MERITAS ADVISORS

Comprehensive Wealth Management

October 24th 2013

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE:

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.

UPCOMING EVENTS

- Feb '14: **The Importance of Estate Planning** with attorney Nadine Aarsheim
- 05/07/14: **Top 10 Strategies to Enhance the Value of your Business** with M&A attorney Jessica Karner
- 09/15/14: **Maximizing the Value of your Privately Held Business** with David Ryan of Upton Financial
- Dec '14: **Vital tax Changes and Your Checklist** with Coree Cameron of Cameron Coffey & Kaye

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Dear Clients and Friends: We are sending our monthly outlook later than we had wanted as a bit of a kerfuffle has been going on in the capital which warranted our full attention. Perhaps you've heard it mentioned ever so briefly in the news? Yes, you detected a wisp of sarcasm. A Google search for "Debt Ceiling 2013" generates over 1 *billion* results.

On a more upbeat note, our own Greg Tull was recently inducted into the Phoenixville Area School District Sports Hall of Fame for his impressive swimming career, which includes a NCAA All American, several record-breaking sprint performances while at Harvard and his continuing accomplishments at the Masters level where he's been on world record-breaking teams. Congratulations Greg! Your accomplishments both in and out of the water continue to impress.

Now on a bookkeeping note, you may notice throughout our newsletters lately that portions of the text are in blue, such as the reference to the Princeton Study below or in our new Events section at left. If you are reading this online, anything in blue is a hyperlink that when clicked upon, will take you to a website with further information.

Lenore Hawkins, Principal

Market Update

Congratulations to our representatives in D.C. You've created yet another self-inflicted fiasco on a fragile recovery with your only solution the umpteenth iteration of kick-the-can, so we can go through all this again after the holiday shopping season. The media's mind-boggling distribution of misinformation combined with the hyperbolic handwringing from both sides of the isle created an embarrassing spectacle that has increased the reasons businesses in America continue to be wary. The stock market however, in its increasingly short-term myopia was off and running again on the news that we would have a few months of respite before this particularly pleasurable pastime of political pandemonium, pandering and petulance proceeds anew. The markets are so apathetic concerning DC risk that the S&P500 was all of 2.3% below its all-time high in the 24 hours prior to the Treasury officially running out of money. **Bottom Line**: *We believe that the political climate is likely to remain polarized and petulant, making DC an ongoing headwind to any recovery. The markets continue to treat poor or lackluster economic news as good news in that it makes continued Fed support more likely. Clearly a positive response to negative stimuli cannot go on indefinitely, but the markets can and often do remain irrational for much longer than anyone would think possible. Some defensive portfolio positioning is appropriate given this backdrop and valuations that are, while not at ridiculous levels, a bit expensive.*

Tapering Tease

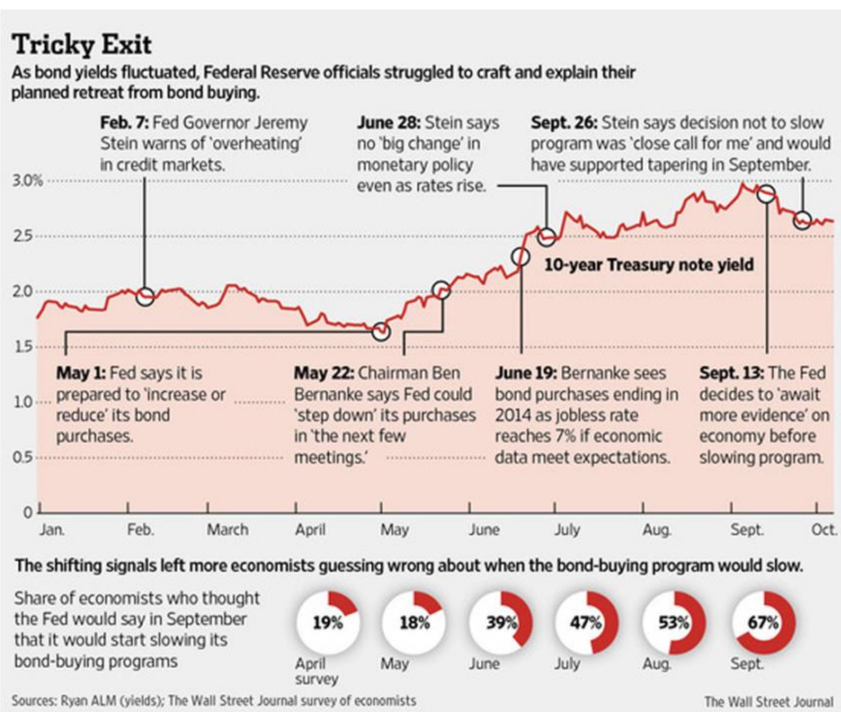
Starting in late May the Federal Reserve diligently prepared the markets for the dreaded tapering of quantitative easing, based on their assessment of an improving economy. By the time the September meeting of the FOMC (Federal Open Market Committee) occurred, the markets had been thoroughly primed and conventional wisdom considered a $10 - $15 billion a month reduction in the Fed's current $85 billion/month rate of purchases of Treasuries and MBS a done deal. To put this amount into historical perspective, consider a few pivotal events.

In 1998 Long Term Capital Management (LTCM) was the first organization to receive the Too-Big-To-Fail treatment, requiring a $3.6 billion bailout after losing $4.6 billion in less than four months when the Russian debt crisis threw a massive monkey wrench into its carefully crafted models. At the time I was with JP Morgan with a front row seat to the stock market drama and witnessed the terror running rampant. Conventional wisdom declared loudly that the global financial system would implode unless LTCM was somehow saved. It is interesting to note that the year before LTCM nearly brought global finance to its knees, two members of its Board of Directors, Myron Scholes and Robert Merton, were recipients of the Nobel Prize in Economics. Just for fun, check out the Board of Directors for Dimensional Fund Advisors.

In 2008, Bear Stearns required an infusion of $25 billion from the Federal Reserve to prevent its collapse, an amount that was considered astronomical. This evolved into a $30 billion loan to JP Morgan in order to fund its takeover of Bear to once again, stave off the specter of global financial collapse.

Later on in September of 2008, Lehman went bust without the support Bear had received and global liquidity froze, prompting the TARP bailout package of $787 billion. Ignoring the impact of inflation for simplicity, let's look at the relative size of the ***monthly*** QE program compared to these bailouts.

Current QE program = $85 billion/month
23.6 times the entire bailout for LTCM
2.8 times the one-time loan for Bear Stearns
1.3 times TARP on an annual basis



As the chart at left from the Wall Street Journal illustrates, by September 2/3rds of all economists though it was a done deal. The Fed managed to have the markets fully primed for a reduction in the level of stimulus, and had instilled an increase in uncertainty to somewhat reduce the level of risk-taking, but not enough to cause the markets to get overly skittish. This was the Fed's master soufflé, cooked to perfection and ready to serve… then Ben sneezed.

The world was stunned to have seen the Fed put in all that hard work to prime the markets, only to have the Fed bow its head with a plaintive, "Just kidding," at the last moment.

The Fed shocked markets across the world by leaving its $85bn-a-month asset purchase scheme unchanged on Wednesday, despite guiding traders to believe that so-called "tapering" would begin this month. Most Fed followers had expected the stimulus programme to be reduced by between $5bn and $15bn a month. ***UK Daily Telegraph, September 19, 2013***

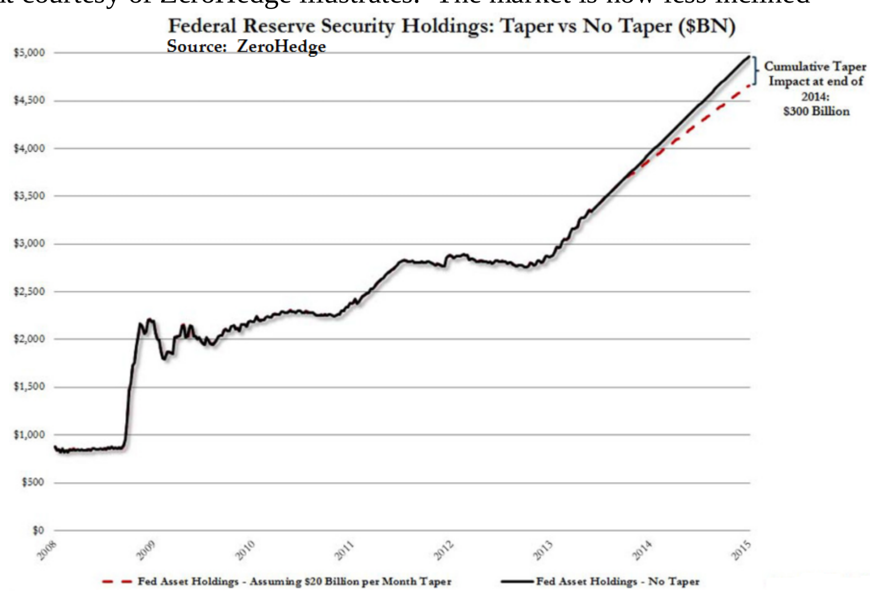
After the Fed's superb job of convincing most market participants that tapering was a fait accompli, this reversal comes at a high cost.

"This FOMC edition feels less dovish than it does outright scared. Confidence in the outlook has dimmed. That Bernanke had a free pass to begin that tapering process and chose not to follow is telling. The Fed had the market precisely where it needed to be. The delay today has the effect of raising the benchmark to tapering and ultimately makes that first step harder to achieve." Eric Green, Global Head of Rates, FX and Commodity Research at TD Securities.

"The US Federal Reserve has damaged its credibility and sown confusion about central banks' communication strategies by surprising markets with its decision to keep quantitative easing on hold, economists have warned." The UK Daily Telegraph

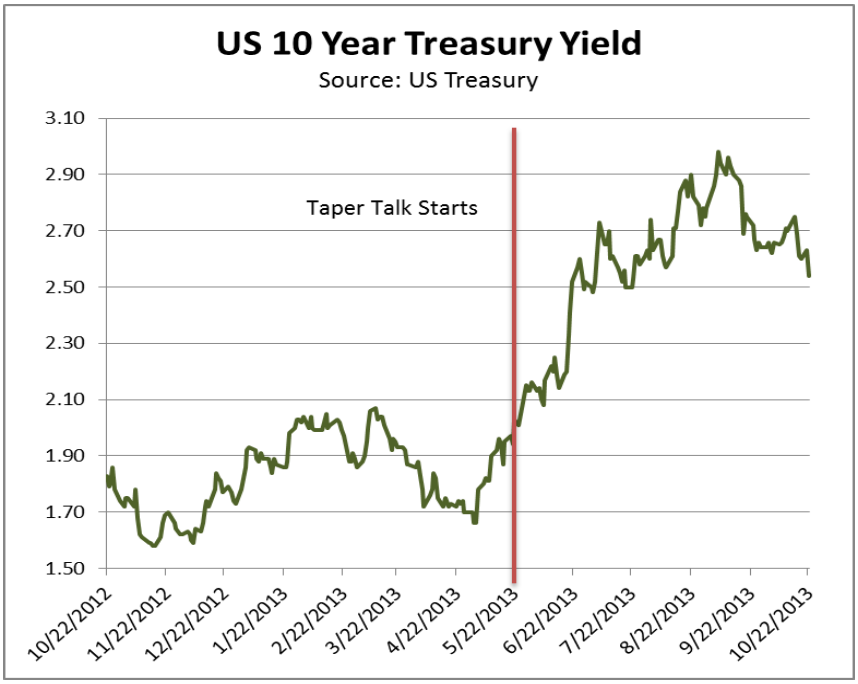
"Well, as I said in my remarks, I'm a very big believer, the Fed Reserve is a very big believer in transparency and communication. I think transparency in central banking is kind of like truth-telling in everyday life. You got to be consistent about it. You can't be opportunistic about it." Federal Reserve Chairman Ben Bernanke in July 11th, 2013 interview with the Wall Street Journal.

The Fed is giving the markets some confusing mixed signals, with Bernanke repeatedly announcing a desire for increased transparency, and for clear communication, and then does this about- face on a reduction that was relatively small in any case, as the chart at right courtesy of ZeroHedge illustrates. The market is now less inclined to believe what the Fed says. Why would the Fed damage its credibility, a valuable asset, over such a trivial change in policy that would arguably have had a negligible impact?



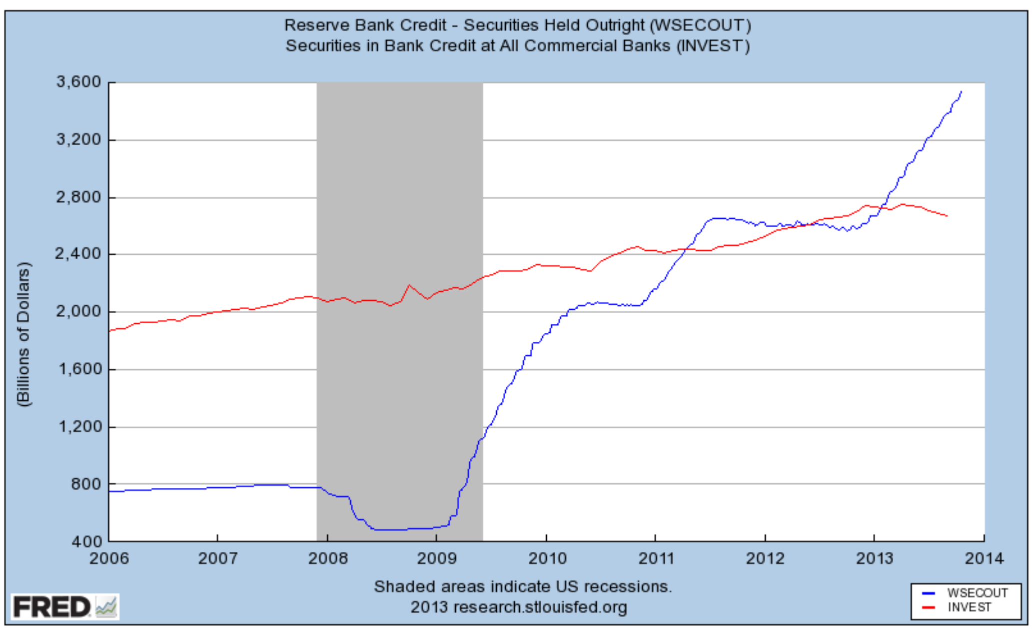
Bear in mind also, according to a recent research report by the San Francisco Fed, all that the Fed has accomplished with its intervention has been a net contribution of 0.13% per year to annual real GDP growth. So what else could it be? If we look to the headlines, the two biggest topics in recovery-talk are getting people back to work and a recovery in housing.

If we delve into the drivers of employment, we see that according to a study by the Kauffman Foundation, between 1996 and 2009 virtually all new jobs come from companies less than five years old. According to the SBA, small firms accounted for 65% of the 15 million net new jobs created between 1993 and 2009. Small businesses produced 46% of private nonfarm GDP in 2008. Small firms are also more intensely innovating. They produce 16.5 times more patents per employee than larger firms. Thus we can easily deduce that new and small businesses are critical to economic growth, but their ranks are dwindling. The level of entrepreneurship in the U.S. is declining. The number of incorporated, self-employed fell from 5.78 million in 2008 to 5.12 million in 2011. The number of unincorporated self-employed declined from 10.59 million in 2006 to 9.45 million in 2011. While incorporated data only go back to 2000, unincorporated self-employed numbers date back decades: the ***2011 number was the lowest in a quarter century!*** The ways to address this depend largely on your economic and political ideology, but there is no denying that small and new businesses depend considerably on personal savings, small loans, and tapping into home equity.



This brings us to the housing recovery. Homes are typically bought using a significant percentage of debt, thus the price of debt, interest rates, will have a material impact on home prices. The chart at left makes it a bit clearer. The 10 year Treasury yield rose almost 50% in less than 4 months on the tapering talk. That kind of enormous jump in rates cannot help but have an impact on mortgages and financing options for new and small businesses. The Fed has used quantitative easing to artificially lower interest rates, which helps the housing market recover and helps small businesses get moving. If it decreases or stops its bond buying, interest rates rise, the housing recovery stumbles and small businesses have a tougher time getting funding. The hope is that given enough time, the economy will become strong enough under its own steam and no longer need the Fed's support. The risk is that the economy and the markets will continue to need the Fed's support indefinitely, meaning it cannot stop its QE programs. Obviously quantitative easing is something that cannot go on forever, and a forceful ending would likely be very painful.

The chart at right gives another hint as to what might have the Fed more concerned. Banks have been scaling back their loan portfolio growth rates and now, the year-over-year growth in bank securities holdings is at its lowest level since the financial crisis. While banks are cutting back, the Fed keeps on buying, so much so that now the Fed's holding of securities exceeds that of all US banks combined! Previously banks owned about 2.5x the Fed's holdings.



Bottom Line: *Without being privy to the Fed's inner communications, we can't know for certain its rationale behind the tapering delay, but we can deduce that the Fed's assessment of the potential damage from starting the taper in September was worth the damage to the Fed's credibility. This warrants careful attention.*

Evening with Nassim Taleb

I have the great fortune of traveling extensively for work and was recently lucky enough to be able to spend an evening with Nassim Taleb, sponsored by RBS (Royal Bank of Scotland) in Milan, Italy. His discussion focused on his most recent book, Antifragile, which I highly recommend, but he's probably most famous for his tome, The Black Swan, which has become a staple of economic discussions. His comments were so intriguing that I thought I'd share a few, with my commentary in italics:

- Too many decision makers in the world today do not have sufficient skin in the game, which degrades the quality of their decision making. Without skin in the game, decision makers have incentives to hide risks, *thus the wisdom of Hammurabi's the Law of the Builder in which bridge engineers slept under the very bridges they were building: those with the ability to have the most thorough knowledge would take on the greatest risk. This is one of the many reasons we prefer fund managers to have a considerable portion of their own wealth invested in the funds they manage.*
- Organic systems that are most likely to survive and thrive need volatility. Removing it slowly kills them. *Consider the great lengths that various public entities have gone to in order to reduce volatility in the economy. By the time the financial crisis occurred, almost every bank executive in office had never experienced a financial crisis first-hand, thus their ability to accurately identify emerging risks and manage them was correlated with their lifelong experience in the "Great Moderation". The Federal Reserve had for years assured them that it would make sure that a crisis was avoided. The consequence of this tempering of previously normal levels of volatility speaks for itself, in our experience with a financial crisis that surpassed any previously experienced.*
- GDP generated by borrowing ignores the future impact of having to repay those funds. *In 2006, total US Federal Debt reached $8 trillion. It is now over $16 trillion.* ***The debt incurred in the 230 years from 1776 to 2006, has more than doubled in the past 7 years.***

Musical Delights

A few days after hearing Nassim Taleb, I had the great fortune to attend a performance sponsored by Deutsche Bank, with the Dresden Orchestra at La Scala in Milan, featuring a rising young pianist, Daniil Trifonov. Martha Argerich of the Financial Times beautifully describes the experience of hearing him play. "He has everything and more. What he does with his hands is technically incredible. It's also his touch – he has tenderness and also the demonic element. I never heard anything like that." If you have the opportunity, please go hear him. I thought I'd seen and heard some of the best in the world, but after hearing him, I know I've never experienced a truly great pianist before. It was breathtaking. Seeing former Prime Minister Mario Monti chatting up the crowds with his entourage of body guards did put a surreal twist on the evening!

Greg Tull's Your Money

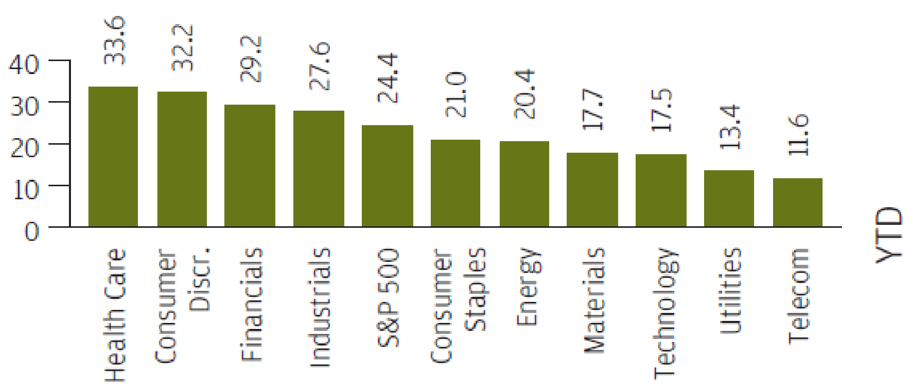
"Home bias" is a term used to mean having an excessive amount of your portfolio invested in stocks and bonds in your own country. For most investors, it is appropriate to have a portion of your portfolio invested in both international developed and international emerging markets. Developed markets include economies such as Western Europe and Japan, while emerging markets include nations such as Brazil and India. In the 3rd quarter of 2013, we experienced an excellent example of the benefits of diversification in action. While the S&P500 domestic large cap index had a strong quarter, the international developed and emerging market investments that we use in our client's portfolios both grew at more than 2 times the rate of the benchmark US stock index. On the bond side, our favorite international active bond fund posted gains close to 2 times the rate of the domestic fixed income benchmark known as the Barclays US Aggregate Bond Index. An old saying in investing is that there is always a bull market somewhere. In additional to lowering portfolio risk and volatility, having a globally diversified portfolio greatly increases the likelihood of capturing the bull markets, as exemplified this quarter by the international stock and bond markets. Rebalancing the portfolio by trimming the investments in the winning markets and adding to those that have temporarily underperformed helps to best position the portfolio to benefit from the next bull market, wherever it may be.

Market Recap

(as of October 18th, 2013)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1745	2.44	3.85	24.41	22.38	57.11
Dow Jones 30	15400	1.04	1.85	19.86	17.70	49.40
Russell 2000	2770	2.82	3.85	32.60	35.06	63.58
Russell 1000 Growth	537.04	2.66	3.48	25.08	23.47	58.62
Russell 1000 Value	544.87	2.32	4.15	25.47	24.11	58.41
MSCI EAFE	1878	2.77	3.33	20.48	24.03	27.85
MSCI EM	1042	1.88	5.63	1.34	5.77	2.04
NASDAQ	3914	3.23	3.82	30.93	29.21	63.52
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.30	0.55	0.51	-1.39	-0.95	8.95
U.S. Corporates	3.19	0.84	1.11	-1.53	-1.32	15.03
Municipals (10yr)	2.92	0.03	-0.25	-2.31	-1.59	11.55
High Yield	6.53	0.91	1.69	5.48	7.52	30.09

	Levels (%)					
Key Rates	**10/18/13**	**10/11/13**	**9/30/13**	**12/31/12**	**10/18/12**	**10/18/10**
2-yr U.S. Treasuries	0.33	0.35	0.33	0.25	0.29	0.38
10-yr U.S. Treasuries	2.60	2.70	2.64	1.78	1.86	2.52
30-yr U.S. Treasuries	3.65	3.74	3.69	2.95	3.02	3.93
10-yr German Bund	1.83	1.86	1.78	1.31	1.64	2.39
3-mo. LIBOR	0.24	0.24	0.25	0.31	0.32	0.29
3-mo. EURIBOR	0.23	0.23	0.23	0.19	0.21	1.01
6-mo. CD rate	N/A	N/A	N/A	0.31	0.35	0.35
30-yr fixed mortgage	4.46	4.46	4.49	3.52	3.57	4.34
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



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