MERITAS ADVISORS
Comprehensive Wealth Management

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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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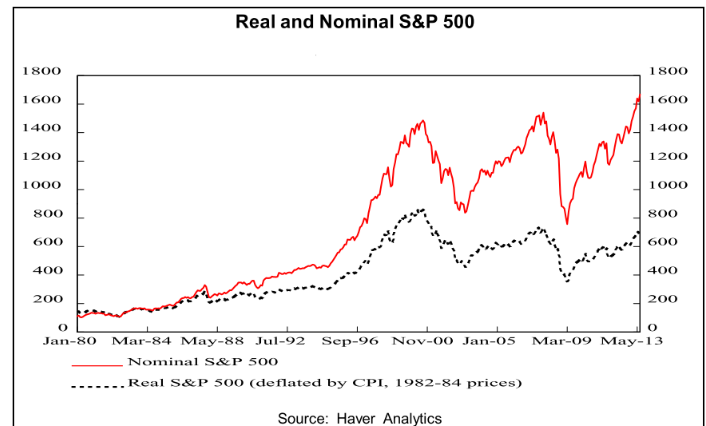
Dear Clients and Friends: As we head into the last days of summer, Wall Street continues its obsession with tapering talk from the Federal Reserve, so we thought we'd review where we are in the recovery and go over some simple stock market math to help you better understand just what it is that generates equity returns. We hope that you are yours are enjoying the warmth and sunshine of the season and thank you again for your continued trust.
Lenore Hawkins, Principal

Market Reality

With the headlines touting 52 week highs these days and the talk of a wild bull run in the market, it would be easy to assume that we're back on easy street. As always, it is useful to take a step back and look at the big picture. The chart below, (hat tip to Gary Shilling) shows that in real terms, the S&P is still well below its 2000 highs over thirteen years later, having put investors through a very rocky ride if they'd been fully and exclusively invested in equities.



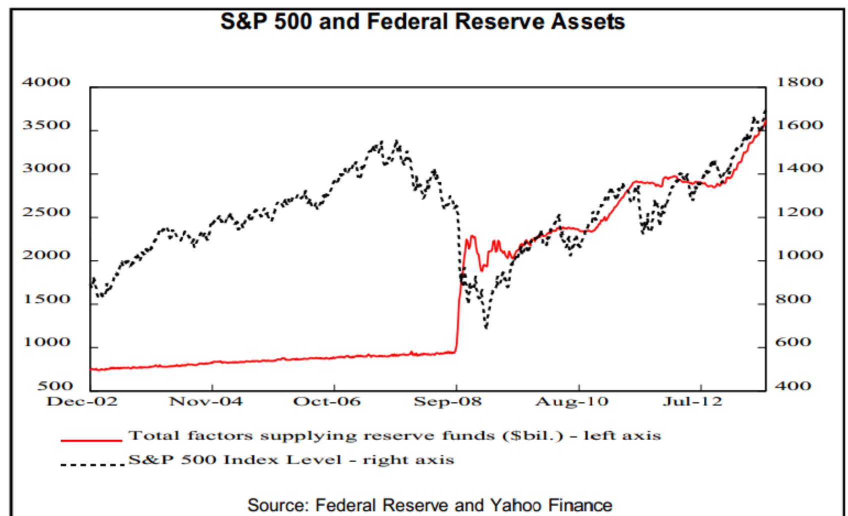
The stock market now faces a variety of headwinds that warrant close attention.

- A potential renewal of a contentious debt-ceiling debate by the end of September.
- Sentiment is running at highs similar to those seen just before the 2007 peak.
- Earnings growth was down to a meager 1% over last year in the most recent quarter.
- Revenue growth has been pared down to low single digits with continued reduction in clarity of outlook.
- Margin debt has risen over 30% in the past year, which means this is a highly leveraged market. Recall our discussions in previous newsletters of the volatility and risks associated with leverage.
- Valuations have P/E ratios hitting up against 3 year highs. We go into further detail on P/E ratios later in this newsletter.

Bottom Line: *Equities have been on a tear lately, driven largely by the Federal Reserve but we are still in a range bound market with increasing headwinds.*

The Fed and Equities

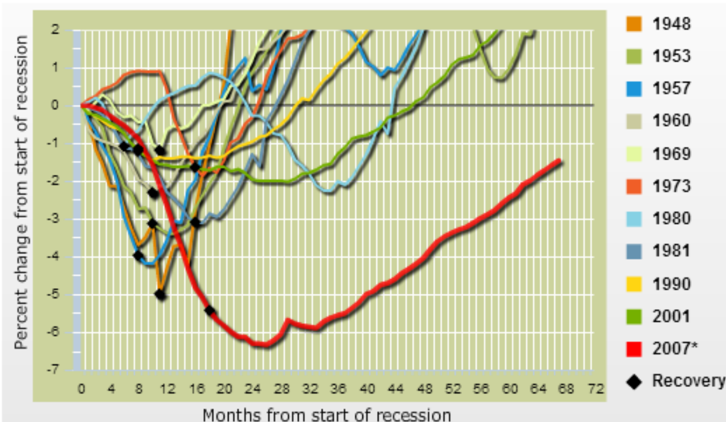
Our regular readers have heard us talk for some time about the impact of monetary policy on the stock market. The chart at right illustrates how prior to the financial crisis and its resulting series of quantitative easing programs, there was no correlation between the assets of the Federal Reserve and the S&P 500. In August of 2008 the Federal Reserve began the first of its expansive monetary policies and the impact that speaks for itself. The stock market now has a 90% correlation with the Fed's balance sheet, creating what one of our favorite analysts, David Rosenberg, refers to as the Potemkin rally.



When the Federal Reserve buys securities, such as treasury and mortgage bonds, it buys them from banks. The payments to the banks are then added to bank reserves, which can then be lent and re-lent in the fractional reserve system. (Click here for a quick primer on how our fractional reserve system works.) Historically this lending and re-lending resulted in an increase of about $70 in the money supply, (as defined by M2) for every additional dollar in reserves. With the current level of deleveraging, (reducing outstanding debt) occurring in the economy and with banks understandably nervous about lending, each new dollar in reserves has only boosted M2 by $1.4 for every additional dollar in reserves since the QEs began in mid-2008.

Research by Ken Rogoff and Carmen Reinhart, among others, revealed that the deleveraging cycle that occurs after a financial crises normally takes about 10 years, so we are likely only halfway through this process. All those excess reserves at the Fed, now totally about $2 trillion, aren't likely to be able to spur significant growth as long as the private sector is continuing the deleveraging process. ***Bottom Line***: *Since the financial crisis the stock market has been highly correlated with the balance sheet of the Federal Reserve despite the declining impact of Fed actions on the real economy. Changes in monetary policy which could reduce these reserves continue to dominate the market's attention with significant market volatility driven by comments made by Federal Reserve officials.*

Changes in US Employment: Recessions



* Start of recovery for the 2007 recession is June 2009.
Source: Federal Reserve Bank of Minneapolis
Updated August 2, 2013

Employment Recovery

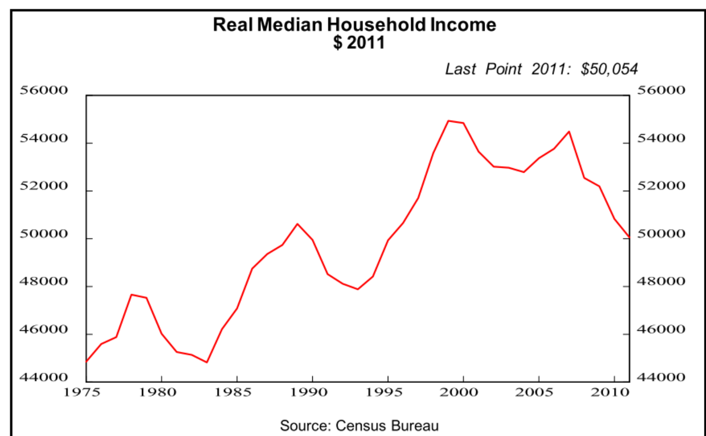
The popular media has been giving a lot of lip service to any glimmer of improvement in the labor market. At Meritas we like to go a bit deeper than the conventional headlines to understand what is really going on and believe that a longer-term perspective is invaluable. The chart at left shows the change in employment since the start of every recession going back to 1948. The current recovery, or rather lack of recovery in employment is without precedent. Today's unemployment rate is rather deceptive in that we have a significantly declining labor participation rate, meaning more and more people are leaving the workforce. If the labor participation rate, meaning the percentage of the population working

or looking for work, was the same today as at its peak in February 2000, the unemployment rate would be 13% versus today's 7.6%. Since the 2000 high, 9.83 million people have left the labor pool.

Fiscal tightening has also been affecting the labor market, but more dramatically than one would expect. State and local government spending represent the second largest GDP component after consumer spending. Municipal government jobs pay on the order of 45% more than private sector jobs, meaning that the loss of two state and local jobs is roughly equal to the loss of three jobs in the private sector in terms of lost income.

The quality of new jobs has been decidedly poor as well. In the first half of 2013 4.2 part-time positions were added for every 1 full time. The June employment survey reported a loss of 240,000 full-time jobs but an increase of 499,000 part-time jobs. The report also revealed that 38% of the 195,000 new payroll jobs were in the lower paying sector of leisure and hospitality, which is four times that sector's share of total employment. In contrast, the number of manufacturing jobs, which pay almost twice as much as leisure and hospitality positions, are still well below pre-recessions levels and continue to be in a long-term downtrend.

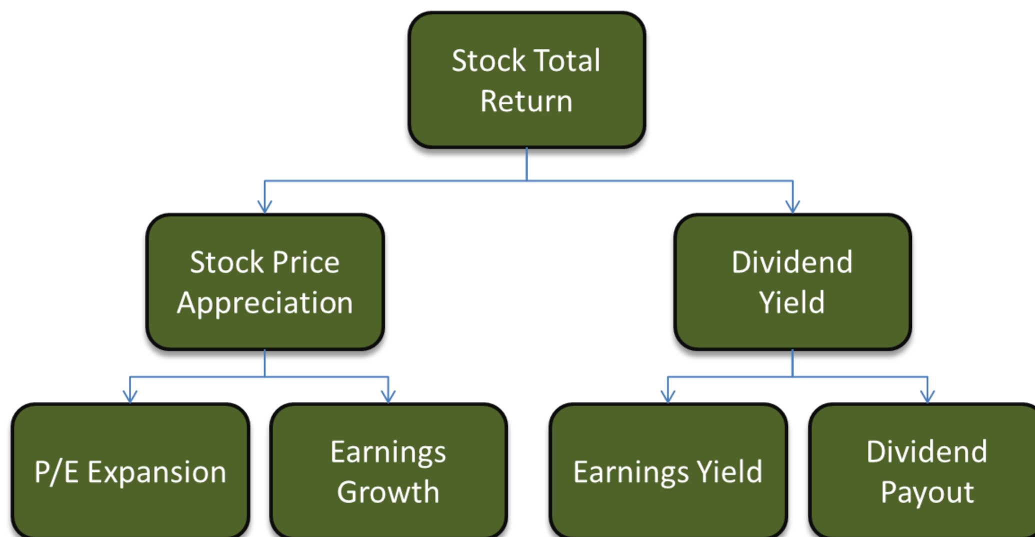
The lack of both quantity and quality of employment opportunities is visibility evident in the chart at right showing household income levels in 2011 dollars. With nearly 70% of GDP coming from consumer spending, the falling trend in income is a notable headwind to growth.



Bottom Line: *Economic growth depends primarily on two things: labor and capital. With a shrinking labor pool and falling wages it continues to be more and more difficult to generate the type of growth the United States has historically enjoyed.*

Simple Stock Market Math

There is a lot of talk, with convincing arguments from both sides, concerning whether stocks are poised to continue their upward trend from earlier this year or are they more likely to take a downward turn. To analyze that question properly, we must first ask, what is it that drives stock prices? Total stock returns are driven from two things: (1) stock price appreciation and (2) dividend yield. Oh great, that really helped, didn't it? Fair enough, let's take it a step further as each of these is driven by fairly easy to understand factors.



Stock price appreciation occurs if the price to earnings ratio expands and/or earnings increase. Dividend yield increases if the earnings yield increases and/or the level of dividend payout increases. Let's now investigate what would cause any of these four factors to increase.

P/E Expansion: The P/E ratio refers to the ratio between a company's earnings per share and its stock price. If a company earned $2/share last year with its stock trading at $24/share, its trailing P/E ratio is 12. P/E can be thought of as how much you are willing to pay for every dollar a company earns. P/E ratios are very helpful when comparing companies. At $465/share Apple is trading with a forward P/E of 10.7 while Google is currently around $890/share which represents a forward P/E of 18.3. The share price of either company doesn't really tell you much of anything, but the P/E ratio tells us that the market considers a dollar of Google earnings more valuable than a dollar of Apple earnings. Did you notice what I just did there though? I compared forward earnings. When we talk of P/E ratios, the E (earnings) can be anything from the past 12 months, to an average of the past 3-years, 5-years or even 10-years or in the case of a forward P/E ratio, forecasted earnings. P/E expansion means that P (price) has increased for the same E (earnings). Simply stated if you buy a stock today with a P/E ratio of 10 and that ratio increases to 12 in the coming months while E (earnings) remains unchanged, the stock price will have gone up and you will have a gain on your investment.

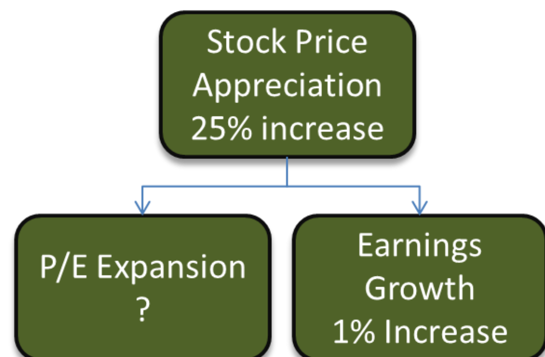
Earnings Growth refers simply to a company generating more income over time. This can result from an increase in revenue that exceeds any increase in costs or a reduction in costs that exceeds any decrease in revenues. Simply stated if you buy a stock today with a P/E ratio of 10 and that ratio remains unchanged in the coming months while E (earnings) increases, the stock price will go up and you will have a gain on your investment.

We've now covered the two factors that affect stock prices, however equity investment returns can also come from dividends. Dividends are driven by two factors, earnings yield and dividend payout.

Earnings Yield is the inverse of the P/E ratio, meaning it is the earnings per share divided by share (stock) price. If the stock price of Apple increases while the earnings remain flat, earnings yield will drop. We care about earnings yield because it affects how much a company can pay its shareholders in dividends. The higher the earnings yield, the higher the income a company has generated per dollar invested by shareholders, which means more funds are available to pay dividends, but how much is paid out in dividends is determined by the next factor.

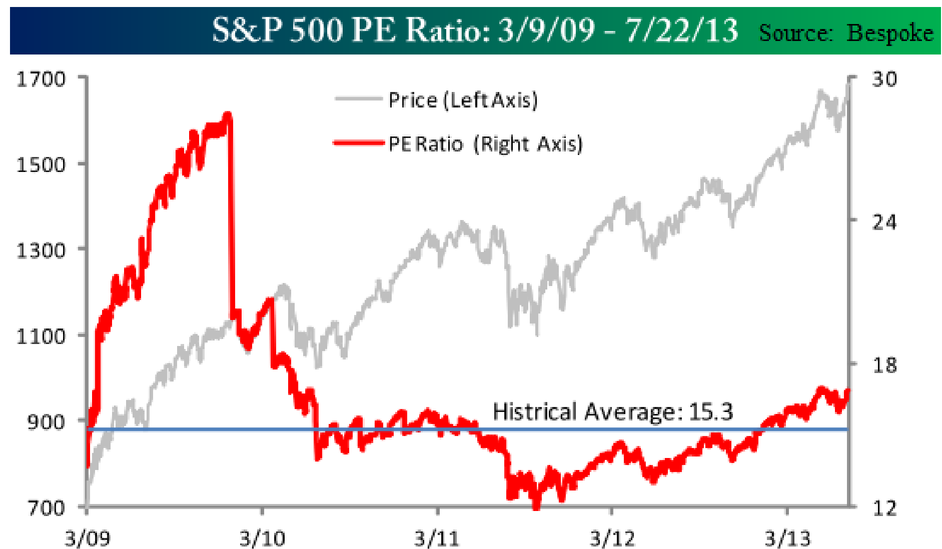
Dividend Payout Ratio is the percentage of earnings paid to shareholders in dividends calculated as the yearly dividend per share divided by earnings per share. The higher the dividend payout ratio, the greater the percent of earnings that are paid out to investors rather than being reinvested back into the company.

So where are stocks today as we look at these four factors? The second quarter earnings season is shortly coming to a close. So far the S&P 500's trailing four-quarter earnings per share on an operating basis is $99.60, which represents an increase of just over 1% in earnings from a year ago while the S&P 500 is up by nearly 25%. Using what we just learned, this means that we've experienced a significant P/E expansion.



The chart at right shows just how the trailing P/E ratio for the S&P 500 has risen and its impact on price. The trailing P/E ratio is currently above the historical average, which is one indicator that stocks are relatively overpriced today.

Next month we will go into further detail on the four factors we've discussed here and how they affect investment decisions.



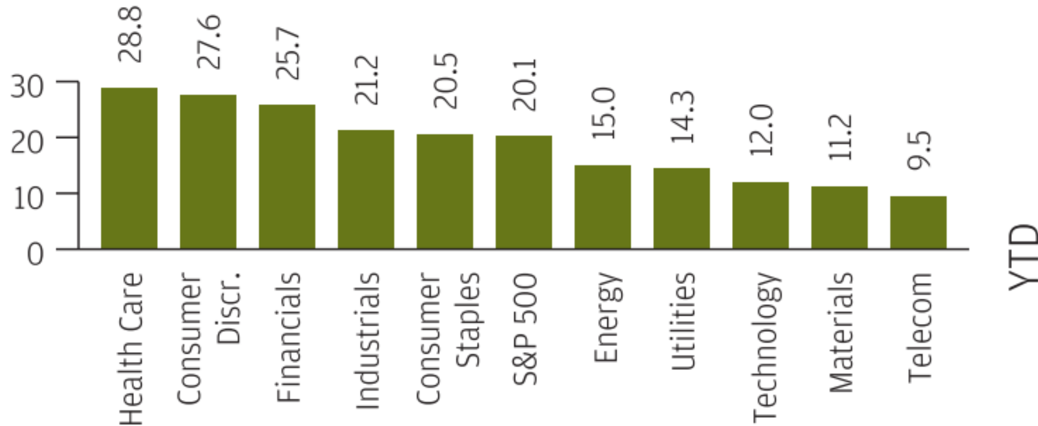
Greg Tull's Your Money

Today we will explore some of the lessons of behavioral finance, and how it can be a hindrance to investment performance. Behavioral finance is the study of how emotions and psychology can lead people to make decisions based on imprecise impressions and beliefs, rather than rational analysis. The field's origins are traced to Adam Smith's *The Theory of Moral Sentiments*, published in 1759. In 2002, Daniel Kahneman was awarded the Nobel Prize in Economics for his work in the field of behavioral finance. The thrust of behavioral finance is that human nature can often lead people to do the wrong thing at the wrong time with their investments. A practical example of this work is the annual Dalbar study of investor behavior. Dalbar's work shows that for the 20 years ending December 31, 2010, the average annual return of the S&P 500 was +9.14%, while the average annual return for the average equity fund investor was +3.27%. This 5.87% shortfall is referred to as the "behavior gap." One year returns show much more volatility than average annual returns, with the S&P 500's biggest calendar year return in the past 10 years being +28.2% in 2003 and its lowest year being -36.8% in 2008. A person's instinctive reaction to the pleasure of high returns is to want more of the investment that is doing so well, while the instinctive reaction to the pain of very negative returns is to want less of the investment that is doing so poorly. In many cases, these instincts are counterproductive. In last month's issue, we discussed the rebalancing that we do for client's portfolios. Rebalancing acts as an antidote to the pitfalls of behavioral finance, and also enables investors to take advantage of the opportunities created by behavioral finance. For example, when an asset class such as domestic U.S. equities falls out of favor and declines substantially, rebalancing will lead us to trim a sector that has done much better (e.g. bonds or international stocks), and buy more of the out of favor domestic equities when they are "on sale" at a discount. Rebalancing moves are optimized when they are done in the context of a personalized portfolio that is designed to match the total amount of risk taken in the portfolio with the investor's tolerance for risk.

Market Recap
(as of August 9th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1691	-0.98	5.55	20.14	23.30	60.04
Dow Jones 30	15426	-1.44	3.81	19.56	20.22	56.05
Russell 2000	2606	-1.06	7.35	24.37	32.47	65.64
Russell 1000 Growth	511.60	-0.85	6.21	18.75	20.80	61.46
Russell 1000 Value	533.67	-1.08	5.56	22.35	28.14	60.92
MSCI EAFE	1768	0.35	8.01	12.84	23.68	28.41
MSCI EM	951.37	-0.35	1.60	-7.95	-0.11	1.97
NASDAQ	3660	-0.70	7.72	22.19	22.99	64.43
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.34	0.14	0.29	-2.16	-1.28	9.76
U.S. Corporates	3.24	0.06	0.88	-2.56	0.05	16.35
Municipals (10yr)	2.99	0.01	-0.52	-3.28	-1.51	12.42
High Yield	6.74	-0.10	1.66	3.10	8.52	32.46

	Levels (%)					
Key Rates	**8/9/13**	**8/2/13**	**6/28/13**	**12/31/12**	**8/9/12**	**8/9/10**
2-yr U.S. Treasuries	0.32	0.30	0.36	0.25	0.29	0.54
10-yr U.S. Treasuries	2.57	2.63	2.52	1.78	1.69	2.86
30-yr U.S. Treasuries	3.63	3.69	3.52	2.95	2.78	4.01
10-yr German Bund	1.68	1.65	1.73	1.31	1.43	2.52
3-mo. LIBOR	0.26	0.27	0.27	0.31	0.44	0.40
3-mo. EURIBOR	0.23	0.23	0.22	0.19	0.37	0.92
6-mo. CD rate	N/A	N/A	0.27	0.31	0.42	0.51
30-yr fixed mortgage	4.61	4.61	4.58	3.52	3.76	4.57
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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