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## Financial Market Commentary 1<sup>st</sup> Quarter 2010

April 21, 2010

### Summary

Stock prices rose again last quarter as more and more investors became convinced that the global economic recovery was real. Early indicators had been signaling recovery since last summer. Now we are seeing even lagging indicators like employment move into positive territory. Many investors who left the market in late 2008 or early 2009 are getting back in now (at higher levels, of course). U.S. stocks have gained for six consecutive weeks, creating the feeling that the stock market is a lot less risky that it was. This is not altogether true, as will be discussed in the Commentary section. However, it is psychologically comforting.

Mid-size companies (mid-caps) led the way last quarter with a gain of more than 9%, and small caps were a close second at 8.6%. These kinds of companies had two things going for them. One, for the most part smaller companies are more economically sensitive such that they benefited more from the economic recovery than larger companies did; and two, they are less likely to benefit from foreign trade. Since the dollar gained during the quarter, currency translations were a drag on profits. The large cap S&P 500 gained 5.4% and the Dow Jones Industrial Average rose only 4.8%. Retail stocks did very well during the quarter. Moves made in early 2009 to cut costs in the face of falling consumer demand paid off handsomely when demand came back. Financial and real estate stocks also did well, continuing their recovery from extremely low levels a year ago. Again, it was the conservative sectors that fared poorest. Utilities posted a modest loss and investors gave up yield in favor of appreciation potential.

As mentioned, the dollar rose last quarter. The chief explanation was the turmoil in Europe concerning Greece. Not surprisingly, European stocks performed the poorest last quarter (down 1.8%). As a whole, foreign stocks returned just 0.9% to dollar-based investors. The surprise was Japan, which soared 8.2% on the strength of a rising yen. Emerging market stocks gained an average of 2.4%.

Bonds were up 1.8% as a whole. Risk-taking was also rewarded on the bond side, as high yield bonds posted a 4.6% advance. Short term and government bond returns were closer to one percent. Interest rates have been moving up in

recent weeks and that is posing a challenge to bond investors. Some are moving down the quality spectrum (to high yield bonds), others are jumping to stocks. In the short term, that is a very sensible move.

### Activity

We modestly reduced our cash exposure last quarter. We added to certain to certain stocks and mutual funds that we felt comfortable with. A couple of the individual stocks in our portfolios had gained enough we have begun to take some profits. Market conditions at this part of the economic expansion tend to favor economic sensitivity, which some of the equity positions tend to downplay.

There is still money to be made in this part of the economic cycle but you have to have a plan. Eventually there will be interest rate pressure, which historically tends to cause a very rapid return to risk avoidance. In all, we are pleased with how we have handled the year so far.

### Outlook

The easy money this cycle has been made. Stocks are back to fair value (if not modestly overvalued) by and large, so even if it seems like a low risk environment out there right now, it isn't. We said last year that in time cheap stocks will be discovered, and they have been. That opportunity is pretty much over. We are now in a medium risk environment with positive momentum, meaning that one can be fairly confident about the rest of the month, but less confident about the remainder of the year.

The fact is history doesn't help us much right now. We are in uncharted territory in terms of being able to ascertain how the government's massive borrowing needs will affect interest rates. Low interest rates help an economy recover and no one can argue that 0% interest rates have not been extremely beneficial to the stock and bond markets over the last 12-13 months. If there were no unwanted consequences of very low rates, however, every government would keep rates low at all times. Recent gains in the gold market suggest that investors are not giving the world's policymakers the benefit of the doubt.

### Commentary - Volatility and Risk

Many people actively invest. Statistically, most people achieve a rate of return that is lower than the market's return. If most people under-perform, therefore, it must logically be true that there is a minority that out-performs the market averages. It would be valuable if one could determine what the latter know that the former do not know. Experience over the past three decades plus tells us that there is key piece of understanding that successful investors have that unsuccessful investors don't, and that is the difference between volatility and risk.

As it applies to investments, volatility is the chance that your investment is going to decline meaningfully in the near future. Risk is the chance that your investment is going to decline and not recover anytime soon. We cannot over-state how important that distinction is. Approximately one year ago investors were looking at market losses of 50% from their 2007 peak. Many stocks were off 70 to 90% or more. The stock market at that time was pricing in a long-term loss in value on the belief that we were entering a 1930s-style deflationary recession. The record corporate profit levels that we saw from 2005 to 2007 were supposedly gone and not returning anytime soon.

Given the experience we had with technology stocks at the beginning of the decade and real estate more recently, it was understandable to have this view. However, it has turned out to be wrong. In fact what we saw was a very sharp but temporary drop in liquidity and demand. Investors in January 2009 faced record high VOLATILITY, but RISK had been largely squeezed out. They would not have been surprised to see a 300-point down day, but their chance of losing another 3000 points with the market already off close to 7000 points from its high was extremely small.

It is important to keep in mind that volatility events happen all the time. Most are fairly small. Risk events are infrequent (especially as it applies to large sectors of the economy). Any individual stock carries a lot of risk. A company can have a product failure, a major lawsuit, competition can increase, their technology can grow obsolete, etc. *Only one of the original 30 Dow Industrial members is currently still in that index.* By contrast, the whole market is far more volatile than it is risky. It takes an epic event (war, major earthquake, debt default, etc.) to cause a long term loss of value for an entire economy.

Today stocks are more than 70% above their 2009 lows. As the market realized that while GM, AIG, and Fannie Mae were not going to be \$50 billion dollar companies again anytime soon the economy would still need cars, insurance, and mortgage servicing. These meant that someone would move in and fill the demand for these things and that more money would be made for example, in Ford Motor Co., Travelers Insurance and Wells Fargo.

It may seem that stocks are a lot less risky that they were last year. The truth is that they are a lot less volatile. Volatility (measured as VIX) has come all the way back down to 15.9 from north of 80 in October 2008. Risk, on the other hand, rises as prices rise. So while nobody expects the market to drop 300 points tomorrow, the odds that it will be 3000 points lower a year from now (while small) are actually substantially greater than they were a year ago.

Volatility and risk are sometimes used interchangeably but they are not the same thing at all. There are two important distinctions that we hope we have made. One is that individual stocks are risky while the stock market is volatile. The other is that while volatility is clearly down over the last year, risk is higher. We're not suggesting that we are at exceptional risk right now; in fact we expect

**stocks will continue to rise in the short term. However if we are right about this being a cyclical bull market within a longer term (secular) bear market, then all we can expect the market to do is gain back most of what it previously lost before the major (down)trend re-establishes itself. At Capital Strategies we are using our skill and knowledge to do better than this (in fact we expect our investors to be made more than whole before this cyclical bull market ends) but we are still subject to the same macro-economic forces as the market as a whole. This is why while most investors are focusing on the less volatility part of the equation, we are keenly aware that there is more risk now.**

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