-third the size. In this environment, it is essential to focus on the prudent fundamentals of diversification and value-oriented investing.
- Wealth creation also depends on careful management of investment tax liability. Fortunately, this goal is congruent with a value-oriented approach to portfolio strategy.

Introduction

Financial markets again registered positive returns in the first quarter of 2013, but with increasing disparity in performance across asset classes (Figure 1). US stocks delivered double-digit gains—more than twice as high as overseas equity markets—while emerging stock markets declined. US real estate and high-yield bonds continued to rally, while gains in other fixed income sectors were modest. Commodity prices fell across the board, although natural resource stocks performed better.

Figure 1. Benchmark Asset Class Returns

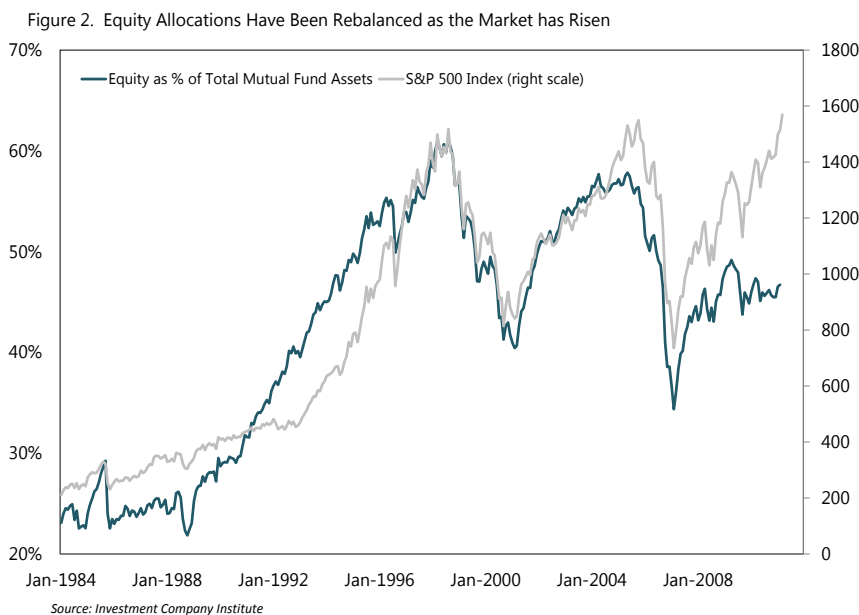


Source: Bloomberg

The contrasting performance of various “risk” assets (US and foreign equities, corporate and emerging market bonds, real estate and commodities) indicates an uncertain investment market, characterized by widely divergent opinions regarding the outlook for global growth. Markets are caught in the cross-currents of weak economic fundamentals and aggressive government intervention to support asset prices. Investors are being induced by central banks to move up the “risk curve,” away from traditionally safe bond investments (which have become very expensive) into equities and other volatile assets. While the latter are more attractively valued on a *relative* basis, few assets are “cheap” and valuations reflect heightened near-term risks.

Déjà Vu All Over Again?

Investors certainly understand these risks. In contrast with past history, equity allocations have been rebalanced down, even as the US stock market has risen (Figure 2). Baby boomers who suffered through two major bear markets, and are now close to retirement, are understandably reluctant to stick their necks out again. As the saying (almost) goes, “Fool me once, shame on you. Fool me thrice, shame on me.”



Until recently, investors continued to flock to bonds, even as these became very pricey. This year, mutual fund assets have finally been allocated to equities, but the flows are tilted toward defensive markets and sectors (i.e., the United States, consumer staples, health care, utilities, and dividend-paying stocks). More cyclically-sensitive investments, including most overseas markets, have been lagging well behind.

Some caution is justified. Many of the economic risks we highlighted last quarter are now materializing. US and overseas economies are slowing (or, in the case of Europe, failing to recover) and it appears that the global economy is heading toward yet another soft patch. The US housing sector continues to improve, helped by low interest rates and stabilization of the job market. Much of the recovery owes to wealthy investors who have been buying vacant properties and converting these to rental units. However, ongoing recovery in the sector confronts the headwinds of a large latent inventory of existing homes (which were pulled from

the market by frustrated sellers) as well as unfavorable demographics as baby boomers age. Business and consumer sentiment and spending have deteriorated, and job growth has moderated. These developments are not indicative of a looming recession, but are an inevitable result of higher payroll taxes and sharp cuts in government spending adopted as part of the fiscal compromise at the end of last year.

Growth overseas has also moderated. The Chinese economy—now the world’s second largest—continues to improve. However, China has entered a slower trajectory, as policymakers seek a more sustainable and balanced growth model, one that is less dependent on capital spending and exports. More worryingly, the European economy remains mired in recession, with a financial policy framework that is inconsistent, unpredictable, and unsupportive of growth. Activity in the region’s emerging economies is curbed by weakness in their trading partners.

A Primer on US Corporate Earnings

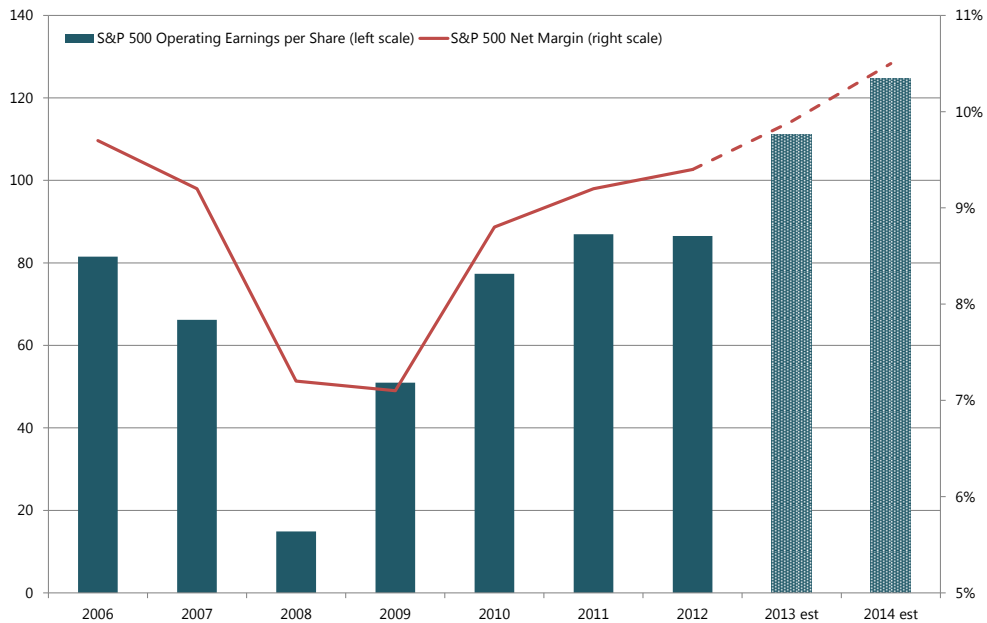
Against this sluggish but stable backdrop, US corporate earnings have stagnated since late 2011, even as the S&P 500 has gained 45%. In other words, all of the recent equity market gains have been a result of higher price-earnings multiples. To be sure, some multiple expansion can be justified by the stabilization of the global financial system, which has improved the outlook for future growth and earnings. However, it appears that US earnings expectations are now unrealistically high, which may pose risks to equity markets over the coming months.

There are two drivers of corporate earnings: revenue growth and profit margins. Revenue is closely correlated with (nominal) GDP growth, which has been slowing as consumers adjust their spending down, in line with their resources. Falling inflation has also contributed to slower revenue growth. Profit margins have risen since 2009, but much of the improvement came from declining interest expense, as companies took advantage of lower interest rates to refinance their outstanding debt. Interest rates have now fallen to rock-bottom levels, while the US Federal Reserve has signaled a tapering off of its bond purchase program, perhaps later this year. The tailwind to corporate margins from falling interest rates is indisputably gone.

Lower commodity prices will provide support to corporate earnings, mitigating some of the recent pressure on margins. However, given existing supplier contracts, these benefits are unlikely to materialize until later this year, and may already be priced into stocks. Wall Street analysts anticipate a 17% rise in profit margins, and a 13% rise in operating earnings per share, by the fourth quarter of this year (Figure 3). Such an improvement would take net margins from

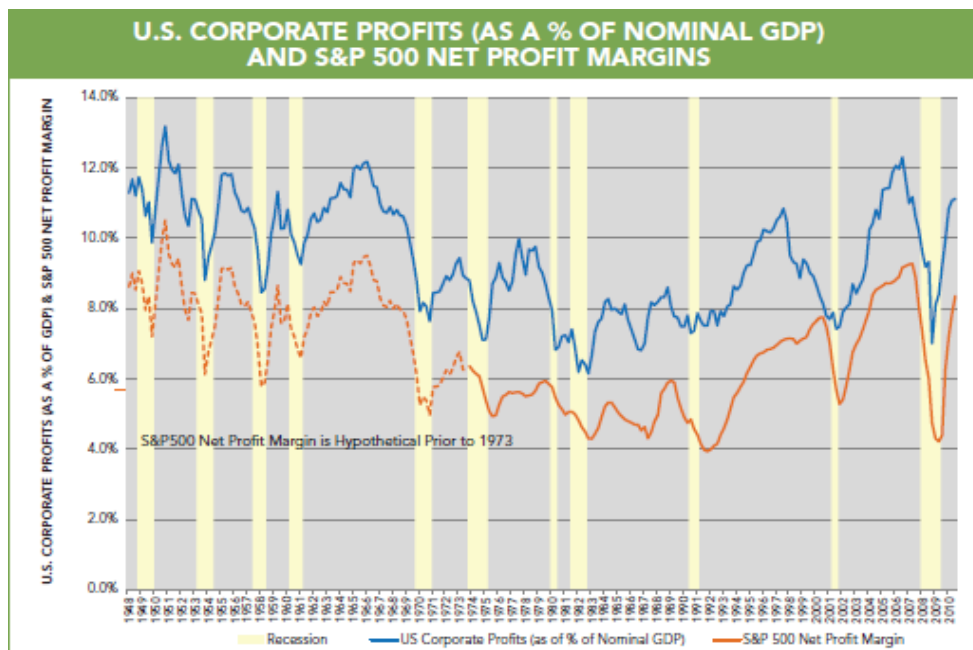
their recent range of 8-9%—which is already high by historical standards—beyond 10% of revenue, a level not seen even in the last decade’s boom (Figure 4).

Figure 3. Wall Street Analysts Forecast a Sharp Rise in Margins and Earnings in 2013-14



Source: Howard Silverblatt, S&P Dow Jones Indices, and Shiraz Meran, Zacks Investment Research

Figure 4.



Source: PMFA, Standard & Poor's Compustat, Federal Reserve

History courtesy of Plante Moran Financial Advisors, July 2011.

We are not among those who believe that US earnings, which are high by any measure, must necessarily or quickly revert to historical norms. The decades-long improvement in US corporate profitability owes, in large part, to structural changes (technology and the integration of global goods, labor and capital markets) whose effects are enduring. For this reason, and given relative valuations and global liquidity conditions, we are constructive on equity investments over the longer term. Nevertheless, we wonder whether US earnings can accelerate when global growth is slowing and inflation declining. There is a meaningful risk of earnings disappointments, and an associated correction in stock prices, over the next several months. We would view such a pullback as a buying opportunity for long-term investors.

Spiking the Punchbowl

How much of a pullback might occur, when the markets are awash in money, is difficult to say. We are in a brave new world, as global central banks force liquidity into financial markets as rapidly as they possibly can. The US Federal Reserve's longest-serving Governor, William McChesney Martin (1951-1970), famously described the Fed's job as "to take away the punch bowl just as the party gets going." Now, central banks are the ones spiking the punch. The US economy is now a mule, but the Fed is feeding it high-octane fuel in the hopes of turning it back into a racehorse. Massive liquidity injections may have lent only mild support to the economy, but have been clearly effective in boosting stock prices, equity market sentiment, and leverage (Figures 5-7).

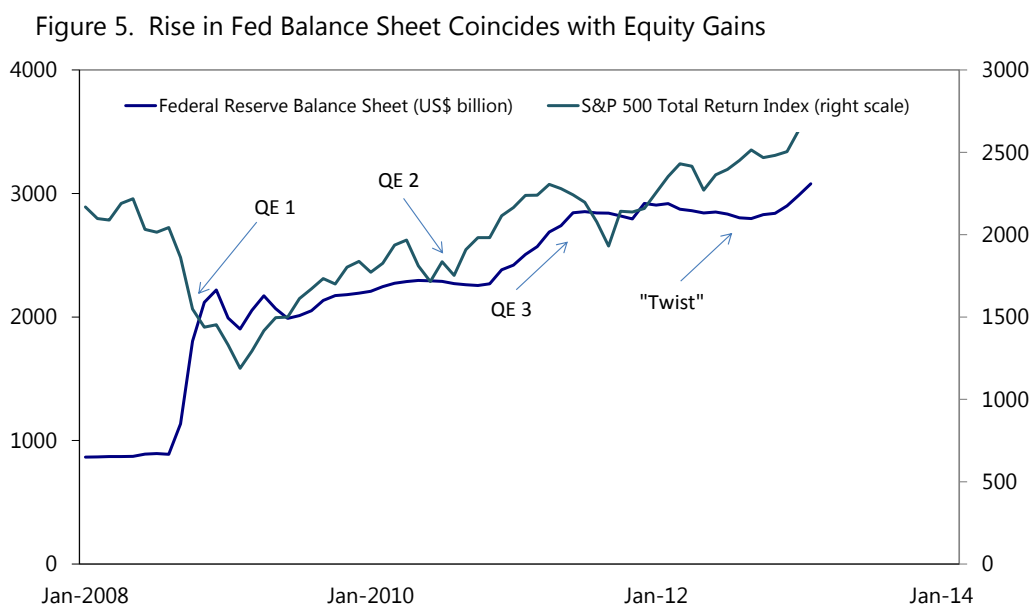
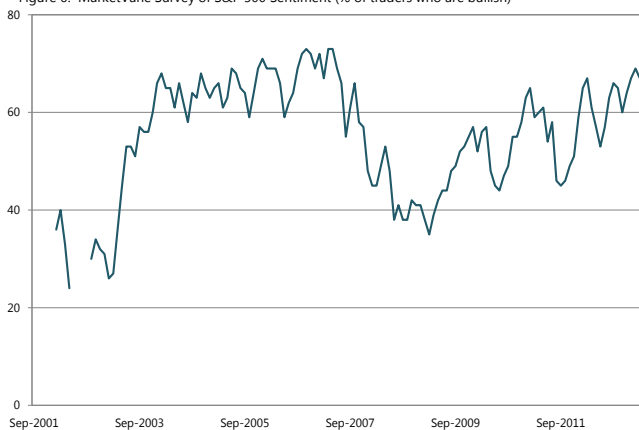
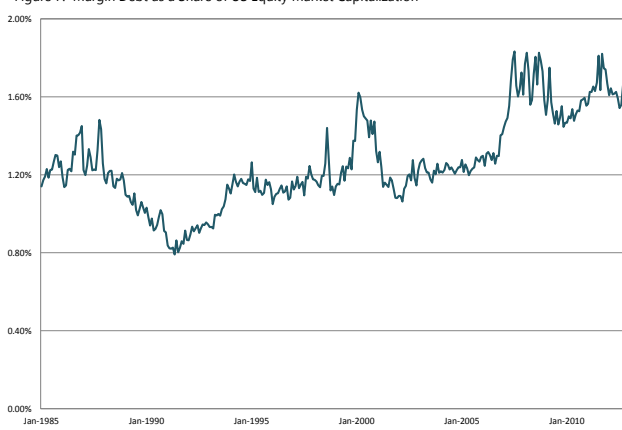


Figure 6. MarketVane Survey of S&P 500 Sentiment (% of traders who are bullish)



Source: Haver Analytics

Figure 7. Margin Debt as a Share of US Equity Market Capitalization



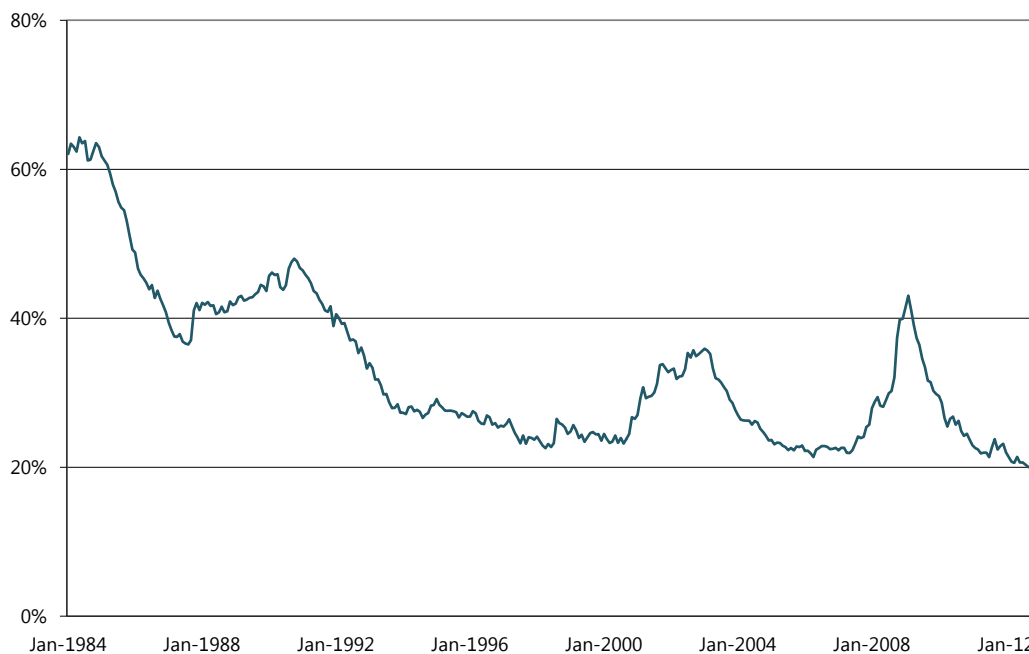
Debit balances in margin accounts of broker-dealers vs. combined market capitalization of NYSE and Nasdaq. Source: Haver Analytics

The Bank of Japan recently joined the party, announcing a schedule of Japanese government bond purchases (\$70 billion per month) that is nearly as large as the Fed's. This is an enormous amount of money, considering that the Japanese economy and financial markets are only about a third as large as those of the United States. Much of this liquidity will undoubtedly flow into overseas markets. Indeed, weakening the yen through a massive expansion of the Japanese money supply is a central element of the government's strategy to support export-led growth. In effect, the Bank of Japan is taking the baton from the US Federal Reserve, providing liquidity support to asset markets around the world.

In these circumstances it is difficult, if not impossible, to predict when or how quickly asset prices will validate economic and corporate fundamentals—whether they be improving or deteriorating. What is apparent is that by underwriting investment risk-taking all across the financial markets, central banks are sowing the seeds of longer-term instability and uncertainty. Policymakers are "doubling down" on their policy mistake of the past two decades, trying to remedy the effects of two liquidity-driven asset bubbles with yet more liquidity.

There seems to be a general belief—perhaps it is wishful thinking—that investors can rotate *en masse* from debt to equity without altering price relationships too abruptly. However, things are unlikely to go smoothly, even with help from the Bank of Japan. That's because US investors will not be using cash to buy stock; cash levels are near all-time lows (Figure 8). Rather, they will be reducing their fixed income holdings (as they should, given where interest rates are) even as the Federal Reserve steps back from the US bond market. The attendant rise in bond yields will likely diminish the attractiveness of US equities, at least until growth picks up.

Figure 8. Money Market Funds as a % of Total Mutual Fund Assets



Source: Investment Company Institute, Haver Analytics.

In this context, we believe it is essential to remain focused on the fundamentals of prudent investing. That means constructing diversified portfolios of assets that offer the best prospects for (a) long-term capital preservation and/or (b) price appreciation stemming from attractive valuations. It also means holding an adequate reserve of cash, so that one can purchase assets cheaply after prices have fallen. It is not our policy to buy securities simply because others are doing so—even if those others are the world’s central banks. We are seeking portfolios that are resilient to the vicissitudes of policy and markets—indeed, those that are “antifragile” in the words of Nassim Taleb¹.

Managing Tax Liability

’Tis the Season...tax season, that is! Santa has already come bearing gifts for those who have been good; now Uncle Sam is accepting contributions from those who have been successful. It’s a nice problem to have, even in April, the cruelest month.

¹ *AntiFragile: Things that Gain from Disorder*, by Nassim Nicholas Taleb, Published by Random House, 2012.

As described above, we believe a well-diversified and value-oriented investment approach is the most prudent strategy for long-term wealth accumulation. The second pillar of wealth creation is careful management of investment tax liability. These two goals might seem to conflict with one another, for it is in the nature of value investing that one must occasionally realize capital gains. Periodically, we take highly appreciated assets off the table, to make funds available for other investments that are more attractively valued. Naturally, we are loath to realize short-term gains, which carry a very heavy tax burden for our clients. However, even taxes on long-term gains deplete portfolio capital that could otherwise be invested profitably. Therefore, one must weigh the costs vs. the benefits of rebalancing investment exposures. Such analysis is complicated by the fact that markets (and tax policy) are inherently uncertain. The optimal course of action, given one set of assumptions, may not be so attractive under another.

Fortunately, there is much useful research on the subject of optimal portfolio rebalancing. This literature shows that it is cost-effective to adjust portfolio allocations when positions have moved significantly away from target—i.e., by 20% or more. In such circumstances, the benefits of protecting the portfolio from (or exposing it to) a price correction of over- (or under-) valued assets outweigh the costs in terms of realized capital gains². The opportunity cost of rebalancing a portfolio is the investment return that could have been achieved *on the same assets* whose sale generates the tax liability. This cost is typically small when the reallocation is based on valuation principles. When an asset is highly valued, the likelihood of further large gains diminishes; therefore it is cost-effective to redeploy the capital to investments with greater appreciation potential than to maintain the holding in the interests of deferring tax payments.

We apply this insight in our portfolio decisions in two ways. First, we assess valuation risk (and opportunity) using multiple metrics, and act only to reduce (or participate in) an investment when there is compelling evidence that valuations have moved far from the norm. In concrete terms, that means our allocation targets are adjusted when an asset's valuation falls into the 80th or 20th percentile of the distribution of the relevant indicator. Second, we rebalance client positions, regardless of valuations, only when they have moved well away from our targets. We are similarly opportunistic about raising and investing cash flowing out of and into clients' portfolios, to minimize unnecessary trading and tax liability. In sum, unless there is a compelling investment reason to realize a capital gain, we avoid doing so.

² "Opportunistic Rebalancing: A New Paradigm for Wealth Managers." Govind Daryanai, *FPA Journal*, January 2008.

Toward the end of 2012, we made an exception to our usual practice, and proactively realized long-term capital gains for many of our clients. We believed there was a high probability that they would soon confront sharply higher taxes on their investments. Indeed, the “fiscal cliff” deal of late 2012 produced a sizable rise in the top capital gains tax rate (a 60% increase, including the Medicare surcharge that was legislated in 2010 and introduced in 2013) as well as higher taxes on dividends and other investment income. With the rapid appreciation in stock prices in 2013, a marginal capital gains tax liability of \$100 in late 2012 would have increased to as much \$180 by April of this year. Being proactive saved money.

These were exceptional circumstances, however. Ordinarily, the best course of action is to defer tax liability for as long as possible (allowing assets to compound tax-free) and to realize gains only when there is a compelling investment (or personal) reason to do so. Among the best tax-deferral opportunities are employee retirement and college savings plans, whose income and capital gains are tax-deferred (or tax-exempt, in the case of 529s) until they are used for retirement or college. We allocate our clients’ investments across taxable and tax-deferred accounts so that those assets that are least tax-efficient (i.e., those with a high total return, generated principally through income) are placed in the tax-deferred accounts, whereas those that are most tax-efficient are placed in the taxable accounts. We also help clients determine whether and when to draw funds from taxable vs. tax deferred accounts, depending on the goal.

KPF Global Portfolio Strategy

We made only modest changes in our portfolio strategy over the quarter. We continue to reduce US equity risk, trimming positions and/or reducing beta by rotating to safer market sectors (i.e., large cap vs. small, growth vs. value, and dividend-paying stocks). Our low-volatility equity income strategy continues to perform well in these defensive markets, returning 22.4% (after fees) since inception in February 2012, on par with the Russell 3000—but with a standard deviation of less than half that amount.

We have raised our clients’ cash allocations to about 10% on average, while retaining our investments in overseas equity markets and commodities. These are attractively valued, albeit volatile, and will generate good long-term returns for patient investors. Our fixed income investments continue to focus on municipal debt, mortgage-backed securities (both commercial and residential), emerging market debt (with an increased tilt toward local and corporate bond markets), and high-yield debt.