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MONTHLY INVESTMENT OUTLOOK

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Meritas Advisors structures portfolios to meet our clients' personal goals and preferences within the scope of their risk tolerance. We strive to manage risk most effectively by utilizing a wider blend of asset classes, with the objective of achieving our client's goals with a reduced amount of overall portfolio volatility.

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Dear Clients and Friends: For months we've been warning that the run up in the equity market is built on tenuous ground and yet the markets have stubbornly continued their upward trend. I've talked to many other portfolio managers who've confessed that there are days when they just have to look away from the markets, as the seeming irrational exuberance puts one into an ever more challenging position. We know that the market must at some point more accurately reflect the underlying realities, but as that oft quoted economist John Maynard Keynes said, *"The market can stay irrational longer than you can stay solvent."* The question is, when does economic reality meet up with market behavior? Oh what any of us would give to be able to divine that date! While we wait, we need to engage with the market and carefully take advantage of the run up, while implementing protection when and where we believe it to be appropriate and cost-effective.

We'll cover what is happening in the markets and economy this month, but thought it would be useful, with all the talk concerning Dodd Frank and financial regulation, to go over how banks work and what the brouhaha over capital requirements means.

Lenore Hawkins, MBA, Principal

Where's the Boogeyman?

With the markets on a roll, our prose may at times appear overly cautious as we assess the markets, but remember that's our job. Portfolio managers are essentially professional worriers, looking around every corner and under every data point for the hint that a major shift is on its way as our primary job is to protect. These days many of us feel like we are in a CNBC version of a thriller, with the ominous music getting louder and louder as our handsome hero approaches the dimly lit house. When is the boogeyman going to jump out!?



"For as long as I can remember, veteran businessmen and investors – I among them – have been warning about the dangers of irrational stock speculation and hammering away at the theme that stock certificates are deeds of ownership and not betting slips... The professional investor has no choice but to sit by quietly while the mob has its day, until the enthusiasm or panic of the speculators and non-professionals has been spent. He is not impatient, nor is he even in a very great hurry, for he is an investor, not a gambler or a speculator. The seeds of any bust are inherent in any boom that outstrips the pace of whatever solid factors gave it its impetus in the first place. There are no safeguards that can protect the emotional investor from himself." J Paul Getty (Hat tip to John Hussman for helping us recall this sage sentiment.)

Looking at today's markets, *"Never have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk."* Bill Gross of PIMCO on May 14th, 2013. Ouch!

Stock Markets

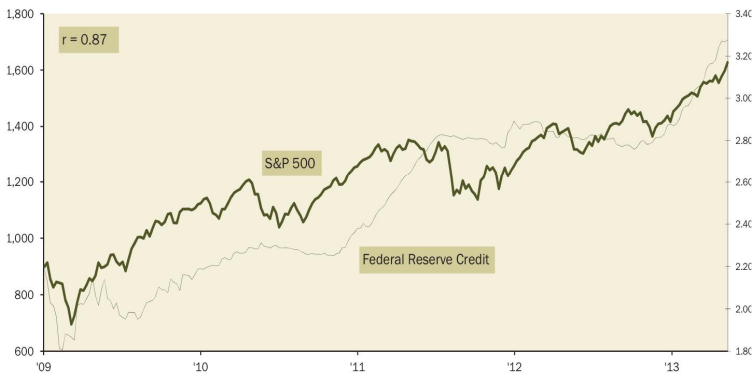
On May 22nd the markets became exceptionally jittery, the boogeyman soundtrack getting a tad louder. Concerns over a withdrawal or reduction of the Fed's bond buying program from Ben Bernanke's comments before Congress coupled with the minutes of the FOMC added to increasing nerves over the level of data fakery coming out of China, which has turned up the volatility volume considerably. Keep in mind that *if the stock market were to be reflective of the fundamentals and not experiencing a Fed induced bubble, why the tizzy fit at the slightest whisper that the Fed could reduce its bond buying program*, a program which has seen the Fed's balance sheet increase a mind-blowing 40% year-to-date? Whether this is the beginning of a correction or a temporary blip remains to be seen, but the dramatic swings during the day warrant caution. Is that the theme from Halloween I hear in the distance?

- May 22nd the Japanese Nikkei fell 7.3%, its biggest drop since the tsunami/nuclear disaster in March 2011. Before Thursday, the Nikkei has risen 50% this year and 10% in less than two weeks. Kudos to ZeroHedge for the chart at right which points out how similar the recent run up has been to the boom and following bust in 1987.
- After the tumult in Japan, investors quickly jumped out of riskier assets. Spanish and Italian government bonds weakened, as did more-speculative currencies like the South African rand. Havens such as German government bonds and the Swiss franc gained. Gold rose.
- Hong Kong's Hang Seng dipped by 2.5%. Shanghai maintained a moderate fall at just 1.2%. The following day all the major European markets dropped by over 2%.

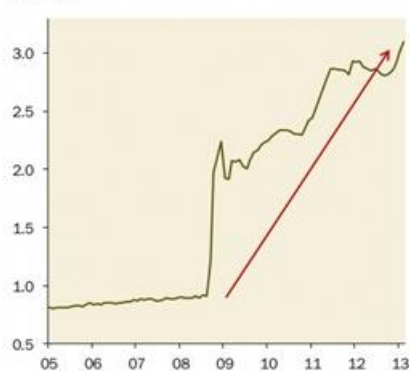


Bottom Line: *We doubt the past few rocky few days are the start of the correction we've been expecting as the primary drivers of the market run, namely Central Bankers, are still putting pedal to the metal, despite the nerves over yesterday's FOMC meeting notes, (see charts below). We do think that it is likely we will continue to see volatility increase in the coming months before we see any potential correction.*

S&P 500 (left axis, index)
Federal Reserve Credit (right axis, \$trillions)



Fed Balance Sheet - Total Assets (\$ trillion)

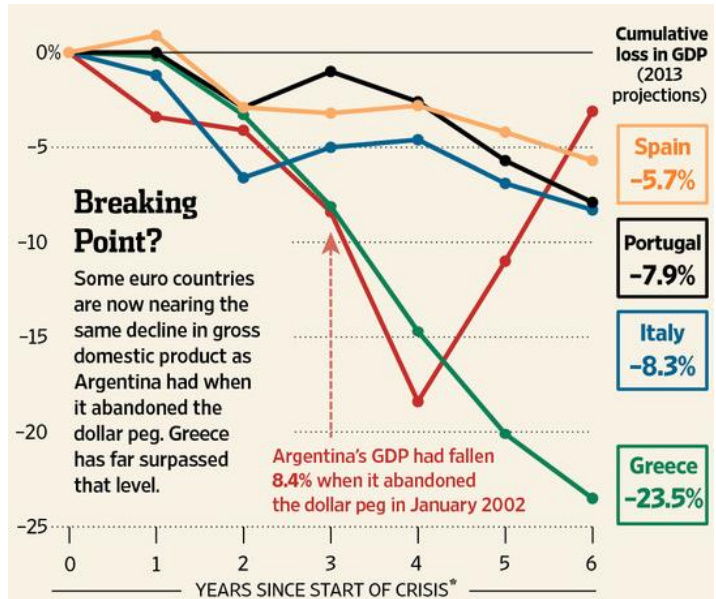


Source: Haver Analytics, Gluskin Sheff

Eurozone

In Europe the situation continues to worsen. The chart below from the Wall Street Journal shows the cumulative decline in GDP from the start of the financial crisis and how it compares to when Argentina gave up its peg to the U.S. dollar. It is interesting to note that the vast majority of Argentinians, much like the Europeans, wanted to maintain the dollar peg until suddenly one night, they didn't. I call this the Grain of Sand Effect. Major shifts often occur as a result of the drop of one last grain of sand onto the pile that causes the mountain that had built up to fall apart, rather than from some obvious cataclysmic event.

According to the Wall Street Journal, "EU policy makers who take comfort in the apparent popularity of the euro should consider that Argentinians also widely supported the dollar peg—right up until the moment they exploded. In a poll published in December 2001, the same month that Argentinians rioted, just 14% said the currency regime should be scrapped; 62% said they wanted to keep it. That's virtually the same proportion of Spaniards and Greeks who say they want to keep the euro today."

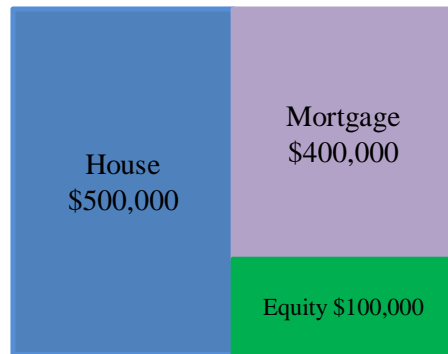
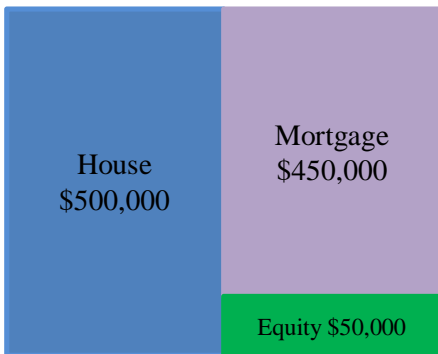


Bottom Line: Public opinion can change in an instant, particularly as more and more of that public loses hope that tomorrow will be an improvement over today. European youth unemployment is dangerously high and the majority of the countries have little hope that significant growth, and the ensuing jobs, will return anytime soon. What level of desperation will it take before the first country chooses to leave the euro, hoping that will shock its economy back to life? If that happens, how quickly would others follow? History has shown that currency unions don't end well. Can this time truly be different?

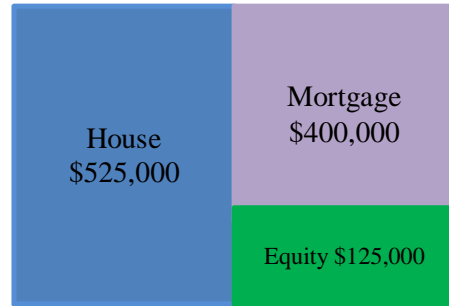
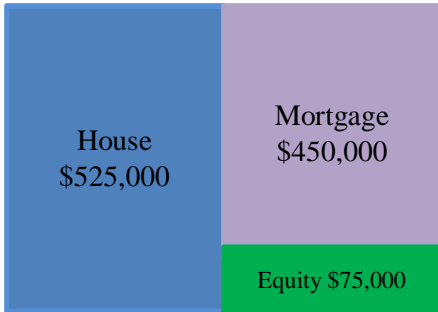
Banks Demystified

There has been a lot of jawboning on Capitol Hill and in the media over how to make the banks safer. We've been told that those in charge will make sure that the market terrors resulting from "too big to fail" will not be repeated. If we are going to address the illness, we need to first understand the anatomy of a bank and just what this contagion cold was all about. We'll start out with an example everyone can relate to and then apply it to the banks.

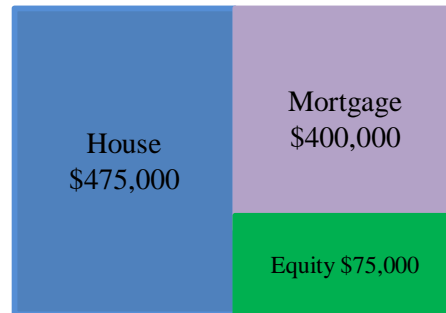
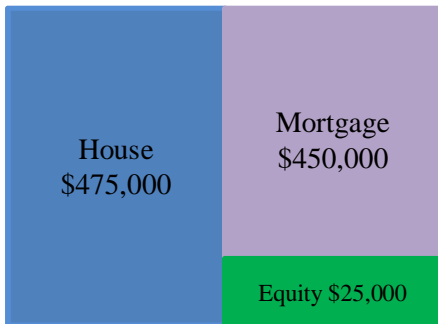
Jane wants to buy a home for \$500,000. She is not able to pay all cash for it, so let's look at two scenarios, one in which she puts down 10% or \$50,000 and one in which she puts down 20% or \$100,000.



If the house increases in value 5%, the home will be worth \$525,000. The mortgage is unaffected by the change in the home's value. Jane's down payment/equity in her home increases 50% from \$50,000 to \$75,000 if she had put down 10%. If she put down 20%, it increases only 25%. Here we see that the less she puts down, the lower her equity, the higher her return. Remember all the zero or very little down mortgage programs back in the housing boom? They made sense if you truly believe that home prices could only go up. But what if they drop?



If the house decreases in value 5%, the home will be worth \$475,000. Again, the mortgage is unaffected by the change in the home's value. Jane's down payment/equity in her home decreases 50% from \$50,000 to \$25,000 if she had put down 10%. If she'd put down 20%, it would fall only 25%. This illustrates that the more equity is invested, the less that investment is affected on a percentage basis by a downturn in asset price.

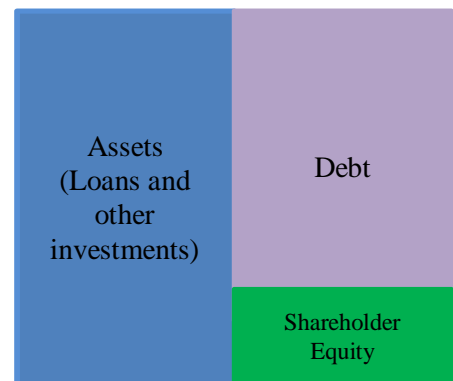


Borrowing creates leverage and makes the equity investment riskier while equity acts as a buffer that can absorb losses on the house. The more equity, (the larger the down payment) the more likely Jane is to remain above water and have some equity left in her home, even if it drops in value. This is why prior to the housing bubble, banks typically demanded 10%-20% down.

The same balance sheet can be used to explain how corporations in general and banks specifically work. Banks have equity investors (down payment). They borrow money, typically on a short-term basis (mortgage) and then lend on a long-term basis, which is the asset/house in our previous example.

When you hear references to bank capital, what they should be referring to is the Shareholder's Equity (down payment). However, the discussion of bank regulation has become quite convoluted and unfortunately many on Capitol Hill and in the media aren't exactly clear on their terms so the term is often misused.

Banks use both the borrowed money (mortgage) and the unborrowed money (down payment) to make loans and other investments (assets). Capital regulation requires that a sufficient portion of the bank's investments (assets) be funded with unborrowed money. In our previous example this is synonymous with a minimum down payment requirement.



Many companies fund their activities using both borrowed and unborrowed money. For the vast majority of nonfinancial corporations in the United States, borrowing represents less than 50% of assets, which means that their δ down payment δ is 50% or more. From our previous example, it is easy to see that this provides them with a very nice cushion when times get tough.

By contrast, for banks debt is often more than 90% of assets, meaning the δ down payment δ is less than 10%. For some large European banks debt can be even higher, over 96%! Some of the major U.S. investment banks found themselves in this position before 2007, as did the mortgage giants Fannie Mae and Freddie Mac. You δ ve probably heard about how banks are such a great investment.

Going back to our home analogy, if these banks had only 3% shareholder equity, it wouldn δ t take much of a rise in their assets to result in a spectacular return on equity (down payment). But the reverse is true as well in that they would be δ underwater δ if their assets dropped by 3% or more. For most banks, their assets consisted of mortgages and other investments. With so many homeowners finding themselves underwater and walking away from their mortgages, the value of many mortgages fell well below the amount loaned. The only way the loan could be recovered to any degree was by foreclosing on the home and trying to sell the home. We know all too well what happened to home prices during this time, so it is easy to see how the value of mortgages would drop significantly as well. Recall as well how the value of most everything in the markets, stocks, bonds, commodities etc., all dropped significantly during the crisis which gives you an idea of how the δ other investments δ for banks fared.

For banks things were even worse. In our home buying analogy, the home owner has a mortgage which is typically paid off in full in 30 years. On a monthly basis the home owner, if they want to keep their home, just needs to scrape together enough funds for the monthly mortgage payments. Much bank funding consists of debt which is due in full on a very short-term basis of days to weeks, thus the bank runs the risk that it will not be renewed. In our home owner analogy, this would mean that the mortgage is due in full say every 90 days. There is nothing to worry about as long as Jane can get another mortgage every 90 days to pay off the one expiring, but what if the banks stop lending to her? What if she had only 3% down and her home value had dropped 5%. Who would lend to her? If no one will give her a loan, she will lose her entire 3%, even if her home has not dropped in value! This is the position that many of the banks found themselves in during the financial crisis. Their debt needed to be rolled over and no one would lend to them, thus Central Banks came in and provided the loans they needed. Sounds like a good idea right? This was the argument that the banks were facing a liquidity crisis. But what if the house that Jane bought for \$500,000 is still today only worth \$400,000? Is that still a liquidity problem or would you say that since she is still grossly underwater, she is insolvent? Hmmmmm, now to go take a good look at those banks δ assets and figure out just exactly what it is all worth, but that δ s for next month δ s newsletter as is a discussion on the ramifications of the mark-to-market requirement.



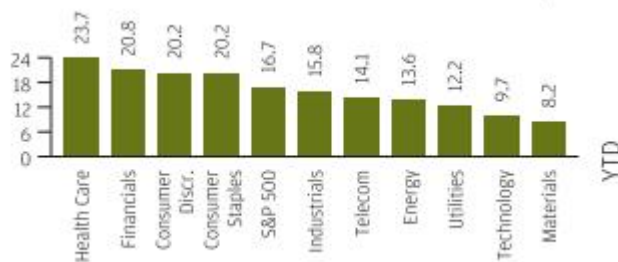
Greg Tull's Your Money

Traditionally, the investment advisory industry has recommended two main types of investments for client portfolios, equity (stocks) and fixed income (bonds). In most environments, high quality fixed income investments carry lower risk (as measured by price volatility) than high quality equity investments. To make a portfolio more conservative and less risky, a higher percentage of bonds is recommended, and to make it more aggressive, a higher percentage of stocks is recommended. A third category of investments has risen to increasing prominence over the past 20 years or so, going by the name of specialty fund or alternative investments. The category of specialty funds that we find most compelling at Meritas are those that seek to mitigate or decrease risk while generating additional returns per unit of risk that they are taking. Long/short funds are one example of specialty investments. Many specialty fund types appear first in the private markets, as opposed to being available on public exchanges with daily liquidity like mutual funds are. Increasingly,

specialty funds are being offered in the public markets in mutual fund form, with more regulation and transparency than those available in the private markets. Meritas often includes public specialty funds in suggested portfolios for two reasons. First, we believe they offer important diversification benefits to clients' portfolios. In addition, we believe that the best funds offer an opportunity to increase the returns generated for each unit of risk they take. For example, one of our favorite public long short funds has generated 5 year compound annual returns of 10.27%, with a standard deviation (risk measurement) of 12.69 as of April 30, 2013. Over that same 5 year time frame, the S&P 500 generated compound annual returns of 6.05%, with a standard deviation of 18.83. This means that not only did the long short fund generate greater returns than the index, they did so with lower volatility and less risk than the index.

Market Recap (as of May 24th, 2013)

Index Returns (%)						
Equities	Level	1 week	QTD	YTD	1 year	3-yr. Cum.
S&P 500	1650	-1.04	5.48	16.67	27.77	63.90
Dow Jones 30	15303	-0.29	5.31	17.96	25.36	64.62
Russell 2000	2446	-1.19	3.59	16.43	30.28	59.91
Russell 1000 Growth	498.47	-1.29	5.28	15.33	22.78	64.73
Russell 1000 Value	517.21	-0.98	5.06	17.99	33.21	63.67
MSCI EAFE	1733	-1.61	4.72	10.20	32.57	43.03
MSCI EM	1027	-1.77	-0.13	-1.70	17.07	25.01
NASDAQ	3459	-1.12	6.12	15.16	23.57	61.70
Fixed Income	Yield	1 week	QTD	YTD	1 year	3-yr. Cum.
U.S. Aggregate	1.96	-0.23	-0.10	-0.22	2.23	14.87
U.S. Corporates	2.79	-0.24	0.50	0.39	6.84	24.49
Municipals (10yr)	2.09	-0.37	0.37	0.73	3.77	19.97
High Yield	6.20	-0.30	1.99	4.94	15.83	42.52
Levels (%)						
Key Rates	5/24/13	5/17/13	3/29/13	12/31/12	5/24/12	5/24/10
2-yr U.S. Treasuries	0.26	0.26	0.25	0.25	0.29	0.77
10-yr U.S. Treasuries	2.01	1.95	1.87	1.78	1.77	3.23
30-yr U.S. Treasuries	3.18	3.17	3.10	2.95	2.86	4.12
10-yr German Bund	1.43	1.33	1.28	1.31	1.39	2.65
3-mo. LIBOR	0.27	0.27	0.28	0.31	0.47	0.51
3-mo. EURIBOR	0.20	0.20	0.21	0.19	0.69	0.71
6-mo. CD rate	N/A	0.26	0.27	0.31	0.47	0.68
30-yr fixed mortgage	3.78	3.78	3.76	3.52	3.93	4.80
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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