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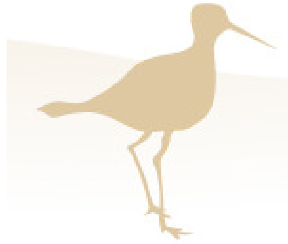
**Sandpiper Capital**

# Gleanings



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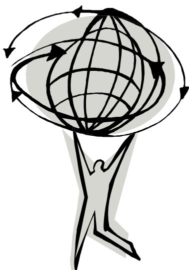


## Market Returns Annually and Through Ten Years Ending 9/30/2013

| Index | 2011 | 2012 | YTD | 10 Yrs |
|---|---|---|---|---|
| **S&P 500** | 2.1 | 15.9 | 19.8 | **7.6%** |
| **ML 1-5 yr Gov't/Corp** | 3.1 | 2.5 | .2 | **3.4%** |
| **EAFE (Dev Fgn Mkts)** | -12.2 | 17.2 | 16.1 | **8.0%** |
| **Gold** | 10.1 | 7.1 | -26.6 | **13.2%** |

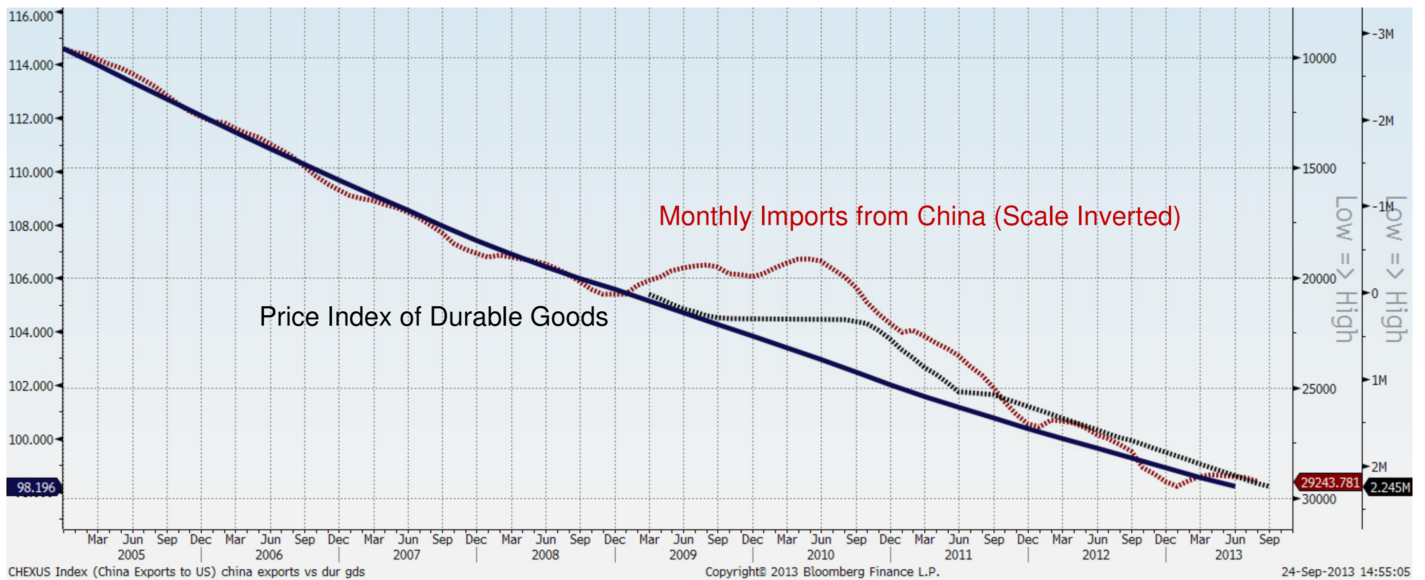
## "Balance..."

If you think about the events that have impacted your life, at least that is, when I think about the events that have impacted *my* life, both positive and negative, the things that I was paying attention to, planning for, worrying about, were not the things that affected me the most. Bigger things are affecting us than our own plans for our own lives. For those who work diligently to try to create a future consistent with their idea of a good life, it's not so much the unintended consequences of their actions as it is the unexpected intrusions of a bigger reality that often can catch them flat-footed. Besides the wisdom of an attitude of flexibility and resilience that we can learn from these experiences, the need for balance in our lives becomes obvious. Relationships, work, recreation, community, creative outlets, all are essential parts of a full life that in aggregate can help us withstand an impact in any one area.

In our investment lives, this same diversification can help with many of these seemingly random events that impact portfolios. That is, if an unlucky unexpected event negatively makes one investment sour; by owning enough unrelated securities you have just as good odds that an unexpected good event will benefit another. The trick for this to work is that the different investments should be *sufficiently* different from each other. This is particularly true for big events with big consequences. A recession will push most stock prices down. Inflation will degrade almost all fixed rate investments. And deflation will penalize all but the safest, most liquid securities. A risk-averse portfolio will be sufficiently diversified so as to not have any portion's adverse reaction to unexpected events affect the whole disproportionately.

At Sandpiper Capital, we have found that avoiding losses helps maximize long run returns. That means that diversification sufficient enough to prevent overall losses is required. The penalty for this behavior is that we will rarely be only in those securities that are currently outperforming. The benefit of a loss avoidance strategy comes from the math of compounding returns. At the risk of repetition, remember that while a portfolio that is up 60% one year and then down 50% the next has averaged 5%/year, it is still at a 20% loss when compounded, (1.6*.5=.80). Alternatively, 6% followed by -5% is still profitable added *or* multiplied. In operation, that has meant that our portfolios have traded off higher annual returns for smoother annual returns. We've done this by adding asset classes that benefit when others are penalized. We own high quality bonds because they give a fixed return even during an economic downturn. We have a lot of liquidity (money market and maturing bonds) to protect from the systemic risk that comes from a low growth, highly leveraged financial system. We own gold and gold miners because they benefit from governments' efforts to stave off deflation. We own stocks to protect us from the depreciating value of money being printed to support our economy. Maintaining this balance is essential in order to offset risks that we see as greater currently than at any time in the last thirty years.

If we define deflation as too many goods chasing too few dollars, then the dramatic increase in China industrial capacity over the last decade is certainly a deflationary threat. Below you can see this reflected in the red dotted line that represents each successive month's total $ value of imports to the US from China, (inverted scale). The falling price of all durable goods is illustrated by the black solid line. The *dotted* black line, again, on a reverse scale, shows Fed purchases of Treasuries. The more China makes, the more prices drop, the more the Fed needs to put $'s into the economy. This massive intervention has lifted the PCE inflation index (a Fed favored broad measure of consumer costs) from a rate of change that was negative in 2008 to about 1.1%/year currently. Imagine it if stimulus stopped.




Massive monetary stimulus succeeded in lifting corporate profits if not personal incomes out of recession lows, (see the black line on the chart below showing the S&P 500 trailing 12 month profits.) The market (green line), however, has gotten ahead of itself relative to profits. This is especially so considering that the main components of corporate profitability in this recovery, (industrial production, productivity and lending activity combined and indexed in red below) have gone flat in spite of Fed efforts. It certainly looks as if the money banks get from the Federal Reserve purchases is making its way to trading floors and not to people or businesses. We have a mini-bubble in stocks now but we can handle that. A deflationary spiral where spending stops as prices drop is 1930's-like event that we can't.