INVESTMENT PERSPECTIVES

JANUARY 1, 2014

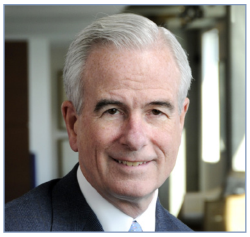
# Guidance

As the year winds down and this issue of *Investment Perspectives* is put to bed, we can't help but allow ourselves a brief moment to savor what a good year it's been for stocks. Except for a short summer swoon triggered by the prospect of the Federal Reserve's "tapering" its massive bond-purchase program, the market's rise has been relatively steady, almost relentless. Moreover, the fear that plagued the markets during the financial crisis and its aftermath has seemingly given way to indifference or perhaps even confidence, as indicated by reduced measures of market volatility.

But instead of looking in the rearview mirror, our focus is on the road ahead, to be sure that our portfolios are well positioned for the future. In thinking about opportunities, we're inevitably drawn to the fundamentals that drive each security we own for clients. In the case of equities, this means a combination of the outlook for earnings, financial strength, competitive dynamics and the like—which is where our analysts spend the bulk of their efforts.

## VALUATIONS IMPROVED

Apart from fundamentals, the other key determinant of stock movements is the market valuation placed on securities by investors. In fact, changes in valuation are the primary drivers of stock prices in the short run, and last year was no exception in this regard. By most estimates, corporate earnings grew 5 to 7% in 2013, accounting for well under a third of the gain in the S&P 500 Index, which is up about 25% as we go to press. In the context of historical averages, stocks began 2013 with price/earnings ratios somewhat below normal levels but ended it with P/Es at or slightly above normal. Without getting into a lengthy discussion of what constitutes "normal" in this regard, suffice it to say that in most respects stocks no longer sell at a significant discount to their long-term averages. According to FactSet, the 10-year average P/E ratio based on forward 12-months earnings per share is 14x, and stocks are now around 15x, depending on the exact estimate one uses for the calculation. This isn't to say that valuations can't move higher (indeed there's a good case to be made that they will), but it does cause one to focus even more clearly on the earnings outlook.



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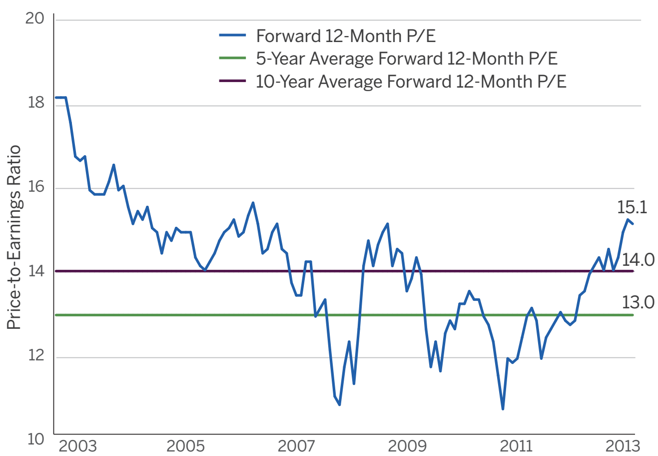
Looking at the year ahead, our sense is that earnings expectations should be tempered. The U.S. economy is still struggling to achieve a more robust recovery despite the Federal Reserve's aggressive expansion of the money supply through Quantitative Easing. Corporate profit margins are already near historic highs, thanks in part to a lack of wage pressure, little or no inflation in commodity costs and low interest rates. If any of these factors began to reverse without an acceleration of economic activity, it might be difficult to maintain margins. On the positive side, large corporations with significant international exposure may benefit from a long-awaited upturn in the eurozone, which appears to be unfolding. Further, share buyback programs have boosted reported earnings per share and could continue to do so in the year ahead, as many companies are carrying excess cash on their balance sheets and may deploy it by repurchasing shares. All in all, it seems reasonable to expect a 5 to 10% gain in earnings this year.

**FIGURE 1:** Forward 12-Month P/E Ratio, S&P 500 Index 2003–2013*




*11/28/2003-11/28/2013
Source: FactSet Research Systems Inc.

## EARNINGS OUTLOOK

It's not quite that simple, however. To complicate matters, earnings estimates for broad market indices are generally calculated in two ways: top-down and bottom up. So-called top-down estimates are based on the views of investment strategists who try to gauge the direction of the economy, input costs and other variables, as we've just highlighted. These estimates currently average out to an estimated gain in earnings per share of about 8% for the year ahead. Bottom-up estimates, on the other hand, are made by analysts who focus on specific stocks and build earnings models to reflect their best thinking about the outlook for each one. Based on historical patterns, Wall Street analysts tend to be optimistic about their companies—perhaps because their stock recommendations are based on what they see as favorable earnings prospects. Their estimates are typically adjusted downward over the course of a year, eventually coming into line with reality, as shown graphically in Figure 2. The year 2013 was no exception, as analysts who originally estimated that profits would grow about 8% now estimate that they ended the year up 5 to 7%, according to FactSet data. Top-down estimates, in contrast, finished the year about where they began. (We should note that both top-down and bottom-up estimates can be wildly inaccurate at inflection points in the economy. In 2010, for example, as the U.S. emerged from recession, projections of either type drastically underestimated the actual results.)

As we said, top-down estimates for earnings growth in 2014 are clustered around 8%, but bottom-up estimates currently call for growth of about 11%, a figure that we find a bit of a stretch at this point. Even the 8% figure would seem to assume acceleration in GDP growth over the course of the year. Such a pickup seems unlikely to be fueled by consumer or government spending, and capital investment is still fairly stagnant. With the exception of a few very large enterprises, such as Amazon or Boeing, corporate executives do not seem prepared to commit to major capital or expansion initiatives unless they see clear signs that activity is picking up. Instead, the focus is on items that won't jeopardize quarterly results. Gradually expanding payrolls, repurchasing stock or increasing dividends are examples of relatively "safe" avenues for growth during a period of modest economic expansion. These measures generally allow management to maintain profit margins, in contrast to large capital projects, which can hurt profits in the short term before finally paying off.

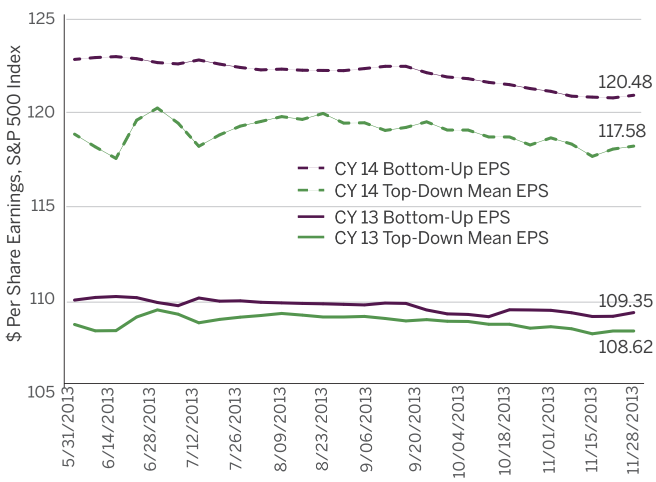
Part of the reason for "playing it safe" may be the evolving nature of executive compensation plans. Andrew Smithers, a noted economist and author of *The Road to Recovery: How and Why Economic Policy Must Change*, argues that the growing use of stock options and substantial cash bonuses linked to stock prices has inhibited executives from making decisions that would cause earnings to lag consensus estimates, thereby causing a decline in equity value. This may partially explain why the ratio of business investment to GDP in the U.S. is still near recession lows. This type of short-term, "don't rock the boat" mentality also reflects a general lack of confidence among business executives, and the worry is that it can be self-fulfilling.

## CORPORATE GUIDANCE

A phenomenon known in investment circles as "guidance" may have exacerbated this problem. This term refers to the efforts of senior corporate executives in setting Wall Street earnings expectations to conform to management's own thinking. If analyst estimates are significantly higher than management's internal projections, for example, an effort will be made to manage expectations downward. Most companies now issue guidance as a matter of course, updating it quarterly. Of course, management can be wrong about the outlook, just as analysts can, but at least they are acting with full access to corporate information. One of the problems with guidance, however, is that it can cause managements to focus excessively on the short term. If, for example, earnings are likely to miss estimates (and guidance), costs may be cut and investments delayed. As has often been stated, one of the disadvantages of being a public company is being beholden to Wall Street, and issuing guidance has only compounded the problem.

**FIGURE 2:** S&P 500 Index Earnings Estimate Revisions, 2013

CY Bottom-Up EPS vs. Top-Down Mean EPS (Trailing 26 Weeks)




Source: FactSet Research Systems Inc.

## FED GUIDANCE

Like many public companies, the Federal Reserve has adopted a practice of what it calls "forward guidance." As in the case of the corporate world, part of its motivation is to operate in a more transparent fashion and to set expectations more clearly. Before the financial crisis, the Fed was under pressure to be more explicit with regard to its economic forecasts so that its decisions in managing the money supply and interest rates could be seen in the context of its outlook. Since the crisis, however, the practice has evolved further out of economic necessity. With short-term interest rates already set at effectively zero and bond purchases helping to keep mid- to long-term rates low, almost the only tool left in the Fed's toolbox is to offer assurances about the future of monetary policy.

In managing expectations since the crisis, the Fed initially said it would keep rates low for "an extended period." As events unfolded, it then tied its commitment to specific dates (rates would be effectively zero "at least through mid-2013," etc.). More recently, its policy has been linked to economic variables. Over the summer, the Fed announced that rates would be kept at current levels until the unemployment rate declined to at least 7.2%, but it has since lowered that threshold to 6.5%, as long as inflation is not greater than 2.5%. Recognizing that maintaining full employment and keeping inflation at bay are the twin objectives of monetary policy and essentially constitute the Fed's mission, these goals seem perfectly logical. They also send the message that an aggressive expansionary policy will likely remain in place until conditions improve. The idea is to assure companies that the monetary rug will not be pulled out from under them unless there is a risk of over-heating—a prospect that seems remote at the moment.

The Fed's assurance of a long runway with low rates hasn't yet pushed companies to accelerate their investment spending. Part of the reason may be that inflation remains exceptionally low, so there's little urgency to make investments today on the basis that they will be significantly more expensive tomorrow. (Consumers appear to lack motivation for similar reasons.) Further, many Fed observers may be skeptical that the central bank will ultimately allow inflation to rise as much as it says it will, since they know that containing inflation is critically important. In other words, some fear that the rug will be pulled out well *before* the economy heats up. Such is the dilemma of issuing guidance.

## OPPORTUNITIES

In light of the Fed's "forward guidance" and what we hear in the form of corporate guidance, the economic environment would appear to be rather uninspiring. Indeed, following last year's robust stock market, one could argue that there's little reason to be excited about equities now. On the contrary, while stocks in general have done well and valuations are somewhat higher today than a year ago, we continue to find opportunities we believe will make money. This is a time to be discriminating, and research holds the key to selectivity.

U.S. large-cap stocks are still attractive, in our view, and we recommend staying the course in terms of equity weightings in balanced portfolios. In contrast to most companies, those we own in our growth portfolios *are* investing in their respective futures, and their long-term growth rates, averaging 14 to 15%, bear testimony to their successful strategies. Our Flexible Equity portfolio also focuses on companies with high rates of reinvestment and above-average long-term growth, and our Equity Income strategy contains a number of stocks that we believe will continue to grow their dividends at rates well above inflation. Even our Value Equity portfolio has a bias toward companies with strong underlying fundamentals and competitive positioning. On balance, we think value stocks are better positioned than growth stocks to benefit from the recovery, which appears to be gaining momentum, and they tend to be more modestly valued in the marketplace.

The primary area that we believe calls for a shift in asset allocation is U.S. small-cap stocks. For some time, we have recommended overweighting them in portfolios in recognition that they are generally able to outgrow their larger counterparts by gaining market share and being more agile during a period of relatively modest overall economic growth. That strategy has worked well, as small stocks have generally outperformed large-caps by a meaningful margin since the financial crisis. (The Russell 2000® Index is up more than 35% in the 12 months through mid-December.) Recently, however, valuations have increased to the point where small-caps are on the high side of historical averages, so we have moved to a "neutral" weighting. Within small-caps, we find value more compelling than growth at today's price/earnings ratios.

Outside the U.S., we believe that emerging markets stocks are particularly attractive. For those clients underexposed to this asset class, the present environment provides what we think is a good entry point. Emerging markets have severely lagged the global indices for the last year or so, and valuations are now at a significant discount to developed markets, yet the long-term case for superior growth is largely intact. The financial condition of most developing countries is good, and growth concerns with respect to China appear to have stabilized and are largely priced into shares.

In keeping with our focus on strong fundamentals, we recently partnered with Wellington Management in London to create a new Strategic European Equity portfolio for clients, available in the form of a mutual fund. European equities have performed well for the last 18 months in anticipation of an economic upturn (which finally began last summer), so one might well ask, why invest in Europe at this stage in the cycle. We believe that the continent contains a number of world-class companies that will benefit from the global upturn but have been neglected by investors due to concerns over Europe's sovereign-debt crises, uncompetitive labor practices and aging demographics. Again, good research can uncover potential opportunities in the market.

Finally, fixed income should not be overlooked. While it's hard to argue that bonds provide great value with interest rates at historic lows, we believe they do serve the important purpose of providing stability to balanced portfolios. As equities have recovered strongly over the past couple of years, they have tended to skew allocations toward stocks, and it's important to rebalance in line with strategic objectives.

We want to take this opportunity to wish our clients and friends a most Happy New Year.



The S&P 500 Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. An investor cannot invest directly into an index.

The Russell 2,000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2,000 is a subset of the Russell 3,000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2,000 Index is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure that larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The Russell 2,000® Index is a trademark/service mark of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

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