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Investment Review & Outlook
4th Quarter 2013

A Year to Remember

The U.S. stock market punctuated an extraordinary year with gains on the last trading day, moving many of the American indexes to record highs on the final trading day for only the sixth time in history. Despite all the uncertainties that we faced (the government shutdown, Boston bombings, the ongoing Syrian uprisings, debt ceiling debates, NSA revelations, the lingering economic aftershocks of Superstorm Sandy, nuclear standoff with Iran) people will look back at 2013 as one of the most profitable years for investors on record.

The S&P 500 index of large company stocks gained 29.60% in 2013, with 9.92% returns in the year's final quarter.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained a remarkable 39.01% for the year; 9.10% of the returns came in the final quarter. The technology-heavy Nasdaq Composite Index gained 38.32% for the year, after posting 10.74% gains in the last quarter of the year.

By any measure, these returns were remarkable. The S&P gains were the highest since 1997, and the 3rd highest since 1970. The small cap returns are the 3rd highest since 1980, and the Nasdaq returns were the seventh-highest ever. What makes the year even more remarkable was that nobody was predicting a rampaging bull in 2013, and many economists and pundits didn't think returns like these would be possible.

If anything, the five-year gains since the market downturn have been even more extraordinary. The Wilshire 5000 has posted an average 18.58% gains over the last 60 months, and the midcap (23.08%) and small cap (23.86%) indices have fared even better. Investors who got out of stocks during the market crisis of 2008 and worried ever since have missed out on one of the best 5-year bull market runs in American history.

Is this a bull market? Commentators, investment strategists and economists don't agree on whether we are experiencing a temporary rise in the midst of a long-term bear market, like we experienced during the Great Depression, or the strong early stirrings of a long-term bull like the one which started in 1982. The truth is, nobody knows, just as nobody knew that the U.S. stock markets would reel off such strong returns after the near-collapse of the global economic system.

Long-term investors can be compared to farmers, who plant seeds with no foreknowledge of the weather during their growing season, and no belief that what happened this year has any impact on what will happen in the next one. There will be bad years and good years, but over time, the good years have tended to outnumber bad ones. This is why it makes economic sense to continue planting the seeds each Spring--or staying invested in the stock market when each coming year is a mystery.

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Around the world, the returns fared well in 2013, even though returns lagged the booming U.S. market. The broad-based EAFE index of developed economies rose 19.43% in dollar terms in 2013, aided by a strong 5.36% return in the final quarter. European stocks were up 21.68%, giving them a strong year despite the constant threats of sovereign debt default and internal trade imbalances.

Emerging market stocks were a very different story. In 2013, the EAFE Emerging Markets index of stocks in Latin America, the Middle East, Eastern Europe, Africa, India and Russia was down 4.98% for the year, despite a 1.54% rise in the year's final quarter.

Other investment categories also lagged their long-term averages. Real estate, as measured by the Wilshire REIT index, gained just 1.86% for the year, after a modest 0.83% drop in the last three months of 2013. Commodities, as measured by the S&P GSCI index, experienced a price drop of 1.22% in 2013. Gold investors, meanwhile, experienced the precious metal's worst annual loss in 32 years, dropping 28% in value over the past 12 months.

Bond yields remain low by historical standards, but a slow rise in rates caused bond holders to experience paper losses. Investors in the Barclay's Global Aggregate bond index lost 2.60% in 2013, and 2.02% in the U.S. Aggregate index. In the Treasury markets, 10-year bonds now yield 3.03%; 5-year bonds are yielding 1.74%.

What's next? Who knows? Long-term, stocks tend to reflect the overall growth of the economy. One possible reason why so many investors remain nervous about stocks is the persistent--and erroneous--belief that the U.S. economy is still mired in a recession. You hear words like "sluggish" in the press, but in fact, the total output of the American economy has grown steadily since the 2008 meltdown, and the pace of growth seems to be accelerating. The Bureau of Economic Analysis statistics show an annualized increase of 4.1% in the third quarter of last year (the most recent period for which we have statistics), following a 2.5% rise in the second quarter.

Other economic signs are also encouraging. Corporate profits continue to rise. Individuals and corporations are carrying less debt than in the past. U.S. home prices recently posted their largest one-month rise in more than seven years, and some markets have seen housing values reach their pre-recession levels.

Even so, many investors will continue to wait on the sidelines, looking for "proof" that the market recovery is finally for real, while others will keep their money from working on their behalf in expectation of a crash. The former will finally get back in when prices have peaked, and will, in fact, be our most reliable indicator that the market has become overvalued. The latter will miss the next downturn, but also lose out on the positive returns that have, historically, outweighed the losses suffered in bear markets. The past five years have given us a useful lesson: that you plant your seeds in the expectation that there will be bad crops from time to time, but these unexpected booming years will more than make up for the losses.

As always, we appreciate your continued confidence in us. Please feel free to contact us with any questions you may have.

The FAM Team