THOMPSON WEALTH MANAGEMENT, LTD.

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Goldilocks, Gridlock, Diversification and Market Valuation

While the Easter bunny is popular at this time of year, it is the "Goldilocks" economy that's got the stock market hopping. Investors have woken from winter hibernation to find that the economic porridge is just about right for stocks – not too hot and not too cold.

Why is this important? Historically, stocks have performed best under conditions of moderate growth and inflation. Slow growth conditions beget concerns about poor corporate sales and recession. On the other hand, very strong growth (think 1970's) often leads to a spike in inflation expectations and shrinking profits from rising interest rates, materials and labor costs. At the current time, the balance between growth and inflation seems to be in, well… in a sweet spot.

As of March 25, 2013	
Name	**YTD**
Small Cap Value	12.42
Small Cap	11.79
Mid Cap	11.55
Large Value	11.31
S&P 500	9.69
International Small Co	6.48
REIT Index	6.53
Large Cap Growth	5.56
Intl Stock	2.93
Multi Sector Bond	2.21
Short-Term Corp Bond	0.34
Adj Rate Govt Bond	0.24
Total Bond Market Index	-0.27
Emerging Markets	-2.34
Commodity Index	-0.28
Inflation-Protected Bonds	-0.7
Gold	-4.05
Average	**5.6**

Gridlock and the Congressional Effect

We all bemoan gridlock in Washington, especially when major problems aren't being addressed, but the reality is that the stock market tends to perform well when Congress can't get anything done (think Clinton's first term).

Have you ever heard of the Congressional effect? Apparently, going back to the 1940's, an investor who had been fully invested in the S&P 500 when Congress was out of session and fully in cash when Congress was in session, would have beaten the annual return of the S&P 500 Index by a convincing margin. Obviously Congress has been in session for much of the rally in the market over the last several months but, as far as Wall Street is concerned, policy gridlock is the next best thing. (By the way, I don't necessarily agree with that attitude. I'm just the messenger).

Diversification rules over the long run, but not always in the short run

How you view performance often depends on your perspective. So far this year the S&P 500 Index is on a sugar high – up 9.69% -- but the performance of diversified portfolios won't be quite as bright.

The bond market index, for example, is showing a small negative return so far this year and the typical intermediate term municipal bond fund is down around -1%. Municipals had a very strong showing last year, possibly in anticipation of higher tax rates. Ultimately, the tax increases weren't as bad as feared and the municipal market adjusted in Q1.

Equity categories had more significant divergences as illustrated in the YTD Performance Table. Large cap growth stocks have led the market since the 2009 recovery, but in the last quarter we note a marked shift toward value. The Vanguard Value Index returned 11.31% compared with just 5.56% for the Powershares QQQ (largest 100 companies in the NASDAQ). After a very strong Q4, international stocks trailed domestic stocks, up just 2.93% this year. The Emerging Markets index declined -2.34%. And gold did anything but glitter, slumping -4%.).

The net result is that broadly diversified portfolios most likely will lag benchmarks for the first quarter 2013. It is important to keep in mind that, over the long run, diversified, multi-asset class index portfolios have significantly outperformed the benchmarks. At the end of this letter I've attached two slides from our Investing Basics Powerpoint illustrating the long-term benefits of diversification.

Stock Market Valuation (Price-earnings ratio)

The big rally in the stock market is welcome, but it brings the ten year price-earnings ratio (PE) up to 23. We consider that to be a mild *yellow light* based on historical performance data.

It is interesting that in last week's FOMC (Federal Open Market Committee) meeting the Fed Chief said he didn't think the market was too high, implying that the current run-up is consistent with higher earnings. Bernanke also stated that the Fed was not targeting the stock market (meaning they're not trying to inflate it with their monthly asset purchases).

But he's blowing smoke. Bernanke is a depression-era expert. When FDR assumed the Presidency in 1933, in the depths of the depression, he ignored the establishment economists who were advising him to essentially tighten monetary policy. Instead he listened to a little known agricultural economist from Cornell who told him – "if you get prices [crops, land, and stocks] moving upward again, confidence will return." Indeed stocks rose 385% from 1933 to 1937. That history lesson underlies Bernanke's policies over the last four years…and thank God!

But what made the Great Depression so harrowing was the second downturn in 1937-38, which happened because FDR was forced to cut stimulus spending – obviously a lesson many of our present day lawmakers missed. Based on this it has been my belief all along that Bernanke would keep applying monetary stimulus for many years, until the economy is on very sound footing and shows signs of inflation. (Some inflation is good.) Our belief in a monetary floor to the market has itself underpinned our confidence as the market advance has been punctuated with a correction of at least 15% in each of the last three years. Staying the course has been the right thing to do, and I believe that continues to be the right general course.

So why the yellow light? Am I being an Easter Grinch? And what does that mean for portfolio management?

First, it is important to see that price-earnings ratio (stock market valuation) is not a dependable indicator of market returns in the short term, e.g. one year. (See October blog article, Vanguard Study, What Market Signals Matter). But there is a very strong historical inverse correlation between extreme valuation conditions – approximately when the PE ratio is < 13 and >25 -- and longer term returns, e.g. ten years. In the short run results are always random (anything can happen). And in the middle valuation range, results are pretty random too. But when values are very low or very high, long term returns are not random. It doesn't become apparent immediately, but low priced markets correlate with higher than average forward ten year returns. And very high priced markets are likely to result in much lower than average forward ten year returns. You don't have to go back very far in history to see this.

In 1982 the PE was under 10 and the market return over the following two decades averaged 15% a year. By 2000, the PE was 40 and the following decade stocks returned about 2.5% per year. It basically took two bear markets to get the PE down into a reasonable range. Of course the market generally overshoots "reasonable" and by early 2009 the market traded at a PE below 13. Since then the market has gained 120% in four years.

Things are not that simple, however, because inflation adds another dimension to the equation. Over the long run equities have returned about 6% over inflation (this is called "real return"). In 1982 expectations were for inflation to rise 10% annually. So in order to get a 6% return after inflation, investors needed to price stocks low enough to return 16% per year. Pay a lower price; get a bigger chunk of the earnings (the "E" in "PE"). But jump forward to 2013. Inflation expectations are in the range of only 2%. Now an 8% return will generate the historical 6% real return, and stocks are priced accordingly. **So we absolutely expect PE ratios to be high when inflation is low.**

One reason for bringing this to your attention is so that you have realistic expectations for equity returns going forward, and can adapt financial plans accordingly. The whole psychology of Wall Street is such that people tend to get more confident about the market and overestimate returns when market prices are high. But the reality is likely to be just the opposite. You need to defend your mental process – and your investment strategy – from popular delusions. "Following the market" is a terrible idea over the long run! But it is among the hardest temptations to resist, which is why investment success is elusive for many.

Second, while the market isn't there yet, it is close enough for us to be on the alert for the possibility that it might continue to rise to levels that historically have warranted caution. Positive factors are driving a reallocation of money from bonds into equities – resilient corporate profits, low interest rates and accommodative Fed policy, low inflation, market momentum, and a strengthening (but not too strong) economy. There is plenty of sugar in those factors to drive stock prices still higher!

So what's the concern? We – you, me and those of us who focus on long-term investing – can take market fluctuations in stride as long as we know that we have a margin of safety. That means two things. First, it means that we have a prudent asset allocation that accurately reflects our financial and behavioral ability to handle risk. This is something we can control, and it puts us in a position of competitive strength. The banking geniuses have a bad habit of getting into an extended risk position every five to seven years so that, when the inevitable hiccup comes, they have no choice but to panic and sell out in a fire sale. That's not a position you ever want to be in.

Margin of safety also means that we can be reasonably confident that our investments, despite constant price fluctuations, will eventually reflect their fundamental value. **However, there is little margin of safety when prices are so high that the return <u>of</u> our investment can't be obtained through accumulated profits over a realistic time frame and, therefore, that investment outcomes must rely to a larger degree on speculation – hope upon hope that a greater fool will come along and buy from us at an even higher premium.**

I may not get my wish, but I do think it would be constructive if the market were to pull back somewhat, and I'd encourage you to prepare mentally for that. I don't take out my crystal ball much, but there is a scenario for a correction, just not one you might expect. Right now the market is banking on "Goldilocks" and moderate growth/inflation.

Main Street wants to see faster growth to reduce unemployment. If growth accelerates it will likely cause an uptick in inflation expectations. This may set up a counterintuitive situation. The economy will grow faster, but the stock market will go through a moderate correction. Earnings will rise. Prices will go sideways or down. And the earnings recession from 2003 will no longer be in the ten-year PE data. That will reduce the PE to sustainable levels.

We are maintaining your portfolio at or just below your long- term asset allocation target for equities. At the same time we are looking to rebalance if possible into those asset categories and stocks that are trading at lower valuations and offering higher potential long-term returns.

As always it's important to make sure that money needed to fund near future portfolio withdrawals is liquid in cash or short-term bonds. We want to hear from you if your financial goals have changed to include the potential for sizable withdrawals over the next few years. It is also important to double check risk tolerances. Rising markets can cause us to overestimate our ability to take on risk.

If the market indeed trades up to unsustainable levels, we will follow our discipline and implement *valuation driven rebalancing* to maintain portfolio risk at targeted levels by progressively reducing equity allocations to the low end of allowed ranges.

Once again, from the entire team here at TWM, we wish you a happy Easter or chag Pesach sameach. Please don't hesitate to call with questions or comments. And, above all, thank you for your continued confidence and support

Best Regards,

Bruce P. Thompson

Primer: Relationship between PE Ratio, Return, Margin of Safety

Suppose a neighbor knocks on the door and offers to sell you a property which can be rented for income. Let's further suppose the price offered is $500,000 and that you determine after checking with some brokers that the property has a very stable history of generating $25,000 rent per year after expenses. Your return would be 5% per year and it would take you 20 years at that rent to recoup your investment.

This your *fundamental* return. You may end up selling the property for more or less than you paid – that is the *speculative* portion of the return. The fundamental return offers a margin of safety against unexpected events. Over ten years you would collect $250,000 in rent (leaving aside potential rental increases, etc.) If there is a big downturn in real estate or someone builds a parking lot next door and you end up selling the property for $400,000 (20% loss), you've still got a good margin of profit.

But now let's suppose that when you bought the house you got caught up in a rapidly rising market and engaged in a bidding war with another neighbor. You bought the property for $1,000,000 instead of $500,000. With the same rent your fundamental return would be 2.5% and it would take you 40 years to recoup your original investment through profits. You've got a slim margin of safety. You'll collect the same $250,000 in rent, but if the property declines 20% in value it will just about wipe out your profit.

Let's consider one more example wherein you purchase the property for $250,000. With rent at $25,000 per year, your return is 10% per year. It will only take you 10 years to recoup your original investment. Over twenty years you will collect $500k in rent -- a large margin of safety in the event the property is sold for a loss.

Margin of Safety – essentially the fundamental components of an investment, including the profits that a company earns and either distributes to you in the form of a dividend or reinvests in the company in your behalf as a shareholder/owner. This can take the form of reinvesting for additional growth, purchasing other companies, buying back stock or paying down debt.

The key here is to understand the distinction between the fundamental and speculative components of return and the relationship with price paid. The higher the price paid relative to profits, the more investment outcomes will rely on speculation.

Demystifying the Price- earnings ratio – the PE ratio simply refers to how many years of profits it would take a company to earn back the stock price at the current earnings per share. In example #1, the price of the property was $500,000 and the rent (earnings) was $25,000. The Price/Earnings is 20 – meaning it would take 20 years of earnings to equal the price. In the same way, a company with a $50 stock price and earnings of $2.50 would have a PE ratio of $50/$2.50 = 20. It would take this company 20 years to earn back the price paid for a share of stock.

The investment in Example #2 is purchased at a higher price-earnings ratio ($100/$2.50 = 40) and this gives a much lower fundamental return of 2.5%. The investor is basically hoping that either earnings will grow rapidly or someone will come along and pay a much higher multiple of earnings. Either way the investor has only a slim margin of safety against the chance that the future might not turn out quite as planned – that earnings might not grow as rapidly as hoped or investors might not afford a higher price earnings multiple. Things must go swimmingly for this investment to work out well. And this could be a great “safe” company, but if the price paid is too high the investment outcome is still speculative.

Ho w would you compare the investment in Example #3 to the one made in Example #2?

When you hear commentators talk about the PE ratio for the stock market, e.g. the Dow Jones or the S&P 500 Index, it refers to the cumulative price/earnings per share for all the companies in the index. The concept is exactly the same and it provides a guidepost for understanding value – what you’re getting for what you’re paying – for the market as a whole.

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Thompson Wealth Management, Ltd is a boutique investment counseling firm, providing integrated portfolio management and financial planning for an intentionally limited number of individual and corporate clients.

Our highest priority is to help clients achieve financial independence, and the time and peace of mind to enjoy it.

TWM’s values, best practices and investment policies have been shaped by the experience and personal convictions of its principals. The articulation of these values throughout our website and client letters serves as both a compass and a map to the firm and its clients.

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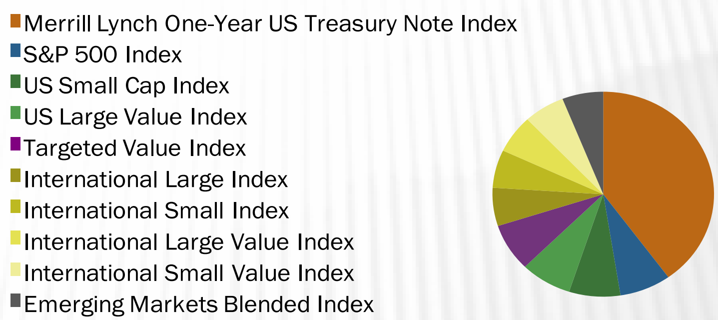
Benefits of Diversification

The table below illustrates the results of five model portfolios, 1975-2011. While each model is comprised of 60% equities and 40% fixed income investments, Model Portfolio 5 invested among eleven different asset classes had a significantly higher return than the two asset class portfolio (Model 1) with similar standard deviation of returns (volatility). Past performance is not a guarantee of future returns.

DIVERSIFICATION 1975-2011

S1920.7

	Annualized Compound Return	Annualized Standard Deviation
Model Portfolio 1	**9.47%**	**11.16%**
Model Portfolio 2	**8.83%**	**10.23%**
Model Portfolio 3	**9.74%**	**11.88%**
Model Portfolio 4	**10.68%**	**11.81%**
Model Portfolio 5	11.65%	11.26%



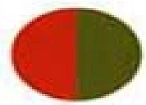
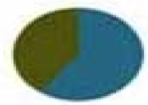
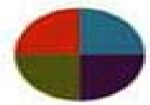
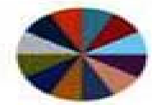
	Barclays US Govt./Credit Bond Index	S&P 500 Index	BofA Merrill Lynch One-Year US Treasury Note Index	US Small Cap Index	US Large Value Index	Targeted Value Index	Intl. Large Index	Intl. Small Index	Intl. Large Value Index	Intl. Small Value Index	Emerging Markets Blended Index
Model Portfolio 1	**40%**	**60%**									
Model Portfolio 2		**60%**	**40%**								
Model Portfolio 3		**30%**	**40%**	**30%**							
Model Portfolio 4		**15%**	**40%**	**15%**	**15%**	**15%**					
Model Portfolio 5		7.5%	40%	7.5%	7.5%	7.5%	6%	6%	6%	6%	6%

Rebalanced annually. Barclays Capital data provided by Barclays Bank PLC. The S&P data are provided by Standard & Poor's Index Services Group. The Merrill Lynch Indices are used with permission; copyright 2011 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Dimensional Index data compiled by Dimensional. Emerging Markets Blended Index consists of 50% Fama/French Emerging Markets Index, 25% Fama/French Emerging Markets Small Cap Index, and 25% Fama/French Emerging Markets Value Index. Fama/French Emerging Markets, Fama/French Emerging Markets Value and Fama/French Emerging Markets Small Cap Index weightings allocated evenly between Dimensional International Small Cap Index and Fama/French International Value Index prior to January 1989 data inception. Dimensional International Small Cap Value Index weighting allocated to International Small Cap Index prior to July 1981 data inception. International Value weighting allocated evenly between International Small Cap and MSCI World ex USA Index prior to January 1975 data inception. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance. See cover page for additional information.

The advantages of diversification appear to apply to retirement portfolios as well. The chart below, with data provided by Lipper, compares the performance of six different index fund portfolios with varying degrees of diversification during the difficult fifteen year period ended 2012. The study illustrates a beginning investment of $500,000 with 5% annual retirement withdrawals and a 3% annual cost of living increase. The twelve asset class portfolio had the highest return and was the only portfolio to maintain its value (both before and after inflation). Past results are not a guarantee of future returns.

15–YEAR RETIREMENT PORTFOLIO SURVIVAL TEST (1998–2012)

$500,000 starting balance on Jan. 1, 1998; 5% initial withdrawal; 3% annual cost of living adjustment

Retirement Portfolio Asset Allocation Model		1-Asset Portfolio Very Conservative	2-Asset Portfolio* Conservative	2-Asset Portfolio* Traditional	4-Asset Portfolio* Moderate	12-Asset Portfolio* Moderately Aggressive	1-Asset Portfolio Very Aggressive
		100% Cash	Cash and Bonds (50% in each)	U.S. Stock and Bonds (60% Stock, 40% Bonds)	Large Stock, Non-U.S. stock, Bonds, Cash (25% each)	12 Asset 7Twelve Model (8.33% each)	100% Large U.S. Stock
Calendar Year	Annual Cash Withdrawal (3% annual increase)						
				Year-End Account Balances			
1998	$25,000	501,686	509,721	579,825	554,431	486,828	618,371
1999	$25,750	501,063	494,179	621,113	597,807	539,079	718,608
2000	$26,523	506,053	511,504	585,618	560,180	549,034	622,278
2001	$27,318	499,806	516,088	536,682	501,836	512,587	521,468
2002	$28,138	479,927	518,024	457,490	440,688	480,451	380,955
2003	$28,982	455,249	501,790	511,447	488,494	581,625	459,256
2004	$29,851	430,439	485,335	523,226	500,943	655,070	478,522
2005	$30,747	412,642	467,533	513,043	499,916	704,029	471,029
2006	$31,669	401,122	457,154	538,153	530,619	779,044	513,783
2007	$32,619	389,130	451,943	537,513	534,488	834,496	507,474
2008	$33,598	366,316	443,802	392,112	400,619	595,479	287,622
2009	$34,606	333,660	418,607	425,255	424,434	709,174	328,696
2010	$35,644	298,223	396,037	440,515	422,466	776,374	342,486
2011	$36,713	261,644	374,837	423,955	383,783	731,850	312,239
2012	$37,815	**223,941**	**344,395**	**433,566**	**383,280**	**774,486**	**324,447**
% Internal Rate of Return		2.65	4.15	5.07	4.57	7.73	3.93

*The multiasset portfolios were rebalanced at the start of each year.
Areas shaded in yellow indicate account is below the initial balance.
Source: Lipper Investment View, author calculations