ATR Advisors

ABSOLUTE TOTAL RETURN
FOURTH QUARTER 2013 COMMENTARY

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Stock Are Up! – But How Do I Balance My Portfolio Now?

A Good Quarter and a Good Year for US Stocks

The 4th quarter of 2014 was extremely strong for the US stock market with several of the US equity indexes up around 10% for the 4th quarter alone. Overall, 2013 was one of the strongest years in recent memory for US stocks. Assuming dividends had been reinvested throughout the year, the S&P 500 Index returned about 32% for the year. What was especially encouraging was that the market continued to rise even as the US central bank began to reduce its "Quantitative Easing" (QE) program at the end of the year.

Since company earnings were only up about 6% for the year, the bulk of the US stock market's gains came from "multiple expansion." In other words, the Price/Earnings multiple grew substantially for most US stocks over the course of 2013.

In the ATR portfolio, several sectors were very strong in 2013. The energy master limited partnerships (MLP's), represented by the AMZX Index, were especially strong in the first half of the year and returned just under 30% for the entire year. The general partners (GP's) of energy MLP's had an exceptionally strong year, dramatically out-performing the MLP Index, and benefitting from merger and acquisition activity among MLP's.

The buyback achievers – companies which consistently bought back their own shares – represented by the PKW exchange traded fund, returned about 45% for the year. On the other hand, the REIT sector was our worst performer. The IYR exchange traded fund, which represents the REIT sector was *down* about 2.5% without dividends included, and *up* only a little over 1% on a total-return basis for the year, with dividends included.

In general, our goal is to capture the bulk of upside runs of the US stock market, while only capturing a much smaller percentage of the S&P 500 Index downside when the US stock market corrects.

A Bad Year for US Bonds

At the same time as the US stock market was having one of its best years in recent memory, the US bond market was having one of its worst years in recent memory. The Barclays US Aggregate Bond Index (represented by the LAG exchange traded fund) was actually *down* for 2013, representing the first negative year for bonds since 2000. In fact, 2013 was only the third time in its entire 37-year history that the Barclays bond index suffered a loss.

The future outlook for US bonds also looks somewhat pessimistic. With the winding down of the Fed's quantitative easing program, it appears that interest rates may have ended their 30-year decline. Since bond prices move inversely to interest rates, this does not bode well for future capital gains.

In addition, there have been some structural changes within the US bond market itself, which also make bonds appear less attractive as a long-term investment. These changes include the following:

1) Growing concentration in US Treasuries. The Barclays US Aggregate Bond Index contained 22.4% US Treasuries in 2007, before the Financial Crisis. In 2013, the percentage of US Treasuries in the Index rose to 36.1%.
2) Longer duration risk. A bond's "duration" is a measure of how much the principal value of the bond goes down, for each 1% rise in interest rates. Since 2006, the effective duration of the Barclays bond index has risen from 4.47 years, to 5.41

years in September 2013. This means that the index is now approximately 20% more vulnerable to interest rate increases.

3) Increased volatility of US bond prices. Longer duration bonds exhibit much more volatile daily price movements than do shorter duration bonds. As the duration of the Barclays bond index has increased, so has the price volatility.
4) Increased correlation between US bond prices and US stock prices. Traditionally, bonds were recommended as part of a "balanced" investment portfolio, largely because of their diversification benefits. However, since Fed Chair Ben Bernanke announced the "tapering" of the QE program in May 2013, correlation between bond prices and stock prices have spiked sharply higher. In fact, correlation has gone from negative (inverse correlation) to positive correlation, which negates the attractiveness of bonds for diversifying a stock portfolio.

Functions of a Bond Allocation

Traditionally, bonds have held an honored place in a so-called "balanced portfolio." They were supposed to serve the following functions:

1) Diversification
2) Income
3) Less volatility.

However, because of the above recent changes in the bond market, it appears that an allocation to US bonds may not serve these functions as well in the future, as it has in the past. What alternatives does an investor have?

A balanced stock/bond portfolio has traditionally been recommended to avoid major sell-offs in the US stock market. This has usually done well, *but not always*. During the Great Depression, a balanced portfolio would have actually lost a significant percentage of its value *twice* – first, from 1928 – 1932; and second, from 1936 -1947. In addition, it would have lost value from 1968 – 1982.

We would propose the following alternatives to the standard bond allocation within an investor's stock portfolio:

1) Commodities;
2) Currencies;
3) Real Estate;
4) Cash;
5) Long/Short Equity Investments.