

IS BEN BERNANKE BOOSTING THE MARKETS FOR US?

Current monetary policy has worked because it has helped lift stock prices which in turn have fueled the economic recovery, former Federal Reserve Chairman Alan Greenspan told CNBC on Friday. "There's a real upward momentum here. I think we are underestimating and continuing to underestimate how important asset prices, very specifically equity prices, are not only to shareholders but the economy as a whole." -Alan Greenspan on CNBC, December 3, 2010.

"Monetary policy works for the most part by influencing the prices and yields of financial assets, which in turn affect economic decisions and thus the evolution of the economy." -Ben Bernanke, American Economic Review, May 2004.

Federal Reserve Chief Ben Bernanke appears to be doing his best to send stock prices higher. The Fed is running out of monetary policy ammunition, and the policy of Quantitative Easing II is one of the last quivers in the arsenal. The policy of Quantitative Easing in its simplest form involves the Federal Reserve buying U.S. Treasury Bonds on the open market to expand the money supply to offset the contraction of the money supply due to the decline in aggregate consumer demand and from banks not lending. The Fed is hoping to prevent the U.S. economy from falling into an elongated period of economic stagnation, similar to what happened in Japan in the 1990s.

The Fed's thinking goes like this. To avoid Japanese-style deflation: get money back into equities, especially in growth and high-yielding stocks, and send the stock market back up so that people start spending again.

Many people seem to think the Fed's policies directly affect the economy, but that's not exactly true. The Fed, unfortunately, can't boost home prices or wages, or create jobs for that matter. Thus, they're left with what tools they do have at their disposal to try to create an environment where these things are possible. Consequently, the Fed has kept interest rates low enough that you would have thought there would be more hiring by now. In addition, the Fed wants to prop up the stock market. Specifically, the Fed is trying to flood the world with U.S. dollars to drive up commodity prices. This policy is also trying to keep the dollar's value low, allowing American companies to have more attractive exports and make more profits for companies doing business overseas. These increased earnings entice investors back into stocks. In addition, the Fed is keeping interest rates low to make Treasury bonds and CDs very unattractive as investments. This causes investors to favor stocks, too.

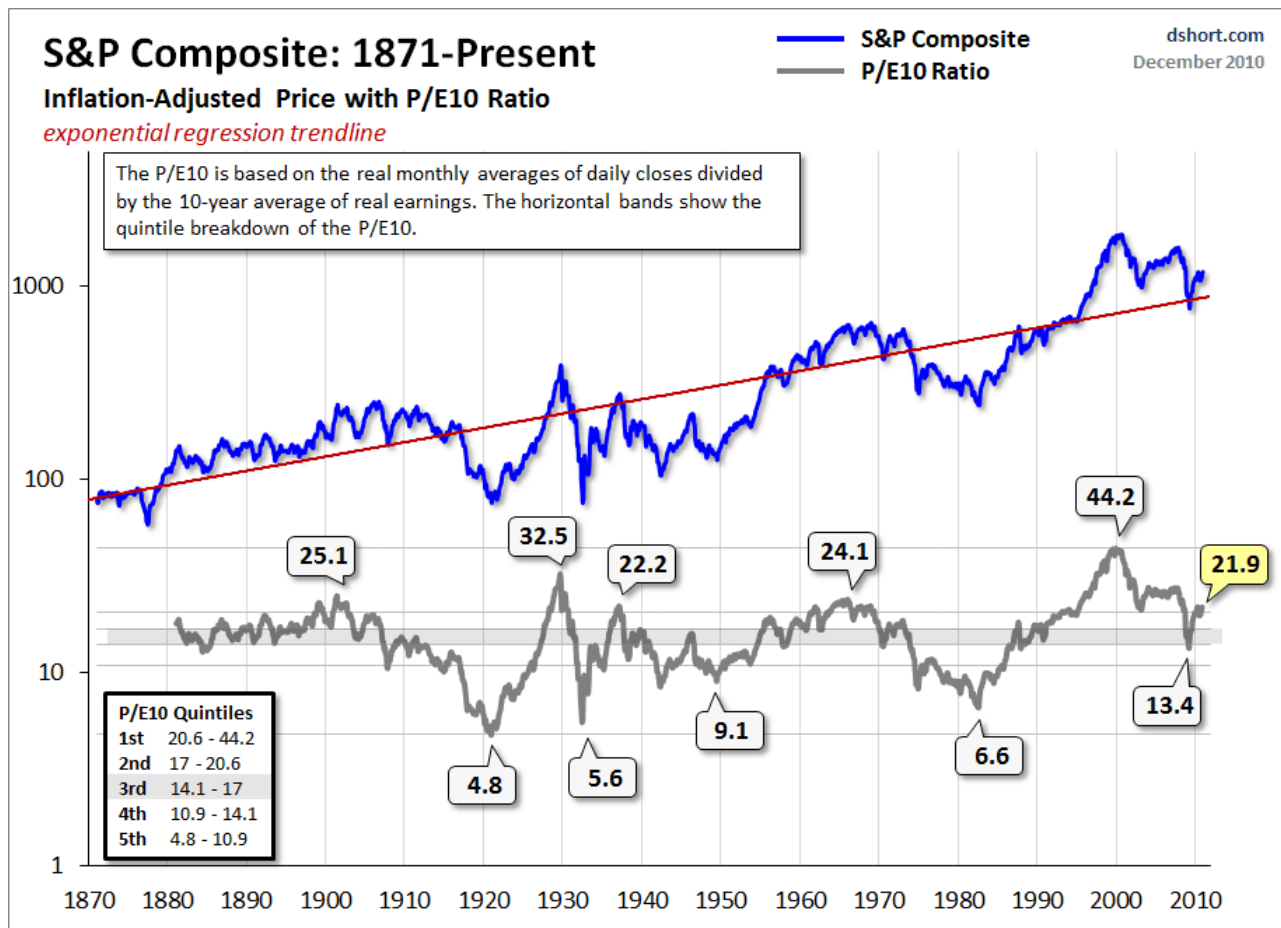
If we have learned anything over the past 15 years, it is that the stock market responds very favorably to accommodative Fed policy in the short-term. The Fed under Alan Greenspan and now under Ben Bernanke has taken a more and more active role in “managing” the economy instead of its historical mandate for inflation control and price stability. This approach of smoothing economic cycles has caused irresponsible and reckless speculation, allocation of capital away from productive assets towards financial assets, moral hazard (careless lending without repercussions), and illusory “wealth effects.” This has resulted in bubble-pop-bubble-pop behavior in many asset classes from stocks to real estate to commodities. Given this continued behavior of the Fed, it seems likely they realize that higher asset prices have a beneficial short-term impact on the economy through the “wealth effect.” The unfortunate economic ramification of stimulating higher asset prices has been that all of the additional “growth” was given back with interest as the bubbles broke causing intense financial and economic pain.

While seeing a bubble develop over time always appears easy to spot in hindsight, knowing when or how the bubble will pop or how severe the crash will be is extremely difficult. Are we in a bubble today or will we move into bubble territory in the future? We hope not, but valuations are becoming extended. We are cautiously optimistic that the economy will continue to strengthen, employment will continue on an upward trend, and the added stimulation of Quantitative Easing II will be seen as unnecessary, causing the Fed to avoid additional purchases and start unwinding the ones it has already made.

Unfortunately, we still have a great lack of clarity today on a variety of fronts. One of the most important factors for investors is the above-average corporate profit margin rates today. Currently, the S&P 500 companies have an average 8.1% profit margin on revenue. That is, 8.1% of all revenue taken in by S&P 500 companies becomes profit. This is the highest it has ever been. The average over the last 25 years is closer to 5.7%. Thus, when one looks at total current profits and compares the multiple that stocks trade at relative to those profits, it is easy to come to the conclusion that stocks are trading well below their long-term average. However, it is quite difficult to maintain very high profit margins over extended periods of time. There is only so much cost cutting and near term productivity enhancements companies can do before they’ll need real organic revenue growth to offset their need to hire more people, replace plant and equipment, pay higher interest rates on their debt, or adjust to higher input (commodity) prices. Consequently, profit growth for many companies could be difficult over the next several years as profit margins contract and organic earnings growth stagnates. Over the next several years, it might become clear that there may not be enough global aggregate demand from either the public or private sector. The developed economies of the world are reducing spending at both the government and private sector level, while at the same time trying to increase tax revenue and reduce debt. This diverts “dollars” from being spent on consumption to deficit reduction in the case of governments and to debt reduction in the case of the private sector. The emerging economies of the world are still too dependent on exports to fully drive their economies and

therefore cannot adequately increase demand at home to completely offset the decline in consumption by the developed world.

We just completed a review of long-term rolling 10-year average earnings on the S&P 500 (Robert Shiller Long-Term, Stock, Bond, and Interest Rate Data since 1871). Ten-year average earnings, designed to provide a normalized earnings number by smoothing out the ups and downs of profit cycles, have grown about 4.5% to 6.0% annually for the last century. Thus, it appears it is very difficult to dramatically increase corporate earnings growth for extended periods of time at a rate beyond 6%. Hence, any return on the S&P 500 above its long-term earnings growth average plus dividends has either been a recovery of stock prices to their long-term average price-earnings multiple or conversely an advancement of return as stocks prices move beyond their long-term price-earnings multiple. Today, while many pundits are claiming that stocks are quite inexpensive at around 13 times current earnings on the total U.S. stock market, we feel they are moderately overpriced by 15-20% based on a multiple of 21.9 times the average earnings of the past ten years (P/E10). The chart below gives a good review of the data in graphical terms.



Our concern lies in how the markets may respond over the next several years. In the short-term, as Fed policy remains overly accommodative, stocks may become pricier and move into bubble territory. Unlike the most recent two market declines of 50% (2000-2002 and 2008-2009); the

popping of stock bubbles have historically caused large investor aversion to stocks pushing equity prices significantly below their long-term average price-earnings multiples. This didn't happen in the 2000-2002 decline and only briefly touched 13 times 10-year earnings in March of 2009. While low stock prices are healthy for markets and investors in the long-run, since the stage would be set for stocks to recover to their average long-term multiple, it could cause significant near term pain to investors as they are hit with another large market pull back. Historically, a 40% or more market decline occurred about once every 30 years or so. However, as the Fed has created this bubble-pop-bubble-pop phenomenon, these 40% or more declines have occurred twice in the past 10 years. We would rather not see another one over the next few years should stock prices continue their ascent at a rate faster than underlying earnings growth.

Given how strongly markets have responded to Fed policy and the near term corporate profit recovery, it is clear that all assets of higher risk were heavily rewarded over the past 18 months and risk control/aversion type assets were largely ignored. Generally, assets with higher risk characteristics experienced higher returns. The lower quality and heavily leveraged companies' stock prices did significantly better than their fiscally strong counterparts. Lower quality and longer-duration bonds produced returns more than double their short-term and high quality counterparts. Likewise, emerging market stocks did better than domestic and other developed market stocks.

As many of you know, we have been quite mindful of the unintended consequences of the Fed behavior and Fiscal spending following the credit crisis. This aversion to unintended and so far unrealized risk has resulted in many of our holdings, outside of traditional equities, producing rather modest returns over the past 18 months. In the short-run, it appears we have been too concerned about risk on many of our accounts. We also know these types of exaggerated results in one type of asset class never last forever, but they can go on for quite some time (even a few years). The challenge for many investors is to stay the course as they see outsized returns in which they may not have fully participated. The more conservative holdings are likely to be rewarded at some point over the next few years as markets adjust to a variety of potential events, such as a change in Fed policy, an increase in inflation or interest rates, a decrease in corporate profit growth (or decline in actual profits), reduced government spending, higher taxes, or some unexpected external event like a debt crisis in Europe or a large confrontation with North Korea.

We wish we had a crystal ball that could tell us when outlier events would take place causing an aversion to risk taking, or when to expose client portfolios to above average risk during periods of euphoria. Since we don't, we have relied on the strong correlation of low valuation stocks producing above average long-term results. Thus, we select managers that pay close attention to buying businesses trading with large margins of safety relative to their assessment of intrinsic value. This approach worked beautifully well in nearly every bear market since the end of WWII where value stocks declined less than the markets as a whole. However, this worked less well during the 2008-2009 market decline driven by the global credit crunch when assets were being

sold to raise needed capital rather than based on recognition of underlying value. To help further protect against these large unexpected outlying events when valuation doesn't work, we added some alternative investments with downside risk protection strategies for many of our clients that were in or nearing retirement. In the near term, it is clear these higher protection assets have been a drag on returns. However, we still believe these types of investments are worthwhile for many of our clients. These large outlier events have been at best encouraged by Fed policy and more likely driven by Fed policy.

Given our belief in realism, our concern about current Fed policy, and our assessment of overall stock market valuation, we are likely to continue to carry some exposure to lower risk assets while still selectively exposing the bulk of most client portfolios to good stocks (offering higher expected long-term return than the market as a whole) trading at significant discounts to intrinsic value. We commented previously about how this more conservative approach will likely cause our portfolios to have larger "tracking error" to the broad market as we lag more in strong momentum driven advancements while also providing more stability in market retreats. However, should the market experience a sizable decline and valuations move to levels that offer the potential for above average long-term returns, we would likely become even more constructive in our exposure to equities.

Even though we feel there are various risks that may or may not materialize with respect to the stock market, we feel the global economic recovery has now finally begun to take hold. Unemployment appears to have peaked and is very slowly coming down. Manufacturing in the U.S., Europe, and China has been growing. Consumption and spending are up, even though only time will tell whether this is a sustainable uptick or conversely driven by large incentives to consumers. The recovery is fragile but appears to be making headway. Should the recovery continue, this will help stabilize economic activity around the world and should result in more normalized corporate profits over the next 7-10 years. However, as we mentioned earlier, economic growth is likely to be slower than the long-term average and profit margins are likely to contract a bit. These factors are likely to somewhat mute stock returns even though the global economy is healing and people are feeling better overall. We feel our active equity managers are well positioned to potentially produce stronger results than the market as a whole as they invest in businesses trading at lower prices that have stronger growth characteristics than the average stock.

At the risk of sounding like a broken record, we do thank you for your continued confidence and patience. Everyone in our firm realizes the special trust you've placed in us. We continue to seek prudent ways to help you achieve your long-term goals. From all of us here at EnRich Financial Partners, we wish you the best this holiday season! May it be filled with joy and love as you connect with family and friends.