April 28th 2014

MONTHLY INVESTMENT OUTLOOK

IN THIS ISSUE

- Markets & Earnings Reports
- Real vs financial economy, thoughts from Monte Carlo
- Greg Tull's Your Money
- Market Recap

UPCOMING EVENTS

- 05/07: **Simple, Timely and Subtle Ways To Increase the Value of Your Business** with M&A attorney Jessica Karner
- 09/24: **New Tools for 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

SPEAKING ENGAGEMENTS

- May 20th **Lenore Hawkins** on Varney & Company
- May 21st **Lenore Hawkins** on Neil Cavuto
- July 9-12th **Lenore Hawkins in Las Vegas** at **FreedomFest**

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.

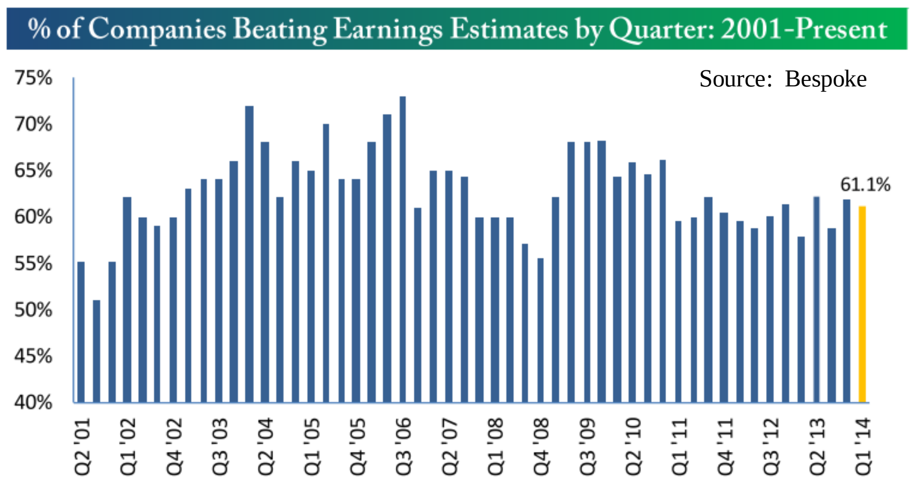
Northern California
4040 Civic Center Drive, Suite 200
San Rafael, CA 94903
415.690.8547

Southern California
11622 El Camino Real, Suite 100
San Diego, CA 92130
858.461.8547

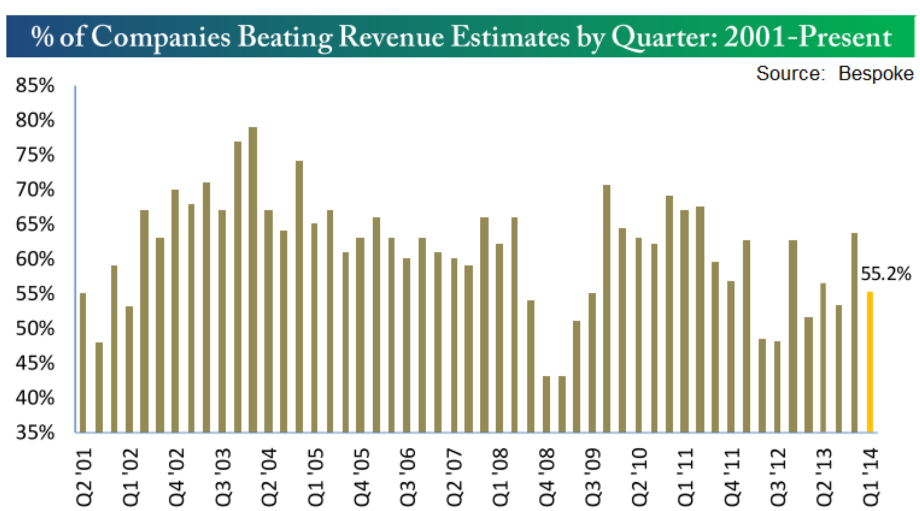
Dear Clients and Friends: We have a lot to discuss this month between an earnings season with more optimism than we've seen in some time, while markets continue to offer a volatile ride amid deeper discussions of the global state of affairs from Monte Carlo, so let's get at it!
Lenore Hawkins, Principal

Markets & Earnings Reports

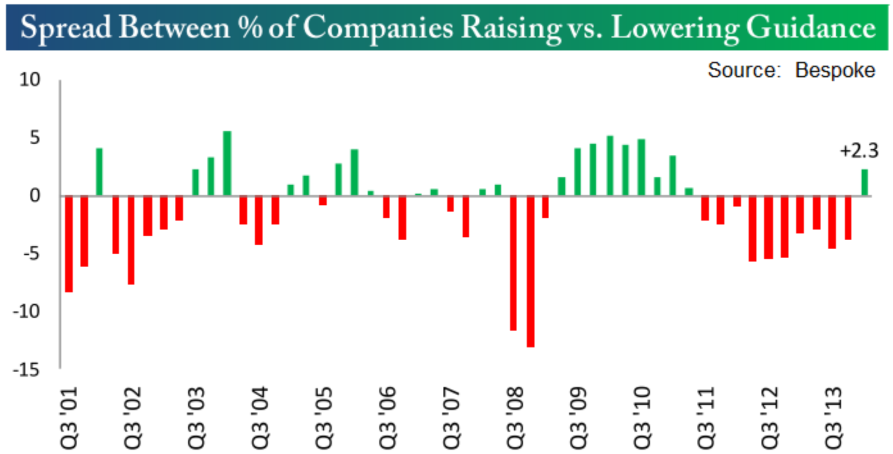
Over 700 companies have reported earnings so far this season. As of Friday 4/25, 61.1% of all U.S. companies had beaten consensus earnings estimates, which is just slightly below the 62% from last quarter and is consistent with the rate we've seen during the current bull market.



When earnings season began, top line revenue estimates were relatively weak, but have improved over the last five days. Currently 55% of the companies reporting have beaten estimates, up from 50% last week.



The two prior charts show that so far, things are looking decent during this reporting cycle, but nothing to get giddy about. The big change this quarter, and it is decidedly something to get giddy about, is guidance. The past 10 quarters companies have given the markets pretty grim forward outlooks, with a negative guidance spread, meaning more companies lowering guidance than raising, in each of the last 10 earnings seasons. *This season we finally see a positive ratio*, (chart at right).



Last earnings season investors bought aggressively during the season, despite the negative outlooks. This season the opposite appears to be occurring with the average company falling 0.39% on its reporting day. Companies that beat estimates are not rewarded all that much, rising an average of 0.13% while those that miss are falling 0.52%.

Last week the market was a condensed version of what we've been experiencing for much of the year, a great deal of whipsaw back and forth action that hurts sentiment more than actual portfolios. The market closed Friday 4/25 at nearly the same place it was on the close of Thursday the week prior, (markets were closed on April 18th in observance of Good Friday). The much maligned Nasdaq is now about 6% off its recent cycle high while the S&P500 is 1.4% below its recent April 2nd high of 1890.9. If we go a bit deeper we find that while corporate earnings reports are painting a sunnier picture, stock prices have been struggling. Last weekend Barron's pointed out that *the average stock in the S&P500 has fallen 12.5% from its peak*. The average *consumer discretionary is down 16%*, despite some positive March retail sales data. *Internet stocks are down 18% on average with biotech, the darling of 2013, down 25%*. The average *large-cap has lost just under 9%* with *small cap falling nearly 16%*. We've been warning for months that stocks have been richly priced, so while the fundamentals appear to be improving, prices are moving in the opposite direction, falling off their heady highs. For those who read these pages regularly, this will come as no surprise.

That being said, the majority of country stock markets are still above their 50-day moving average, including the U.S. which is just keeping its neck above water at 0.3% above this key support level. If we take a broader six month look, the S&P500 and the Dow 30 have been fairly consistently moving above their 50-day moving averages, so while it's been painful, the longer-term uptrend remains in place. Small caps are a different story, with both the Nasdaq 100 and Russell 200 below their 50-day moving averages, where they have been for over a month. Nasdaq internet stocks are well below their 50-day moving average and still losing ground.

Bottom Line: *After last year's blow away market that greatly outpaced growth in underlying earnings, we are unsurprised to see some consolidation in prices. So far we see the longer-term upward trends holding firm for the more value-oriented firms that we tend to prefer. We've seen the usual reversal of last year's highest fliers become this year's dogs, in yet another example of why it doesn't pay to chase returns*.

The Real versus Financial Economy: Thoughts from Monte Carlo

Last week I had the great honor of being invited to speak at the XIIth Annual International CIFA Forum, (the Convention of Independent Financial Advisors which is in special consultative status with the United Nations) in Monte Carlo. Who knows how I got invited back after speaking there last year, but when someone asks me speak in front of such an impressive audience, I don't question. The conference is truly first rate with phenomenal guests as well as speakers, excluding of course the statistical anomaly of yours truly. If you find yourself in Monaco, I recommend staying at either the Hotel Hermitage or l'Hôtel Métropole and you cannot miss dining at Joël Robuchon at Métropole. If you want to see more of the famed nuttiness that is Monte Carlo after dark, make your way to Buddha Bar and I guarantee you'll come away with stories to entertain for hours.

I highly recommend driving into Monaco from the Italian side on the Autostrada dei Fiori, (A10) which essentially means the highway of flowers. The road is high on the side of sheer mountains, winding along the coast of the Mediterranean, with countless bridges followed by tunnels and as you wander through the beauty of the land where the Dolomites meet the sea. Greenhouses, full of brightly colored flowers, dot the mountainside with unexpected flashes of color amongst the lush shades of green. As you look south, the Mediterranean's beauty changes throughout the day as her moods softly sway, ranging from bright aquamarine, to the more subtle tones of oxidized copper to a moody ashen navy. Looking back towards the mountains, you may even catch sight of snow covered peaks. Surely some of the heavens' best work is to be found in Italy. The drive however, is not well suited for those who have a significant fear of heights as the picture at right illustrates!

At the conference I spoke about the real versus the financial economy, which is a topic that I've alluded to often in these monthly pages. This month let's go a bit deeper. When we think of the economy, it can be broken into two distinct aspects: the real and the financial.

The real economy is what we primarily think of when referring to the economy. It is essentially composed of four types of capital:

- *Natural capital* provides the basis for all human activity. It consists of raw natural resources such as minerals, timber, water etc. From this platform, human capital combines with social capital to general built capital and intermediate goods.
- *Human capital* refers to individual productive capacity
- *Social capital* refers to the networks and connections between individuals that facilitate the production of, and exchange of, goods and services.
- *Built capital* refers to the man-made materials and productive devices utilized by human capital to produce desired goods and services.

The financial economy is essentially the world of money, including the various prices for money, namely interest rates and exchange rates. The financial economy overlays and supports the real economy by facilitating transactions and setting market prices for the stock and flow of the four capitals in the real economy.

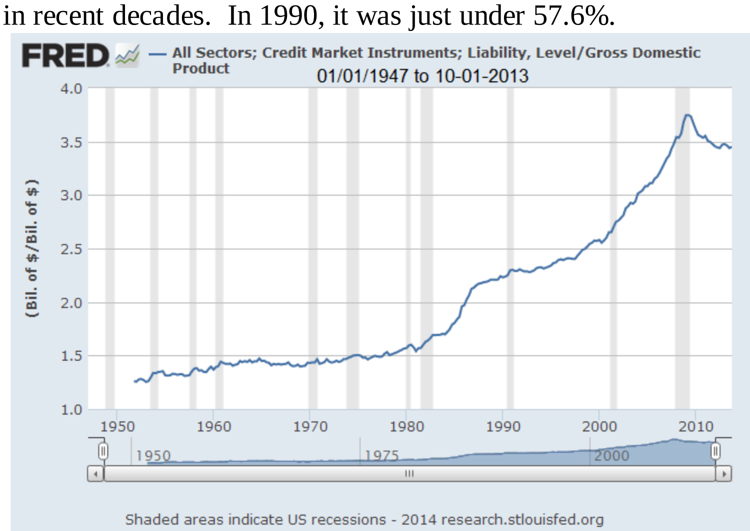
When the real economy is healthy, market prices reflect the value of the true contribution of the four capital stocks and the real and financial economy align. In this environment debt and equity markets, as a percent of GDP, are small and are principally designed to channel savings into investments.

When the two are misaligned, and the financial economy dominates, the capital market is far larger than GDP and channels savings not only into investments, but also continuously into expanding speculative bubbles. The danger of this arrangement is somewhat intuitive. When there is more money floating around than the underlying real economy calls for, that money is going to race about nervously, seeking ways to generate returns. Since it is not attached to anything real underneath, its flows can be quite volatile, with bubbles able to quickly form and dissipate even more rapidly.

That is not to say that bubbles don't occur when the real economy dominates, but those bubbles tend to stay small and have little impact on the overall economy. In the real economy, bubbles tend to be contained by the availability of savings and credit, whereas in the financial economy (where capital markets are disproportionately large relative to the real economy), the effectively unlimited availability of credit leads to speculative bubbles, which cause enormous price distortions and excessive flow of capital from the real economy into the bubble. We saw this occur in housing boom that reached its pinnacle in 2007 and has as of yet only recovered, on a national basis, about 1/3 of the cumulative decline during the recession.

When bubbles form in the financial economy, the size of the "white elephant" investments can be so large that the economic benefits that arise from an investment boom are dwarfed by the damage from the inevitable bust. In the most recent housing boom and bust, excessive investments were made in the housing industry on the somewhat Ponzi-style belief that prices would simply continue to go up and up. (Hmmm, I believe we mentioned the dangers of chasing returns in our prior section!) That led to more and more people building skills in construction, mortgage generation and other housing sector-specific skills. At the end of it all there were too many people working in a sector with too much capacity built up, so all those people and the physical capital that goes along with them needed to get shifted around into other parts of the economy; an arguably painful process for those who have to endure it.

So just how big has the financial economy become? According to data from the World Bank, stock market capitalization to GDP for the US has risen remarkably in recent decades. In 1990, it was just under 57.6%. In 1999 it peaked at 162%, dropping to 115% by 2003, only to once again rise up to a peak of 141% in 2007. After the crisis, it fell to 97% in 2009 and is now back up to about 115%, still about twice where it was in 1990.



If we look at total credit market debt as reported in the Federal Reserve Flow of Funds report, in Q1 1990, total debt to GDP was 120%. In April 2009 that number had more than doubled to 274% and is now about 245%.

Now that's all very interesting, but how does it pertain to investing and why do you care?

When looking to invest capital, there are essentially two choices:

- Allocate "entrepreneurially" to the real economy, meaning in the production of goods and services, or
- Allocate "financially" in legal claims against such activities.

Think of "entrepreneurial" allocation as investing in your cousin's new restaurant or in the construction of a new corporate office complex that your attorney suggested as opposed to the financial economy which is, for example, about buying shares of Apple, call options on General Electric or Ford bonds.

A study by Philipp Mudt, Niels Forster, Simone Alfarano and Mishael Milakovic looked at just this, by studying over 30,000 publicly traded firms in more than forty countries that represent 70% of the global population and about 90% of the world's income, comparing both average rates of return and volatility of returns from 1997 to 2011. Unsurprisingly, average returns for investments in either the real economy or the financial economy were roughly equal, but volatility of financial returns was a magnitude higher than that of "real" returns.

When you think about this, it is somewhat intuitive. We know that in the real economy, profits face a negative feedback mechanism which helps establish a rather stable profit level; a fairly well understood process in classical notions of competition. A sector that is experiencing high profit levels will naturally attract more capital, which in turn attracts more labor, thus increases output, which eventually reduces prices as supply increases relative to demand and puts downward pressure on profits over time. As profits decline, capital has incentives to go elsewhere, and the reverse process occurs leading to higher prices and profits for firms that remain in the industry.

In the financial sector, rather than this negative feedback mechanism, we can see a temporary positive feedback mechanism and strong cross-correlations which can lead to an almost Ponzi scheme effect. Prices for a particular security or type of security rise. This rise attracts additional capital, and the momentum generated by speculators chasing the hot sector attracts more and more capital until finally you find yourself getting tips on the hottest sector or stocks from your cab driver and dry cleaner.

I call this a sort of market-directed Ponzi scheme simply because in the long run companies cannot afford to pay more to financial stakeholders than they earn from their real activities, thus financial returns are eventually tied to real returns… unless of course one seriously mucks with the financial economy, as is the case today. Under today's conditions, the long run rule still holds, but "long" is much longer.

As all Ponzi schemes eventually fail when no new buyers can be found, the stock prices start to fall when new buyers cease to come in and existing owners struggle to find someone to take their shares when they need to cash out. We have all seen this accelerating decline in various forms. Here's the latest example. A lot of air has already come out of the euphoria for social media stocks in 2014. Most of the leading stocks in the social media sector are down substantially for the year to date through April 28th, including Linked In (-32%), Twitter (-34%), Yelp (-19%), Groupon (-40%), Youku (-25%), SINA (-43%) and Yandex (-44%). Speculators who chased last year's bubbly returns in social media shares have been stung by substantial losses in the first several months of 2014.

One of the most striking aspects of the panel in Monte Carlo was unanimous concern regarding the significant potential risks in the global economy today as a result of the size magnitude of the financial economy relative to the real, the actions of central bankers during and after the crisis and the lack of any meaningful reform post-crisis.

Gretchen Morgenson of the New York Times noted that financial crises seem to have become much more impactful on the overall economy and more severe in recent decades. She expressed concern that we have the makings for a much more severe correction in the future as she believes that few if, any of the causes of the last crises have been accurately and adequately addressed.

Roger Nightingale had a more distressing outlook than Ms. Morgenson's, stating that he believes the world is in for one whopper of a depression when central banks find they have no choice but to cut back on the liquidity they've been injecting into the economy since the start of the crisis. He believes the cut back to be inevitable as he attributes the high levels of fraud we've seen in the financial sector to be a direct result of the excess levels of liquidity. He claimed that a sharp pull-back will be necessary, else society as a whole will cease to have any faith in our institutions if the fraud is able to continue at its current levels.

Louise Bennetts stirred the crowd with her assessment that Dodd-Frank has done very little to address the problems of the financial crisis and has in fact made the situation far more volatile as much of the legislation gives regulators considerable discretion concerning how to deal with bank problems. Throughout history, discretion translates into inconsistent treatment and typically to considerable levels of graft. These combine to inject significant uncertainty into the markets, which as we've already seen, increases instability in a sector that has not yet recovered. I highly recommend her work, along with Arthur Long on the impact of proposed bank regulations on global growth.

The group also engaged in a stimulating debate concerning why the media continues to present such a simple "all is well and let's be on our merry way" version of the economy. Explanations ranged from lack of true understanding of the deeper data, to political positioning and the possibility that with the media cycle reality of today, there is no real interest in discussing risks that are more than a year or so out into the future. Whatever the cause, we could all agree that it certainly provides us with plenty of work with which to earn our keep!

Bottom Line: *The size of the financial economy relative to the real economy has grown substantially in recent decades, making comparisons to historical norms difficult at best and misleading at worst. Additionally, sovereign debt levels are at perilously high levels relative to GDP for many of the world's largest economies at a time when interest rates are at exceptionally low levels, (debt is likely to become increasingly more expensive over time) and aging demographics make future growth more challenging. While the current recovery looks to be thankfully gaining ground, longer-term significant problems loom large on the horizon; a reality to keep in mind when assessing portfolio risks. On the bright side, the market has done some correcting of the bubbly valuations in the most euphoric sector of 2013, social media, as expectations for what these companies can achieve in the real economy have come down.*

Your Money with Greg Tull

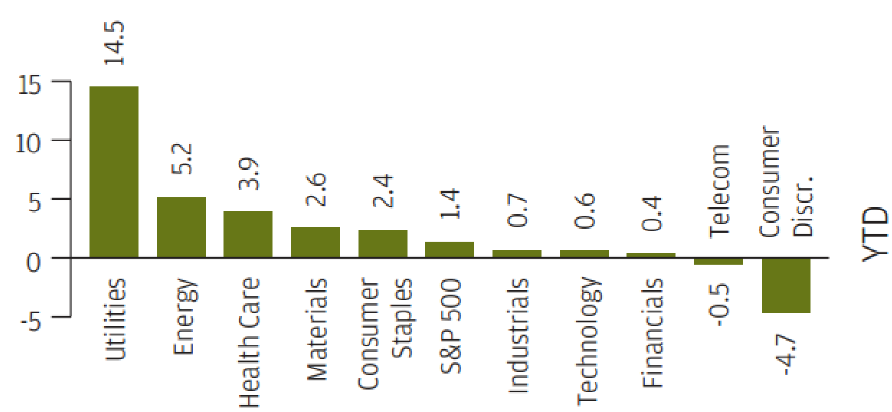
The mini boom and bust in social media stocks of 2013 – 2014 is a good reminder of the potential hazards of speculation to long term financial health. Let's look at some important mathematical examples. If you invest $100 in a stock and make 50% on it that year, the value of your position grows to $150. If the bubble then pops and the stock falls 50% in the following year, the value of your position falls to $75. The net return of a 50% gain followed by a 50% loss is not 0%, it is a loss of 25%. Worse still, chasing a hot stock or sector that falls 50% soon after purchase, can quickly turn a $100 position into $50. In order to get back to the original $100, the stock now has to grow 100%, or double in value, to recoup the 50% loss. An investment strategy that is repeatable and sustainable, and that avoids excessive swings up and down in value, has the best chance of meeting lifetime financial objectives. As the old Wall Street adage goes, bulls make money, bears make money, and pigs get slaughtered. Performance chasing, ignoring reversion to the mean, and excessive trading are three mistakes for Porky and Wilbur to make, and for the seasoned investor to avoid.

Market Recap

(as of April 25th, 2014)

		Index Returns (%)				
Equities	**Level**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
S&P 500	1863	-0.06	-0.37	1.43	20.05	48.98
Dow Jones 30	16361	-0.24	-0.42	-0.54	13.94	41.57
Russell 2000	2791	-1.30	-4.22	-3.15	21.01	38.71
Russell 1000 Growth	568.06	-0.25	-1.18	-0.07	20.52	46.64
Russell 1000 Value	585.93	0.05	-0.03	2.99	20.44	50.93
MSCI EAFE	1920	0.30	0.57	1.35	14.56	21.76
MSCI EM	993.35	-1.78	0.11	-0.26	-0.50	-10.05
NASDAQ	4076	-0.48	-2.90	-2.10	25.48	49.65
Fixed Income	**Yield**	**1 week**	**QTD**	**YTD**	**1 year**	**3-yr. Cum.**
U.S. Aggregate	2.34	0.36	0.72	2.58	-0.22	11.55
U.S. Corporates	3.03	0.48	1.11	4.09	0.98	19.25
Municipals (10yr)	2.30	0.12	1.53	4.70	0.88	18.98
High Yield	5.92	0.16	0.48	3.48	6.69	28.58

	Levels (%)					
Key Rates	**4/25/14**	**4/18/14**	**3/31/14**	**12/31/13**	**4/25/13**	**4/25/11**
2-yr U.S. Treasuries	0.43	0.37	0.44	0.38	0.23	0.67
10-yr U.S. Treasuries	2.68	2.63	2.73	3.04	1.74	3.39
30-yr U.S. Treasuries	3.45	3.48	3.56	3.96	2.91	4.46
10-yr German Bund	1.48	1.52	1.57	1.94	1.24	3.26
3-mo. LIBOR	0.23	0.23	0.23	0.25	0.28	0.27
3-mo. EURIBOR	N/A	N/A	N/A	0.29	0.21	1.38
6-mo. CD rate	N/A	N/A	N/A	0.27	0.26	0.31
30-yr fixed mortgage	4.49	4.49	4.56	4.72	3.65	4.80
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25



Meritas Advisors, LLC is a Registered Investment Advisor with the State of California Department of Business Oversight. This newsletter is provided for educational purposes only, does not constitute a complete description of our investment services and is not intended to provide specific advice or recommendations. The views expressed represent the opinions of the author and not necessarily those of Meritas Advisors, LLC and are subject to change without notice. The information contained herein is based on information we consider to be reliable, however, accuracy is not guaranteed. Past performance is not an indicator of future results.

4040 Civic Center Drive, Suite 200
San Rafael, CA 94903
415.690.8547

11622 El Camino Real, Suite 100
San Diego, CA 92130
858.461.8547

info@MeritasAdvisors.com
www.MeritasAdvisors.com