WEISS WEALTH MANAGEMENT GROUP of RAYMOND JAMES®

THE WEISS REPORT

SMART AND STEADY

Volume 17, Number 3 | July 1, 2014

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Watching Grass Grow

It is amazing what an overly positive year can do to investor expectations. Calendar year 2013 was a powerfully pleasant year for the overall stock market. Popularly reported indices were up over 20%. This significant market growth elevated the value of portfolios. However the almost uniformly positive market for the year also elevated investor expectations for 2014.

Like a child anticipating a big present, investors sat wide-eyed waiting for 2014 to deliver another straight up market just like 2013. As of May 31, 2014, markets have gone mostly sideways. The Standard & Poor's 500 (S&P 500) has grown approximately 5%, however the small-cap Russell 2000 has declined almost -3.5%.

This disconnect shows a lack of true growth in the overall market for 2014. Index investors, those who place their faith in popular "no-load" index investments, likely have seen their eyes glaze over from boredom. For these investors it is essentially like watching grass grow.

It is important for active investors to recognize that sideways moving markets require patience. The reason patience is important is because sideways markets can be a signal of an upcoming correction, but can also be a consolidation period from previous gains leading to another leg up in a bull market. By definition, sideways markets imply that there are an equal number of willing sellers as there are buyers. At some time in the future that balance will cease to exist and new highs or lows will come.

We have noted many times in the 17 years we have been writing this commentary that the dominant emotions that drive investor behavior are greed and fear. When these emotions are at extremes, markets are also most often at their extremes. When corrections are likely, people wonder whether they should liquidate their holdings for cash and let the market decline. The problem with this tactic is that even if one is right as to the timing of when to liquidate, the investor must then make another decision of when to repurchase their holdings. Don't forget one of Weiss Wealth Management Group's market axioms. The market will do what it needs to do to confound the most number of people in the short term.

This is why we are willing to raise some cash when we think a correction is likely, but we are willing to hold positions we think will stand up to a headwind.

In cycles like this, we are reminded that it is a market of stocks, not a stock market. This means that there are opportunities available regardless of what the larger market is doing. In times like this, we gravitate toward trends that are growing robustly. Recently, we have seen appreciation in the energy MLP, transportation, and manufacturing sectors.

What we expect ahead:

As 2014 approached, the consensus of economists expected an economy with accelerating growth coupled with rising interest rates and inflation. Now that the year is more than half over, we expect to see some hand wringing and backtracking on those forecasts.

At this time, their expectations seem to not match reality. Economic vitality, as judged by GDP growth, is virtually stagnant at a stall speed. We have been told many times in the last 5 years that accelerating growth is right around the corner. Last winter, the consensus of economists forecasted the GDP near 3% growth for 2014. This is now going to be very difficult to achieve given the first half of 2014.

Part of the rosier forecast for 2014 had interest rates rising reflecting a more robust economy. We began the year with the benchmark 10 year Tbond near 3%. The forecast was for rates to rise to 3.5-4% by year's end. The 10 year rate has actually fallen to 2.55% as of May 31st, 2014

Inflation is like cholesterol. There is good inflation and bad inflation. Good inflation is usually seen in rising commodity prices. In the last five years the price of gasoline has doubled, beef prices are at all-time highs, and staples such as coffee, fruits and vegetables have spiked in price too. However, last year was the first year on record where more small businesses closed their doors than opened. Lastly, other inflation components such as the price of clothing have declined. The combined result of this has had little effect on core inflation.

But there is bad inflation. Bad inflation is driven by wages rising faster than worker productivity. As noted above, there is too much unused capacity in our economy for wages to rise. In fact, they have been stagnant, and median family income has been declining in the last five years. Without more economic activity, we don't see how bad inflation can begin. We still see the Plow Horse Economy, a phrase coined by Brian Wesbury of First Trust Advisors and regularly mentioned in The Weiss Report.

In the near term, we are finally joining those who are expecting a correction. There are plenty of data points that point us in this direction. However our favorite research tool for markets like this is a gauge of investor sentiment. When bullish sentiment is too high, it indicates that most people are fully invested and greed is dominant. Going by our old adage, most people cannot be right most of the time, too much optimism can turn into an inflection point for a correction.

Our expectation is not all bad. Even after factoring in a possible correction, there seems to be little reason to think the economy is headed back into a recession. As noted above, there are some sectors of the economy that are booming. Accordingly, we do not see a correction turning into a bear market at this time.

Portfolios:

Portfolios we manage by discretion have been reviewed during this sideways market. We are currently over weighted into the aforementioned sectors: energy MLPs, transportation, and manufacturing. These portfolios also hold tactical managed investments that are designed to limit risk in down periods.

Both within managed investment and individual holdings, we have focused on dividend paying stocks. When selecting investments with this trait, we look for companies that treat a dividend or distribution as an expectation rather than a bonus. A perfect example of this is Union Pacific Railroad (UNP – NYSE $99.79). This company, held in many portfolios, has paid a dividend on common stock for 115 consecutive years. That is not a typo. This commitment to dividends is an example of something we look for in a conservative, high-quality stock.

The energy MLP sector continues to excel. Through the end of May, the Alerian MLP Index has gained 7.68% for the year. As mentioned previously, the S&P 500 is up approximately 5% in the same time. We see this overachievement as a vote of confidence in the build out of our pipeline infrastructure. The increase in pipelines is needed to process the newly found enormous oil and natural gas reserves.

Enclosures:

Enclosure #1 We have heard over the past few years that the unemployment rate has been steadily falling. It is currently reported near 6.5%. While this number sounds nice, upon further examination the true numbers tell a different story.

The Bureau of Labor Statistics (BLS) has different calculations of unemployment. The headline number reported in the media (BLS U3) is derived by only counting people receiving benefits. The hundreds of thousands of people who leave the work force each month and are no longer looking for work are not considered unemployed anymore by the this calculation! With this concept, if all unemployment benefits were revoked, the unemployment rate would fall to 0%. But as mentioned, the BLS has different calculations of unemployment. BLS U6 is a combination of the BLS U3 number plus the number of people who have lost benefits and are no longer counted in the BLS U3 and the number of people who say they are working part time because they can't find full time work. Weiss Wealth Management Group believes the BLS U6 is the best measure of unemployment. When you see the data, you will see that the current rate is still above 12%.

Enclosure #2 is a recent commentary from Chief Investment Strategist for Raymond James, Jeff Saut. His weekly commentary of June 23, 2014 focused on the problems associated with managing assets when a correction seems warranted.

The piece focuses of how managers and investors manage being wrong in their decision making. Have an investment process requires a strong dose of decision discipline. Making a decision to buy or sell must occur before the decision maker can know if the outcome will favor a decision. As much as we try to anticipate the future, the truth is it cannot be done. We can only hope that a disciplined practice can lead to more decisions that work favorable. Still, we know that we have to wrong at some point too.

Enclosure #3 is our attempt to show you the long-term effects of innovation. We are intrigued by all the innovation we've seen over the decades and the overwhelming amount of innovation that has been developed in the United States.

To highlight this innovation, we look to the Indianapolis 500. Looking at the winning driver's speed can show us how much in awe we should be by our own achievements.

What is the Real Unemployment Rate?

HOUSEHOLD DATA
Table A-15. Alternative measures of labor underutilization

[Percent]

Measure	Not seasonally adjusted			Seasonally adjusted					
	May 2013	Apr. 2014	May 2014	May 2013	Jan. 2014	Feb. 2014	Mar. 2014	Apr. 2014	May 2014
U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)	7.3	5.9	6.1	7.5	6.6	6.7	6.7	6.3	6.3
U-6 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force	13.4	11.8	11.7	13.8	12.7	12.6	12.7	12.3	12.2

NOTE: Persons marginally attached to the labor force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not currently looking for work. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule. Updated population controls are introduced annually with the release of January data.

We believe the BLS U6 calculation of unemployment is the most accurate measure of unemployment. It includes those who are close to dropping out of the labor force, but also those who say they are working part-time but still seek full-time work.

What the calculation does not show is how many people are represented in the real unemployment rate. Forbes recently reported that as of yearend 2013, 102,896,000 people were either unemployed or out of the labor force. Put simply, this is the number of people that are not working. This figure is close to the populations of New York, California, Texas and Florida combined.

We see this condition as a leading cause to our stagnant economic growth. We also believe this condition to be an economic calamity that will negatively affect the career paths of many young adults.

RAYMOND JAMES

Investment Strategy
Published by Raymond James & Associates

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June 23, 2014

Investment Strategy: Revised

"Truth or Consequences?"

> After 28 years at this post, and 22 years before this in money management, I can sum up whatever wisdom I have accumulated this way: The trick is not to be the hottest stock-picker, the winning forecaster, or the developer of the neatest model; such victories are transient. The trick is to survive. Performing that trick requires a strong stomach for being wrong, because we are all going to be wrong more often than we expect. The future is not ours to know. But it helps to know that being wrong is inevitable and normal, not some terrible tragedy, not some awful failing in reasoning, not even bad luck in most instances. Being wrong comes with the franchise of an activity whose outcome depends on an unknown future (maybe the real trick is persuading clients of that inexorable truth). Look around at the long-term survivors at this business and think of the much larger number of colorful characters who were once in the headlines, but who have since disappeared from the scene.
>
> . . . Peter Bernstein

The aforementioned quote, from the brilliant Peter Bernstein (author, historian, economist, and investor), hangs on the wall of my office, for in this business one is often wrong. But, as Bernstein notes, "Being wrong comes with the franchise of an activity whose outcome depends on an unknown future." My redeeming feature is that when I am wrong, I am typically wrong quickly. Or as stated by William O'Neil, "The majority of unskilled investors stubbornly hold onto their losses when the losses are small and reasonable. They could get out cheaply, but being emotionally involved and human, they keep waiting and hoping until their loss gets much bigger and [that] costs them dearly."

Importantly, I am always trying to manage the "risks" inherent with investing (or trading), for as Benjamin Graham stated, "The essence of investment management is the management of risks, not the management of returns. Well-managed portfolios start with this precept." And that, ladies and gentlemen, is why I often "wait" on an investment until its share price is at a point where if I am wrong, I will be wrong quickly, and the incidence of "loss" will be small and manageable. To be sure, I am always considering the consequences of being wrong. This is when risk management lives up to its real meaning. Again as Peter Bernstein wrote in a recent *New York Times* article:

> The key word is 'consequences.' I learned this lesson many years ago from studying Blaise Pascal, a French mathematical genius in the 17th century who spelled out the laws of probability more clearly than anyone before him. This was a thunderclap of an insight that, for the first time, gave humanity a systematic way of thinking about the future. Pascal was both a gambler and a religious zealot. One day he asked himself how he would handle a bet on whether 'God is or God is not.' Reason could not answer. But, he said, we can choose between acting as though God is or acting as though God is not. Suppose we bet that God is, and we lead a life of virtue and abstinence, and then the day of reckoning comes and we discover that there is no God. Well, life was still tolerable even if less fun than we might have liked. Here, the consequences of being wrong would be acceptable to most people. Suppose, however, we bet that God is not, and lead a life of lust and sin, and then it turns out that God is. Now being wrong has put us into big trouble.
>
> RISK management, then, should be a process of dealing with the consequences of being wrong. Sometimes, these consequences are minimal — encountering rain after leaving home without an umbrella, for example. But betting the ranch on the assumption that home prices can only go up should tell you the consequences would be much more than minimal if home prices started to fall.

To these "truth or consequences points," I turned cautious on the equity markets as the S&P 500 (SPX/1962.87) traveled into its upside target zone of 1950 – 1975, which was generated by the SPX's upside reversal session of April 15, 2014 when the SPX reversed from its intraday low of 1816. Last Wednesday morning, however, I wrote, "Still, the market 'feels' like it is coiling-up for a post FOMC move and right now the weight of the evidence suggests it will be up." And on Thursday morning I

Please read domestic and foreign disclosure/risk information beginning on page 3 and Analyst Certification on page 3.

noted, "Such a large short position should put the 'carrot in front of the horse' for an upward bias into Friday's expiration expiation." Of course those quips were trading "calls" and not an investment "call." So far that trading call has proved generally correct with the SPX lifting from Wednesday morning's low of ~1939 into Friday's expiration close of ~1963. It will be interesting, therefore, to see if the 1950 – 1975 zone is going to offer the anticipated formidable upside resistance this week. Keep in mind, all of these "trading calls" are to be considered within the construct of a secular bull market, a point CNBC's Mandy Drury questioned me on last Friday.

To be specific, she asked, "So Jeff, what do you think could be the biggest obstacle ahead of us, what is the potential either black swan event, or something out there that you see that could bring all of this undone?" I responded, "Well, over the weekend it looks like ISIS has diverted its attention from Baghdad to Samarra, which is the most holy Shia city in Iraq. And, if they take that city and start desecrating the temples, and some of the other religious objects, you could have a holy war break out in the Middle East that could drag in other nations. I don't know if that is going to happen, but it certainly has the potential now that they are focused on Samarra." To which Mandy said, "And you think that would really hurt our market?" Again I responded, "Unless we get a spike in the price of oil, I think it is going to be non-impactful. But if you get a spike in the price of oil, it is going to be impactful for the U.S."

Speaking to crude oil, surprisingly it was down -0.02% on the week basis WTI (spot), but is up 8.5% YTD. More importantly for the U.S. consumer, gasoline (NY, spot) was up 2.31% for the week, leaving it higher by 12.06% YTD. Yet of everything I follow, silver (Handy & Harman Base) had by far the biggest Weekly Win with a 6.68% gain. Such action broke silver out of a basing pattern in the charts that began in June 2013. The same can be said of gold, which is why I wrote this in Friday's *Morning Tack*. To wit, "While I am certainly no 'gold bug,' it does feel like gold could trade into the zone between its recent high of $1390 and its August 2013 high of ~$1430. Unsurprisingly, the idea of buying depressed gold, and gold stocks, as opposed to buying some of the "up on stilts" darlings of the past few years, has a certain appeal to a contrarian like me." Obviously the reason for the strength in precious metals, and commodities in general, were last week's stronger than expected inflation reports, and the statement from Janet Yellen that it didn't matter, interest rates are going to remain low. In my view Ms. Yellen made a mistake with her inflation is "noise" comment. The months ahead will tell us if this insight is wrong or right, aka Truth or Consequences!

With everything else capturing the headlines last week, what went largely unnoticed was a decided shift in analysts' earnings expectations with earnings revisions for the S&P 1500 flipping from more negative revisions to more positive revisions. And maybe, just maybe, that is what caused the P/E multiple expansion we have seen year-to-date. Verily, the trailing 12-month P/E for the SPX has expanded from 17.06 at the start of the year to 17.93 as of Friday. On a sector basis, 8 of the 10 S&P macro sectors have experienced P/E multiple expansions YTD with Energy seeing the largest (16.62 vs. 14.95). The only two sectors seeing a contraction are Consumer Discretionary and Telecom. I have liked Energy all year and have often mentioned Goodrich Petroleum (GDP/$28.65/Outperform), which has drilling results due at the end of this month. For more information, please see our fundamental analyst's report.

The call for this week: Late last week Saudi Arabia warned of the risks of a civil war in Iraq with unpredictable consequences for the region. The problem is things are happening so fast it is hard to know what to do. As Joint Chief of Staff General Martin Dempsey reported to Congress last week, "Until we can actually clarify this intelligence picture [our] options will continue to be refined." What he was referring to was the fact that over a two-day period a military base next to the city of Mosul had been controlled by Iraqi forces, then occupied by ISIS, and then seized by the Kurds. Plainly, time is running out for a political solution. So far, however, our equity markets don't seem to care with this morning's SPX futures up 1 point even though over the weekend Baghdad forces abandoned the Jordan border, leaving the entire Western frontier outside of government control. I guess China's stronger manufacturing growth is offsetting Iraq, at least for now. Let's see how the SPX handles the 1950 – 1975 resistance zone.

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Underperform (Sell)	5%	3%	0%	16%	0%	40%	0%	0%

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Innovation and the Indy 500

Every year on Memorial Day weekend, Indy Car Racing presents the Indianapolis 500 at the Indianapolis Motor Speedway. They have run this race since 1911. We think that a great way to anecdotally see how technology and innovation has advanced is to note the speed achieved by the drivers.

The driver who achieves the fastest practice lap wins the pole position. This means that they will have the "best" position when the race begins. The speed of the pole position winner was not kept until 1915. That year, the winner clocked in at a speed of 98.9 miles per hour.

Over time, the winner's speed steadily rose. This increase in speed can be attributed to the application of new building materials, new car designs, tires, fuel, and suspensions.

Year	Name	Speed
1950	Walt Falkner	136.5 MPH
1960	Eddie Sachs	146.6 MPH
1970	Al Unser	170.2 MPH
1980	John Rutherford	192.3 MPH
1990	Emerson Fittapaldi	225.3 MPH
2000	Greg Ray	223.5 MPH
2014	Ed Carpenter	231.1 MPH

Most of us are very comfortable driving on interstate highways at or above 70 MPH. The driver in the pole position for the 2014 Indy 500 travelled just over three times that speed.

We believe that innovation is a main driver of economic growth. As evidenced by the increasing speeds over time, significant innovation has occurred in this field. This is just one example of how innovation can change things right before our eyes. Sometimes it requires a view over time to truly see the magnitude of the change.