Party Like It's 1999

Fourth Quarter Market Review From Your Portfolio Management Team—January 15, 2014

After stalling through the summer, the U.S. stock market party kept rolling through the end of the year. Large companies, smaller companies, and everything from social media stocks to airline stocks forged ahead strongly. Even a government shutdown, as well as, news that the Federal Reserve would finally begin to taper its $75 billion a month purchase of government bonds could not keep investors from snapping up shares of U.S. companies. Even bonds managed to recoup some of their losses in the final quarter.

2013 certainly surprised most everyone. Stocks, and in particular, U.S. stocks, posted their best returns since the late 90s. On the other hand, it was a dismal year for bonds, as the Barclays Aggregate index posted its worst return since 1994. Granted, the index was only down 2% for the year, but bond investors have gotten used to consistent mid to upper single digit returns, not negative returns, which haven't been seen since the 90s.

It was also a disappointing year for most commodities, such as oil and gold, with gold finishing down almost 30% and oil only modestly higher. And it was a mixed bag for foreign stocks, with emerging markets finishing mostly lower (a big surprise for most experts), while European and Japanese stocks more or less kept up with the U.S. stock market.

Portfolio Review

Below we review the five broad strategies that FSA manages. Keep in mind that your specific portfolio may differ to some degree from the averages, as our portfolios are individually managed.

Income (Strategy #1)

A very challenging year for this strategy which must invest within the fixed income world, since most areas of the bond market finished the year in negative territory. Nevertheless, this strategy finished the year relatively flat. High yield bonds and floating rate bonds managed to offset losses from higher quality taxable and municipal bond funds.

Income & Growth (Strategy #2)
As the bond market weakened during the spring, we shifted the stock allocation from 10% to 40%. (This strategy has a maximum allocation to stocks of 50%.) As a result, these conservatively oriented portfolios managed to generate a small positive return for the year. We also shifted the make-up of the bonds in the portfolio to include those types of bonds that fare well during rising interest rates. This strategy is most appropriate for clients who are making consistent withdrawals from their account, and are thus, very concerned with safety of principal.

Conservative Growth (Strategy #3)
The large overweight to bonds hampered returns earlier in the year (2013), as did the lagging returns from high yield bonds, our favorite category for 'low risk equity-like returns.' During the spring and summer, we shifted the portfolios more towards stock funds, in reaction to the flow of money out of bonds. With stock fund allocations increased from 20% at the beginning of the year to 50% currently, these accounts participated nicely in the 4th quarter rally. The returns were also helped by the healthy bond allocation as even bonds rallied at the end of the year.

Core Equity (Strategy #4)
This strategy posted the strongest results for 2013 among the FSA strategies thanks to a relatively high allocation to stocks all year. During the 4th quarter, we added an emerging markets stock fund to most portfolios, expecting this area to pick up some steam in 2014, after lagging significantly in 2013. These portfolios were helped last year by sector funds within the following areas—Transportation, Leisure, Retail, and Health Care.

Tactical Growth (Strategy #5)
This eclectic (go anywhere) strategy posted a solid return for the 4th quarter with its mix of European stocks, Japanese stocks and U.S. stocks, coupled with a 30% allocation to high yield bonds. We sold the small allocation to a volatility ETF at the end of December, as volatility in the stock market continued to fall. On the other, hand we recently added an energy sector fund to the portfolios during the quarter, as an area to continue its winning ways in 2014.

2014 Outlook
As we enter a new year, there are plenty of reasons to be optimistic on the investment front. Investor money is finally moving back into stocks, the economy continues to show signs of recovery, with GDP growth from the third quarter over 4% and unemployment falling below 7%. Clearly, U.S. stocks remain in a solid uptrend, with foreign stocks in a choppier uptrend. Even bonds, which were much maligned in 2013, seem to have rebounded, and our current holdings are all trading above their trend lines.

Is there more room for stocks to go higher after a strong year like 2013? Historically, if you look at years when stocks rose 25% or more, not including the recovery years right after recessions, the average of the following year's gains is a relatively modest 6% (a bit below the long-term average for stocks—10%). Of course, in the late 90s, stocks posted five years in a row of returns 20% or higher. It represented the strongest run of returns ever for U.S. stocks. So, unless you believe stocks are at the beginning of a multi-year recovery, we would caution against expecting a repeat of last year's stellar results.

We are in the sixth year of this recovery. Bull markets have often seen reversals in the sixth years (witness 2000 and 2008). But every cycle is different, so we will watch for signs that this market is running out of steam. For now, we are comfortable with our current holdings and it is 'steady as she goes.' Nevertheless, with FSA accounts at or near all-time highs, we want to make sure we don't get complacent.

All of us at Financial Services Advisory wish you a healthy and prosperous new year. Please let us know if there are any changes to your personal situation that might suggest some changes to your investment profile or objectives.

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