STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

Our 2013 Review (with a Peek Ahead to 2014)

A Good Year Is Not Just A Blimp

If your memory is better than ours, and it probably is, you may recall the title of Sterling Capital Management's year-end letter for 2012—***Hoping for an Encore***. Well, we got it, and then some. The S&P 500 shot ahead by 32%, and the equity component of your portfolio also generated substantial percentage returns. Anticipating a buoyant market, we increased account equity weightings to the upper end of their prescribed allocation ranges, which boosted portfolio performance. As usual, the return for the equities in your portfolio is included on the Performance Report along with the return for the entire portfolio, including its bond and cash equivalent positions.

Most analysts attribute the market's strength to the Fed's continued purchases of Treasury bonds and agency mortgage-backed securities at a rate of a trillion dollars' worth per year, which kept yields at historically low levels, making stocks relatively attractive investments and providing the liquidity to purchase them. They also cite the Fed's decision to maintain its overnight borrowing rate (Fed funds rate) at essentially zero, which made money market funds and other cash equivalents extremely unappealing alternatives for investors.

It wasn't all about quantitative easing and low short-term rates, however, as operating earnings for companies in the S&P 500 expanded around 10% last year, a rate that considerably exceeded 2012's growth. Although a few of our gold mining stocks performed poorly, the great majority of our positions delivered strong gains, reflecting operating performance that met or exceeded expectations.

Despite the Fed's massive bond purchases, returns on fixed income investments were poor. Rates began rising from suppressed levels in the spring, causing bond prices to tumble, as the market began to anticipate that the Fed would taper its bond buying. Long-term Treasury bonds were clobbered—the Barclays U.S. 20+Year Treasury Bond Index lost 14% in 2013. Because of the short maturities in our fixed income portfolios, our clients' bonds did not experience these losses but instead managed tiny gains. (You may remember our warnings about the perils of reaching for yield in earlier letters.) Keeping bond allocations at the low end of the stated investment parameters was another way we minimized bonds' drag on performance.

Time To Get Worried?

In spite of the fact that the economy appears to be gaining steam, many market analysts are cautioning investors that 2014 could be a rough ride. These analysts argue that the market has been too strong for too long and that history teaches that a sell-off is likely. The S&P 500 has now risen 5 years in a row, which has happened just three other times since the inception of the Index in 1950. In each of the previous cases (1987, 2000, 2008), Year 6 featured a harrowing sell-off.

The 2014 decline, they contend, will be triggered by the beginning of the Fed's tightening cycle, which will halt the nascent expansion of the U.S. economy and also bleed liquidity from the stock market. They point to bearish economic data, such as last week's disappointing non-farm payroll report, as proof that the economy's growth is tenuous. Concerns about projections of slowing growth in China also fuel their pessimism. In these skeptics' view, the stock market is particularly ripe for a fall because of excessive optimism among market participants, as evidenced by investor sentiment surveys and by data showing that money is once again flowing out of bond mutual funds and into equity funds.

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Although these arguments are sobering, we are not convinced that a steep decline is inevitable. The three 5-year periods cited above differ from the current 5-year period in two key respects. First, the S&P as measured by the price/earnings ratio (how many dollars are being paid for $1 of earnings) was more richly valued in the three earlier periods. The p/e was very high—between 20 and 30—shortly before the sell-offs. Today it is a reasonable 17. Second, in the earlier 5-year time frames, economic growth, as measured by Gross Domestic Product, was either peaking or already slowing in the months before the decline. Today, the economy appears to be in the early stages of expansion, and GDP is accelerating from depressed levels. In fact, the annual rate of expansion increased each of 2013's three reported quarters (the 4th Quarter report has not been released yet), growing over 4% in 3Q13.

The current expansion, we believe, may be sustainable. Most of the recent growth in GDP has been driven by the consumer as capital spending by businesses has remained weak. But this could be changing. The nation's capital equipment stock is overdue for replacement, demand for business loans is picking up, and recent surveys show that new orders received by manufacturers have popped to a 3-year high.

Although we are concerned by the readings of high optimism, we do not believe investors are exhibiting the kind of exuberance that often signals a market top. From what we can tell, the market's rise has not captured the attention of the investing public, whose behavior still appears influenced by the collapse caused by the credit crisis of 2008-09. In our opinion, the recent reversal of flows back into equity mutual funds is not a manifestation of frothiness but more likely evidence that the public's appetite for risk has just started to return.

We do agree that the stock market is extended, and a sharp correction would not be unexpected, particularly since it does appear that much of the good news about near-term earnings prospects is already factored into the market. And Year 2 of the presidential cycle often features a sell-off early in the year, which is sometimes followed by a recovery to new market highs.

Of course, there is certainly the chance that the more bearish soothsayers are right and that a correction could extend into a cyclical decline. In addition to the risk factors noted above, the potential for inflation attributable to the build-up of massive excess reserves on banks' balance sheets could be realized if businesses and consumers become ebullient too soon. (We have written about this before.) This is one reason we will maintain our limited exposure to gold mining stocks.

Putting it all together, we are inclined to believe that the odds favor another positive year in the stock market but also increased volatility. History tells us that another 30% year is unlikely.

Staying On Track

As you know, there is no foolproof roadmap (or GPS system) that charts the course of the financial markets. Although we will monitor economic developments closely, we will continue to focus on the stocks in your portfolio and those candidates for purchase that may become part of your portfolio. As we said last year:

"The long-term returns of your stock portfolio, however, will not hinge on our ability to forecast the swings in the stock market as much as on our ability to select stocks whose value is not being reflected in the prices set by the market."

With that in mind, we continue to appreciate your trust and confidence in our efforts to find promising, long-term investment opportunities. As always, please do not hesitate to call if you have any questions about our outlook for 2014 or any matter pertaining to the management of your account.

Here's to another good year.

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