

HFG Trust White Paper Series

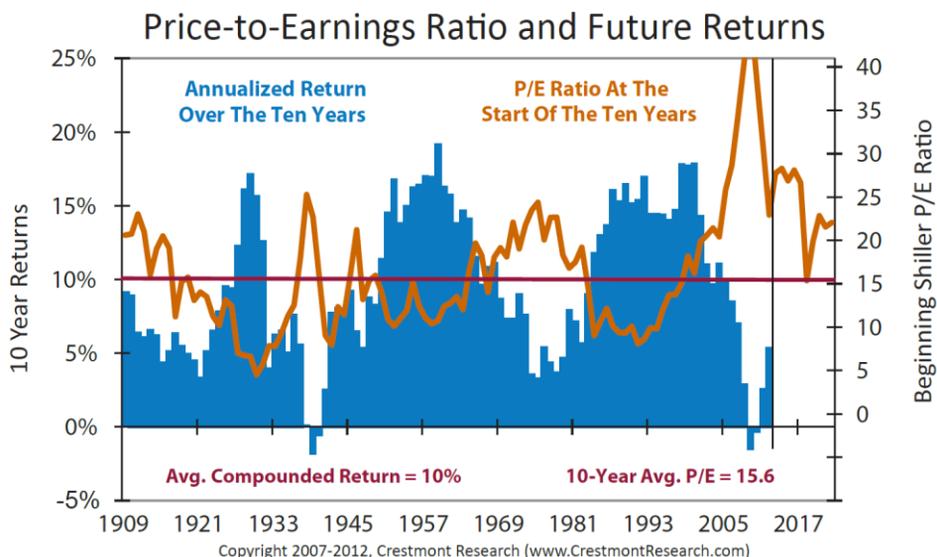
■ **“A smooth sea never made a skillful mariner.”**

Authored by Ty Haberling, CFP®

I don't know about you, but occasionally I read a quote that leaves me with a feeling of, “Hmm. That sums it up.” The quote above is one of them. The 2008 economic and market decline certainly provided those of us in the financial world a chance to become more skilled sailors. The question is did we blow it off as a 1 in 100 year event or did we look for clues that help us foresee similar future events. In other words, are we researching methods to make our ship safer for rougher seas or did we continue using the same design? For those that are curious, which we at HFG believe we are, it provides an opportunity to question past assumptions and beliefs and formulate new ones for the future. I'd like to illustrate where we are placing our emphasis today.

Determining the Investment Climate

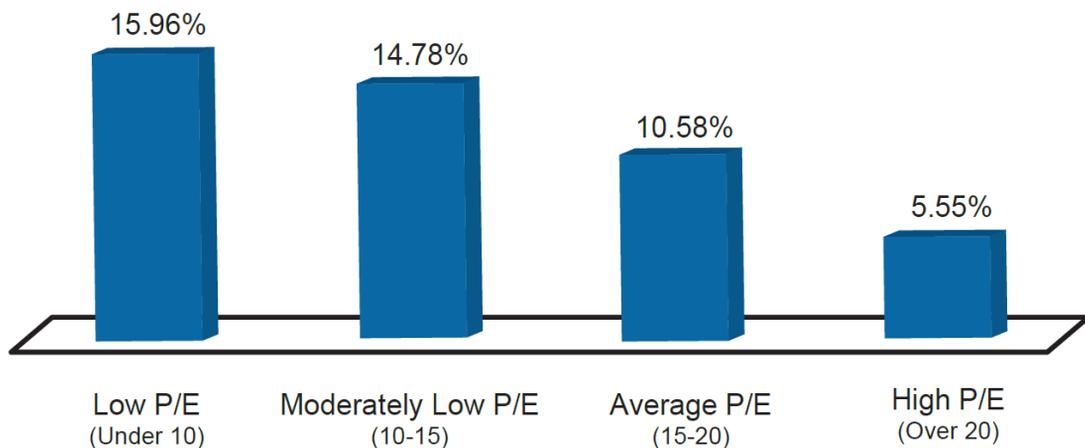
Graph 1 illustrates the inverse relationship of beginning P/E (Price-to-Earnings Ratios) and 10 Year returns. The orange zig/zag line is the Shiller P/E ratio for the S&P 500. Shiller averages the last ten years of earnings of the S&P 500 companies and divides this into the current price to get his P/E ratio. This is an important distinction from the P/E ratio method in common use which is based on current or projected earnings. The blue bar chart is the actual return from an investment in the S&P 500 for each 10 year period from 1909 to Present. For example, the first 10 year period would be 1909-1919, second would be 1910-1920 and so on. As you can see, historically high P/E ratios generally produce below average returns and low P/E ratios generally provide above average returns. We are also using other valuation metrics such as the Price to Sales ratio, S&P 500 market capitalization to GDP, an analysis of current and past profit margins, and the Q Ratio which measures the replacement cost of the S&P 500 corporate assets to the total stock market valuation. What are all of these different valuation metrics telling us today? The S&P 500 is selling at a “rich” investment climate that normally generates below average investment returns 7-10 years out and thus dictates our cautious approach.



How Are You Using the Climate Assessment to Allocate my Portfolio?

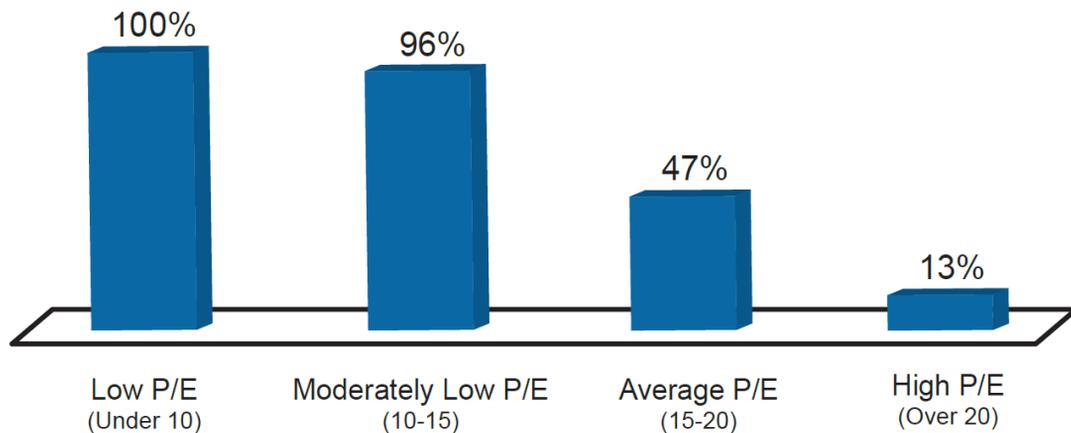
We believe that recognizing the investment climate is the most important aspect of our portfolio management. Climates can be categorized by risk. Our approach is to reduce the allocation of capital to equities in higher risk climates and increase the allocation in lower risk climates. To illustrate I would have you look at Chart II that categorizes 10 year stock market returns for a given category of P/E ratio. To create this table I've generated a report for every 10 year period of the S&P 500 from 1950 to June of 2010. We have sorted these according to the Shiller P/E ratio measured at the beginning of each 10-year period. The first group represents periods with a starting P/E ratio below 10. The second group is for P/E ratios of 10-15, the third is for ratios 15-20, and the 4th group illustrates periods with a starting P/E over 20. Notice how average 10 year returns declined for each group as the period-beginning P/E ratio increases.

S&P 500 10 Year Returns by P/E
1950-2010



Another important observation is how unlikely an investor was to experience a return of 10% or more for periods which begin with a high P/E ratio. (See Chart III) To ignore the investment climate is to ignore probabilities and risk. So, to answer the question of how does HFG use the climate assessment to allocate capital, the answer is that we are willing to allocate more of your capital to the stock market if we are in a climate that has a high historical probability of achieving higher returns and vice versa. Today, we find ourselves in the fourth climate with the Shiller P/E ratio at 22 and thus have reduced our client's normal allocation to equities. Even though there is strong evidence and logic that high prices create a higher risk climate it doesn't mean that prices will fall in the near term. The climate could stay overpriced for an indefinite period. Patience and the preservation of capital in our view is priority one.

Percent of Time Returns were 10% or Higher 10 Year Periods 1950-2010



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