HFG | HABERLING FINANCIAL GROUP

# 1ST QUARTER 2014
# MARKET SUMMARY

## MADNESS OF CROWDS

By J. Tyler Haberling, CFP®

Haberling Financial Group
1141 North Edison, Suite A
Kennewick, WA 99336
509.735.7507
www.hfginvest.com

By J. Tyler Haberling, CFP

## EXECUTIVE SUMMARY

- *Overview of Historical Bubbles*
- *Significant amount of IPO activity*
- *Slight increase in stock and bond prices for the first quarter*
- *New Leadership of the Fed Reserve*

***"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."***
***-George Bernard Shaw***

During the holiday break I re-read portions of the book "EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS." By its title, you might think it was written during America's most dramatic market disaster of the 1930's, or more recently in the early 2000s. Actually, it was written by Charles Mackay in 1841. It is interesting how human nature's tendency to follow the crowd is not a recent phenomenon. The book relates the Mississippi Scheme by John Law, The South-Sea Bubble in 1711, and the Tulip Bulb Mania in the mid-1600s, among other stories. The late John Templeton, a legendary fund manager, wrote the forward in the 1999 edition and outlined the bubbles he had witnessed. He started with the great Florida land boom of the early 1920s and the stock market decline of 1929 when share prices increased six-fold to fall back to even in 1932. In the 1950s, any stock concerned with uranium became popular, often rising more than ten-fold and later declining more than 90% . The tech stock boom that ended in 2000 with the NASDAQ peaking, and failing to exceed its all-time high of 2000.

The story of John Law and the MS Scheme tells of the introduction of paper money to the French economy. Law, a Scotsman, believed that currency was superior to coinage and would increase economic activity. Over time his belief proved to be accurate. However, his unrestrained implementation of the concept spelled disaster. He shared his ideas with different countries until France accepted his concept in 1716. The French were eager for solutions after Louis the XIV died in 1715 leaving the country in financial despair. Law was granted permission by the French to establish a bank in 1716 that could issue paper money or bank notes. The notes were currency that could be used in lieu of gold and silver, and were supported by the bank's assets of the very same commodity.

Later in 1717, Law was granted the right by the French government to organize Company of the West, which would be known as the Mississippi Company. It had trading and development rights for the next 25 years for the MS territory. Rumors of gold and silver in the new country were rampant. Per the terms of his charter, Law was required to develop the colony by transporting 6,000 settlers and 3,000 slaves to the colony within 25 years. Furthermore, in 1718 the French government granted Company of the West a monopoly in tobacco trading with Africa. Later the company obtained trading rights for China and the East Indies and because of these arrangements, Law then controlled all trade with France outside of the country. In order to finance his endeavors, Law initially sold stock for 500 Livre (the French currency at the time) which at its peak reached 10,000 Livre. Law continued issuing stock that was financed by loans from his bank. It was one of the most sought after investments in the day. The value of shares in his Mississippi Company rose dramatically as Law's empire expanded. Investors from across France and Europe eagerly played in this newly created market.

The financial district in Paris became dangerous as investors fought to get in line to purchase his stock. The French government was forced to send in soldiers to maintain order. The market was so enticing that people from the working class invested whatever they could scrape together just to get a piece of the action. New millionaires were commonplace. Similar to our recent financial bubble, by 1720 his venture collapsed. Intelligent investors smelled an opportunity and tried to redeem their notes for gold and silver from the bank. This caused a run on the bank, and with it, greed turned to fear as investors in the Company of the West saw their stock price crash.

The real message is that before Law's enterprise was profitable, everyone thought they saw huge potential. For the initial investors, profit came in the form of stock appreciation rather than income that was generated from economic activity. Potential became more important than results. In my life experience, this story reminds me of the late 1990s with dot-com internet stocks. We should never underestimate the power of "groupthink" and the influence it can have on short term asset prices. Perhaps some of you experienced the mid-2000 real estate boom when the term "flipping houses" became a fad. While rental income was moderately increasing, the price of homes was sky rocketing. The importance of these historical events is that when the price of a new company or a new industry increases at a rate faster than the underlying income of the business or industry, an investor runs the risk of experiencing a Bubble. This is where speculation rears its tantalizing head. Today, some of the new IPOs could result in a bursting bubble scenario.

The events we see unfolding appear reminiscent of the 1999-2001 dot-com era. During this time, venture capital firms invested in the dot-com companies based solely on potential and disregarded traditional metrics. Today, we see similar behavior with well known social media companies. Despite being unprofitable or marginally profitable, investors seem to flock to these stocks and are willing to place their bets on potential, while ignoring basic valuation analysis.

> *"In the first two months of this year, 42 companies went public in the U.S., tying 2007 for the busiest start to a year for IPO's since 2000 ... By one key measure, investors are bidding more aggressively for newly minted shares this year than they have in more than a decade, paying a median 14.5 times annual sales, compared with 6 times sales in 2007 ... Nearly three-quarters of companies that have gone public are not profitable. Just under two-thirds have annual sales of less than $50 million. Both measures are at their highest in any year since 2000." The Wall Street Journal, March 7, 2014*

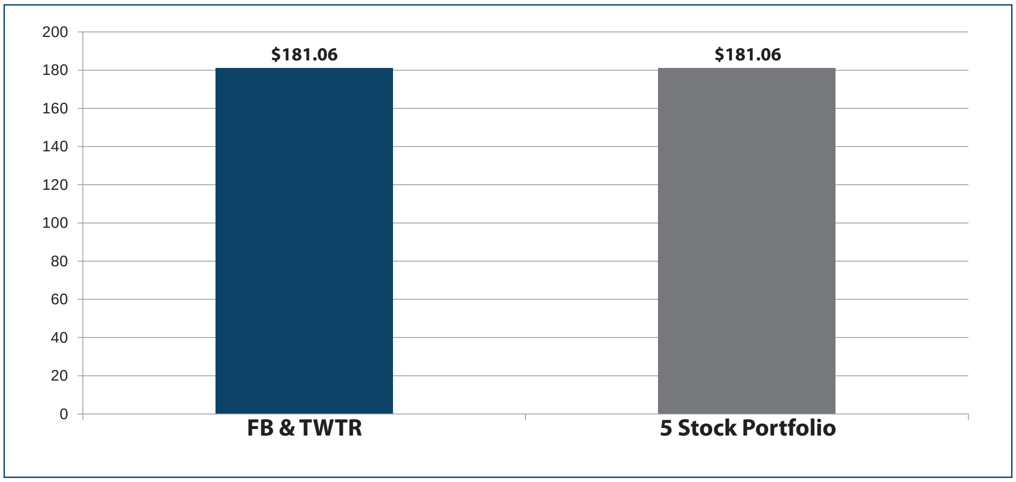
As we can see in Exhibit 1, compared to last year, IPO activity has risen close to 200% in just the 1st Quarter of 2014 alone. At this pace, the US IPO activity is on track to exceed the number of IPO issuances occurred in the 2000 dot-com era when the 1st tech bubble burst.

## Exhibit 1
### US IPO Activity

| | Q1'13 | Q1'14 | % Change |
|---|---|---|---|
| Jan | 7 | 25 | 257.14% |
| Feb | 14 | 31 | 121.43% |
| Mar | 15 | 46 | 206.67% |
| Total | 36 | 102 | 183.33% |

To illustrate just how high prices for newly issued Social Media IPOs have become, let us perform a simple valuation assessment to provide contrast.

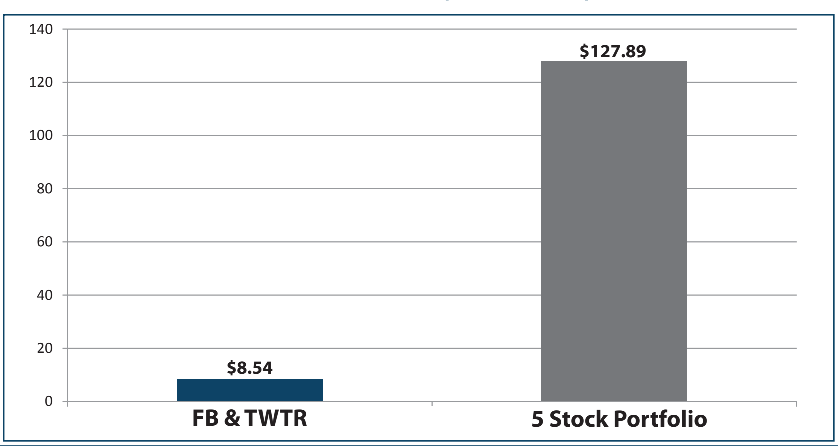
## Exhibit 2
### Investment (In Billions)




Let's assume we have two investment options as shown in Exhibit 2. The first one is to buy the entire companies of Facebook and Twitter. If we buy 100% of FB & Twitter, our investment would be approximately $181 billion as of 3/31/14. Although there could be myriad reasons, for simplicity we will assume investors feel justified with this purchase because of the popular notion that social media is the way of the future and there is so much "potential" to be had. The alternative strategy is to purchase an equal value in well known Brick and Mortar Companies (General Electric GE, Microsoft MSFT, Johnson & Johnson JNJ, Walmart WMT, General Mills GIS). This portfolio would hold $31.2 billion ($181 Billion / 5 Companies =$31.2 Billion) in each of the **five** companies. (Note: There are more than just FB & Twitter that are in the social media space. It is entirely possible that either or both of these companies will grow profits to justify their value. Our use of these as an example is meant to illustrate the entire social media space.)

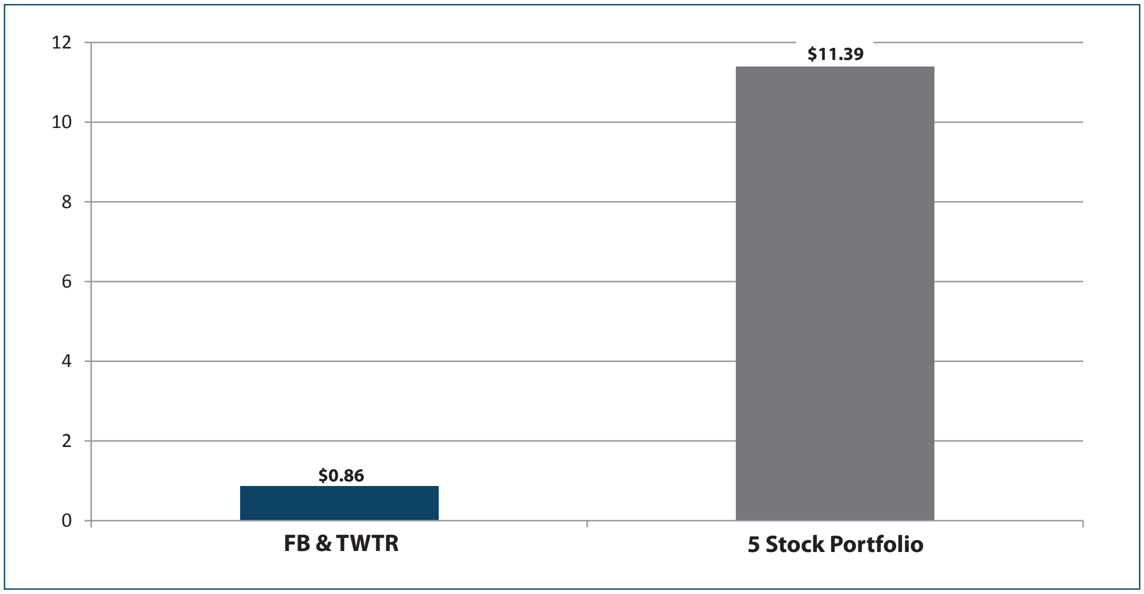
Our first fundamental comparison is to evaluate each of the two investment scenario's revenue. Revenue is Sales. Sales is what generates profits and profits create dividends. In the end, investors are looking for a cash return from their investment. In Exhibit 3, we compare the total revenues of our two social media companies to our portfolio of **five** Brick and Mortar stocks. The social media companies for our $181 Billion investment generate only $8.54 Billion in revenue while the traditional companies generate over $127 Billion.

## Exhibit 3
### Revenues (In Billions)



Although sales is a reliable figure to examine, as it is not subject to the whims of accounting tactics, bottom line earnings are still the key measure of profitability. In short, the stocks that make up our Brick and Mortar portfolio are approximately 13xs more profitable compared to the social media stocks as shown in Exhibit 4. (Latest SEC 10-k filings for companies' fiscal years in 2013)

### Exhibit 4
**Earnings (In Billions)**




What this illustrates is that good companies or new markets are not predetermined as superior investments. What determines superior returns is price. At this time it appears that most social media stocks are significantly overpriced based upon what they produce today and into the future. As my granddad used to say, "Them boys are all hat and no cattle." In today's idiom, these companies are all sizzle, but no steak!

In summary, this is precisely the reason HFG bases its investment decisions on fundamentals and not on momentum or fads. Momentum investing is following the crowd. It can be rewarding if one can surf the greed-wave and know when to get in and out. However, all bubbles end with the majority feeling pain and even financial ruin. Today, we suspect we aren't yet at the crescendo, however, it is starting to look like the formation of a potential bubble.

## 2014 1ST QUARTER REVIEW

The US stock market cooled dramatically in comparison to how it finished in 2013, but it remained positive to start the year. The S&P 500 had a total return of 1.80%, while International EAFE Index returned 0.77%. Gold recovered marginally from last year's fall by increasing 7.34% for the quarter. US bonds remained flat with a return of 0.14% for short duration (1-3 year) portfolios and up 1.84% for BC US Aggregate Index. HFG valuation metrics illustrate that 1 year trailing PEs remain inflated by 23% in comparison to the historical mean. Schiller PE metric, Price to Sales Ratio and the Market Cap to GDP valuations are less forgiving illustrating an overvaluation of 37%, 43% and 48% respectively. **See Exhibit 5 for details*

Exhibit 5

**HFG Valuation Metrics of S&P 500, 1Q'14**

| Valuation Metrics | Current | Average | Decline to the Mean |
|---|---|---|---|
| P/E Year Trailing Earnings | 18.83 | 14.53 | -23% |
| Shiller P/E Ratio (CAPE) | 25.21 | 16 | -37% |
| Price to Sales Ratio | 1.67 | 0.96 | -43% |
| Market Cap to GDP | 1.25 | 0.65 | -48% |
| Q-Ratio (Tobin's Q) | 1.08 | 0.68 | -37% |

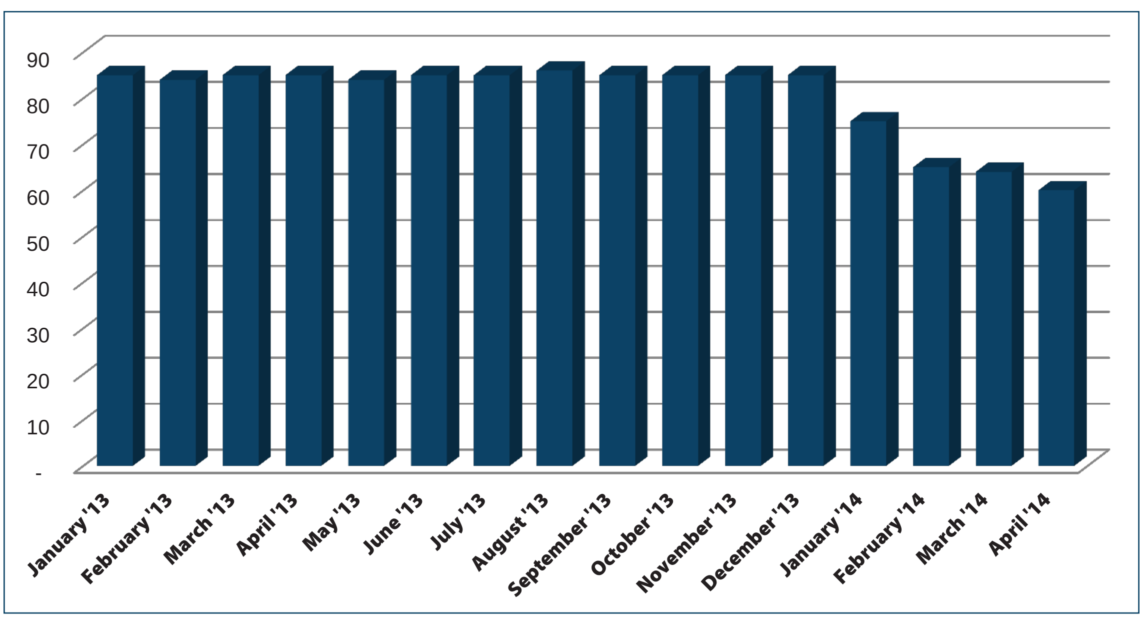
**Decline to the Mean (This is the change in the market that would be needed for the market to adjust to its historical valuation)*

## NEW LEADERSHIP OF THE FED RESERVE

On February 3rd, 2014, Janet Yellen became the 1st Chairwoman to serve on the Federal Reserve Board of Governors. She previously served as the Vice Chair between 2010 - 2014, under Ben Bernanke. All indications thus far illustrate that the plan under Janet Yellen's leadership will look very similar to her predecessor. The number one priority remains reducing unemployment and increasing economic activity with the two year goal of raising the Fed Fund Rate to 2%. Ms. Yellen announced that the Federal Open Market Committee (FOMC) will cautiously move forward with the anticipated tapering of treasury purchases so long as it does not interfere with economic growth and any progress made with unemployment rates. This message has been heard so loud and clear by some financial enthusiasts that they have renamed QE 3 to QE Infinity due to the Fed's stance on maintaining the program as necessary (in other words, no end date). In reality, their goal is to begin raising interest rates somewhere in the better part of 2016. As you can see in Exhibit 6 below, the tapering of treasury purchases has already begun to take place. Once tapering is completed, the Fed will move into a period of holding and replacing existing issues. The last stage of the plan is monetary tightening, in other words the Federal Reserve will allow current debt securities to mature without replacement with the intention of releasing interest rates.

Exhibit 6

**Monthly Net Purchases of Federal Reserve Bonds**



Ben Bernanke has long stated his fear of a second great depression and his policies have focused squarely on driving consumer activity upward. He was quoted in July of 2009 saying, “I was not going to be the Federal Reserve chairman who presided over the second Great Depression.” With this in mind, the entire Federal Open Market Committee (FOMC), which included the current Chair Janet Yellen, devised a plan to lower the cost of borrowing by suppressing interest rates to the floor. The result of this plan was reported in March of 2014, with unemployment rates unchanged at 6.7% over the last quarter, but down 1% in the last 12 months. When you consider the Federal Reserve has long had its sights set on the “full employment” benchmark of 5.2% - 5.7%, on the surface reports look promising. In actuality, this statistic excludes discouraged workers (those who have given up on searching and remain jobless) and forced part time workers (hours cut to part time due to economic reasons). We believe, if you include the entire labor market affected by the financial collapse, the number looks closer to 11% - 12%, significantly higher than what has been widely publicized. Only time will tell if our perceived economic recovery is fueled by true underlying value (productivity) or merely a function of the Fed’s manipulation.

## EXHIBIT 5 DISCLOSURES

*P/E 1 Year Trailing Earnings: This is taking the last four quarters of the as reported earnings of the S&P 500 companies and dividing this number into the Price of the S&P 500 index. This ratio can provide false signals as it doesn’t factor in the cyclical nature of corporate earnings. Post recession periods earnings can decline significantly on a shorter term basis as create very high P/E ratios. These high P/E ratios would normally signify that stocks are overpriced. Source: http://www.vectorgrader.com/indicators/price-earnings*

*Shiller P/E ratio: Yale professor Robert Shiller, the author of Irrational Exuberance, averages the last 10 years of earnings and then adjusts them for inflation to get the Shiller P/E. Shiller refers to this ratio as the Cyclically Adjusted Price Earnings Ratio, abbreviated as CAPE. Source Dr. Shiller’s website 12/31/13*

*The Price to Sales (P/S) ratio is the current market value of the S&P 500 index divided by the last four quarters of sales. It is used because sales are much less susceptible to cyclical swings than earnings. During recessions, profit margins can become depressed, while during booms, they tend to become abnormally high. Source S&P Analyst Handbook and S&P Indices.com*

*Market Cap to GDP: This indicator has been described by Warren Buffet as “probably the best single measure of where valuations stand at any given moment.” It compares the total price of all publicly traded companies to GDP. This metric can also be thought of as an economy wide price to sales ratio.
Source: http://www.vectorgrader.com/indicators/market-cap-gdp*

*The Q Ratio is a popular method of estimating the fair value of the stock market developed by Nobel Laureate, James Tobin. The Q Ratio is the total price of the market divided by the replacement cost of all its companies. The numbers are supplied in the Federal Reserve Z.1 Financial Accounts of the United States of the United States, which is released quarterly. Source: Dshort 12/31/13 http://advisorperspectives.com/dshort/updates/Q-Ratio-and-Market-Valuation.php*

*Haberling Financial Group (HFG) is a financial services corporation specializing in investment management and financial planning. HFG has been providing quality wealth management services since 1983, and currently manages over $285 million in assets for 600 families and retirement plans.*