ATR Advisors

ABSOLUTE TOTAL RETURN
SECOND QUARTER 2014 COMMENTARY

By: Shawn Blau, PhD

The second quarter of 2014 was a strong one for our portfolios. Many of our asset categories significantly out-performed the broader US stock market indexes – which in turn, did quite well themselves.

Overall, the broad-based S&P 500 Index returned around 5%, on a total-return basis, for the quarter. Among our own asset categories, the energy Master Limited Partnerships (MLP's) performed exceptionally well (represented by the AMZ Index), returning over 14% for the quarter, on a total-return basis. The real estate investment trusts (REIT's), also did well (represented by the IYR exchange-traded fund and the RMZ Index), returning over well over 7% for the quarter. The utility sector in general did well (represented by the XLU exchange-traded fund), returning almost 8% for the quarter. In addition, many of our C-corporation energy pipeline companies did even better for the quarter, largely as a result of heavy Mergers & Acquisitions (M&A) activity in the sector.

Our main under-performing sector this quarter was the Business Development Companies (BDC's). The BDC's had been out-performing the market in January and February, and then significantly under-performed through June. During the second quarter, the BDC's (represented by the WFBDC Index) returned only 3.3% for the quarter, compared to around 5% for the S&P 500 Index.

What happened is that at the end of February, the S&P 600 (Small-Cap Index) and the S&P 400 (Mid-Cap Index) decided not to include BDC's in their indexes. Right after that, the Russell 2000 Index followed suit, and also decided not to include BDC's in their index. Many institutional managers are obligated to follow these indexes, and as a result they were required to sell their previous BDC holdings to comply with the new index allocations. This resulted in institutional selling and “technical” weakness of the BDC’s throughout the 2nd quarter, which kept the prices under-performing.

Fortunately, this “index re-allocation” was completed by the end of June, and we believe that the BDC’s will likely trade up to their fundamental values during the remainder of 2014. The BDC Index now returns over 7%/year in dividends alone, which we consider a good value in today’s market.

Where do we go from here?

At this point, the broad-based stock market has not had a full 10% “correction” since 2011. This is unusual for the US stock market, which usually is much more volatile. Many investors are asking us what is driving the market up so steadily.

In our view, there are three main factors that are driving the US stock market higher:

1) First, share re-purchases (“buybacks”), in which companies buy back their own stock from the public stock markets, have been a significant factor. US publicly traded companies continue to buy back about $400 billion/year of their own stock (which represents about 2-1/2% of US GDP). In doing this, they represent the largest single purchaser of their own stocks. This continues to exert a positive force on US stocks.
2) Second, profit-margins continue to remain historically high among publicly-traded US companies. In our view, this is largely a result of our sluggish employment market, which keeps payroll expenses down.
3) Finally, the central bank in the US, the Federal Reserve, continues to expand its balance sheet, by purchasing Treasury and Mortgage-backed bonds. Although the rate of NEW bond purchases by the Fed has steadily slowed throughout the year, the TOTAL of the bonds held by the Fed has grown from around $900 billion before the Financial Crisis, to almost $4-1/2 TRILLION now. This inevitably pushes investors out of bonds into equities – which at this point mainly means US stocks.

As long as the above three macro factors remain in place, our view is that the US stock market continues to be a good investment. And, within the stock market, we believe our Absolute Total Return (ATR) strategy will continue to perform well.