July 9, 2014

INVESTMENT LETTER – SECOND QUARTER, 2014

Nervous Yet? (The "Everything Boom" Persists)

Front page above-the-fold headlines proclaim, " . . . We're in a world where there are very few unambiguously cheap assets* . . ." Real estate prices in New York, London and Hong Kong have reached bubble proportions again, but sanguine equity markets and surprisingly benign bond markets, world-wide, seemingly have investors trapped in a kind of torpor of complacency. Possibly it's merely inertia born of the confusion of our "always-in-touch, and need to be up-to-date" electronic information age mindset? Perhaps it's the first signs of the summer doldrums?

Rapidly shifting economic cross-currents, as well as, almost daily, a constant diet of unsettling geopolitical events in eastern Europe and the Middle East, all abetted by a sensationalist media, intrude on our attempts to make rational decisions in an increasingly irrational world. The assessment gauges used by many to predict the future are swinging wildly; pundits hold forth as always, but their credibility erodes (see www.pundittracker.com). In the global financial markets today, the effect of these conflicting indicators, and inputs, seems to have resulted in a kind of investor paralysis.

A Decision Framework

Predict your own future scenario. In a two-dimensional matrix of economic growth and inflationary expectations, will the next few years see rising or declining economic growth rates, coupled with mild or accelerating inflationary expectations? A new assumption for one does not necessarily dictate the direction or magnitude of the impact on the other. At the moment, the stock markets' record-breaking highs and near-record-low price volatility patterns appear to reflect a certain investor comfort with inflationary expectations and continuing corporate earnings growth. After a dismal first quarter, US economic growth and unemployment measures appear to be moving in the right direction. More of the same would burnish the "Bullish" case for equities. The US Federal Reserve (Fed), as well as other central banks elsewhere, continue to pursue stimulative monetary policies aimed at job creation and economic growth. The monetary printing presses are running around the clock, although in the US since last September, tapering somewhat. Labor employment slack in the US shows signs of tightening. As loan covenant terms relax, bank lending to the REAL economy appears to be turning up. Business capital expenditures finally seem in a cyclical up-turn. Usually when this latter indicator begins to break out on the upside, it's an indication corporate CFOs foresee both rising revenues, but more concerning, increasing labor costs and accelerating inflationary pressures ahead.

*Russ Koesterich, Chief Investment Strategist, BlackRock, *New York Times*, July 8, 2014

Global Financial Market Outlook

So, if one were patrolling for markers signaling reasons to reassess the outlook for global equity markets, a combination of closing economic output gaps, falling unemployment, asset class price appreciation bubbles (e.g., *record stock market price levels*), higher wage levels, synchronized global GDP growth, and rising commodity prices and volatility, would be both encouraging and concerning.

The May US job creation report (288,000 new jobs vs. consensus estimate of 210,000) might be the beginning of a series of better-than-expected indicators, presaging an unexpectedly rapid narrowing of the unemployment gap, but also has inflationary expectation implications. As now always seems the case, the global economic equation is constantly seeking a new equilibrium, but the input variables *are* always different and difficult to anticipate.

A Wave of Bullishness, A Sense of Optimism

Behaviorists suggest that an ever-present human trait is a kind of mental inertia, the tendency to let gains run until the anxiety of the risk-of-loss overpowers, but that a risk aversion bias generally dominates. Group-think optimism in the current complacent investment market mode appears to hold sway. Sentiment measures are generally improving in the developed markets. Stock market indexes in the US, since the dismal days of March 2009 have moved up over 250%, and the cognoscenti are starting to talk about the S&P 500 Index (today at 1,960) moving up to 3,000 in three to four years! So practically speaking, given the caldron in the Middle East, the stand-off in Ukraine, serial confrontations in the South China Sea, etc., how can one reduce an investment market outlook to some range of probable expectations?

In the end, as we have said probably too often, present stock market valuation levels discount the amount and direction of future corporate earnings per share. Absent some unexpected global economic disruption, presently, future earnings growth prospects appear headed in the right direction. How can we put all this into practical context?

What to Pay for a Dollar of Future Earnings?

Investors, professionals (today nearly 90% of US stock market activity), as well as individuals, employ a wide variety of "proprietary" indicators, ratios, and sophisticated financial models to determine portfolio strategy and tactics. Many of these computer-based models and techniques, designed by Caltech and MIT PhD-types, uncover anomalies of the moment, but which when identified are arbitraged away quickly and give rise to extraordinary trading volume. However, in the end it still seems that when dealing with investor emotions and attempting to assess the direction of sentiment in the marketplace, reducing the equation to its simplest set of factors yields the most useful outcomes. That essential analytical tool, in our opinion, is the much maligned Price-Earnings (P/E) ratio. This binary measure in real time collects and summarizes the investment markets' concerns and cross-currents, but its components need careful scrutiny if it is to be used as a cross-market relative valuation comparative guide.

Clients, during our portfolio review sessions, endure our presentations which focus on global relative P/E ratio comparisons. As such, we provide a few thoughts on the P/E ratio below.

A Refresher on P/E

The Price-Earnings ratio, or the P/E of a stock is a straightforward calculation which divides the current market price of a stock by the earnings per share of that same stock. Most pundits, television hosts, newspaper articles and practitioners commonly reference one of two versions of the P/E. The first version utilizes a consensus estimate of earnings per share for the next 12-month period (forward-looking), while the second version utilizes actual earnings per share for the trailing 12-month period (backward-looking). The CAPE Ratio (Cyclically Adjusted P/E), a version of the backward-looking P/E, has garnered much attention of late. This calculation attempts to adjust for the cyclicality in earnings by using actual earnings per share for the trailing 10-year period, rather than the trailing 12-months. In our analysis and communications, we typically focus on forward-looking P/E.

The term "consensus earnings estimates" requires further clarification. An "official" source of consensus earnings estimates does not exist. Rather, a small number of well-known financial data providers independently collects earnings estimates from sell-side research analysts and then aggregates them to form consensus earnings estimates. Although the exact number and mix of analysts submitting estimates to each financial data provider may vary, resulting consensus earnings estimates of well-covered stocks tend to be fairly similar across the various providers.

The accuracy of consensus earnings estimates has been lackluster. Said differently, consensus earnings estimates hardly ever accurately predict the actual earnings of a stock over the corresponding 12-month period. At least to us, it appears analysts react to the most recent quarterly earnings report and then extrapolate the results over the next four quarters. Given their poor historical track record, one might wonder why estimates so often miss the mark, or what purpose consistently inaccurate estimates might serve.

In fairness to the analysts, predicting the future proves a difficult task in the best of scenarios, let alone under the corporate/political pressures they often find themselves. Today's mega-sized financial firm conglomerates many times own stakes in brokerage/trading companies and investment banks; both of which are transactional, commission-based businesses. Imagine the difficulty facing a broker trying to sell the stock of a company, or an investment-banker trying to underwrite the corporate debt of a company for which their internal analyst has just published a downgrade to the company's stock rating and earnings potential. Whether real or perceived, we feel this conflict of interest seriously compromises the analyst's ability to remain impartial. Beware of supposedly "unbiased," free research offered by retail-investor-focused trading platforms!

An investor can still glean useful information by analyzing forward-looking P/E ratios. Despite questions surrounding their relevance, accuracy and impartiality, consensus earnings estimates do serve as a widely utilized common base for comparison. The price multiple of consensus earnings estimates at which a stock trades indicates the level of optimism or pessimism the market is pricing into a stock. High P/E ratios often suggest to us that the market has gotten overly optimistic and is underestimating the likelihood of below average returns or even a correction. Likewise, low P/E ratios suggest to us that the market has gotten overly pessimistic and is underestimating the likelihood of positive returns or even significant price appreciation. As value investors who view market sentiment as a contrarian indicator, we prefer the latter scenario.

260 Franklin Street, Suite 1888 | Boston, MA 02110 p617.210.6700 f617.210.6750 www.tfcfinancial.com

Our View

Despite many investors considering current economic trends to be somewhat extended and perhaps concerning, we still generally find the overall environment encouraging and supportive of continued growth.

The MSCI All Country World (ACWI), a proxy for global equity markets, now trades at a P/E of 14.5x forward-looking earnings. At these levels we view global equities as reasonably valued in absolute terms and attractively valued relative to fixed income. Given our constructive view on the global economy and global equity valuations, we will continue positioning your portfolios for growth and capital appreciation.

Update on Client Reporting

In our effort to improve the overall aesthetics and usefulness of client reporting and to keep pace with current industry practices, you will notice we have made several changes to your quarterly reporting package:

- New TFC color scheme, logo and updated fonts have been added across the reporting
- A Table of Contents, along with pagination, has been included to direct readers to report sections
- Performance by Asset Class is now available for each report
- Asset Allocation views have been rearranged from fixed/equity to *equity/fixed* to align with industry reporting

As always, we welcome your comments and questions.

Sincerely,

James L. Joslin
Chairman, CEO & CCO

Renée Kwok
President

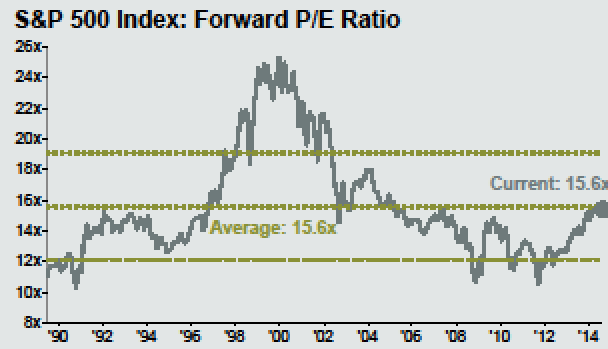
Charles E. Hipp
Director of Investment Research

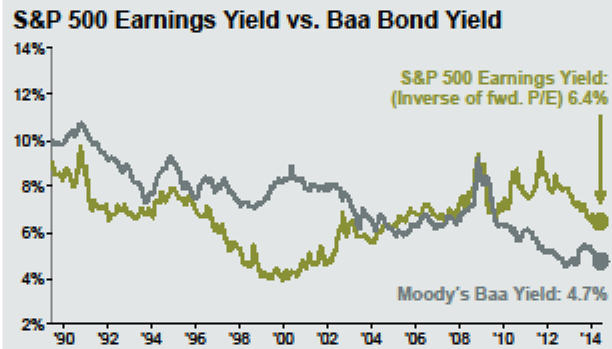
MARKET INSIGHTS

Equities

Stock Valuation Measures: S&P 500 Index

U.S. Equity: Valuation Measures			Historical Averages			
Valuation Measure	**Description**	**Latest**	**1-year ago**	**5-year avg.**	**10-year avg.**	**25-year avg.***
P/E	Price to Earnings	15.6x	13.8x	13.4x	13.8x	15.5x
CAPE	Shiller's P/E	25.6	24.4	21.7	22.9	25.1
Div. Yield	Dividend Yield	1.9%	2.0%	2.0%	2.0%	2.1%
PEG	Price/Earnings to Growth	1.5	0.8	1.1	1.7	1.4
P/B	Price to Book	2.8	2.6	2.2	2.4	2.9
P/CF	Price to Cash Flow	11.0	10.3	8.9	9.5	10.6
EY Spread	EY Minus Baa Yield	1.7%	1.5%	2.0%	1.2%	-0.7%





Source: Standard & Poor's, FactSet, Robert Shiller Data, FRB, J.P. Morgan Asset Management. Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation adjusted earnings as reported by companies. Dividend Yield is calculated as the trailing 12-month average dividend divided by price. Price/Earnings to Growth Ratio is calculated as NTM P/E divided by NTM earnings growth. Price to Book Ratio is the price divided by book value per share. Price to Cash Flow is price divided by NTM cash flow. EY Minus Baa Yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. *P/CF is a 20-year avg. due to cash flow data availability.
Latest reflects data as of 6/30/14.
Guide to the Markets – U.S. Data are as of 6/30/14.

J.P.Morgan Asset Management