WOODSTOCK

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Recently we were reminded of a key concept in our investing style by reading a quote from Benjamin Graham: "The risk of paying too high a price for good quality stocks (while a real one) is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions. The purchasers view the current good earnings as equivalent to 'earning power' and assume that prosperity is synonymous with safety". As Tom Stakem discusses in his article, risk assets appear ready to benefit from existing economic conditions for a while longer. We expend much effort trying to determine which are good-quality versus which are low-quality risk assets and adding good-quality to our clients' portfolios.

In the "macro" investing world there are many intriguing ideas floating around: pipelines to participate in the US energy boom, emerging markets funds to participate in the growth from a lower to a higher standard of living around the world and private investments because they have the potential to outperform public investments. But on the one hand, "no investment idea is so good that what you pay for it doesn't matter" and every investment vehicle needs a "micro" check to see how it works, and on the other hand higher quality US companies have managements and Boards trying hard to solve the very same problems and take advantage of the opportunities created. In looking around at this macro world (1) an investment that offers a steady return (bond-like) but carries with it an equity-type risk is asymmetrical on the down side, and hence a poor investment, (2) emerging markets funds tend to be heavily weighted to financial stocks (perhaps, low quality but certainly out of favor with governments and subject to excessive regulation) and those wishing to pick emerging markets consumer or utility stocks to benefit as the emerging markets consumer strengthens, encounter high valuations. "Investors looking to benefit from the 'EM Consumer' might do better to look in developed markets for companies which place emphasis on benefiting from EM consumption." And while analyzing the risks of a private investment, remember that leverage can be a significant component of private investment returns and sometimes is hard to spot. We are familiar with and even invest in some of the above, but we believe that the vast majority of a portfolio should be in higher quality US stocks.

At Woodstock our investment managers both work independently and as a group: the divided and collegial aspects of research on companies and concepts combined with the sharing of those ideas with other managers, and then the individuality of standing next to your own performance and meeting with a client. We ask a lot of our managers and they and we inhabit a very competitive financial market place. Sometimes we are lucky to find top flight talent that wants to work in our environment and sometimes we lose talent to others. We can understand, but still be disappointed, that Bob Davidson and Naomi Delassandro have left Woodstock to work for others. We feel very confident in the managers at Woodstock and are heartened by the comment of one client whose manager was leaving who said he enjoyed working with his manager very much but appreciated Woodstock's philosophy more. As we add new managers we will work hard to maintain our philosophy.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

Please feel free to call or email either of us with questions, comments or concerns regarding Woodstock.

We thank you for your support and want you to know that we are dedicated to serving your best interest.◆

William H. Darling, Chairman
Adrian G. Davies, Executive Vice-President & CIO

[1] *from The Intelligent Investor*
[2] *Ask your PM for reference*
[3] *Ask your PM for reference*

Are Higher Stock Prices Ahead?

Thomas C. Stakem

With a -2.1% real GDP Q1 print in the rear view mirror (despite other indicators that suggested positive growth for the period), low interest rates, a positive sloping yield curve and a Federal Reserve which will err on the side of data being too strong before taking serious breaking action, the outlook continues to be favorable for "risk assets" (aka stocks). Earnings have grown with little help from sales (or top line) growth as productivity, cost containment actions by companies and the lack of pressing commodity cost pressures have allowed profit margins to surprise the entire business cycle since December 2008. "Regression to the mean theorists" believe it is late innings for profit margins and that the rarified air of 10% net margins [A 10.2% margin is implied in the 2015 EPS estimate] will regress to the mean level of 7% using the last twenty-two years of Standard & Poor's data. However, with almost synchronized global growth looking more and more likely and an uptick in inflation (an avowed policy in some countries) over the next few years an argument can be made that profit margins will not regress but continue to trend higher. Perhaps not spectacularly but eking out 0.2 to 0.3 percentage points a year for the next few years would complement revenue growth and allow corporate earnings to rise high single digits for the duration of this cycle. And while we have seen (and complained) for five years that this business cycle has been the weakest on record it also augurs for a longer, if slower, expansion cycle that could last until the end of the decade. Being on recession watch does seem to be very premature with the monetary stimulus focus worldwide. Thus, among the "worries" facing investors sixty-five months into a bull market should be "What if this continues for another few years?" Already elevated, equities are the only asset class that offers a chance of positive real returns. Cash and bonds are unattractive at current yields. Real estate has had a great move and commodities/alternatives are beyond most investors' radar screens. One quickly comes back to stocks and with the S&P 500 trading at 16x forward 12 month earnings one would have to conclude that equities are dangerously overpriced to be terribly fearful. But it is natural to be defensive after a 200% gain in a little over five years.

Equity drift

Being fully invested (optimally given one's asset mix preferences) since early 2009 when the stock market bottomed has obviously been the maximum return tactic or strategy. Unfortunately, most investors were not only not fully invested but were selling then because of the emotional pain of seeing investment values and net worth melt away. For argument's sake, if a 70%/30% equity/fixed income investor was fully invested in equities and portfolio income was reinvested that original 70% equity exposure would now be about 85% of the portfolio. Thus, the danger in even higher stock prices is to become undisciplined and allow the equity weighting to rise further if 70% is the appropriate and comfortable risk tolerance level for the client. Most investors easily and willfully forget that as the market rises, the reward/risk relationship gets more and more unfavorable. At the apex it might even be 1% reward, 25%-30% risk. To compound matters the investor doesn't have their equilibrium long term equity allocation exposure of 70% but 85% (or more) exposing them to more absolute risk. So with higher prices likely ahead for a quarter, or a year, serious consideration needs to be given to peeling back equity exposure in the direction of one's long term equilibrium equity allocation. That asset shift might favor cash or bonds depending on one's situation and how menacing the interest rate outlook is at the time.

Investment stats revisited

For the next several years a reasonable total annual return estimate for stocks is 7% and is consistent with 3% or less returns for cash, bonds and inflation. So while it is pretty easy to establish equities as the asset class of preference for growing wealth or maintaining purchasing power the question is how much risk is one willing to take to overweight that superior asset class. This is where the tricky "risk tolerance" assessment piece comes into play for a manager as well as a client. There are two main ways to think about risk. One would be thinking in terms of to what lengths an investor should go to avoid a 25% drop in stock values in one's portfolio. After a 200% increase a 25% decline might seem rather small but the emotional roller coaster involved may not be easily absorbed by all investors. Plus one never knows, ahead of time, just what the extent of the decline will be. At the 25% decline point a 50% decline looks a lot more realistic than at the peak. But an investor has to ask him/herself "How defensive should I get to avoid a potential 25% decline?" and remember there is a capital gains tax consequence too.

The other way to think about risk is in the statistical sense most common in the investment industry. Asset allocation studies/simulations typically require three inputs for each of the asset classes in the study – an annual return forecast, a standard

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deviation estimate, and the correlation coefficient relationship to each of the other asset classes under study. Assessing risk in these terms has its limitations, but it does help to illustrate some points. A common annual equity standard deviation statistic would be 17%. Thus the equity asset class return/risk coordinates are 7% and 17%. Similar coordinates for cash, bonds are required before the portfolio optimization exercise can be performed. This too has a bearing on how an investor should think about equity exposure. The equity return and risk coordinates represent that in any one year there is a 68% probability that the equity return will fall between -10% and +24% – that's the statistical definition of a one standard deviation outcome around the 7% expected return. There's a 95% probability that the equity return falls between -27% and +41% -- that's two standard deviations. Yes there is higher confidence but the range of outcomes is wider. Isn't that a big help in gauging what one's equity exposure should be?! After the stock market has tripled since 2009 and one's equity exposure has drifted up 15% over equilibrium the thought of the return of 85% of one's portfolio swinging from -10% to +24% certainly should grab one's attention particularly if one's investment horizon is less than five years. Thus, the danger of additional stock price strength is that complacency replaces vigilance in terms of an investor's asset mix balance.

For a mathematical analysis of your risk tolerance, contact your portfolio manager. We use a financial analysis software package that applies risk tolerances to your portfolio and aspirations.

Other Worries

Bull markets reportedly require a "wall of worry" to sustain their longevity – keeping an adequate number of investors on the sidelines to provide liquidity for ever higher prices. This cycle appears to be no different. We have had the slow GDP growth rates, an anemic employment recovery, cautious consumer confidence and muted capital spending despite record corporate cash flows. Companies are generating mid-to-high single digit earnings growth on little or no revenue growth due to ruthless control of costs and muted expansion plans because of all the economic and policy uncertainties.

By our math the net after tax margin of the S&P 500 constituents since the end of 2008 increased by 5.65% from 3.61% to 9.26% as of Q1 2014 (5.25 years). This is despite DD&A (depreciation) and Research & Development collectively increasing by 1% pretax. 60% of the net margin enhancement came from lower cost of goods sold, 36% from lower SG&A (selling, general & administrative) and 21% from lower interest expense (this occurred solely as a result of a 30% decline in the effective interest rate as total debt was about unchanged at $5.8 trillion. The effective reported tax rate also declined 36% from 45.1% to 28.3%. Obviously, costs have been well under control in the post financial crash period and corporations have benefitted from the cost deflation trend as a percent of the revenue dollar. The icing on the cake has been the ability of companies to reduce their share counts with the excess cash flow generated from increasingly profitable operations. Expecting earnings to grow 7% a year at a time when companies may continue to purchase ~ 3% a year of their shares leaves an undemanding 4% growth expectation from ongoing operations. Should capital spending pick-up smartly reducing ability to repurchase shares at a $125 bns. per quarter rate the onus would shift to the presumably faster growth from operations implied in the decision to raise capex.

Since our analysis was based on absolute dollars we are not easily able to put the nearly $2 trillion in common share buybacks since December 2008 in per share terms. However, with the market capitalization of the S&P 500 averaging about $13 trillion during the period these buybacks amounted to a hefty 15% of market capitalization.

The list of worries has not shrunk over the last year and may have even grown. From China's growth rate to the interest rate impact of the Federal Reserve's taper program (and its impact on housing and autos which have been U.S. bright spots) to energy prices globally while tensions are flaring again in the Middle East, Iraq, etc., etc. Is Portugal's fragile banking system a canary in the Euro "economic recovery" coal mine? Even Germany's economic vigor may soon need some QE from the ECB according to some observers.

Because they seem to occur so frequently what used to be thought of as "exogenous factors" are now almost recurring occurrences. Perhaps the market has become conditioned to this persistent uncertainty. Sideline liquidity around the world is apparently so vast that any new negative influence may knock the markets off their pins for days or weeks but doesn't derail the cyclical upswing.

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Mid-single digit corporate earnings growth can still be accompanied by P/E expansion (16x forward today) for another few years as inflation and interest rates will remain low. But against this backdrop of continued equity price advance the prudent investor is assessing the actions they should take at some point to combat the reality that their equity exposure is 15% points above their long term equilibrium levels which were established based on their investment objectives, age, and tolerance for risk. [Our example assumed an investor was fully invested at the bear market low and there hasn't been periodic reductions in the equity weighting over the last five years, an admittedly extreme buy & hold, no turnover investor. It was an intentional oversimplifying assumption to ease the math challenges]. Naturally, for a client with a truly long term time horizon (20 years or more) staying fully invested would be advisable as they are never above their equilibrium equity exposure.

"Lightening up on strength" is not a new diet fad but rather a sensible approach to today's healthy stock valuations and the prospect of these conditions continuing for a while longer. As one bank CEO said a few years ago "When the music is playing, you have to dance". But being vigilant and monitoring one's equity weighting in rising markets should always be a conversation point between client and portfolio manager. While we anticipate that equity prices will continue rise over the long-term, an investor must keep focused on their equilibrium equity allocation because the higher prices rise the more unfavorable the reward/risk ratio turns. Yes, stocks are likely to outperform cash and bonds over the balance of the decade but they will likely return only 50-75% of their long term average return which will still be superior to the 3% or less from cash and bonds.

Contact your portfolio manager with questions, comments, or suggestions.◆

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What is GIPS?

David M. Layden

"It is an immutable law in business that words are words, explanations are explanations, promises are promises but only performance is reality." This oft-referenced quote by Harold S. Geneen is certainly applicable to the investment advisory world, where people invest their money with the expectation of positive returns that will help them achieve their financial goals (college, retirement, etc.). But how are these returns most reliably measured? The short answer is by the Global Investment Performance Standards (GIPS®). Woodstock works diligently to comply with GIPS.

GIPS is a rigorous set of investment performance measurement standards that have received worldwide recognition for their unparalleled credibility, integrity, scope and uniformity. Simply put, GIPS maintains a set of standardized principles used to calculate and present investment performance to potential and existing clients. The standards are sponsored by the CFA Institute, and are created and developed through the collaboration of the global investment community. GIPS mission is to promote ethics and integrity and instill trust through the use of these Global Investment Performance Standards.

An investment management firm can only claim to be GIPS compliant when the standards have been successfully implemented on a firm-wide basis. The firm must meet comprehensive requirements, which include data input, calculation methodology, composite construction, disclosures, presentation and reporting. GIPS is voluntary; investment management firms are under no legal obligation to comply, as they are standards, not laws.

Prior to GIPS, investors had a difficult time finding meaningful comparisons of investment performance information. This standardization of investment performance reporting provides investors a certain level of transparency they require when evaluating investment managers. With these specific guidelines in place, investors have the ability to make "apples-to-apples" comparisons.

For an investment firm, being GIPS compliant can provide legitimacy, which gives investors confidence that their firm strives to meet the highest standards. These standards are recognized as one of the industry's best practices. In addition to being compliant, a firm can choose to be independently verified by a third party. Verification provides an extra layer of scrutiny of a firm's policies and procedures. Woodstock Corporation claims compliance with GIPS and has been independently verified for the period of 7/01/2005 through 12/31/2013. Please contact Woodstock Corporation if you would like a copy of a compliant presentation.◆

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