Newsletter

January 7, 2014

While Knox & Downing Advisors has been in existence for only a few months, it may be some time before we see another year in the stock market like 2013. The S&P 500 Index (S&P 500) closed the year with a total return of 31.6%, while the total return of the Dow Jones Industrial Average (DJIA) was 29.6%, the NASDAQ composite 40.1%, and the Russell 2000 (small cap stocks) 38.8%.

The gains in both the S&P 500 and the DJIA were the largest since 1997 and 1996, respectively, and the vast majority of stocks in the two indices advanced. Within the S&P 500, the Consumer Discretionary sector advanced 41% while Health Care, Industrials and Financials all outperformed the index. The Technology, Consumer Staples, Materials and Energy sectors all rose over 20% while the Utilities and Telecommunications sectors advanced less than 10%.

The weakness in the Utilities and Telecommunications sectors can be partially attributed to the general concern about rising interest rates. The companies in these sectors generally sell at a higher dividend yield and are considered more interest rate sensitive. AT&T, for example, has a 5.3% dividend yield. When interest rates rise, or an increase is expected, many of the stocks in these sectors decline or underperform.

The expectation of rising interest rates was one of the concerns for investors in 2013. As the year came to a close, the yield on the 10 year Treasury Notes rose to over 3% yet did not negatively impact stocks. The decision by the Federal Reserve to gradually taper the purchase of government bonds, but keep the target interest rate low, seemed to calm fears of rapidly rising interest rates for the next year or so. Since one of the reasons for the tapering is the continuing improvement of the economy in an environment of minimal inflation, the stock market may be able to withstand a modest increase in interest rates in 2014.

One measure of relative valuation we review compares the earnings yield of the S&P 500 with the yield on 10 year Treasury Notes. This comparison is known as the Fed Model and measures the relative attraction of stocks versus bonds. While not endorsed by the Federal Reserve, this measure has been a helpful guide over the long term in analyzing relative valuations. The expected earnings for the S&P 500 are divided by the current price of the index (the inverse of the Price/Earnings ratio) and the result is compared to the yield to maturity of 10 year Treasury Notes. Current consensus 2014 estimates for the S&P 500 divided by the price results in a 6% earnings yield, versus a yield of roughly 3% on 10 year Treasury Notes. Over the long term the earnings yield and Treasury yield have been more closely correlated.

This may seem an overly complex way to reach a rather basic conclusion that with 10 year Treasury Notes at 3%, good quality stocks seem a much better value. Also, since rates on 10 year Treasury Notes have ranged from a high near 16% and a low of 1.4% during our investment careers, the conclusions drawn from such calculations require thoughtful perspective.

According to a recent article in the Wall Street Journal, a year ago the consensus projection for the total return of the S&P 500 for 2013 was 8.2%. With the year now history, we know the actual total return of the S&P 500 was 31.6%. This dramatic difference between the consensus prognostications and the actual returns illustrates the folly of these projections. We prefer to adhere to a sound, long term investment strategy based upon client investment objectives, needs, and risk tolerances.

In our opinion, the general stock market is not cheap as certain stocks seem significantly overvalued and many appear fully valued. Yet we continue to find some stocks that appear to be reasonably priced based upon solid fundamentals and traditional valuation measures. Given the continuing recovery in the worldwide economy, many foreign stocks seem attractive as well. We expect higher interest rates this year but believe the increase will not derail the stock market. We are positive on stocks but mindful that many advances are often hard won with volatility and temporary declines along the way. We appreciate your confidence in our new business and wish you the very best in the New Year.

477 CONGRESS STREET, 5TH FLOOR • PORTLAND, MAINE 04101 • OFFICE: 207.523.3494 • WWW.KDA-ASN.COM

Advisory services offered through Knox & Downing Advisors • A Member of Advisory Services Network, LLC • 1040 Crown Pointe Pkwy, Ste 840, Atlanta, GA 30338 • 770-352-0449