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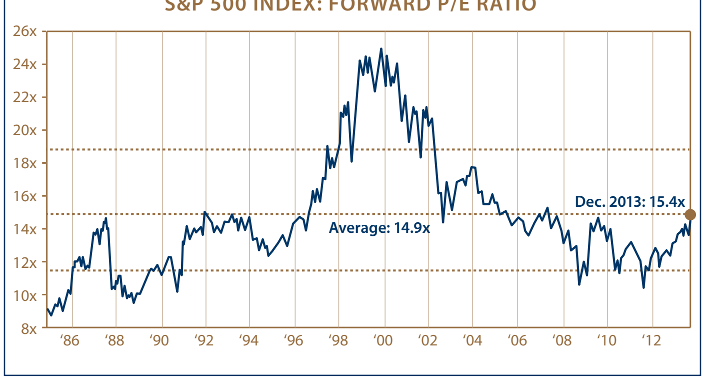
THE HEADINVEST QUARTERLY

MarketComment.

In 2013, U.S. stocks surprised to the upside, posting the best one-year gain since 1997. Given the multiple headwinds of a sluggish economic recovery, fiscal consolidation, budget theatrics, high under-employment and rising interest rates, it seems fortuitous that the year could turn out so well for equities. Though earnings of companies in the S&P 500 index are estimated to have grown 4-5% in the year, much of the return came from an expansion of valuation of stocks relative to earnings, or the price/earnings ratio ("P/E ratio"). The expansion of this ratio reflects markedly higher confidence in the future than prevailed earlier in the year. A combination of gradual broadening of the economic recovery and central bank support served to allay investor fears and move stock markets ahead.

> A COMBINATION OF GRADUAL BROADENING OF THE ECONOMIC RECOVERY AND CENTRAL BANK SUPPORT SERVED TO ALLAY INVESTOR FEARS AND MOVE STOCK MARKETS AHEAD.

The increase in investor confidence, as measured by the *forward* P/E ratio (the price relative to expected earnings in the coming year), can be seen in the accompanying chart. Since the Presidential election of 2012, when the forward P/E ratio was at its recent low of 11 times, the valuation of the S&P500 stock index has steadily expanded. At year end, the ratio was 15.4x, just above the average of the past 28 years.



S&P 500 INDEX: FORWARD P/E RATIO

Economic and political developments in 2013 contributed to the increase in confidence. The recovery accelerated and broadened, some progress was made in Washington, employment continued to slowly expand, and interest rates, though higher than before, remain low.

THE YEAR IN REVIEW Though 2012 was a decent year for the economy and for stocks, growing consternation about the fiscal cliff seemed to rattle the stock market in the fourth quarter, when it gave up more than a third of its gains. Though the fiscal cliff—a combination of tax increases and budget cuts that threatened to restrain GDP growth by as much as 5%—was eventually addressed in a last minute budget deal, the political dysfunction on display around it seemed to sap confidence throughout the economy. The annualized rate of GDP growth slowed to a barely perceptible 0.1% in the fourth quarter as a result of a reduction in federal spending and private inventory de-accumulation, a sign that businesses were hedging their bets.

> THE RECOVERY ACCELERATED AND BROADENED, SOME PROGRESS WAS MADE IN WASHINGTON, EMPLOYMENT CONTINUED TO EXPAND, AND INTEREST RATES REMAIN LOW.

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Against a long-term historical rate of return of 10% or so, the ~30% gain in the S&P 500 in 2013 is remarkable but not unprecedented. In fact, in the 86 years since 1927 stocks have produced an annual return of 25% or more a total of 24 times—about a third of the time!

The other side of the coin is that the stock market returned 0% or less an equivalent number of times. In other words, since 1927, a stock market investor has had about the same probability of making 25% or more in a year as of making 0% or less, sometimes much less. The chart below shows annual returns grouped by a given range. The year just ended can be found in the row labeled "+25 to +30%." Given this wide dispersion of possible returns, no wonder it is difficult to formulate expectations about stock market performance.

IN THE 86 YEARS SINCE 1927 STOCKS HAVE YIELDED AN ANNUAL RETURN OF 25% OR MORE A TOTAL OF 24 TIMES – ABOUT A THIRD OF THE TIME!

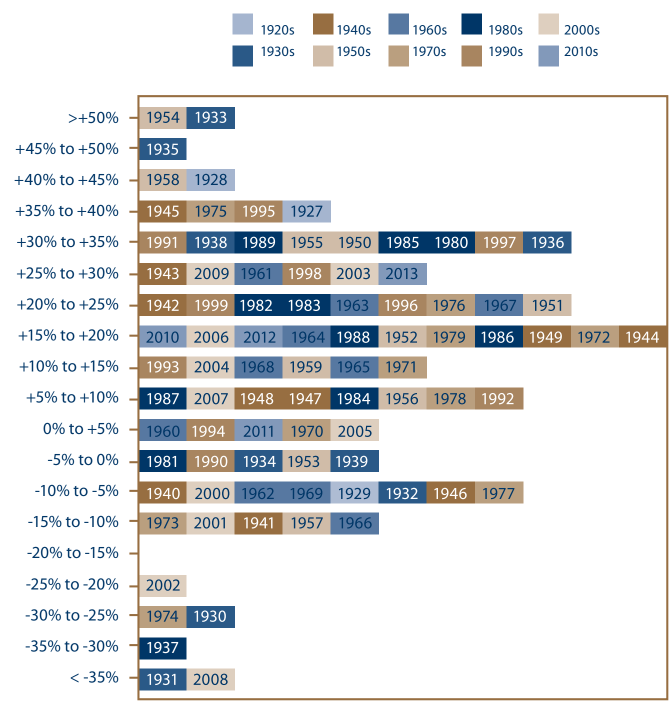
Though many hate to admit it, professional advisors cannot predict annual returns either. What we can do, though, is help our clients understand the range of potential outcomes, the significance (or lack thereof) of performance in any one year, how best to position portfolios to take advantage of return opportunities to meet their financial objectives.

Because of the inherent lack of predictability of stock returns, it is essential to view investing probabilistically. While many stock market forecasters project a return that is about equal to the long-term average return of 10%, they usually do not add the qualifier "plus or minus 20%" which is the standard deviation of annual returns. This is a critical oversight. Statistically-speaking, we can say that, historically, the average annual return from stocks has been 10% and two-thirds of the time it has been between –10% and +30%.

Over longer time periods, the range and volatility of potential outcomes is much lower. The average of 10-year compound average returns since 1926 has been 10.4% annually, but the standard deviation is only 5.7%. Based on history, then, we can say with reasonable confidence that over a ten-year period, annual returns will fall between 4.7% and 16.1% two-thirds of the time. Probabilistically, this is a much surer bet. While it is true that the future may not be the same as the past, it is extremely useful to use the past as a guide.

To best take advantage of potential returns in equity markets, it is essential to have a long-term view. Equity allocations are predicated on each individual's situation. As advisors, we recommend periodic reviews of your personal circumstances, including anticipated spending needs, so that appropriate asset allocation adjustments can be made.

S&P 500 ANNUAL TOTAL RETURN 1927-2013*



Source: *LPL Financial Research, Bloomberg Data 11/14/13*

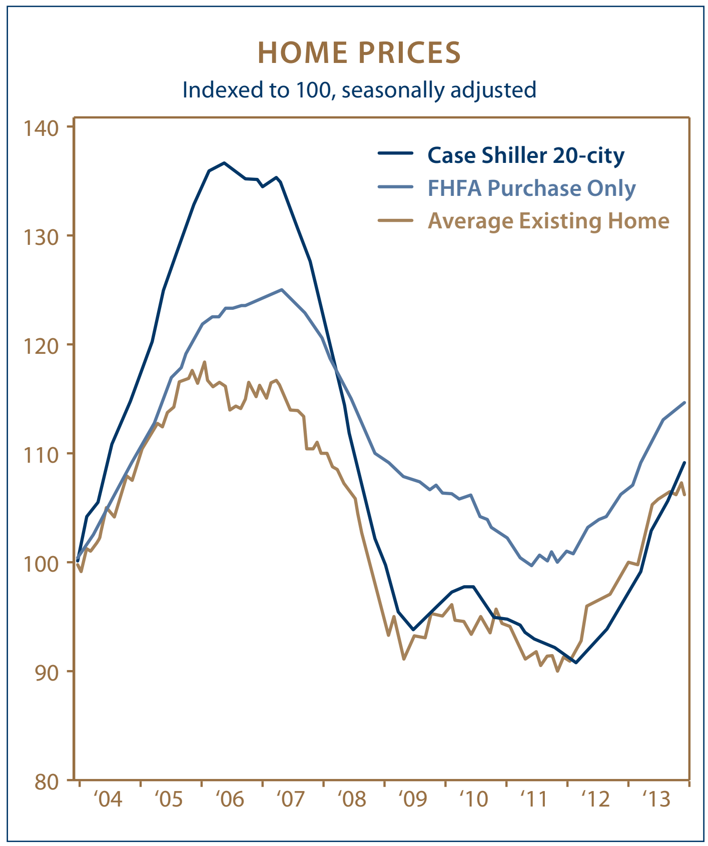
But growth picked up in the first quarter of 2013 and strengthened throughout the year. While consumption was stable, there was a marked pickup in private investment. In May, consumer confidence climbed to the highest level in more than five years and home prices advanced by the most in seven. Since the steep decline in housing prices was felt so broadly throughout the economy—and so personally by individuals, the housing market recovery no doubt convinced many that the financial crisis was indeed finally behind us.

Employment gains were fairly steady throughout the year, and even seemed to accelerate somewhat in the second half. Conditions in the labor market, however, remain far from robust. It is too early to tell if the much weaker than expected gains in December should be considered one-off or some sort of turning point. For the market, however, gains were sufficient to offset the worst fears.

THE RISE IN INTEREST RATES WAS CERTAINLY FELT IN THE FIXED INCOME MARKETS – WHERE MUTUAL FUND OUTFLOWS ACCELERATED AND MORTGAGE COSTS ROSE.

In May, on the developing strength of the economy, Fed Chair Bernanke told Congress that the central bank might soon reduce the size of its bond-buying program. The announcement precipitated a decline in stocks and also provoked a near-doubling of the yield of the 10-year U.S. Treasury note from an historic low. Perhaps in reaction to the market's shudders, Bernanke and his team were deployed on speaking tours throughout the country to reassure investors that a reduction of bond-buying should not be seen as tantamount to monetary tightening. Instead, Bernanke assured us, rates were to remain low for a good while, perhaps even beyond the point when unemployment reached 6.5%. The nomination of Janet Yellen—perhaps even more of a monetary dove than Bernanke—to replace him also seems to have helped investors overcome initial concerns.

The rise in interest rates was certainly felt in the fixed income markets—where mutual fund outflows accelerated and mortgage costs rose. It also hit certain stock market sectors, particularly the stocks of slow-growing but high-yielding companies. The largest negative impact, however, was felt in emerging markets. Low interest rates in the U.S. (and other developed nations) had encouraged large investment flows into emerging markets. With rates higher in the U.S., however, some of this money returned, or seemed likely to, negatively affecting emerging market asset prices, interest rates and exchange rates. In the end, this flow of funds provided support to U.S. markets.



Political dysfunction manifested again with the government shutdown in October. Once again, a solution was found, this time with the promise of putting the entire budget process back on track after years of polarizing outcomes. In December, the sequester was replaced by a bipartisan agreement on spending and in early January, the details were worked out. The U.S. budget process, where much work remains to be done, is at least functioning slightly better.

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The dissipation of headwinds during the year seems to account for the increase in valuation of the market as noted above. Over long periods of time, changes in valuation tend to cancel each other out, leaving earnings growth and dividends as the primary factors determining investor returns. In shorter periods, changes in valuation can dominate, as they did in 2013. The somewhat ephemeral nature of valuation changes are neatly summed up by Benjamin Graham, as quoted by Warren Buffett: "In the short term, the market is a voting machine. In the long term, it is a weighing machine."

INVESTMENT ENVIRONMENT The first weeks of the New Year remind us that stocks do not move upward in a consistent pattern. The stock market has shown several days of decline. It is reasonable to expect some sort of pause or even correction in the year ahead, just as it is reasonable to expect continued gains. Both are within the realm of historical experience, and stock market movements in a year, as we have just seen, cannot really be predicted. In the article entitled "Portfolio Matters" in this edition of our quarterly newsletter, we delve more deeply into this topic.

After several months of concern about the impact of higher rates in the U.S. on emerging markets, recent developments include signs of stress in Turkey, India, Brazil and South Africa. These countries face what Alexandre Tombini, Brazil's central bank governor, termed the "vacuum cleaner" of rising interest rates in the developed world. To counteract the flow, or potential flow, of funds out of emerging markets, these nations must contemplate raising interest rates, even while economic conditions in their respective countries are less than robust. Otherwise, their currencies may weaken and contribute to higher rates of inflation. Neither alternative—higher rates nor a lower currency—is particularly attractive.

EMERGING MARKETS AS A GROUP ARE GROWING FASTER THAN DEVELOPED MARKETS AND WILL CONTINUE TO DO SO.

Instability in emerging markets, as noted above, is so far the biggest manifestation of concern about how the Fed and other central banks will navigate an exit from unprecedented levels of quantitative easing. Though the Fed has not yet begun to tighten, and may be years from doing so, the uncertainty over the potential long-term fallout from its policies is high.

Though a change in global currencies and capital flows may well be underway, the long-term damage to emerging markets is probably limited. Emerging markets as a group are growing faster than developed markets and will continue to do so. In addition, valuation of equities in emerging markets is already attractive. This underlying dynamic is likely to prove decisive through any potential changes in currency values, trade flows and policy measures.

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