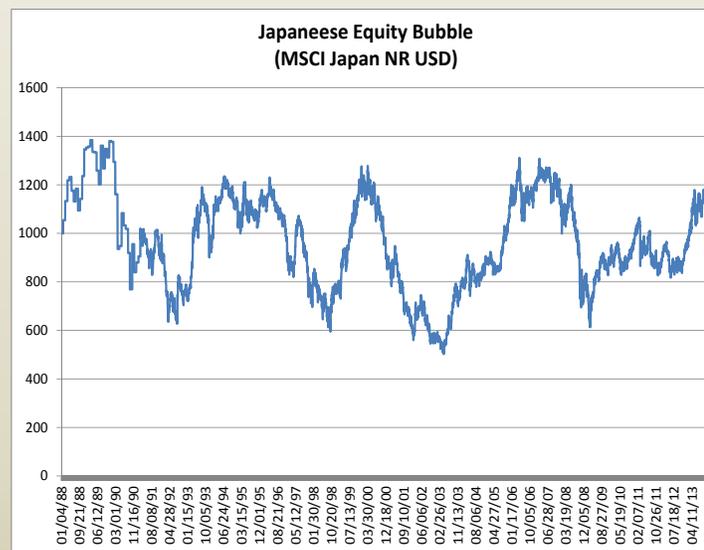




*In the old legend the wise men finally boiled down the history of mortal affairs into the single phrase, "This too will pass." Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto – Margin of Safety.*

*- Benjamin Graham*

The word investing comes with a singular meaning to most, but in reality it encompasses multiple concepts. To us, it means deploying financial resources in order to accomplish two objectives. First, we seek to maximize return per unit of risk within each investor's tolerance for risk. If an investor is conservative, we seek to either capture the most return that we can within their limited ability to tolerate market fluctuations or earn that return by taking as little risk as possible. Second, we believe in order to be successful in investing, one must prevent a permanent impairment of capital. Capital is impaired in two primary ways, only one of which is obvious. First, unfortunate situations like Enron happen. Seemingly strong organizations can and do go bankrupt causing them to disappear. The list is long and not so distinguished and includes names like WorldCom, Lehman Brothers, and Washington Mutual with some noticeable near misses by Merrill Lynch and Citigroup. Preventing capital impairment in this format is easy. Diversify. Own Enron at 100% of your portfolio and it hurts way more than if you own it at 1%. Capital is also impaired in a more ambiguous but equally devastating way, owning bubble assets. It's fair to say those that purchased the NASDAQ at 5000 are still waiting to get their principal back 15 years later. What makes bubble assets far more dangerous than the Enrons of the world? As they occur they are not obvious to the untrained eye, and diversification is less effective against them. Consider that an investor who bought a well-diversified (by count of holdings) MSCI Japan Index on January 3, 1989 would have effectively reduced their risk of having a single stock become worthless. The index includes over 300 individual names. However, 25 years later that investor would have 14.5%<sup>1</sup> less than when they started,



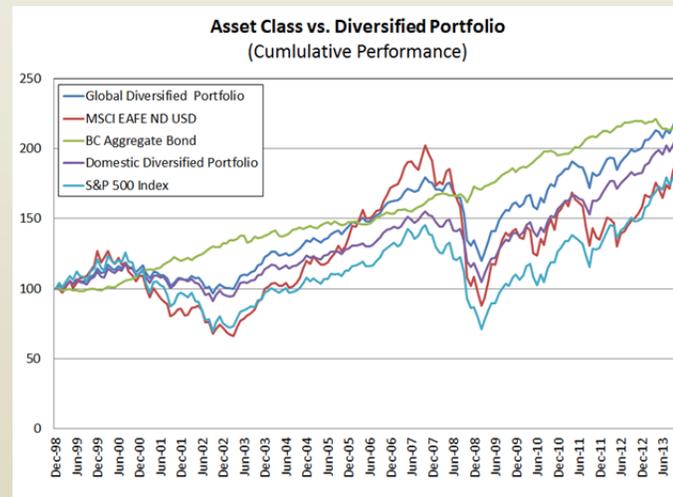
*An investor in Japanese equities in early 1989 would still be waiting to recover their capital 25 years later. Seemingly diversified is not always truly diversified.*

Source: MSCI, MPI Stylus

<sup>1</sup> MPI Stylus, MSCI

assuming the investor held the asset for the entire period – an unlikely scenario given the volatility the index experienced. By 1992, that original investment was worth  $\frac{1}{2}$ <sup>1</sup> of what they started with in 1989 and by 2003 it was worth less than 40%<sup>1</sup> of the original purchase price. What makes bubbles even more dangerous one may ask? Consider that the performance of the MSCI Japan Index in 1988 (immediately prior to the market peak) was +35%<sup>1</sup>. Japan didn't just become expensive in 1988. It was expensive prior to 1988. The 35% return was the same type of fevered buying or animal spirits that we experienced in the US in 1999 and is typically experienced in the formation of bubbles. It is like the Sirens' call that entices investors into the trap. All is well, until it isn't.

In the late 80's Japan was thought of as a nation built on technological advances and innovation that would change the world. By contrast, the US was an old manufacturing economy, a nation that had lost its swagger. Picture yourself as an investor in 1988. In 1987, the S&P 500 gained 5.3%<sup>2</sup> (after a 22.61% one day decline) while Japanese equities gained 43%. As mentioned earlier, in 1988, the Japanese stock market gained an additional 35%<sup>3</sup> while the S&P 500 gained a meager 16% in comparison. The sequence of returns and qualitative arguments surely left some feeling that they were missing the party in Japan. This is how bubbles lure you in....a good story and tantalizing returns. If you diversified by owning both US and Japanese equities, you would have cushioned the fall. However, what many fail to realize is that leading up to the fall, the diversified investor also feels pain. It is the pain of not owning a concentrated portfolio in the hottest asset class.



*As is the case in most bull markets rallies, recently diversification has come under fire for failing to adequately protect against losses in 2008 and hindering gains in the ensuing rally. Yet, from 1998 to present a globally diversified portfolio consisting of 36% S&P 500, 15% MSCI EAFE, 3% MSCI EM, 6% DJ UBS Commodity Index & 40% Barclay Aggregate Bond Index has outperformed all of the primary single asset components including both the S&P and Barclay Aggregate Bond Index. Diversification is alive and well!*

Source: S&P, Barclay's Capital, MSCI, Dow Jones, MPI Stylus

### Diversification is Dead, or is It?

Diversification, and in particular Modern Portfolio Theory, can trace its roots back to the 1950's. In 1952, Harry Markowitz developed techniques to determine the "optimal" mix of assets given a set of assumptions. This optimal mix later became known as the Markowitz Efficient Frontier and the foundation of the science behind Modern Portfolio Theory. In short, Markowitz found that by blending together two risky assets that were imperfectly correlated – (their pattern of returns moved in random if not opposite directions as opposed to advancing or declining in unison) an investor could create a blend of assets that possessed less risk than either component alone. Lately, diversification has come under some fire for both failing to more

<sup>2</sup> MPI Stylus, S&P

<sup>3</sup> MPI Stylus, MSCI

adequately protect the downside in 2008 and detracting from gains in the rally that has ensued. That criticism, in our opinion, is in technical terms, hogwash, and stems from a poor understanding of what caused diversification to allegedly fail.

The argument stipulates that when diversification matters most, correlations rise and assets move in unison. The fact is if one makes the statement that correlations rise without stating why, it is akin to seeing bruising and swelling on a patient's leg and calling it a boo-boo when in reality it may be a fracture. More appropriately stated than diversification is a failure is that diversification failed us in 2008. The reason is not that all assets are perfectly correlated to one another. Rather, there are groups of assets that are all correlated to risk or non-risk factors, credit being one of them (risk factor). Sadly, diversification didn't fail. Most investors failed to truly diversify by owning a group of seemingly unrelated assets that were all positively correlated to credit. Like the Japan example in the prior paragraph, a portfolio extending beyond a single asset of hundreds of securities that effectively diversifies your single stock risk, may be concentrated by its correlation to a more subtle risk characteristic. Diversification did not fail and continues to be the best approach for the vast majority of investors. Much like a coach who has drawn up a brilliant game plan, the execution of that game plan is equally important, and in this case was the failure, not the game plan itself.

### Bad Stuff Happens From Bubble Valuations!

If you are in this business long enough and pay attention, history does repeat itself. As quantitative investors, not only do we sit quietly and pay attention to everything, we record and preserve it in data! My one caveat to the statement that investing repeats, is that when it repeats, it's not in the identical set of circumstances as previously seen (see internet bubble vs real estate bubble). I will, however, make the following statements from a nearly absolute perspective:

- 1) Bubbles will come and go as long as capital markets exist.
- 2) Bubbles will form in one seemingly logical step at a time until you arrive at a completely unreasonable destination. (NINJA Loans, I mean no income, no job mortgages?!? C'mon!)
- 3) Most bubbles form in environments of ample credit/credit expansion.
- 4) Almost all bubbles involve some reason/excuse of why "it is different this time."
- 5) Near the peak, conventional investment techniques, portfolio strategy and diversification will almost certainly come under fire as investors are drawn to the hot assets like moths to a flame.
- 6) Bad stuff happens from expensive valuations!

Other than the prior 6 statements, I offer no other truths (at least not at the moment) that I can state with conviction and certainty. The table below presents some of our findings with regard to the impact of valuations on long-term results. After all, if we are long-term investors, (those who are investing with time horizons that are longer than the typical 5-7 year market cycle) one-year results mean very little other than causing some angst. There are a few important take-aways from this table. First, the table consists of data from the S&P 500 dating back for nearly 100 years. The frequency of this data is monthly. That is, from every month of every year we observe a valuation for the S&P 500. We can then measure the return from each one of those valuation points forward for the next 10 years. The point being, what level of return did the valuation cause? The data is then sorted from most expensive (Quintile 1) to least expensive (Quintile 5) and presented below. We can see that the average return produced from expensive valuations, 3.39% per year, is very different from the least expensive level which produces 15.56% annual returns on average.

Notice also the maximum and minimum returns from each valuation level. Inexpensive valuations tend to produce the highest returns over the course of the ensuing decade in terms of greatest maximum and minimum levels. Said differently, investors have historically fared best in inexpensive markets. The findings aren't exactly rocket science other than to put some quantitative data around a logical concept. Notice the number of negative ten-year periods column. In total, there have been 53 negative ten-year periods (remember, using monthly frequency of ten-year rolling returns) out of a possible 935 intervals. This equates to a relatively low probability or 5.66% chance of experiencing a negative decade in total. However, all of those negative decades occurred from above fair value and 47 of 53 occurred from the most expensive quintile of valuations, bubble levels if you will. A whopping 88% of all negative ten-year periods on the S&P 500 were the result of extreme valuation levels. Bad stuff happens from bubble valuations!

Quintile	Adjusted P/E	Average 10 Year Forward Return	Standard Deviation of Returns	Max Return	Min Return	# Negative 10 Year Periods	% Negative
1	27.95	3.39	3.78	11.06	-4.95	47	25%
2	19.26	8.5	3.92	17.8	-2.87	6	3%
3	15.61	11.45	4.59	19.48	0.4	0	0%
4	11.96	13.6	3.52	19.23	2.71	0	0%
5	9.46	15.56	3.25	21.23	5.27	0	0%
Average	16.85	10.47	5.68	21.23	-4.95	53	5.66%

*Valuations can impact long term average returns, minimums and maximums as well as the likelihood of an exceptionally long period of negative results. Of the 53 total negative 10-year periods (using rolling monthly returns), 47 of them were the result of the top 20% of valuation levels that have been recorded.*

Source: S&P, iCM Capital Markets Research

### Stretching the Valuation Rubber Band!

At an asset class level, valuations have this relatively elastic quality, an elasticity of return to be specific. Move the valuation dial and there is a corresponding movement in the long-term future return. While this may seem fairly intuitive, most investment firms and planning models operate using an unintentional assumption of return inelasticity with regard to valuations. Many to this day continue to use static long-term average returns for both planning inputs and Markowitz efficient portfolio construction. We mentioned previously that diversification did not fail, investors failed in their implementation of truly diversified portfolios. I would also offer that an additional failure was in the assumption that all assets perform to the average return over long-term time horizons. This last assumption is a gross miscalculation and another implementation failure. In fact, returns are only projectable and comparable when using like beginning period valuations. One should not assume the same level of return beginning from a P/E of 10 as from a P/E of 20, yet we see it happen time and again.

Returns and valuations are elastic in both an economic and figurative sense. In fact, valuations and their corresponding long term returns at the asset class level work much in the same way

as a simple rubber band. Picture if you will, a child holding a rubber band in their left hand stretching a rubber band with their right hand. They can stretch it a little, and then a little more and perhaps even further still as the thrill of the activity takes hold. However, the further that rubber band stretches, the greater the force of the snap back. At the most basic level, this is how valuations and bubbles in asset classes work. Investors become enthusiastic about an asset class like technology in the late 90's. The story supporting it is seemingly logical and becomes increasingly compelling each time it is passed from one person to the next until it is unrecognizable from where it began. The returns are also quite tempting, almost too good to be true. Then one day, there is no marginal buyer to stretch that rubber band even further. Without the firm hold of that next investor hand grabbing for ownership, the rubber band snaps back with varying degrees of force depending on how far it was stretched.

To understand the cause we must first differentiate the sustainable source of returns from temporary returns in equities. The long-term sustainable return generated by an equity investment is captured through its earnings stream. Price (and dividends) can perpetually advance by an equal amount as its earnings without changing the valuation. When demand exceeds supply, the next investor may be willing to pay just a tad more than the last investor or than the current earnings will support. When this demand outpaces earnings growth, valuations climb. This is called P/E multiple expansion. This is the rubber band portion of the long-term return equation. There is no sustainable economic basis behind this action. P/E multiples can change for a variety of reasons, not the least of which being that the price has increased simply because the marginal buyer is willing to pay more for it. In essence, this is the greater fool theory. This can persist for some time, much like the stretching of the rubber band. However, the further the stretch, the greater the snap back and the pain if you are on the wrong side of it. This is what ultimately causes the prolonged periods of reduced returns beginning from overvalued levels as seen in the table on the prior page.

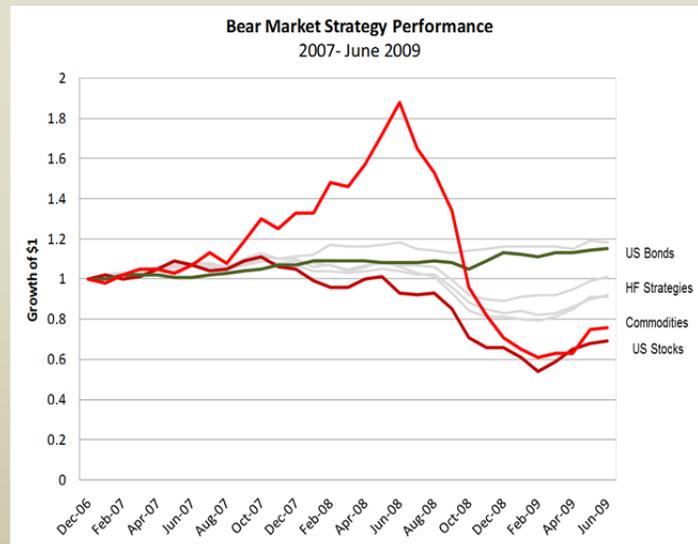
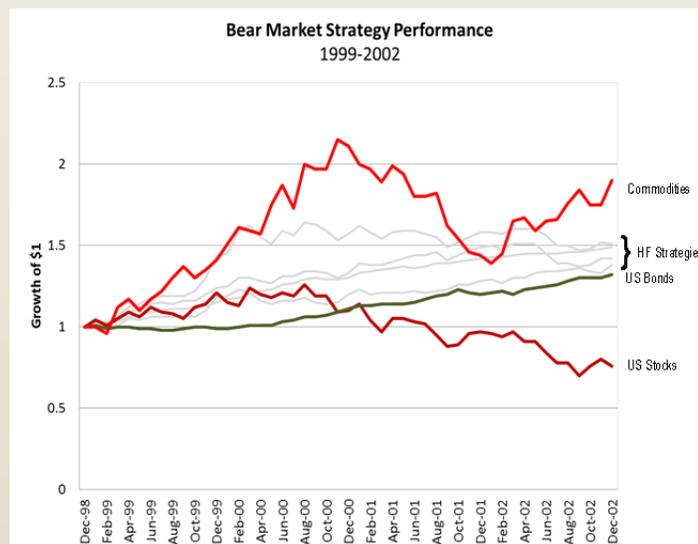
Additionally, we began this article by saying that capital is impaired in two ways, the second being the purchase of bubble assets. Unlike market fluctuations, where long-term investors can ride out market downturns by maintaining a long-term perspective and staying the course, bubbles rarely form in an identical manner twice. Both the late investors in Japan and the NASDAQ have waited a long time to recover lost capital.

### Lackluster Returns by Looking Like Yale

A decade ago, David Swenson, the Yale Endowment CIO, had remarkable success using a rather unconventional investment structure. Rather than invest the majority of college assets in liquid capital markets, Mr. Swenson allocated large portions of assets to illiquid alternative investments such as private equity and hedge funds. Given the perpetual nature of the endowment, Swenson willingly sacrificed liquidity and as a result captured this premium as an additional source of returns. As a result, many investors rushed to look like Yale adjusting their portfolios to include heavy doses of alternatives in favor of this new optimal structure. Not surprisingly, this strategy has not fared well. At iCM, we have not been immune to it as we have also included some alternatives in our portfolios, although to a much lesser degree than most, as our allocations have been smaller and later due to our valuation sensitive nature. We would argue that this is also a bit of a rubber band itself. Said differently, the opportunity to benefit from these assets tends to be greatest when liquid assets are expensive as is the case with most today.

To understand this better, let me first provide a bit of an explanation on what they are and how they function. To most, alternative assets and hedge funds are this nebulous concept that draws up images of large gains and equally large collapses. This image is for the most part false. Collectively, alternative assets at iCM mean anything that resides outside of the liquid equity and fixed income universe including a repackaging of these assets through non-conventional

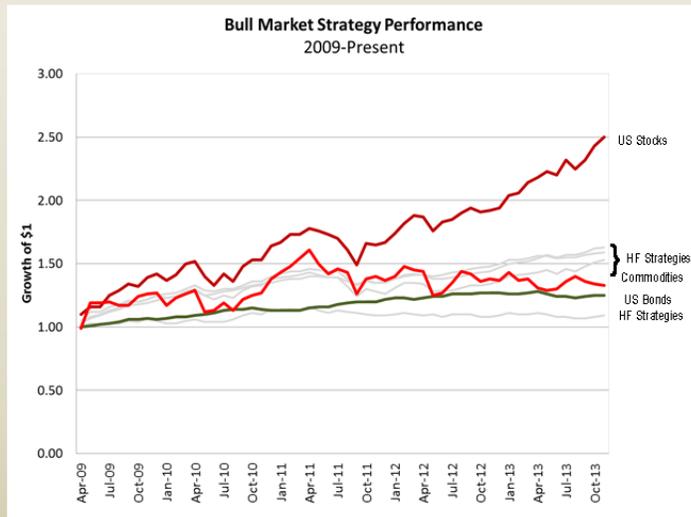
trading techniques (hedge funds). This brings up the first misconception. That is, many think of and model hedge funds as an asset class. This is false. They are merely a variety of management styles and or trading techniques as it relates to liquid assets. To be an asset class an investment should demonstrate quantifiable risk, return and correlation characteristics that are unique unto that asset in passive form. Explained differently, if there isn't a passive formula to replicate it, it probably isn't an asset class. They are active management techniques much like growth or value investing. The second misconception is that hedge funds are an offensive strategy which is also a false statement (with a few exceptions). In fact, most hedge funds share characteristics in between stocks and bonds and often perform their best when liquid capital markets are at their worst. From the charts on the prior page we can see that in both bear markets of the past 15 years, hedging strategies held up better than long only equities. Think of it like driving down a steep windy hill with your foot on the brake. This slows your descent and prevents a horrible crash. Likewise, it also diffuses your momentum at the bottom of the hill or the market, but impedes your progress during the climb. This is seen in the third chart, identified as bull market performance. Remember, the role of such assets in a portfolio is as a diversifier. By definition they should not be performing in the same pattern as liquid stocks and bonds.



*Most hedge funds share characteristics in between stocks and bonds and often perform their best when liquid capital markets are at their worst.*

Source: DJ, BGI, S&P, HFRI, iCM Capital Markets Research

From a portfolio management perspective we have several goals when including alternative assets. First, we acknowledge that owning them slows your descent as well as your ascent. As such, we expect to trail liquid markets like the S&P 500, Barcap Aggregate & MSCI EAFE in bull markets for those assets. Yet, there is still value to be gleaned from this strategy. Let's remove, for a second, the concept of alpha or risk adjusted excess returns and pretend it doesn't exist. Again, it doesn't matter. Alternative assets do not need to outperform liquid markets to add value to a portfolio. They merely need to generate comparable risk adjusted performance in a different pattern than liquid markets to be a benefit. Much like Markowitz determined back in the 1950's, you can blend two risky assets together and end up with less



*While hedging strategies can be beneficial as a defensive component to a portfolio, they are of little help during bull market rallies.*

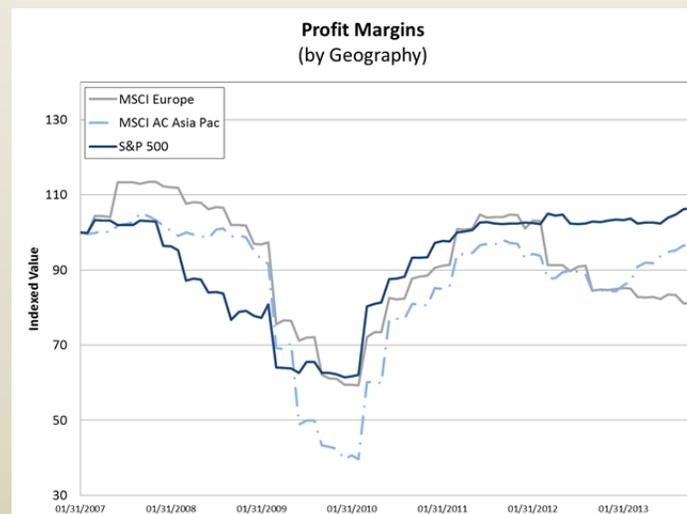
Source: DJ, BGI, S&P, HFRI, iCM Capital Markets Research

risk in the portfolio than either component as long as the assets are less than perfectly correlated. Hedge Funds can provide a diversification benefit which is our goal for including alternatives. In our view, from current valuation levels, we would argue that alternatives have become an increasingly important piece of an investor's portfolio. Remember, bad stuff happens from expensive valuations.

### A Pink Elephant!

Just when I thought I would never see them again, low and behold there they are. A quarter ago in our 4Q Market Insights – The Paradox of Profits, I addressed US corporate profits. In particular we stated that profit

margins are the most reliable mean reverting series in all of finance, for a variety of reasons, not to be rehashed here. Since 2003-2004, profits have remained stubbornly high, less a short span below the mean in 2008, leading some to wonder if it was in fact "different this time." Rest assured, I have found a pink elephant in the form of mean reverting profits. Sadly, those are European profits not US profits, but nonetheless provide us with valuable information. As of December 31, 2013 the P/E of the S&P 500 Index stood at 19.11, high by its own account, but only the tip of this iceberg. Hidden beneath the surface are record high profit margins creating an environment whereby that 19 P/E will look and act more like a P/E of 25 or 26, not quite quintile 1, but pretty darn close. By contrast, Europe offers a P/E of 17, fair by historical measures but based on average earnings. This P/E should look and act more like a 17 P/E because its profits and earnings aren't as likely to mean revert from record highs since they have already mean reverted to what we witness today. While we have been favoring International Developed Market



*While profits have remained stubbornly high in the US, they have mean reverted to normal levels in Europe. Coupled with less expensive valuations, this makes for a strong argument in favor of European Equities as a part of investor portfolios.*

Data Sources: Factset, iCM Capital Markets Research

Equities for some time, it's becoming increasingly difficult to not advocate a more precise allocation targeting Europe.

We opened this letter with a quote from legendary value investor Benjamin Graham. To paraphrase, Graham took to task the challenge of boiling down his investment philosophy into a single phrase, margin of safety. Similarly, we would boil down our own to, valuations matter. The point of the quote and this article is to speak to investing from an iCM perspective. That is to view it through the lenses of value-conscious investors of global capital markets. By doing so, one gleans a perspective of common pitfalls and traps that can cause permanent impairment of capital. These traps range from attacks on fundamental diversification, arguing that diversification fails you when it matters most. I think we have shown that the failure was not in the strategy but in the implementation of true diversification by many investors. We also spoke of the "Bad Stuff that Happens from Bubble Valuations", the valuation rubber band, and European equities. The point or commonality between each is that they have all come under fire to some degree. This is common as markets reach a point where animal spirits are high and herding/chasing momentum are behavioral norms. We caution you during these times. It's easy to abandon tried and true strategies in order to participate in hot cocktail party fodder where the entertainment value of these approaches are high. The cost to you and your portfolio can be equally high. As such, we remain steadfast in our approach, and if challenged to distill the secret of a sound investment philosophy into a single phrase, we venture the motto – Valuations Matter! Thank you for your trust and confidence.

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