ABULS, BONE & ELLER GROUP OF RAYMOND JAMES®

OCTOBER 2014

# LOOKING INTO THE CRYSTAL BALL

*"You don't climb mountains without a team, you don't climb mountains without being fit, you don't climb mountains without being prepared and you don't climb mountains without balancing the risks and rewards. And you never climb a mountain on accident – it has to be intentional."*

- Mark Udall

We spent a couple of days at an industry conference and many days of conference calls and manager visits during the past quarter. The conference was a Raymond James semi-annual retreat for discretionary managers hosted by our asset management services group. It is a good group of some of our brightest and forward-thinking peers, hosted by some of Raymond James better support teams in the investment management area and always has an outstanding group of industry professionals outside Raymond James as contributors and guest speakers. We always find it informative and return with some constructive ideas to help improve our investment policy or our practice management.

There were two sessions and themes that left an impression on us from the last conference; bench-marking investment performance and portfolio model management. We have actively produced portfolio performance for over 20 years in one form or another. Many of you have known nothing else. However, as it compares to other financial advisers this was as rare as a Cubs World Series victory 20 years ago. And today, though not as rare as it was 20 years ago, performance reporting remains a rarity for retail clients even today.

Chris Davis, portfolio manager of the Davis New York Venture fund, in their 2014 fall commentary addressed some concerns about passive versus active management and the likelihood of active management out-performing over the long-term. He wrote the following, "These characteristics include an alignment of interests, significant experience, a willingness to look different, a long-term time horizon, a consistent and disciplined framework, and individual accountability." We would like to think we embody all of these in our investment management process. As it relates to portfolio performance and benchmarking, 'individual accountability' is the reason we considered it necessary to provide our investment performance many years ago; i.e. accountability to ourselves for our internal objectives and accountability to our clients for the success in achieving your goals.

Particularly since the financial crisis, there has been an industry push to deemphasize performance in financial advisory practices. Generally, it is because performance has been difficult to achieve with the tech and telecom crisis followed by the financial crisis of 2008. We have always considered our performance reports one of the most transparent and honest expressions in black and white of how we make a contribution to your financial well-being

In the majority of our earlier years, portfolio performance was a positive conversation due to exceptional markets and our allocation to asset classes that proved to be favorable in the global financial markets. In the last several years, performance has sometimes lagged our benchmarks. In the long-term we are still pleased with the performance results. And as we look at our current investment policy, we remain confident our results will support your financial goals and meet the expectations and high professional standards we have set for our work on your behalf.

Investment performance can be analogized to the engine in a car. Without it, things will not move forward. However, much like the engine is not the only vital or important aspect of a car (consider the absence of no brakes or lights for a brief second), portfolio performance is only one aspect of wealth management.

Other contributors such as a written financial plan, proper insurance planning, adequate savings, intelligent tax management, thoughtful estate plans, and maybe the most important 'behavioral management or counseling' during personal and market crises all add up to our value proposition in helping your family achieve financial success. The 'value of advice' contains all of these elements and more.

Portfolio model management was another topic of note at the conference. In laymen terms this means what is your plan for investing. When we talk to other advisors or individual investors we are frequently concerned by the lack of an articulate plan others have for their investments. Additionally, we are often alarmed at the frequent reconstruction some advisors and investors have of their investment plan.

For 30 years we have been witness to some of the best money managers in the world. Without exception, they have remained true to their core philosophies and processes and they are never year in and year out at the top of performance rankings. They have been willing to be **out of favor** in the short-term to be **favored** in the long-term.

We describe our investment style as being **active, strategic, global, value-oriented** asset allocators. It too has its ups and downs. **'Active'** often means contrarian and we will zig when others are zagging. **'Strategic'** means we are longer-term in our planning and it will often take longer for our expectations to be realized. **'Global'** entails looking at asset classes across the world and all the financial, political, social and monetary dynamics that encompasses. Getting all those variables to cooperate based on our analysis is often not a concise and quick result. **'Value-oriented'** requires one to be early in setting the foundation for future investment returns. Value suggests buying when prices are lower and generally out of favor. Assuming the pricing analysis is correct, the timing aspect to realizing the value is impossible to predict in any short-term period.

Our global and value-orientation attributes contributed to better performance during the early 2000's and has been a detractor leading into 2014. Our small cap overweight and growth stock under-weight contributed to performance in the early 2000's. Our early exit from small cap stocks in the last 5+ years detracted from performance. In 2014 our small cap overweight is beginning to show its potential promise and we remain confident in our convictions.

Another of our strong conviction today lies in our international allocation. The US stock market has significantly outperformed the broad international stock markets in the last 5 years. For example the S&P 500 has returned 15.70% and the MSCI EAFE has returned 6.56% for the 5 years ending September 30, 2014.

The mixed news coming out of Europe and to some extent Japan has beaten down security prices in international markets. By some estimates, US equities are trading at a 60% premium to international stocks and an 80% premium to emerging market stocks on a price-to-book valuation metric (Brandys Investment Partners July 2014 'International Equities Now: the Why and How').

As we watch the managers of active allocation funds and global equity funds, we have noticed a growing allocation to international stock in their portfolios. In many instances, international stocks now represent the most heavily weighted asset class in the portfolio. This is particularly true for price-conscious value investors.

One theme espoused from several of our management visits recently was a disconnect between corporate profits and valuations in the US and internationally. Corporate profits in the US are riding elevated levels. A frequent question is whether they can sustain their current pace. When combined with faster rising security prices, the earnings growth story raises questions about the sustainability of higher US stock prices.

On the other hand, corporate profits in Europe are analyzed by many to be lower than average in the current economic cycle. If this is true, and they have the ability to return to just average metrics, when combined with lower stock prices the potential return for international stocks is compelling. We are witnessing our international managers notably increasing their allocation to European and Japanese stocks. As value investors, we are encouraged by what appears to be a mispricing in this asset class and our manager's active plan to take advantage of the opportunity.

### THE ABULS, BONE & ELLER EQUITY ALLOCATION AS OF SEPTEMBER 30, 2014:

| | |
|---|---|
| Large Cap Value | 22% |
| Large Cap Growth | 22% |
| Small Cap Value | 1.5% |
| Small Cap Growth | 0% |
| International Large Cap | 25.5% |
| International Small Cap | 4% |
| Emerging Markets | 6.50% |
| Natural Resources | 4.5% |
| Allocation Funds | 10% |
| Cash | 4% |
| Total | 100% |

### THE ABULS, BONE & ELLER INCOME ALLOCATION AS OF SEPTEMBER 30, 2014:

| | |
|---|---|
| Core Bonds | 60% |
| Global Bonds | 20% |
| Multi-Sector Income | 10% |
| Allocation Funds | 10% |

## REQUIRED DISCLOSURES

Views expressed in this newsletter are the current opinion of the author, but not necessarily those of Raymond James & Associates. The author's opinions are subject to change without notice. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Past performance is not indicative of future results. This is not a recommendation or a solicitation to buy or sell any security. Investments and strategies mentioned may not be suitable for all investors. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices rise.

Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Investments are subject to market risk, including possible loss of principal. Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US. Alternative investment strategies involve greater risks and are only appropriate for the most sophisticated, knowledgeable and wealthiest of investors. High-yield bonds are not suitable for all investors. When appropriate, these bonds should only comprise a modest portion of your portfolio.

The S&P 500 is an unmanaged index of 500 widely held stocks. The MSCI Emerging Markets Index is designed to measure equity market performance in global emerging markets. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. Barclays Capital U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government / Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. The MSCI EAFE (Europe, Australia, and Far East) index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. It is not possible to invest directly in an index. The Vanguard REIT Index is a real estate investment trust fund that offers investors wide exposure in the real estate sector at a low price. The fund holds each of its stocks in approximately the same proportion as the weighting in the MSCI US REIT Index. It is not possible to invest directly in an index.

The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities.

The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability.

This analysis does not include transaction costs and tax considerations. If included these costs would reduce an investor's return. As federal and state tax rules are subject to frequent changes, you should consult with a qualified tax advisor prior to making any investment decision. Raymond James does not provide legal or tax advice on these or any other transactions.



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