BEACON POINTE

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Beacon's Point: Growing Pains

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Confidential – Proprietary

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Growing Pains

The stock market has put on quite a show. While some investors believe this rally will continue forever, others are starting to question how much longer the running of the bull will last. Is it getting tired? When the end is near, will it gradually slow down, giving the public sufficient time to head for the exits? Or will it stop abruptly when it runs out of steam? This is, of course impossible to predict, absent a crystal ball. However, history shows that corrections often occur swiftly, leaving market participants no time to react. Prudent investors should, therefore, design their portfolios for a **full market cycle**, rather than just the bull phase. The investment managers recommended by Beacon Pointe are very cognizant of the dynamics of the market environment and stand ready to take advantage of the opportunities that a correction would create for those that are not running for the exits.

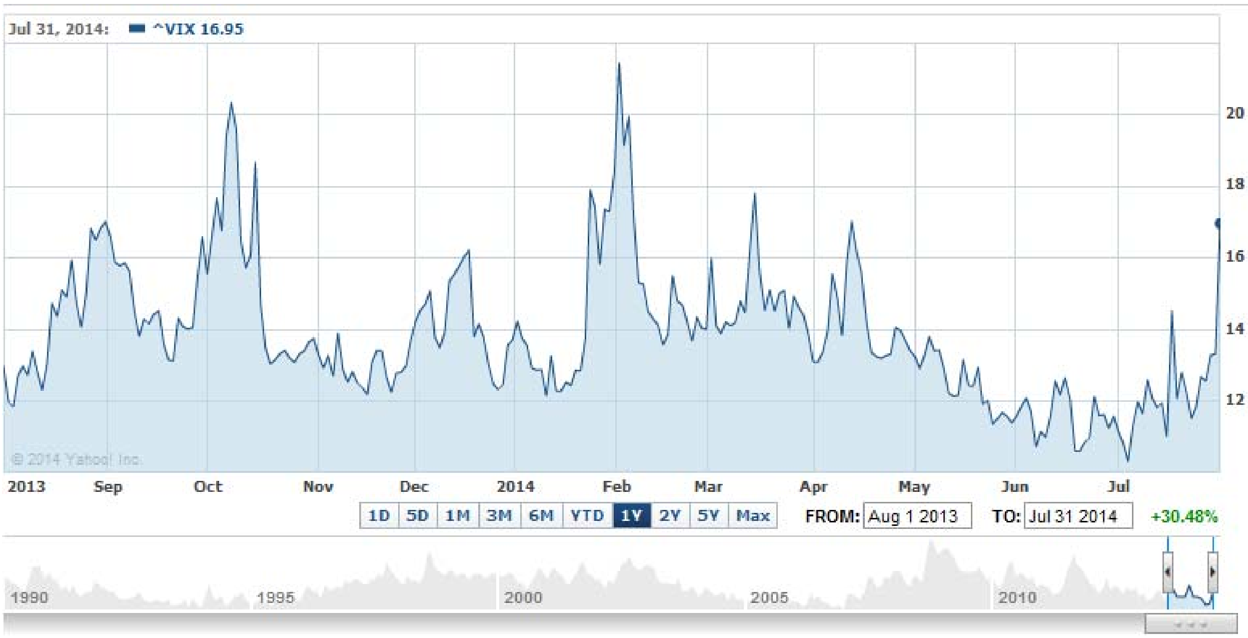
Years with S&P 500 Performance Greater than 25%

Year	Price Return	Following Year's Return	Year	Price Return	Following Year's Return
1928	38%	-12%	1980	26%	-10%
1933	44%	-5%	1985	26%	15%
1935	41%	28%	1989	27%	-7%
1936	28%	-39%	1991	26%	4%
1945	31%	-12%	1995	34%	20%
1954	45%	26%	1997	31%	27%
1955	26%	3%	1998	27%	20%
1958	38%	8%	2003	26%	9%
1975	32%	19%	2013	30%	?
Average				*32%*	*6%*

Source: Geneva Capital

For some context, the table above compares the performance of the S&P 500 Index during its strongest years (when the index returned over 25%) and during the following years. On average, the S&P return was positive but much more muted during years following a 25% or greater return. It should not be surprising then, that after an exceptionally strong 2013, 2014 saw some moderation in the pace of market advances with a +7% gain through June.

The S&P 500 has posted several new record highs in 2014. As it approached the 2,000 level, however, the index started to waver. After reaching 1,991 during the July 24th trading session, the S&P 500 Index retreated to 1,916 on August 1st, a loss of 3.6%. It is not unusual for the market to retreat 3-5% as it approaches or reaches a "round number". In addition, August seasonality is typically weak and September is only slightly better. Finally, volatility had been unusually compressed in July, falling to a record low of 10, before spiking back up to 17 at the close of the month. Combined, these technical indicators provide a helpful framework for understanding the current market dynamics, even if they have no relevance to long-tem investors.



Source: Yahoo Finance

This short-term weakness does not yet qualify as a "correction", which is typically defined as a price decline of 10% or more. However, it serves as a reminder that corrections are a normal part of the market cycle. It has been 25 months since the last 10% correction, and the average for such a correction over the last 83 years is 15 months. Trading volumes have been light -- one observer (Richard Skeppstrom of Eagle Asset Management) characterized markets as "strangely quiet". Strangest perhaps, because the low trading volume and low volatility seem to ignore the escalating risks brewing in several complex geo-political hotspots, most notably Russia-Ukraine and the Middle East. Mr. Skeppstrom quipped: "The market doesn't watch CNN anymore."

While Mr. Market can afford to tune out CNN for a while, it should not ignore the fundamental issues of equity valuations and corporate profits. Valuations, especially in the U.S. and Europe, are elevated. Current price/earnings multiples, using trailing one-year reported earnings, are among the highest in the past 10 years. The 20-year comparisons are slightly better, but not compelling either. (In the table below, the higher the percentile number, the more expensive the asset class is relative to historical norm.) Importantly, active, fundamental, valuation-conscious investment managers do not own "the market"; they need just a small number of attractive opportunities to build concentrated portfolios for their clients, but the pickings are quite slim at present.

VALUATIONS OF MAJOR ASSET CLASSES

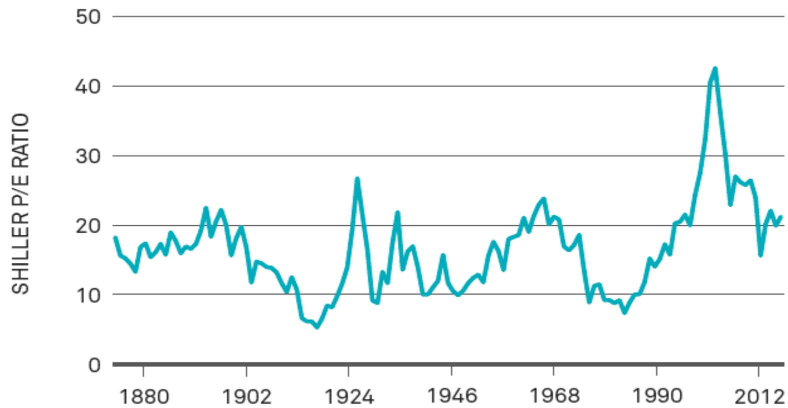
P/E Ratio	Large Cap	Small Cap	U.S. Growth	U.S. Value	Europe	Japan	DM	EM
Current	16.2	19.0	18.1	14.6	13.8	12.9	14.7	10.1
10Y percentile	93.2%	94.9%	68.0%	98.3%	89.0%	15.9%	76.4%	33.6%
20Y percentile	61.9%	84.8%	41.1%	71.4%	51.9%	8.2%	39.8%	26.4%

Source: Bloomberg 4/15/14. Asset classes represented by relevant Russell indexes.

Source: BlackRock

If, instead of reported trailing 12-month earnings, the P/E multiple is calculated using cyclically-adjusted earnings, the valuation opportunity appears even more limited. The following chart plots the so-called Shiller P/E or CAPE over the very long term. The current level (over 20x) is clearly high, but it is also evident from the chart that the Shiller P/E can get higher -- and stay higher -- for a while. Rather than making a call on the timing of a market top, we simply contend that valuation risks are high and caution is required.

FIGURE 3: CYCLICALLY ADJUSTED PRICE-TO-EARNINGS (CAPE) RATIO (1880 TO PRESENT)

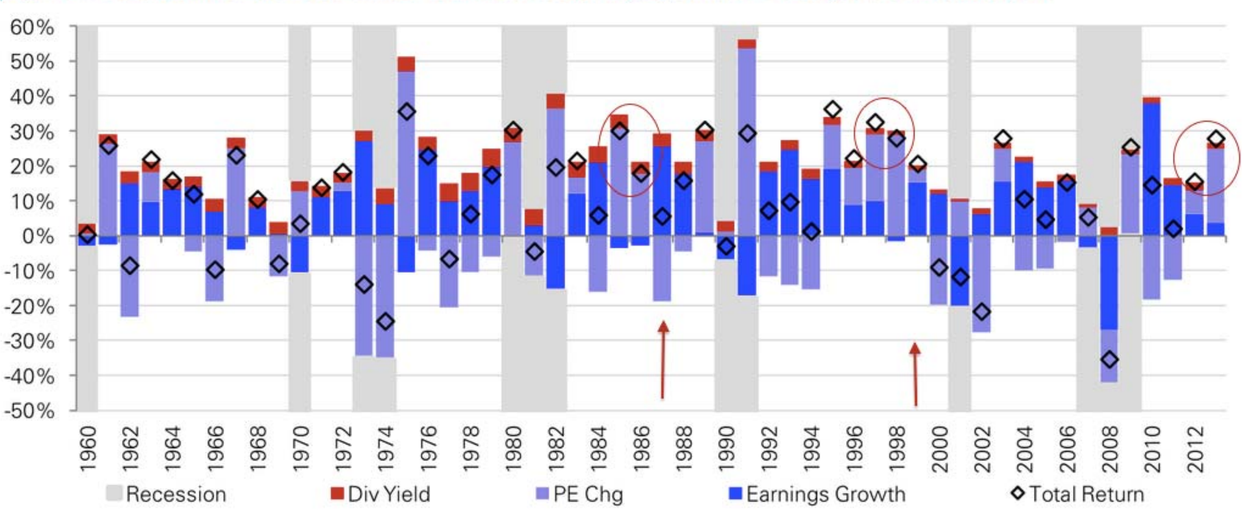


Source: http://www.irrationalexuberance.com/index.htm, accessed 4/15/14.

Source: BlackRock

Equity market returns over the past couple of years have been fueled by multiple expansion, as shown in the following breakdown of S&P 500 return components. The moderation of price gains in 2014 and the recent bout of volatility may be indicative of a market experiencing "growing pains". As valuation cannot keep expanding indefinitely, corporate profits need to catch up via accelerating growth at the top line or further margin expansion at the bottom line.

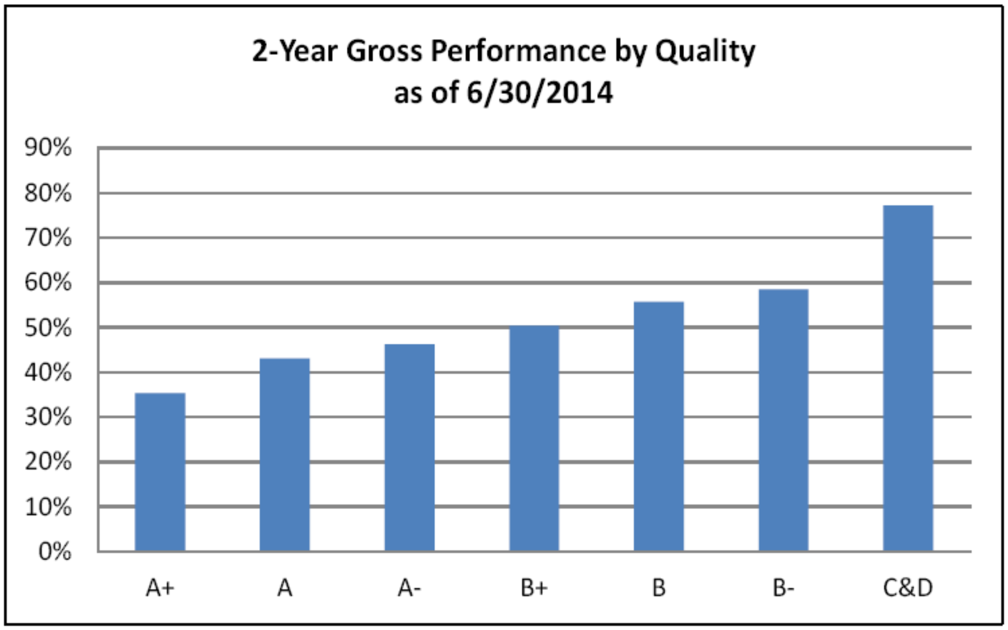
Figure 1: Breakdown of S&P 500 annual total returns earnings growth, PE change, and dividend yield



Source: Company Financial Reports, Standard and Poor's, Deutsche Bank

Source: The FatPitch Blogspot

Profit margins, like valuations, are at historic highs. As mean-reverting variables, they are more likely to decline from current levels, than to continue to go up. Sales growth, on the other hand, has been subpar for this stage of the economic cycle. We have reached the point, it seems, at which businesses need to increase the rate of top line growth in order to justify the valuations assigned to them by investors. High-quality businesses are in a better position to do that than lower-quality businesses -- they have stable business models, strong competitive positions, capable management teams, and solid balance sheets. Furthermore, these companies have lagged significantly their lower-quality counterparts over the past two years, as shown in the bar chart below. As a result, high-quality companies are more attractively priced and are selling at higher margins of safety.



SOURCE: BANK OF AMERICA/MERRILL LYNCH AND SIT INVESTMENT ASSOCIATES, INC., JUNE 30, 2014

Source: Sit Investment Partners

The quality conundrum has been a challenge for many of the best investment managers. When equity markets are propelled higher by high beta/high leverage/high risk stocks, these managers tend to underperform and "miss out" on a parabolic increase in biotech stock prices or the latest social media darling. We acknowledge that one can gain by following momentum. But almost without fail, these gains eventually prove unsustainable. Sooner or later, market momentum turns a corner, the bull tires from the long run, and a period of "growing pains" ensues.

We share Mr. Warren Buffett's belief that "[t]he stock market is a highly efficient mechanism for the transfer of wealth from the impatient to the patient”. As always, Beacon Pointe will closely monitor developments for tell-tale signs that the global economy and financial markets are working through their "growing pains", while the investment managers we recommend to clients will continue to invest capital prudently, relying on original research and bottom-up fundamental analysis, with each client's long-term investment objectives and risk tolerance in mind.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.