Ferguson | Johnson Wealth Management

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Quarterly Report

John Ferguson, Principal

> *"We cannot solve problems by using the same kind of thinking we used when we created them."*
>
> -Albert Einstein

Over the past 30 years I have used, several times, the first lines of the song *What a Difference a Day Makes* in our quarterly commentary*; twenty-four little hours.*

The song returns to my thoughts as I witness the occasional wild daily swings of the stock markets of the world. The last few trading days of September and the first six trading days in October saw the market careen in one direction and then another. On October 7th, the Dow fell 273 points on news that "concerns mount that global economic growth and slowing[1]" The next day, the Dow was up 274 points and the S&P 500 index had the biggest rally of 2014 because "The Federal Reserve's hint that interest rates will stay near zero[2]."

Between Derek, Jon, and myself we have decades in the financial trenches. We think of ourselves as battle hardened, solid footing financial managers. I bring this up because the market gyrations we have witnessed the past couple of weeks are so similar to the dozens we have lived through before. Your financial ship is being guided by sets of hands that have successfully weathered these storms.

We are settling into our new offices.

We are now fully moved in to our downtown Rockville, 51 Monroe Street location. We are just off the Rockville Pike and a short distance from I-270. It took us a little bit to get everything installed and ready to go. Fortunately for Derek, he escaped the bulk of the move while honeymooning in Europe!

Thanks to your referrals, we have grown from one Investment Advisor Representative to three and continue to add support staff. Just this month, we are welcoming our newest member of the team, Angela.

Estate Planning

When was the last time you had you Wills or Trusts reviewed? Changes in the Estate Tax Exemption and the Federal Estate Tax rate along with changes in state laws are reasons to have your Estate Plan reviewed by your attorney. If it has been five years or longer we suggest you put that item on your short-list. This may well save your surviving spouse and/or heirs from significant tax and estate issues.

The Markets

The third quarter was not kind to investors with prudently diversified portfolios. While the Dow rose 1.3% and the S&P 500 gained 0.6%, the benchmark S&P 500 posted 15 new 52-week highs and 18 new lows[3].

It was the developed markets and the small cap stocks that took a hit and these contributed to negative quarterly returns for diversified portfolios.

The following are the returns for various MSCI Large and Mid-cap Stock indexes for the quarter:

MSCI INDEX	3MTD
EAFE	-6.39 %
EUROPE	-7.37 %
EUROPE & MIDDLE EAST	-7.32%
NORDIC COUNTRIES	-5.24 %
NORTH AMERICA	0.05 %
PACIFIC	-4.46 %
WORLD	-2.58 %

The Small Cap indexes also faired poorly.

MSCI INDEX	3MTD
EAFE + CANADA	-8.75 %
EUROPE	-10.52 %
FAR EAST SC	-4.26 %
NORTH AMERICA	-6.19 %
WORLD SC	-6.96 %
WORLD ex USA SC	-8.75 %[4]

I've included an interesting article that I would like to share with you discussing market timing. We thought you might find it thought-provoking and another reason why we do not try and time the markets. It just hasn't proven itself to be a viable investment strategy.

Please give us a call if there's anything you would like to discuss. We would love to hear from you. Best wishes from us to you for a wonderful fall season.

John, Derek, Jon, Christina, & Angela

[1] Associated Press, "US stocks slide as evidence of a global slowdown mounts; SodaStream plunges," US News & World Report, October 7th, 2014

[2] Oliver Renick, "Stocks rally most in 2014 as Fed bets spur rebound," MSN Money, October 9th, 2014

[3] Caroline Valetkevitch, "Wall St. ends down for day, month; indexes gain in quarter," Reuters, September 30th, 2014

[4] Performance data; Source: MSCI as of 9/30/14.

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Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 actively traded "blue-chip" stocks, primarily industrials, but includes financials and other service-oriented companies. The components, which change from time to time, represent between 15% and 20% of the market value of NYSE stocks.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market value weighted index with each stock's weight in the index proportionate to its market value.

Dimensional

DOWN TO THE WIRE

By Weston Wellington
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CAPE Fear: Valuation Ratios and Market Timing

As broad market indices such as the S&P 500 have set new record highs in recent weeks, many investors have become apprehensive. They fear another major decline is likely to occur and are eager to find strategies that promise to avoid the pain of an extended downturn while preserving the opportunity to profit in up markets.

One approach that has attracted considerable attention in recent years is adjusting investments based on the CAPE ratio–the Cyclically Adjusted Price / Earnings ratio.

Developed by Robert Shiller of Yale University and John Campbell of Harvard University, the CAPE ratio seeks to provide a road map of stock market valuation by comparing current prices to average inflation-adjusted earnings over the previous 10 years.[1] The idea is to smooth out the peaks and valleys of the business cycle and arrive at a more stable measure of corporate earning power. Shiller suggests that investors can improve their portfolio performance relative to a static equity allocation by overweighting stocks during periods of low valuation and underweighting stocks during periods of high valuation.

A CAPE-based strategy has the virtue of using clearly defined quantitative measures rather than vague assessments of investor exuberance or despair. From January 1926 through December 2013, the CAPE ratio has ranged from a low of 5.57 in June 1932 to 44.20 in December 1999, with an average of 17.54.

Using the CAPE ratio might appear to offer a sensible way to improve portfolio results by periodically adjusting equity exposure, and many financial writers have focused on this methodology in recent years. As an example, a timing newsletter publisher earlier this year observed, "For the S&P 500, this ratio currently exceeds 25.6, which is higher than what prevailed at 29 of the 35 tops since 1900."[2]

1. CAPE data available at http://www.econ.yale.edu/~shiller/data.htm.
2. Mark Hulbert, "This Bull Market is Starting to Look Long in the Tooth," *Wall Street Journal*, January 18, 2014.

Many investors find such an approach very appealing. Does it work?

The challenge of profiting from CAPE measures or any other quantitative indicator is to come up with a trading rule to identify the correct time to underweight or overweight stocks. It is not enough to know that stocks are above or below their long-run average valuation. How far above average should the indicator be before investors should reduce equity exposure? And at what point will stocks be sufficiently attractive for repurchase–below average? Average? Slightly above average? It may be easy to find rules that have worked in the past, but much more difficult to achieve success following the same rule in the future.

This implementation challenge appears to be the Achilles' heel of timing-based strategies. A study in 2013 by professors at the London Business School applied CAPE ratios to time market entry and exit points. "Sadly," they concluded, "we learn far less from valuation ratios about how to make profits in the future than about how we might have profited in the past."[3]

As an example of the potential difficulty, consider the CAPE data as of year-end 1996. The CAPE ratio stood at 27.72, 82% above its long-run average of 15.23 at that point. Federal Reserve Chairman Alan Greenspan had delivered his much-discussed "irrational exuberance" speech just three weeks earlier. The last time the CAPE ratio had flirted with this number was October 1929; the CAPE was at 28.96 as stock prices were about to head over the cliff. It seems plausible that followers of the CAPE strategy would have been easily persuaded that investing at year-end 1996 would be a painful experience.

The actual result was more cheerful. The next three years were especially rewarding, with total return of over 107% for the S&P 500 Index. For the period January 1997 to June 2014, the annualized return for the S&P 500 Index was 7.67%, compared to 2.42% for one-month US Treasury bills. Stock returns were modestly below their long-run average for this period, but the equity premium was still strongly positive.

By comparison, a timing strategy over the same period that was fully invested in stocks only during periods when the CAPE ratio was below its long-run average produced an annualized return of 3.09%. All timing strategies face a fundamental problem: Since markets have generally gone up more often than they have gone down in the last 90 years, avoiding losses in a down market runs the risk of avoiding even heftier gains associated with an up market.

A successful timing strategy is the fountain of youth of the investment world. For decades, financial researchers have explored dozens of quantitative indicators as well as various measures of investor sentiment in an effort to discover the ones with predictive value. The performance record of professional money managers over the past 50 years offers compelling evidence that this effort has failed.

Despite this evidence, the potential rewards of successful market timing are so great that each new generation sees a fresh group of market participants eager to try. Searching for the key to outwitting other investors may be fun for those with a sense of adventure and time on their hands. For those seeking the highest probability of a successful investment experience, maintaining a consistent allocation strategy is likely to be the sounder choice.

3. John Authers, "Clash of the CAPE Crusaders," *Financial Times*, September 3, 2013.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results.

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